

**ALERTS**

## SEC Proposes Advertising and Cash Solicitation Rules Overhaul

**November 6, 2019**

On Nov. 4, 2019, the U.S. Securities and Exchange Commission issued proposed amendments to the Advertising Rule (“Proposed Advertising Rule”) and Cash Solicitation Rule (“Proposed Solicitation Rule”) under the Investment Advisers Act of 1940 (“Advisers Act”) (collectively, the “Proposed Rules”).<sup>[1]</sup>

The Proposed Advertising Rule represents a comprehensive overhaul of the existing “Advertising Rule” (Rule 206(4)-1), which has not been substantively updated since it was adopted in 1961. The Proposed Advertising Rule seeks to dramatically shift the model for regulating advertisements under the Advisers Act from a prescriptive to a principles-based approach. The proposing release runs over 500 pages and provides detailed and thoughtful analyses of a broad range of issues under the Advertising Rule, seeking to update the Rule for the current era. We have highlighted some of the key proposals below, including with respect to the Cash Solicitation Rule, Books and Records Rule, and Form ADV.

The SEC is soliciting comments on a wide range of items relating to the Proposed Rules, with all comment letters due within 60 days after the publication of the Proposed Rules in the Federal Register. Schulte Roth & Zabel will be submitting a comment letter on the Proposed Rules and we welcome any thoughts or suggestions from our clients. Given the importance of this proposal, we are hosting an in-person discussion session for our clients on this topic later this month at our offices in New York. We look forward to discussing these issues then (or, if interested

clients are not able to join us in person, to discussing these points separately).

## Amendments to the Advertising Rule

Some of the most significant changes for private fund managers include:

- *Distinguishing Between Retail and Non-Retail Advertisements.* The Proposed Advertising Rule creates a new category of “Non-Retail Advertisements,” which would permit greater latitude in content and presentation, but the dissemination of which would be limited to “qualified purchasers” and “knowledgeable employees.” For example, advisers would be permitted to show gross performance without accompanying net performance in Non-Retail Advertisements; provided that the advertisement contains or offers to promptly furnish a schedule of specific fees and expenses. Non-Retail Advertisements are also exempt from new performance reporting requirements that would require advisers to (i) show performance over specified time periods and (ii) affirmatively provide certain disclosures relating to the risks and limitations of hypothetical performance.
- *Case Studies.* The Proposed Advertising Rule incorporates a “fair and balanced” principle to evaluate the use of case studies and other past specific recommendations. The SEC notes that while the guidance from several staff no-action letters can be useful in applying the “fair and balanced” standard, the standard exists independently and advisers would not be obligated to follow the requirements of those letters. Not surprisingly, “cherry-picking” and other presentations of specific investment advice and related performance that are misleading would be prohibited under the “fair and balanced” standard.
- *Hypothetical Performance.* The Proposed Advertising Rule permits the use of hypothetical performance where advisers (i) provide sufficient information to enable the recipient to understand the criteria and assumptions underlying the performance and (ii) provide (or, if a Non-Retail Advertisement, offer to provide) similar information addressing the risks and limitations of the use of hypothetical performance in making investment decisions.
- *“Extracted” Performance.* Under the Proposed Advertising Rule, advisers would be permitted to provide extracted performance in advertisements; provided that such advertisements contain or offer to

promptly furnish the performance results of all investments in the portfolio from which the performance was extracted.

- *Related Performance.* The Proposed Advertising Rule would prohibit advertisements that show the performance of a “related portfolio” (which are those portfolios with substantially similar investment policies, objectives and strategies as those of the services being offered or promoted) unless the advertisement shows the performance of all related portfolios. Advisers would be able to exclude the performance of a related portfolio only when the performance shown would be no higher than if the performance of all related portfolios were included.
- *New Compliance Requirements.* The Proposed Advertising Rule would generally require review and pre-approval of advertisements by a designated employee. This review and approval requirement also applies to updates to previously-reviewed advertisements. The Proposed Advertising Rule would also require advisers to adopt policies and procedures with respect to the use of Non-Retail Advertisements and hypothetical performance.
- *Testimonials, Endorsements and Third-Party Ratings.* The Proposed Advertising Rule would generally permit the use of testimonials, endorsements and third-party ratings in advertisements, provided that they are accompanied by certain disclosures, such as whether compensation has been provided by or on behalf of the adviser to the person providing the testimonial or endorsement, or whether that person is a client.
- *Revised Definition of “Advertisement.”* The Proposed Advertising Rule fundamentally reworks the definition of an advertisement to cover “any communication, disseminated by any means, by or on behalf of an investment adviser, that offers or promotes the investment adviser’s advisory services or that seeks to obtain or retain one or more investment advisory clients or investors in any pooled investment vehicle advised by the investment adviser,” subject to certain enumerated exceptions. The Proposed Advertising Rule would make it clear that communications with existing clients and investors that “offer or promote” advisory services, which could, in certain circumstances, include the adviser’s market commentary and discussions of the adviser’s investing thesis, are considered advertisements.

- *Additional General Prohibitions.* The Proposed Advertising Rule expands on the general prohibitions currently included in the Rule. Advisers would be prohibited from disseminating advertisements that: (i) contain any material claim or statement that is not substantiated; (ii) contain untrue or misleading implications about material facts relating to the adviser, or that are reasonably likely to cause an untrue or misleading inference to be drawn concerning any material facts; (iii) discuss or imply any potential benefits connected with or resulting from the adviser's services or methods of operation that do not also "clearly and prominently" disclose associated material risks or other limitations; (iv) include or exclude performance results, or contain presentations of performance time periods, in a manner that is not fair and balanced; or (v) are otherwise materially misleading.

## **Amendments to the Cash Solicitation Rule**

The SEC also proposed amendments to the "Cash Solicitation Rule" (Rule 206(4)-3) to expand the types of activities and compensation covered by that Rule and update certain compliance obligations under the Advisers Act, including:

- *Solicitors to Private Fund Investors.* The Proposed Solicitation Rule would expand the applicability of the Cash Solicitation Rule to include solicitors of private fund investors (currently the Rule only covers solicitors of "clients," not of "investors" in funds that are clients). An adviser's officers, directors, partners and employees would continue to remain exempt from the written agreement, compliance and oversight provisions of the Cash Solicitation Rule; provided that the affiliation is disclosed to clients or private fund investors.
- *All Forms of Compensation.* The SEC proposed expanding the applicability of the Cash Solicitation Rule to cover all forms of compensation, including non-cash compensation such as awards, prizes, free or discounted services, or directed brokerage. (The Proposed Solicitation Rule would retitle the existing Rule as "Compensation for Solicitations.")
- *Elimination of Brochure Delivery and Disclosure Acknowledgement Requirements.* The Proposed Solicitation Rule would eliminate the requirement that a solicitor deliver the adviser's brochure to clients and

obtain from each client acknowledgements of receipt of the solicitation disclosures.

## **Amendments to the Books and Records Rule and Form ADV**

The Proposed Rules also contain amendments to the “Books and Records Rule” (Rule 204-2) to conform existing recordkeeping requirements to the scope of the Proposed Rules, as well as to require recordkeeping of written approvals of all advertisements by designated employees. The proposed amendments to Form ADV would include new questions requiring disclosure of whether an adviser’s advertisements contain performance information, references to specific investments, testimonials, endorsements or third-party ratings; other proposed new questions relate to third-party verification of performance results and compensation for the use of testimonials, endorsements or third-party ratings.

## **Transition Period and Existing No-Action Letters**

The SEC is proposing a one-year transition period from the effective date of the rules to formal implementation. Advisers would be permitted to rely on the amended rules during the period after the effective date but before the compliance date. The proposing release contains a list of no-action letters under the Advertising and Cash Solicitation Rules that the staff is reviewing for potential withdrawal in connection with the adoption of final rules.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] The SEC’s proposing release can be found here.

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