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Memorandum

Proposed Amendments to Investment Adviser Advertising and Solicitation Rules: Practical Implications for Private Fund Sponsors

December 2, 2019

The Securities and Exchange Commission (the "**SEC**") recently proposed amendments (the "**Proposed Amendments**") to Rule 206(4)-1 (the "**Advertising Rule**") and Rule 206(4)-3 (the "**Solicitation Rule**") under the Investment Advisers Act of 1940 (the "**Advisers Act**").[1] This memorandum summarizes the proposal and analyzes the practical impact the Proposed Amendments, if adopted, would have on registered investment advisers ("**RIAs**") that sponsor private funds ("**Sponsors**").

What You Need to Know

- RIA compliance personnel who review marketing materials currently need to consult a patchwork of SEC staff no-action letters, enforcement actions, and other staff guidance that interpret and apply the Advertising Rule. The Proposed Amendments would, in large part, replace this patchwork with a single set of advertising rules. This set of rules would formalize existing staff guidance in some respects and depart from existing staff guidance in other respects. Consolidating the advertising regulatory framework into a single document would help Sponsors understand their compliance obligations when marketing funds. For this reason, among others, we believe the Proposed Amendments, if adopted, could overall be a positive development for Sponsors.
- The Proposed Amendments, if adopted, would have the following noteworthy practical implications for Sponsors, which will likely receive attention in comment letters:
  - Private fund marketing materials that present gross performance would need to provide, or offer to promptly provide, a schedule itemizing the specific fees and expenses deducted to calculate net performance;
  - Many Sponsors would need to enhance their policies, procedures, and disclosures relating to the presentation of "hypothetical performance" (including targeted and projected returns) in marketing materials; and
  - Fund placement agent agreements would need to include new types of provisions and representations.

[1] *Investment Adviser Advertisements; Compensation for Solicitations,* Release No. IA-5407; File No. S7-21-19 (Nov. 4, 2019).

- Comments will be due in February 2020. We anticipate the SEC will likely seek to adopt amendments to these rules during the first half of 2020.

Background

With the Proposed Amendments, the SEC seeks to modernize the Advertising Rule and the Solicitation Rule, neither of which have been amended for decades. The SEC also proposed related amendments to Form ADV Part 1 and to the recordkeeping requirements set forth in Rule 204-2 under the Advisers Act. In addition, in the accompanying release (the "**Proposing Release**") for the Proposed Amendments, the SEC stated that the SEC staff is considering withdrawing all or a portion of the no-action letters and other guidance the staff has issued relating to the Advertising Rule and the Solicitation Rule.

The SEC has requested public comments on the Proposed Amendments. Comments are due in February 2020 (on the 60th day after the Proposed Amendments are published in the Federal Register).

Proposed Amendments to the Advertising Rule

The current Advertising Rule prohibits an RIA from distributing any "advertisement" that includes any of the following: (1) testimonials concerning the RIA or its services; (2) references to specific profitable recommendations that the RIA has made in the past; (3) representations that any graph or other device being offered can by itself be used to determine which securities to buy and sell and when to buy and sell them; and (4) any statement to the effect that any service will be furnished free of charge, unless the service actually is or will be furnished entirely free and without any condition or obligation. The current rule also has a catch-all provision that prohibits any advertisement which contains any untrue statement of a material fact, or which is otherwise false or misleading. The term "advertisement" is defined to include any written communication addressed to more than one person that offers any investment advisory service with regard to securities.

The Proposed Amendments to the Advertising Rule, broadly speaking, would: (i) modify the definition of the term "advertisement" to be more "evergreen" in light of ever-changing technology; (ii) replace the first four prohibitions of the current rule with a set of principles designed to prevent fraudulent or misleading practices; (iii) permit RIAs to use testimonials, endorsements, and third-party ratings subject to certain conditions; (iv) tailor the requirements for the presentation of performance results, based on the advertisement's intended audience; and (v) require internal review and approval of most advertisements.

Below is a more detailed summary of the Proposed Amendments to the Advertising Rule and a discussion of the practical implications of these Proposed Amendments for Sponsors:

SCOPE OF THE ADVERTISING RULE: DEFINITION OF ADVERTISEMENTS

Summary

The Proposed Amendments would redefine "advertisement" to mean "any communication, disseminated by any means, by or on behalf of an investment adviser, that offers or promotes the investment adviser's investment 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."[2]

The Proposed Amendments would then explicitly exclude the following from the definition of "advertisement": (1) live oral communications that are not broadcast (i.e., not widely disseminated); (2) responses to unsolicited requests for specified information, other than (i) communications to "retail persons"[3] that include performance results and (ii) communications that include "hypothetical performance"[4]; (3) an advertisement, other sales material, or sales literature that is about a registered investment company ("**RIC**") or a business development company ("**BDC**") and is subject to Rule 156 or Rule 482 under the Securities Act of 1933[5]; and (4) information required to be contained in a statutory or regulatory notice, filing, or other communication.

Practical Implications for Sponsors

In a technical change, the new definition makes explicit that communications to prospective investors marketing a private fund are "advertisements." This change should not meaningfully impact market practices because most Sponsors, in our experience, already operate on the assumption that such marketing communications are "advertisements" for purposes of the Advertising Rule.

GENERAL PRINCIPLE-BASED PROHIBITIONS FOR ADVERTISEMENTS

Summary

The amended Advertising Rule would set forth new "general prohibitions," which would prohibit the following advertising practices:

1. Making an untrue statement of a material fact, or omitting to state a material fact necessary to make the statement made, in light of the circumstances under which it was made, not misleading;

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[2] The term "pooled investment vehicle" would be defined as any "investment company" as defined in Section 3(a) of the Investment Company Act of 1940 or any company that would be an "investment company" under Section 3(a) of that Act but for the exclusion provided from that definition by either Section 3(c)(1) or Section 3(c)(7) of that Act.

[3] The term "retail person" would include any person other than a "qualified purchaser" or "knowledgeable employee" as defined in the Investment Company Act of 1940 and the rules thereunder. See the "Performance Information in Retail Advertisements" section below for a more detailed discussion of the "retail person" definition.

[4] See the "Hypothetical Performance" section below, which discusses the definition of "hypothetical performance."

[5] This particular exclusion would, in effect, place most marketing materials for RICs and BDCs outside the scope of the Advertising Rule. However, statements made to investors or prospective investors in RICs and BDCs would continue to be subject to other anti-fraud prohibitions under the federal securities laws.

2. Making a material claim or statement that is unsubstantiated;
3. Making an untrue or misleading implication about, or being reasonably likely to cause an untrue or misleading inference to be drawn concerning, a material fact relating to the RIA;
4. Discussing or implying any potential benefits of the RIA's services or methods of operation without "clear and prominent" discussion of associated material risks or other limitations;
5. Referring to specific investment advice provided by the RIA that is not presented in a fair and balanced manner;
6. Including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced; and
7. Being otherwise materially misleading.

Practical Implications for Sponsors

Overall, these new general prohibitions should not be too consequential for Sponsors because the practices they prohibit are already largely prohibited by the current Advertising Rule's catch-all provision and other Advisers Act anti-fraud provisions. That said, these general prohibitions, if adopted, would have some notable practical implications for Sponsors.

Case Studies and Other References to Specific Investments: Under the current Advertising Rule and related SEC staff guidance,[6] advertisements that reference specific investments made by the RIA's clients must comply with a prescriptive set of conditions and disclosure requirements. The Proposed Amendments would replace this framework with a simpler, principle-based prohibition against references to specific investment advice that is not presented in a fair and balanced manner. This could give Sponsors more flexibility in terms of how they can discuss specific investments in marketing material case studies. The Proposing Release states, for example, that a marketing deck could describe specific investments made in response to a major market event, provided these investments are fair and balanced illustrations of the Sponsor's ability to respond to major market events and accompanying disclosures provide recipients with appropriate contextual information to evaluate those investment decisions.

Clear and Prominent Discussion of Material Risks and Limitations: Advertisements that discuss potential benefits of an RIA's services or methods of operation would need to include a "clear and prominent" discussion of material risks or other limitations associated with those potential benefits. The Proposing Release clarified that it may be consistent with the "clear and prominent" standard if an RIA has reasonable assurance that the investor will access or otherwise view the disclosures, such as by providing the disclosures before the relevant content and requiring the investor to acknowledge their review before accessing the advertisement's substance. Sponsors would need to assess how they could satisfy this standard in the context of print advertisements as well as

[6] *See, e.g.*, *Franklin Management, Inc.*, SEC Staff No-Action Letter (Dec. 10, 1998); *TCW Group*, SEC Staff No-Action Letter (Nov. 7, 2008).

electronic advertisements disseminated via email or a data room. In addition, the Proposing Release suggested that RIA websites that discuss or imply benefits of an RIA's services might fail to meet this standard if the websites only include disclosures about material risks in a hyperlinked "additional information available here" or similar web link. This general prohibition therefore has the potential to impact the manner in which disclosures are made on Sponsors' websites.

Disclosure Font Size: According to the Proposing Release, an advertisement that presents disclosures in an unreadable font would violate the amended rule's prohibition on advertisements that are otherwise materially misleading. Fund marketing materials often make disclosures in footnotes. Sponsors would need to continue making sure the font size for these footnotes is sufficiently large to be readable.

PERFORMANCE INFORMATION GENERALLY

Summary

The current Advertising Rule's catch-all provision generally prohibits the presentation of performance results that contain false or misleading statements. Since the Advertising Rule was adopted, the SEC staff has issued a series of no-action letters that address the application of the catch-all provision to advertised performance information.[7] The Proposed Amendments would revise the Advertising Rule to provide a more prescriptive and comprehensive set of rules relating to advertised performance information. Specifically, the amended Advertising Rule would include the following rules, each of which is discussed in more detail below:

- *Schedule of Fees and Expenses*: Advertisements that present gross performance results would need to provide (or offer to promptly provide) a schedule of the specific fees and expenses deducted to calculate net performance;
- *Related Performance*: Advertisements could not present performance results from fewer than all portfolios with substantially similar investment policies, objectives, and strategies as those being offered or promoted in the advertisements, with limited exceptions;
- *Extracted Performance*: Advertisements that present performance results of a subset of investments extracted from a portfolio would need to provide (or offer to promptly provide) the performance results of all investments in that portfolio;
- *Hypothetical Performance*: RIAs that present hypothetical performance in advertisements would be required to implement policies and procedures reasonably designed to ensure that the performance

[7] *See, e.g.*, *Clover Capital Mgmt., Inc.*, SEC Staff No-Action Letter (Oct. 28, 1986). The SEC indicated in the Proposing Release that the SEC staff is considering withdrawing all or a portion of the no-action letters the staff has issued relating to the Advertising Rule, including those related to the presentation of performance results. Sponsors may have implemented advertising policies and procedures designed to comply with the conditions set forth in these letters. To the extent the SEC withdraws any of these no-action letters, these Sponsors would need to revisit their advertising policies and procedures and identify any necessary updates.

information is relevant to the recipient's financial situation and investment objectives and to provide certain specified information underlying the hypothetical performance; and

- *Performance Information in Retail Advertisements*: Advertisements targeted to a retail audience would need to comply with more stringent requirements relating to gross performance results and performance over prescribed time periods.[8]

Some of these rules use the term "portfolio," which the amended rule would define as an individually managed group of investments and can include an account or pooled investment vehicle.

Moreover, in addition to these rules, the presentation of performance information in an advertisement would also need to comply with the amended Advertising Rule's "general prohibitions" (described above), which prohibit, among other things, advertisements that are materially misleading and advertisements that include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced.

Practical Implications for Sponsors

To comply with these general prohibitions, Sponsors would need to continue to include robust disclosures in their advertisements in relation to performance information. Rather than require specific disclosures, the Proposed Amendments would call on Sponsors to include disclosures that are appropriate in light of the particular facts and circumstances of the advertised performance, including the assumptions, factors and conditions that contributed to the performance.

SCHEDULE OF FEES AND EXPENSES

Summary

The Proposed Amendments would require any advertisement that presents gross performance also to provide, or offer to promptly provide, a schedule itemizing the specific fees and expenses (presented in terms of percentage of the assets under management) deducted to calculate net performance.[9] Where advertisements do not present net performance,[10] the schedule should show the fees and expenses the RIA would apply in calculating net performance as though the RIA were presenting net performance.

"Gross performance" would be defined as the performance results of a portfolio before the deduction of all fees

[8] In addition, the amended Advertising Rule would prohibit any statement that the calculation or presentation of performance results has been approved or reviewed by the SEC.

[9] In explaining the reasoning behind this proposal, the Proposing Release noted that institutional investors may struggle to negotiate for and receive transparent information regarding fees and expenses as they relate to advertised performance results.

[10] Pursuant to the Proposed Amendments, "non-retail advertisements" with gross performance would not be required to present net performance with equal prominence. See the "Performance Information in Retail Advertisements" section below, which discusses the definition of "non-retail advertisement." The SEC staff has historically taken the view that any advertisement presenting gross performance should present net performance with equal prominence, except in the case of a one-on-one presentation that meets certain conditions. *See* *Association for Investment Management and Research*, SEC Staff No-Action Letter (Dec. 18, 1996); *Investment Company Institute*, SEC Staff No-Action Letter (Sept. 23, 1988). The Proposed Amendments would expand the set of circumstances under which fund marketing materials would be permitted to present gross performance without presenting net performance with equal prominence.

and expenses that a client or investor has paid, or would have paid, in connection with the RIA's investment advisory services to the relevant portfolio. "Net performance" would generally be defined as the performance results of a portfolio after the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with RIA's investment advisory services to the relevant portfolio.

Practical Implications for Sponsors

Overall, this new requirement would be particularly consequential for Sponsors, which have generally not provided investors with a schedule of this sort in marketing materials.

Model Fees: In calculating "net performance" for purposes of this schedule, RIAs would be permitted to deduct a model fee (1) when doing so would result in performance figures that are no higher than if the actual fee had been deducted or (2) if the model fee is equal to the highest fee charged to the relevant audience of the advertisement. It is common for different investors in private funds to be subject to different management fee and carried interest rates (e.g., based on capital commitment levels or pursuant to side letter agreements), so these rules regarding the use of model fees could be relevant to many Sponsors.

Classifying Fees and Expenses: The SEC did not prescribe how RIAs should categorize and determine fees and expenses in the required schedule, noting instead that different RIAs may classify the same type of fee differently. Sponsors would need to assess whether broad expense categories, such as "organizational expenses" and "partnership expenses," satisfy this requirement or whether more specific categories would be needed. The more specific these categories need to be, the more likely Sponsors might need to provide proprietary or sensitive information to investors in order to comply with this requirement.

Targeted or Projected Gross Performance: Some Sponsors may currently present targeted or projected fund-level returns only on a gross basis. The Proposing Release did not explicitly address whether targeted or projected gross fund-level returns would need to be accompanied by a schedule of fees and expenses. If the Proposed Amendments are adopted, Sponsors would need to assess whether advertisements that present targeted or projected gross fund-level returns need to provide (or offer to promptly provide) a schedule of fees and expenses the fund would be expected to pay.

RELATED PERFORMANCE

Summary

The Proposed Amendments would prohibit an advertisement from including the performance results of one or more "related portfolios" unless it includes performance results for all "related portfolios" (the "**Related Performance Rule**"). The term "related portfolio" would be defined as a portfolio with "substantially similar investment policies, objectives, and strategies" as those of the services being offered or promoted in the advertisement. RIAs would be permitted to exclude related portfolios if the advertised performance results are no higher than if all related portfolios had been included.

Practical Implications for Sponsors

In general, Sponsors are already aware that fund marketing materials should not cherry pick past or current funds with favorable returns. Nonetheless, the Related Performance Rule, if adopted, would have some noteworthy practical implications for Sponsors.

Funds Managed by Substantially Different Teams: The "related portfolio" definition would technically include an existing fund with "substantially similar investment policies, objectives, and strategies" as the new fund being marketed, regardless of whether the team that managed the existing fund is "substantially similar" to the team that will manage the new fund. As such, Sponsors would potentially need to disclose performance results for funds managed by a substantially different team than the fund being marketed.

Older Fund Performance: The Related Performance Rule would also require that fund marketing materials present the performance results of an older fund – even potentially a fund that was liquidated several years ago – to the extent the older fund had substantially similar investment policies, objectives, and strategies as those of the fund being marketed. And Sponsors would be required by Advisers Act recordkeeping rules to retain support for any returns presented with respect to these older funds.

Newer Fund Performance: The Related Performance Rule could pose compliance issues in relation to newer funds for which internal rate of return figures are not yet meaningful, as is often the case for private equity strategies. Where a newer fund is a "related portfolio" of a fund being marketed, the rule would only permit a Sponsor to exclude the newer fund's performance from a track record if the returns presented in the track record are no higher than if the newer fund's performance were included.

EXTRACTED PERFORMANCE

Summary

The amended Advertising Rule would require that advertisements with "extracted performance" provide (or offer to promptly provide) the performance results of all investments in the portfolio from which the performance was extracted. "Extracted performance" would be defined as the performance results of a subset of investments extracted from a portfolio.

Practical Implications for Sponsors

Marketing Funds with New Strategies: This rule would potentially be relevant to a Sponsor that is looking to launch a new strategy. For example, a Sponsor that manages a fund which invests in real estate in both North America and Europe may decide to launch a new fund that will invest only in European real estate. This Sponsor may wish to present in its marketing materials for the Europe-focused fund the performance results of investments made by its current fund in European real estate. Under the Proposed Amendments, the Sponsor would be required to provide (or offer to promptly provide) the performance results of all investments made by its current fund, including the fund's investments in North American real estate.

HYPOTHETICAL PERFORMANCE

Summary

The amended rule would require RIAs that include "hypothetical performance" in advertisements to implement policies and procedures regarding the presentation of hypothetical performance, disclose sufficient information to enable the recipient to understand the criteria and assumptions underlying the hypothetical performance, and provide (or, where the recipient is a "non-retail person," offer to promptly provide) information addressing the risks and limitations of using hypothetical performance in making investment decisions.[11]

Practical Implications for Sponsors

Fund marketing materials frequently include performance information that would be considered "hypothetical performance" for this purpose. As a result, many Sponsors would need to enhance their policies, procedures, and disclosures regarding hypothetical performance to comply with the amended Advertising Rule. That said, as a practical matter, it is unlikely that these new compliance obligations would prevent Sponsors from continuing to present the kinds of performance information that are often presented in fund marketing materials (e.g., targeted or projected returns).

"Hypothetical Performance" Definition: The amended rule would define "hypothetical performance" as "performance results that were not actually achieved by any portfolio of any client of the investment adviser" and would explicitly include targeted and projected performance returns,[12] among other things. Fund marketing materials often present specific return figures or ranges that a fund is targeting and occasionally detail projected return figures for specific funds. This information would be considered "hypothetical performance" under the amended rule, and Sponsors that present this information would need to comply with the amended rule's requirements regarding hypothetical performance.

Policies and Procedures Requirement: RIAs that advertise hypothetical performance would be required to implement policies and procedures reasonably designed to ensure that the hypothetical performance is disseminated only to persons for which it is relevant to their financial situation and investment objectives. The SEC suggested in the Proposing Release that, as a general matter, reasonably designed policies and procedures could permit an RIA to present to an institutional investor a particular type of hypothetical performance that other institutional investors with similar characteristics have used in the past to assess the RIA's strategy and investment process. Accordingly, this requirement would likely not preclude Sponsors from presenting to institutional investors targeted and projected performance and other types of hypothetical performance information that institutional investors routinely request.

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[11] In addition, pursuant to amendments the SEC has proposed to Advisers Act recordkeeping requirements, RIAs would need to maintain supporting records regarding the calculation of the hypothetical performance.

[12] Unlike FINRA Rule 2210, which prohibits communications that predict or project performance, the amended Advertising Rule would permit RIAs to include projected performance in advertisements subject to the requirements applicable to hypothetical performance.

Calculation Information Disclosure: Sponsors that include hypothetical performance in their advertisements would need to provide sufficient information to enable the recipient to understand the methodologies used and assumptions made in calculating the hypothetical performance (e.g., the likelihood of a given event occurring). Marketing materials that contain targeted or projected returns tend to include general disclosures that these returns are calculated based on assumptions about various factors (e.g., future economic and market conditions, future operating results). To comply with this requirement, Sponsors would likely need to enhance these disclosures to provide more details regarding the methodologies used and assumptions made in calculating targeted and projected returns.

Risks and Limitations Disclosure: Sponsors that include hypothetical performance in their advertisements would also need to provide (or, where the recipient is a "non-retail person," offer to promptly provide) sufficient information to enable the recipient to understand the risks and limitations of using the hypothetical performance in making investment decisions.[13] Many Sponsors already include extensive disclosures in marketing materials regarding the risks and limitations of relying on hypothetical performance. These Sponsors would probably not need to enhance such disclosures too substantially if the Proposed Amendments are adopted.

Responses to Unsolicited Requests: Due diligence materials with hypothetical performance provided to an investor would be considered "advertisements" under the Proposed Amendments, even if the materials do no more than respond to an unsolicited request for information from that investor.[14] Sponsors would therefore need to ensure that such due diligence materials fully comply with the amended Advertising Rule's requirements.

PERFORMANCE INFORMATION IN RETAIL ADVERTISEMENTS

Summary

The SEC's Proposing Release, like the SEC's recent fiduciary duty interpretation,[15] expressed the view that an RIA's obligations to an investor under the Advisers Act should vary to some degree depending on whether that investor is retail or institutional. Along this line, "retail advertisements" would, under the Proposed Amendments, be subject to two additional performance rules that would not apply to "non-retail advertisements": (1) retail advertisements that present any gross performance must also present net performance with at least equal

[13] The SEC clarified that these disclosures should address hypothetical performance generally (e.g., the fact that hypothetical performance does not reflect actual investments) and the specific hypothetical performance presented (e.g., if applicable, the fact that the hypothetical performance represents the application of certain assumptions but that the RIA generated several other, lower performance results representing the application of different assumptions). The SEC also indicated that the amount of calculation information and risk information provided to a "retail person" may differ significantly from the amount that would be sufficient to enable a "non-retail person" to understand it.

[14] By contrast, due diligence materials provided to qualified purchasers that do not contain hypothetical performance would not be "advertisements," as long as the materials do no more than respond to an unsolicited request for information specified in such request about the Sponsor or its services.

[15] *See* *SEC Rulemakings and Interpretations Addressing Investment Adviser and Broker-Dealer Standards of Conduct and Disclosure Obligations*, STB Memorandum (June 20, 2019).

prominence (the "**Net Performance Rule**")[16] and (2) retail advertisements that present performance results of any portfolio must include the performance results of that same portfolio for 1-, 5-, and 10-year periods with equal prominence (the "**Prescribed Time Periods Rule**").

"Non-retail advertisement" would be defined as any advertisement for which an RIA has implemented policies and procedures reasonably designed to ensure that the advertisement is disseminated solely to "non-retail persons," which would be limited to "qualified purchasers" and "knowledgeable employees" as defined in the Investment Company Act of 1940 (the "**Investment Company Act**") and the rules thereunder.[17] "Retail advertisement" would be defined as any advertisement other than a "non-retail advertisement." Similarly, "retail person" would be defined as any person other than a "non-retail person."

Practical Implications for Sponsors

Policies for Disseminating Non-Retail Advertisements: Based on these definitions, Sponsors of funds relying on Section 3(c)(7) of the Investment Company Act would not need to comply with the Net Performance Rule and Prescribed Time Periods Rule, so long as they implement policies and procedures reasonably designed to ensure that advertisements are disseminated solely to qualified purchasers and knowledgeable employees. Sponsors typically require investors to certify that they are qualified purchasers in fund subscription documents. But to comply with this requirement, Sponsors would need to form a reasonable belief that an investor is a qualified purchaser *prior to* disseminating fund marketing materials to that investor (which typically precedes the subscription document completion process). In the case of an investor currently invested in a Sponsor's other funds, the Sponsor could form this reasonable belief based on the amount of "investments" the investor has made in such other funds.[18] In the case of an investor that is new to the Sponsor, however, the Sponsor would need to use other methods to form this reasonable belief. Some Sponsors already have suitability procedures for new investors. These Sponsors would need to confirm their suitability procedures satisfy this requirement.

Performance Rules for Retail Advertisements: Alternatively, Sponsors could opt to not implement such policies and procedures if they are willing to comply with the Net Performance Rule and Prescribed Time Periods Rule. The Prescribed Time Periods Rule would be more likely than the Net Performance Rule to raise compliance issues for Sponsors. This is because while most Sponsors already present gross and net fund-level returns with equal prominence, many Sponsors merely present inception-to-date returns and do not present returns over specific

[16] While "non-retail advertisements" would not technically need to present gross and net performance with equal prominence, such advertisements would still need to provide (or offer to promptly provide) the fee and expense schedule described above.

[17] *See* 15 U.S.C. 80a-2(a)(51); 17 CFR 270.2a51-1; 17 CFR 270.3c-5. Notably, the "non-retail person" definition would, in certain respects, cover a broader scope of investors than the "institutional investor" definition in FINRA Rule 2210. Also, the "non-retail person" definition would not extend to "accredited investors" under the Securities Act of 1933 or "qualified clients" under the Advisers Act that are neither "qualified purchasers" nor "knowledgeable employees."

[18] *See* 17 CFR 270.2a51-1 (defining "investments" as such term is used in the "qualified purchaser" definition).

time periods (e.g., year-over-year returns),[19] and there may be concerns that presenting returns over the prescribed time periods could cause confusion among some investors.

TESTIMONIALS AND ENDORSEMENTS

Summary

The current Advertising Rule strictly prohibits advertisements that contain "testimonials," which the SEC staff has interpreted to include statements of a client's experience with, or endorsement of, an RIA. The Proposed Amendments would replace this absolute ban on "testimonials" with a disclosure-based rule whereby advertisements may include "testimonials," as well as "endorsements" from third parties, subject to certain disclosures.

Under the amended rule, a "testimonial" would be defined as any statement of a client's or investor's experience with the RIA or its "advisory affiliates."[20] An "endorsement" would be defined as any statement by a person other than a client or investor indicating approval, support, or recommendation of the RIA or its "advisory affiliates." The amended rule would permit RIAs to include a testimonial or endorsement in an advertisement, provided that the RIA clearly and prominently[21] discloses (or the RIA reasonably believes that the testimonial or endorsement clearly and prominently discloses) that (1) the testimonial was given by a client or investor, and the endorsement was given by a non-client or non-investor, as applicable and (2) if applicable, cash or non-cash compensation has been provided by or on behalf of the RIA in connection with obtaining or using the testimonial or endorsement. In regards to compensation, no *de minimis* threshold would apply.

Practical Implications for Sponsors

Testimonials from Fund Investors: To ensure compliance with the current rule's testimonial prohibition, Sponsors generally refrain from including in marketing materials any statements made by fund investors regarding their experiences investing with the Sponsors. Should the Proposed Amendments be adopted, fund marketing materials could include such investor statements (which would be "testimonials" under the amended rule), provided that they make the disclosures required by the amended rule. Of course, any such investor statements would also need to comply with the other prohibitions of the amended Advertising Rule, including those relating to performance and references to specific investment advice.

Statements from Portfolio Company Management: Sponsor marketing materials occasionally include statements made by executives at fund portfolio companies regarding the executive's positive experience working with the Sponsor. While the amended rule does not explicitly address statements made by portfolio company executives,

[19] Under the Prescribed Time Periods Rule, Sponsors could continue showing inception-to-date returns, as long as they are accompanied by performance over the prescribed time periods.

[20] The term "advisory affiliate" would include all of an RIA's officers, partners, directors, or employees (other than employees performing clerical, administrative, support or similar functions), and persons controlling or controlled by the RIA.

[21] The Proposing Release clarified that, in order to be "clear and prominent," the required disclosures regarding a testimonial, endorsement, or third-party rating (discussed below) must be at least as prominent as the testimonial, endorsement, or rating itself.

these statements would be either "testimonials" or "endorsements" as defined in the amended rule, depending on whether the relevant portfolio company executive is an investor in any of the Sponsor's funds. In either case, marketing materials containing such statements would need to make the disclosures required by the amended rule, including, if applicable, disclosure that cash or non-cash compensation has been provided by or on behalf of the Sponsor in connection with obtaining or using the statement. A portfolio company executive may, in some instances, be given management fee or carried interest breaks in relation to his or her investments in the Sponsor's vehicles. Sponsors would need to assess whether any such fee or carry break provided to the executive was provided "in connection with obtaining or using" the executive's statement.

Use of Social Media: Many RIAs use social media to market the investment advisory services and products they offer. While Sponsors overall tend to use social media less actively than RIAs with retail clients (in part to avoid general solicitation issues), some Sponsors use social media to market or promote their businesses to investors and management teams at potential portfolio companies. For example, Sponsors and their personnel may post press releases about fund closings and completed transactions on their social media pages, and third parties, including fund investors, may have the ability to "like" or comment on these posts. Questions have arisen in recent years as to whether "likes" or comments posted by clients or investors on an RIA's social media page could potentially be considered "testimonials." Importantly, the Proposed Amendments would make it clearer that comments posted by third parties on a Sponsor's social media page would not be "advertisements" subject to the Advertising Rule, so long as the Sponsor does not selectively delete or alter the comments or their presentation. Similarly, permitting "like" and "endorse" features on social media pages would not, by itself, implicate the amended Advertising Rule.

THIRD-PARTY RATINGS

Summary

The Proposed Amendments sets forth a special rule that would apply to "third-party ratings," which would be defined as a rating or ranking of an RIA provided by any person other than a related person that provides such ratings or rankings in the ordinary course of its business. Specifically, an RIA would be permitted to include a "third-party rating" in an advertisement provided that the RIA reasonably believes that any questionnaire or survey used in the preparation of the rating is structured to make it equally easy for a participant to provide favorable and unfavorable responses, and is not designed or prepared to produce any predetermined result.

In addition, any RIA that includes a third-party rating in an advertisement would need to clearly and prominently disclose (or reasonably believe that the rating clearly and prominently discloses): (1) the date on which the rating was given and the period of time upon which the rating was based; (2) the identity of the third party that created and tabulated the rating; and (3) if applicable, that cash or non-cash compensation has been provided by or on behalf of the RIA in connection with obtaining or using the third-party rating.

Practical Implications for Sponsors

Overall, the amended rule's treatment of third-party ratings and rankings would not represent a significant departure from the guidance that the SEC staff has provided on this topic.[22] As such, it is unlikely that the Proposed Amendments would meaningfully impact the ability of Sponsors to reference third-party ratings and rankings in fund marketing materials.

REVIEW AND APPROVAL OF ADVERTISEMENTS

Summary

The amended Advertising Rule would provide that RIAs may not, directly or indirectly, disseminate an advertisement unless the advertisement has been previously reviewed and approved for compliance with the rule's requirements by one or more designated employees.[23] Two categories of advertisements would be carved out from the scope of this requirement: (1) communications disseminated only to a single person or household or to a single investor in a pooled investment vehicle; and (2) live oral communications broadcast on radio, television, the internet or any other similar medium. RIAs would need to retain a copy of all written approvals of advertisements in accordance with this requirement.

Practical Implications for Sponsors

Compliance Approval Procedures: Most Sponsors have already implemented procedures requiring advertisements to be reviewed and approved by their compliance staff. These Sponsors would need to confirm that the scope of materials that must be reviewed and approved pursuant to their procedures covers all "advertisements" (as redefined in the amended rule) subject to this proposed review and approval requirement. For example, some Sponsors' procedures provide that marketing materials that are not changed from month to month, other than performance figures, do not need to be reviewed and approved again by their compliance staff. However, under the Proposed Amendments, any changes to existing advertisements, including mere performance figure updates, would appear to require review and approval.

Reviewing Materials Prepared by Placement Agents: The Proposing Release clarified that content created by a third party could be considered an "advertisement" in circumstances where the RIA was involved in preparing the content or endorsed or approved the content (either explicitly or implicitly). Accordingly, where a placement agent prepares a marketing material that it plans to disseminate to multiple investors, personnel of the Sponsor would need to be careful not to explicitly or implicitly endorse or approve that material unless it has been reviewed and approved by the Sponsor's designated employee.

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[22] *See, e.g.*, *DALBAR, Inc.*, SEC Staff No-Action Letter (Mar. 24, 1998); *Investment Adviser Association*, SEC Staff No-Action Letter (Dec. 2, 2005).

[23] The SEC stated in the Proposing Release that such designated employees should be competent and knowledgeable about the amended Advertising Rule's requirements. Notably, the reviewer would need to be an RIA employee and not a law firm or compliance consultant.

Recordings of Investor Calls: Some Sponsors may, following a portfolio update or other call with a group of current or prospective investors, provide the investors with a recording of the call. The dissemination of these recordings to investors would fall within the "advertisement" definition under the Proposed Amendments and would therefore need to be reviewed and approved by a designated employee for compliance with the amended Advertising Rule's requirements.

Proposed Amendments to the Solicitation Rule

The current Solicitation Rule prohibits an RIA from paying a solicitor a cash fee for soliciting advisory clients unless the solicitor and RIA enter into a written agreement that, among other things, requires the solicitor to provide the client with a copy of the RIA's Form ADV Part 2A and a separate disclosure that contains information about the solicitor's financial interest in the client's choice of an RIA. The current rule also requires an RIA to receive a client acknowledgement of receipt of the required solicitor disclosure. In addition, the current rule prohibits RIAs from making cash payments to solicitors that have previously been found to have violated the federal securities laws or have been convicted of a crime.

The SEC staff has provided interpretive guidance that the Solicitation Rule generally does not apply to an RIA's cash payment to a person solely to compensate that person for soliciting investors in an investment pool.[24] This has limited the rule's applicability in the context of private funds. Importantly, the Proposed Amendments would partially supersede this guidance by expanding the scope of the Solicitation Rule to the solicitation of existing and prospective "private fund" investors.[25] As a result, private fund investor solicitation arrangements would be governed by the amended Solicitation Rule.

Moreover, the Proposed Amendments to the Solicitation Rule, broadly speaking, would: (1) expand the rule to cover solicitation arrangements involving all forms of compensation, not merely cash fees; (2) require solicitor disclosure to investors regarding the effect of the compensation arrangement on the solicitor's incentives; (3) eliminate the requirement that solicitors provide the client with the RIA's Form ADV Part 2A; (4) replace the client acknowledgment requirement with a more flexible requirement that an RIA has a reasonable basis for believing that the solicitor has complied with the written agreement required by the rule; (5) create new exceptions to the rule for *de minimis* payments (less than $100 in any 12-month period) and nonprofit programs designed to provide a list of RIAs to interested parties; and (6) refine the rule's disqualification provision to expand the types of disciplinary events that trigger disqualification.

[24] *Mayer Brown, LLP*, SEC Staff No-Action Letter (July 28, 2008).

[25] The term "private fund" would be defined for this purpose as an issuer that would be an "investment company" as defined in Section 3 of the Investment Company Act but for Section 3(c)(1) or 3(c)(7) of that Act. Accordingly, the amended Solicitation Rule would not apply to the solicitation of investors for RICs, BDCs and other investment pools that rely on exemptions from Investment Company Act registration other than Sections 3(c)(1) and 3(c)(7) (e.g., investment pools relying on Section 3(c)(5)).

Below is a discussion of the Proposed Amendments to the Solicitation Rule and the practical implications of these Proposed Amendments for Sponsors:

THE WRITTEN AGREEMENT REQUIREMENT

Summary

As with the current rule, the amended rule would prohibit an RIA from compensating a "solicitor," directly or indirectly, for any solicitation activities unless the compensation is pursuant to a written agreement between the RIA and the solicitor. The term "solicitor" would be defined as any person that, directly or indirectly, solicits any client or private fund investor for, or refers any client or private fund investor to, an RIA. The required written agreement would need to: (i) describe with specificity the solicitor's solicitation activities and the compensation terms; (ii) require the solicitor to perform its solicitation activities in accordance with the Advisers Act's statutory anti-fraud provisions; and (iii) require and designate the solicitor or RIA to provide the client or investor, at the time of any solicitation activities, with a separate disclosure statement containing certain information regarding the compensation arrangement and related conflicts of interest.

Practical Implications for Sponsors

Changes to Placement Agreements: If adopted, agreements with placement agents engaged to solicit investors in private funds would need to contain the provisions required by the amended rule.[26] Many fund placement agreements already contain the provisions that would be required under the current Solicitation Rule (notwithstanding that these agreements generally do not need to comply with the rule pursuant to the interpretive guidance described above). However, the Proposed Amendments would, in some respects, expand the set of provisions that solicitation agreements must contain. For example, under the amended rule, solicitation agreements would need to require that investors be provided with disclosure regarding any potential material conflicts of interest on the part of the solicitor. As such, even form placement agreements that contain all the provisions required under the current rule would need to be updated to include the new provisions that would be required under the amended rule.

Disclosure Statement to Fund Investors: Under the amended rule, the Sponsor or placement agent would need to provide solicited investors with a disclosure statement (the "**Disclosure Statement**") that describes, among other things, the placement agent compensation terms (including the terms of any trailing fee arrangement), potential material conflicts of interest on the part of the placement agent resulting from its relationship with the Sponsor (most notably, that the placement agent's incentives to solicit investors present a conflict), and the amount of any additional cost to the investor as a result of solicitation (e.g., where a Sponsor charges one fund it

[26] This memorandum generally focuses on fund solicitation arrangements with placement agents. However, the written agreement requirement would also apply to arrangements with other types of firms that Sponsors compensate to solicit investors in private funds.

markets through a solicitor a higher fee than a second similar fund that is not marketed through a solicitor).[27] Sponsors and placement agents would need to negotiate which party will be responsible for providing investors with the Disclosure Statement. In addition, Sponsors would need to retain copies of the delivered Disclosure Statements pursuant to amendments the SEC has proposed to Advisers Act recordkeeping requirements.

OVERSIGHT OF SOLICITATION ACTIVITIES

Summary

The amended Solicitation Rule would require an RIA to have a reasonable basis for believing that the solicitor has complied with the written agreement required by the rule.[28] The Proposing Release stated that, depending on the facts and circumstances, an RIA could satisfy this requirement if it (1) periodically makes inquiries of a sample of clients or private fund investors solicited by the solicitor to ascertain whether the solicitor has made improper representations or has otherwise violated the agreement and (2) is copied on any emails the solicitor sends to clients or investors with the Disclosure Statement.

Practical Implications for Sponsors

Oversight of Placement Agents: Sponsors would need to have a reasonable basis for believing that placement agents have complied with placement agreements. To meet the first condition mentioned in the Proposing Release, Sponsors could consider making investor inquiries about placement agents as part of their fund closing procedures. The second condition would only be relevant in circumstances where the placement agent is responsible for delivering the Disclosure Statement. In such circumstances, a Sponsor could meet the second condition by arranging for the placement agent to copy the Sponsor's personnel on any emails sent to investors with the Disclosure Statement.

SOLICITORS SUBJECT TO DISQUALIFICATION

Summary

Under the amended Solicitation Rule, an RIA would be prohibited from compensating a solicitor for any solicitation activity if the RIA knows, or, in the exercise of reasonable care, should have known, that the solicitor is an "ineligible solicitor." "Ineligible solicitor" would be defined to include a person who at the time of the solicitation is subject to a "disqualifying Commission action" or a "disqualifying event," employees, officers, and directors of such a person, and certain other affiliates of such a person. "Disqualifying Commission action" and

[27] The Proposing Release clarified that the content and presentation of the Disclosure Statement may not be combined with other content, such as legal disclaimers and marketing messages. Accordingly, the inclusion of this Disclosure Statement in private placement memoranda delivered to investors would not appear to satisfy this requirement.

[28] Pursuant to proposed recordkeeping requirement amendments, a Sponsor would need to retain any document related to its determination that it has a reasonable basis for believing that the placement agent has complied with the placement agreement.

"disqualifying event" would each be defined to include a set of disciplinary events enumerated in the amended rule.[29]

Practical Implications for Sponsors

Sponsors would need to ensure that none of the placement agents they engage to solicit private fund investors are "ineligible solicitors" at the time they solicit investors.

Scope of Ineligible Solicitors: Under the current rule, a solicitor can only be disqualified as a result of its own disciplinary events. Under the amended rule, however, a solicitor could, in certain circumstances, be disqualified as a result of its affiliate's disciplinary events. Notably, a solicitor would fall within the "ineligible solicitor" definition if a person controlling or controlled by the solicitor is subject to either a "disqualifying Commission action" or a "disqualifying event" at the time of the solicitation. Placement agents are typically asked to make representations in placement agreements relating to the disciplinary events enumerated in Rule 506(d) under the Securities Act of 1933. These representations tend to parallel the language of Rule 506(d), covering the disciplinary events of *some* persons that *control* a remunerated solicitor (e.g., the solicitor's managing member), but they do not extend to the disciplinary events of *all* persons that *control* or *are controlled by* the solicitor. Accordingly, if the Proposed Amendments are adopted, placement agents would likely be asked to make disciplinary event representations regarding a broader set of affiliated persons than they currently do.

Scope of Disciplinary Events: If the Proposed Amendments are adopted, disciplinary event representations in placement agreements would need to cover not only the disciplinary events enumerated in Rule 506(d), but also the "disqualifying Commission actions" and "disqualifying events" enumerated in the amended Solicitation Rule. Some form placement agreements already contain representations relating to the disciplinary events enumerated in the current Solicitation Rule. However, because the "disqualifying Commission action" and "disqualifying event" definitions together cover a broader scope of disciplinary events than the current rule, the representations in these form placement agreements would need to be updated to reflect this expanded list of disciplinary events.

Exercise of Reasonable Care: Placement agreements often impose an affirmative obligation on placement agents to promptly notify Sponsors if any of their disciplinary event representations become untrue. Some Sponsors also ask placement agents to complete a bad actor certification in connection with each fund closing. The SEC suggested in the Proposing Release that periodic certifications,[30] coupled with contractual representations and

[29] The amended Solicitation Rule would include a conditional carve-out from the determination of whether a person is an "ineligible solicitor." Pursuant to this carve-out, if the same act or omission that is the subject of a "disqualifying event" for a person is also the subject of a "non-disqualifying Commission action," the "disqualifying event" would be disregarded in determining whether the person is an "ineligible solicitor." "Non-disqualifying Commission action" would be defined as (i) an order pursuant to Section 9(c) of the Investment Company Act or (ii) an SEC opinion or order that is not a "disqualifying Commission action." For such opinion or order to be disregarded in determining whether the person is an "ineligible solicitor," the person must have complied with the terms of the opinion or order and, for a ten-year period following the date of the relevant opinion or order, the Disclosure Statement would need to describe certain information regarding the opinion or order.

[30] Should the Proposed Amendments be adopted, Sponsors may want to revise their "bad actor" certifications to cover those disciplinary events enumerated in the "disqualifying Commission action" and "disqualifying event" definitions that are not enumerated in Rule 506(d). Under the Proposed Amendments, in the event a placement agent becomes an "ineligible solicitor" after a fund's final closing, the Sponsor would be permitted to compensate the placement agent after the fund's final closing for solicitation services provided prior to the fund's final

notification requirements, would be sufficient to exercise "reasonable care" for purposes of the amended rule's disqualification provision in circumstances where there are no indications that a "disqualifying Commission action" or "disqualifying event" has occurred.[31]

Non-Retroactive Effect: The Proposing Release clarified that the proposed disqualification provision would apply only to "disqualifying Commission actions" and "disqualifying events" occurring after the effective date (or the compliance date, as applicable) of the Proposed Amendments. Accordingly, any "disqualifying Commission action" or "disqualifying event" that occurs prior to the effectiveness of the amended rule (or the compliance date, as applicable) would be subject to the current rule's disqualification provision. As such, in determining whether a placement agent is an "ineligible solicitor" as a result of a particular disciplinary action, the timing of that disciplinary action could be critical to the analysis.

IN-HOUSE SOLICITORS

Summary

The Proposed Amendments would provide a partial exemption to the amended Solicitation Rule for in-house solicitors. Pursuant to this exemption, RIAs would not need to comply with the amended rule's provisions (except for the disqualification provision) with respect to a compensation arrangement with a solicitor that is one of the RIA's partners, officers, directors, or employees, or is a person that controls, is controlled by, or is under common control with the RIA, or is a partner, officer, director, or employee[32] of such a person (together, "in-house solicitors"), provided that (1) the in-house solicitor's affiliation with the RIA is "readily apparent" to, or is disclosed to, the client or investor at the time of the solicitation and (2) the RIA documents the in-house solicitor's status as a solicitor at the time the RIA enters into the solicitation arrangement.[33] Overall, compliance with these two conditions should not be difficult for Sponsors.

Practical Implications for Sponsors

Employee Solicitors: According to the Proposing Release, an employee solicitor's affiliation with a Sponsor would be "readily apparent" to an investor where the employee solicitor clearly identifies himself or herself as related to the Sponsor in his or her communications with the investor. In addition, many Sponsors ask their employees to complete a disciplinary events questionnaire when they are hired and on a periodic basis thereafter. If the Proposed Amendments are adopted, Sponsors should consider updating these questionnaires to cover all the

closing. Along this line, Sponsors would not need to ask placement agents for updated bad actor certifications following the relevant fund's final closing in order to comply with the amended rule.

[31] Pursuant to proposed recordkeeping requirement amendments, a Sponsor would need to retain any document related to its determination that it has a reasonable basis for believing that the placement agent is not an "ineligible solicitor."

[32] Notably, this exemption would not explicitly apply to solicitation arrangements with independent contractors.

[33] RIAs would be required to retain a record of the names of all in-house solicitors.

disciplinary events enumerated in the "disqualifying Commission action" and "disqualifying event" definitions. This would help ensure that employee solicitors are not "ineligible solicitors" under the amended rule.

Affiliated Placement Agents: Sponsors would also generally be able to rely on this exemption with respect to affiliated placement agents that solicit investors for the Sponsors' private funds. To ensure compliance with the exemption's first condition, Sponsors would want to confirm that, as a practical matter, when personnel of their affiliated placement agent communicate with prospective fund investors, the affiliation between the placement agent and the Sponsor is readily apparent to, or is disclosed to, those investors.

Policies and Procedures Relating to Advertising and Solicitation Activities

The SEC would expect that Sponsors have in place compliance policies and procedures that are reasonably designed to ensure compliance with the amended Advertising Rule and Solicitation Rule. This would include the policies and procedures expressly required by the amended Advertising Rule relating to qualified purchaser status and hypothetical performance. In addition, if the proposed recordkeeping requirement amendments described above are adopted, Sponsors may also need to update their recordkeeping policies and procedures to reflect these amendments.

New Form ADV Questions Relating to Advertising Activities

In addition to the Proposed Amendments to the Advertising Rule and Solicitation Rule, the SEC has proposed to add certain questions to Form ADV Part 1 regarding RIA advertising practices. Given that the SEC staff would use this information to help prepare for RIA examinations, Sponsors would need to answer these new Form ADV questions carefully.

Transition Period

The SEC has proposed a one-year transition period during which RIAs would be permitted to rely on the current Advertising Rule and Solicitation Rule. RIAs would be required to comply with each amended rule starting one year from the rule's effective date.

Conclusion

While the Proposed Amendments would, in many respects, formalize existing SEC staff guidance and SEC-identified compliance best practices relating to the marketing of private funds, they would, if adopted, have noteworthy practical implications for Sponsors. We encourage Sponsors to assess these practical implications and consider sharing their views with the SEC on the Proposed Amendments. We stand ready to assist Sponsors in their efforts to comply with the final amendments the SEC ultimately adopts.

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