ALERT MEMORANDUM

November 18, 2019

SEC Proposes Overhaul of Advertising and Solicitation Rules for Investment Advisers

Promising Significant Changes, but What Does It Really Signify?

On November 4, the SEC proposed significant revisions to its rules governing advertising and solicitation by investment advisers (the "Proposal"), including Rule 206(4)-1 (the "Advertising Rule") and Rule 206(4)-3 (the "Solicitation Rule"). The Proposal represents the first substantive changes to these rules since their adoption more than 40 years ago, although the Staff has provided extensive interpretive guidance in the intervening period ("Staff guidance").

The proposed amendments to the Advertising Rule are intended to adopt a "principles-based" approach that, in many instances, appears to reaffirm existing Staff guidance and current market practices, but in other instances adopts new guidelines. The proposed amendments to the Solicitation Rule reflect a modest expansion of current requirements. Notably, the Proposal also includes an extensive list of existing Staff guidance that is being reviewed for potential withdrawal if the Proposal is adopted, and solicits comment on the list. We expect the Proposal to generate significant feedback because, among other reasons, it potentially casts doubt on certain established market practices developed in response to Staff guidance, and, in certain areas, may underestimate the compliance burdens associated with monitoring and testing the required new and revised policies and procedures. Comments are due 60 days after publication in the *Federal Register*.

Below is a brief summary of our key takeaways and notable points from the Proposal (available here), along with specific interpretive issues that the industry will want to consider in commenting on the Proposal. As the industry evaluates the practical implications of the potential revisions, additional issues with the Proposal will certainly come to light. We expect to provide additional updates on these issues during the comment period.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors:

NEW YORK

Richard S. Lincer
+1 212 225 2560
rlincer@cgsh.com

Adrian Rae Leipsic
+1 212 225 2504
aleipsic@cgsh.com

Alexander Janghorbani
+1 212 225 2149
ajanghorbani@cgsh.com

WASHINGTON

Robin M. Bergen
+1 202 974 1514
rbergen@cgsh.com

clearygottlieb.com

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Key Takeaways

— Significant structural revisions to both rules are proposed—not just modernizing adjustments on the margins. We expect the most meaningful changes to be (1) new parameters for using performance data in advertisements, including gross performance data and hypothetical and extracted performance, (2) a codified tailoring of advertising rules based on the "retail" or "non-retail" status of a client/investor and (3) removal of the outright prohibition on testimonials and endorsements.

— The Proposal would explicitly subject sponsors of private equity and hedge funds to these rules by covering advertisements and solicitations directed at investors in such funds. However, because Rule 206(4)-8 (the "Antifraud Rule") already prohibits material misstatements and omissions in statements to investors or prospective investors in pooled investment vehicles, the practical implications of this aspect of the Proposal may be limited.

— The Proposal adopts a "principles-based" approach to advertising by articulating regulatory objectives and then requiring advisers to exercise their judgment. This mirrors the approach in the SEC's recent interpretive guidance on the scope of the fiduciary duty for advisers (the "Fiduciary Duty Guidance") discussed in our prior Alert Memorandum. In each case, the SEC continues to emphasize specific and clear disclosure to clients/investors. While advisers may gain additional flexibility under the new approach to tailor compliance practices according to their business and client/investor base, the Proposal presents the risk that previously acceptable practices (based on Staff guidance) could now be challenged in examinations and enforcement investigations.

— Advisers will need to review existing policies and procedures, and develop new ones, if the proposed amendments are adopted. While much of the Proposal reflects what in our experience is current best practice, certain requirements would go beyond current practice or may require more specific policies than many advisers currently have in place. The replacement of specific prohibitions with broad regulatory objectives means, ironically, that monitoring for compliance with the new rules as proposed could be a significant undertaking.

— The Proposal includes a list of no-action letters being considered for possible withdrawal. The breadth of the list suggests the SEC may have broader concerns with compliance programs and practices that have adapted to existing Staff guidance and would not treat continued reliance on such guidance as a safe harbor. Moreover, advisers may have legitimate questions about whether and to what extent to continue to rely on current practices in the identified areas during the pendency of the rulemaking.

Notable Advertising Rule Proposed Changes

"Advertisement" Definition

While the current "advertisement" definition is silent on communications disseminated by third parties, existing Staff guidance treats as advertisements certain communications provided by investment advisers through intermediaries.[1] The Proposal would codify this concept by explicitly including communications that are made "on behalf of" an adviser, triggered by an adviser taking "affirmative steps" with respect to the content.

This standard would capture statements by nontraditional intermediaries (e.g., social media influencers) made through more modern communication channels (e.g., social media of all types). It would remain a facts and circumstances analysis whether third-party statements should be

[1] For example, *In re* Profitek, Inc., Release No. IA-1764 (Sept. 29, 1998).

attributed to an adviser, focusing primarily on whether the comment is "independent" of an adviser.

While the current definition is limited to communications disseminated to more than one person, the Proposal would include all one-on-one written communications. In a modest form of relief, one-on-one communications would not be subject to the proposed review and approval requirement, which we discuss below. Oral communications would not be included in the definition unless broadcast live, although any underlying materials relating to a meeting or presentation likely would be.

Retail and Non-Retail Persons

The Proposal would impose different performance advertising requirements depending on whether persons are either (1) qualified purchasers ("QPs") or knowledgeable employees ("KEs", and collectively with QPs, "Non-Retail Persons") or (2) other recipients ("Retail Persons"). The Retail Person definition is intended to provide greater protections for clients/investors who may lack the analytical and other resources to analyze certain types of information and negotiate the terms of their advisory arrangements, while also providing greater flexibility for advisers in their dealings with sophisticated clients/investors. However, given the examination and enforcement risks involved, the Proposal is likely to create significant questions of application and scope:

— Current Advisers Act principles place significant importance on consistent disclosure across clients. Many advisers may ultimately feel uncomfortable with selective disclosure based on client/investor sophistication.

— It may be difficult to implement the policies and procedures that must seek to ensure that advertisements are disseminated solely to Non-Retail Persons. For example, advertising material with performance data is often distributed by third-party intermediaries and an adviser may not have practical control over distribution. Moreover, the determination whether a fund investor is a QP is often made at the time a subscription agreement is accepted, rather than at first distribution of marketing materials. This timing gap is likely to present an operational hurdle to utilizing the Proposal's flexibility for Non-Retail Persons.

— A Non-Retail Person for purposes of the Advertising Rule may be treated as a retail client/investor under the Fiduciary Duty Guidance, which generally does not specify how to distinguish between institutional and retail clients/investors. While different standards based on client/investor sophistication are rare in the context of the current Advisers Act rules, this approach was a major theme of the Fiduciary Duty Guidance and reflects Chairman Clayton's focus on addressing conduct that most affects retail clients/investors.

Gross Performance

The Proposal would apply different rules to the presentation of gross performance to Retail versus Non-Retail Persons. For Retail Persons, advisers would be strictly prohibited from presenting gross performance without presenting net performance with equal prominence. For Non-Retail Persons, advisers could present only gross performance if (1) accompanied by an offer to provide a fee and expenses schedule and (2) the adviser has policies and procedures reasonably designed to ensure that the advertisement is disseminated solely to Non-Retail Persons. This would reflect a fundamental shift from current practice, where advisers may present only gross performance (without also presenting net performance) in limited circumstances and without regard to audience sophistication if accompanied by adequate disclosure.

Hypothetical and Extracted Performance

The Proposal would permit advertising hypothetical and extracted performance consistent with current practice, but to do so advisers would need to meet new prescriptive requirements.

For hypothetical performance, advisers would need to adopt policies and procedures reasonably designed to ensure that hypothetical performance is relevant to the

"financial situation and investment objective" of the recipient—the recipient must have both the financial and analytical resources to be able to assess the hypothetical performance. In contrast to the requirements for gross performance, these policies would need to provide guidance for, and then monitor the effectiveness of, subjective judgments to be made by advisers' personnel. Advisers may decide that the increased examination and enforcement risks associated with this type of requirement outweigh the benefit of using hypothetical performance.

For extracted performance, advisers would need to provide, or offer to provide, results of the entire portfolio. We expect this revision to provide flexibility to continue to advertise a composite track record of investments for certain sectors made in the context of a broader fund, which will be useful for private fund sponsors when launching new businesses related to the particular strategy.

Overturning Current Guidance

Existing Staff guidance focuses in large part on interpreting the current Advertising Rule's catchall prohibition against false or misleading statements. For example, the cornerstone *Clover* no-action letter[2] set out a prescriptive list of disclosures that should accompany performance data to avoid misleading clients/investors. Since the Proposal does not require specific disclosures of the type described in *Clover*, it raises a question of whether following *Clover* and other similar Staff guidance, which have played a critical role in shaping market practice, remains sufficient. The Proposal only provides general guidance that under its "principles-based" approach, advisers should evaluate the "particular facts and circumstances of the advertised performance" and include "appropriate disclosures" to avoid implicating any of the general prohibitions in the Advertising Rule.

Testimonials and Endorsements

The Proposal would remove the current prohibition on testimonials and endorsements if they are accompanied by clear and prominent disclosure of (1) the status of the person giving the testimonial or endorsement (e.g., whether a client or investor) and (2) any compensation provided for such testimonial or endorsement. Advisers wishing to take advantage of this new flexibility will need to develop robust policies and procedures to ensure that the disclosures are adequately tailored and comprehensive, taking into account the Fiduciary Duty Guidance, and that any particular testimonial or endorsement does not run afoul of the SEC's longstanding concerns regarding "cherry-picking" positive comments.

Unsolicited Requests for Information

Communications that "do no more than" respond to an unsolicited request for information would not be treated as advertisements. However, we expect advisers to face practical impediments to relying on this exemption. For example, advisers' personnel would need to make subjective judgments about when "context" provided around the information requested goes too far and makes the response an advertisement.

Potentially more challenging for advisers is the current market practice surrounding due diligence questionnaires ("DDQs"). The Proposal suggests that this exemption is potentially available for responses to DDQs, but imposes as a condition that responses to unsolicited requests such as DDQs not be disseminated to more than one client/investor. In our experience, many advisers create form responses to types of questions, which then are provided in response to similar DDQs or requests for information. Such an approach may not qualify for the exemption as set out in the Proposal, which would significantly narrow its benefit.

Review and Approval Process

The Proposal would require advisers to have advertisements reviewed and approved by a designated employee, with very limited exceptions for one-on-one communications or live oral communications that are broadcast and not scripted. The exclusion for communications addressed to a single person or household or to a single investor in a pooled

[2] *Clover Capital Management, Inc.* (avail. Oct. 28, 1986).

investment vehicle is a modest holdover from the current rule, which exempts these communications entirely. While many advisers already include a review and approval process for advertisements as part of their compliance program, this blanket review requirement (and the additional recordkeeping necessary to demonstrate compliance) raises questions as to when a communication goes beyond a single investor and when similar communications would be treated as the same communication, and may impose a significant new compliance burden.

Notable Solicitation Rule Proposed Changes

Pooled Investment Vehicle Investors

The current Solicitation Rule applies only to persons who solicit "clients" and, according to existing Staff guidance, does not apply to solicitors of private fund investors.[3] The Proposal would reverse this position. While the practical effect may be modest given that the Antifraud Rule already applies to the solicitation of private fund investors, the arrangements between private fund sponsors and their marketers (e.g., placement agents and finders) would now be subject to the specific requirements of the Solicitation Rule.

Registration

Existing Staff guidance provides an effective safe harbor from Advisers Act registration for solicitors who comply with the requirements of the Solicitation Rule. The Proposal would reverse this position, and based on the facts and circumstances, solicitors may be acting as advisers or broker-dealers by recommending advisers to prospective clients/investors, and therefore potentially subject to SEC or state registration.

Disclosure

The Proposal would permit either the adviser or the solicitor to deliver the required solicitors' disclosures to clients/investors (currently, the solicitor delivers it). Some advisers may hesitate to take advantage of this proposed flexibility, however, given the risk and/or diligence obligation associated with providing another party's conflicts of interest disclosure.

Compliance

The Proposal would retain the requirement that an adviser have a "reasonable basis" for believing that a solicitor has complied with the solicitation agreement, but notes an expectation that advisers make periodic inquiries of a sample of clients/investors referred by the solicitor. Such a change, in our view, would impose a meaningful additional compliance burden for advisers who satisfy the current requirement by obtaining from the solicitor periodic certifications of compliance.

Disqualification

The current Solicitation Rule generally prohibits a person from acting as a solicitor if the SEC has found such person in violation of, the person has been convicted in court of violating, or the person is barred from acting in any capacity under, the securities laws.

The Proposal would expand the scope of disqualification to include other SEC actions (e.g., cease and desist orders for scienter-based fraud) and findings from other regulators (e.g., the CFTC, a state agency, or a banking or insurance regulator).

Persons subject to an SEC order that does not involve a bar or suspension may currently rely on no-action relief to act as a solicitor, subject to certain conditions.[4] The Proposal, however, would exempt a person whose only disqualifying events are those for which the SEC has issued a waiver under Section 9(c) of the Investment Company Act. The practical effect of this change would be to require solicitors to obtain a formal waiver to meet the carve-out requirement and the waiver would be needed for all potentially disqualifying events rather than only those involving bars and suspensions.

Additional Private Fund Issues

Because the proposed definition of Non-Retail Person is tied to QP status, private fund sponsors could face

[3] *Mayer Brown LLP* (avail. July 28, 2008).

[4] *Dougherty & Co., LLC* (avail. July 3, 2003).

different requirements and need to use different advertisements for their 3(c)(1) funds (which may permit investors that are not QPs or KEs), including employee vehicles, compared to their 3(c)(7) funds (which generally only permit QPs and KEs). Notably, advertisements used in marketing 3(c)(7) funds could choose to present only gross performance, whereas 3(c)(1) funds would need to tailor performance-related disclosures to the fund investors that are Retail Persons. However, as noted above, we wonder whether it will be feasible to tailor advertisements in this manner due to the difficulty of determining QP status during the marketing phase.

Under existing SEC guidance,[5] non-U.S. advisers are not subject to most of the substantive requirements of the Advisers Act, including the Advertising Rule and the Solicitation Rule, with respect to their non-U.S. *clients*. The revised rules, however, would apply to advisers' advertisements to and solicitations of *investors* in pooled investment vehicles.

It is unclear whether the Proposal would apply to foreign registered advisers' activities with respect to non-U.S. investors, particularly because the Proposal does not discuss potential extraterritorial effects. We expect this aspect of the Proposal to generate comments because foreign advisers relying on the private fund adviser exemption are now, and would remain, exempt from the Advertising and Solicitation Rules. This may, however, be a distinction without a difference. The Antifraud Rule currently applies to communications by foreign advisers (whether registered or exempt) with investors and prospective investors, which includes advertisements and solicitation-related correspondence. Therefore, in practice, non-U.S. advisers may already provide disclosures similar to the U.S. adviser standard.

Enforcement Implications

The Proposal's focus on (1) the adequacy of disclosure and (2) developing specific policies and procedures, documented review and approval and recordkeeping requirements, suggests that the SEC and the Staff are likely to focus examination and enforcement efforts on these two areas—even in a scenario where advisers may follow the letter of the revised rules. This may lead to increased rulemaking through enforcement, which creates uncertainty.

The Antifraud Rule already prohibits materially false or misleading statements in advertisements, which may be avoided through appropriate disclosure. The proposed requirement to provide specific disclosures in particular contexts may therefore already be expected under the current framework. This raises interesting questions of how much the "principles-based" approach will add to the mix and of how the Enforcement Division Staff will apply the rules to advisers that make good-faith efforts to comply.

If anything, the Proposal may signal the SEC's intention—repeatedly highlighted as a focus of the current enforcement program—to ensure that retail investors are being provided adequate and accurate disclosures beyond what is required for more sophisticated investors, in a manner reasonably designed to be understandable. Moreover, the Proposal suggests that the SEC hopes to make a focus on retail investors a permanent enforcement priority.[6]

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[5] SEC Release No. IA-2333 (Dec. 10, 2004).

[6] This Alert Memorandum was prepared with the assistance of Amber V. Phillips, Mallory Suede Ross, Zachary L. Baum and Patrick J. Vinett.