**SECURITIES AND EXCHANGE COMMISSION**
**17 CFR Part 275 and 279**

**Release No. IA-5407; File No. S7-21-19**

**RIN: 3235-AM08**

**Investment Adviser Advertisements; Compensation for Solicitations**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission (the "Commission" or the "SEC") is proposing amendments under the Investment Advisers Act of 1940 (the "Advisers Act" or the "Act") to the rules that prohibit certain investment adviser advertisements and payments to solicitors, respectively. The proposed amendments to the advertising rule reflect market developments since the rule's adoption in 1961. The proposed amendments to the solicitation rule update its coverage to reflect regulatory changes and the evolution of industry practices since we adopted the rule in 1979. The Commission is also proposing amendments to Form ADV that are designed to provide the Commission with additional information regarding advisers' advertising practices. Finally, the Commission is proposing amendments under the Advisers Act to the books and records rule, to correspond to the proposed changes to the advertising and solicitation rules.

**DATES:** Comments should be received on or before [INSERT DATE 60 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER].

**ADDRESSES:** Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or

- Send an email to rule-comments@sec.gov. Please include File Number S7-21-19 on the subject line.

Paper Comments:

- Send paper comments to Vanessa A. Countryman, Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-21-19. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's website (http://www.sec.gov/rules/proposed.shtml). Comments also are available for website viewing and printing in the Commission's Public Reference Room, 100 F Street NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change. Persons submitting comments are cautioned that the Commission does not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make publicly available.

Studies, memoranda or other substantive items may be added by the Commission or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on the Commission's website. To ensure direct electronic receipt of such notifications, sign up through the "Stay Connected" option at *www.sec.gov* to receive notifications by email.

**FOR FURTHER INFORMATION CONTACT:** Matthew Cook, Emily Rowland, or James Maclean, Senior Counsels; or Thoreau Bartmann or Melissa Roverts Harke, Senior Special Counsels, at (202) 551-6787 or *IArules@sec.gov*, Investment Adviser Regulation Office,

Division of Investment Management, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-8549.

**SUPPLEMENTARY INFORMATION:** The Commission is proposing for public comment amendments to 17 CFR 275.206(4)-1 (rule 206(4)-1), 17 CFR 275.206(4)-3 (rule 206(4)-3), and 17 CFR 275.204-2 (rule 204-2) under the Investment Advisers Act of 1940 [15 U.S.C. 80b-1 *et seq.*] (the "Advisers Act"),[1] and amendments to Form ADV [17 CFR 279.1] under the Advisers Act.

[1] Unless otherwise noted, when we refer to the Advisers Act, or any paragraph of the Advisers Act, we are referring to 15 U.S.C. 80b, at which the Advisers Act is codified, and when we refer to rules under the Advisers Act, or any paragraph of those rules, we are referring to title 17, part 275 of the Code of Federal Regulations [17 CFR part 275], in which these rules are published.

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## I. INTRODUCTION

We are proposing reforms of two rules under the Advisers Act relating to how advisers advertise to and solicit clients and investors. First, we are proposing a rule addressing advertisements by investment advisers that would replace the rule that we adopted in 1961, rule 206(4)-1, which we have not changed substantively since adoption.[2] The proposed rule would replace the current rule's broadly drawn limitations with principles-based provisions. The proposed rule contains general prohibitions of certain advertising practices, as well as more tailored restrictions and requirements that are reasonably designed to prevent fraud with respect to certain specific types of advertisements. This approach permits the use of testimonials and endorsements, and third-party ratings, subject to certain conditions. This approach also permits the presentation of performance with tailored requirements based on an advertisement's intended audience.[3] The proposal recognizes developments in technology, changing profiles of investment advisers registered with the Commission, and our experience administering the current rule.

Additionally, we are proposing to amend the Advisers Act cash solicitation rule, rule 206(4)-3, to update its coverage to reflect regulatory changes and the evolution of industry practices since we adopted the rule in 1979. We are proposing to expand the rule to cover solicitation arrangements involving all forms of compensation, rather than only cash compensation, eliminate requirements duplicative of other rules, and tailor the required

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[2] The current rule has been amended once, when the Commission revised the introductory text of paragraph (a) as part of a broader amendment of several rules under the Advisers Act to reflect changes made by the National Securities Market Improvement Act of 1996. Rules Implementing Amendments to the Investment Advisers Act of 1940, Release No. IA-1633 (May 15, 1997) [62 FR 28112, 28135 (May 22, 1997)].

[3] As discussed below, we are proposing to define clients and investors that are "qualified purchasers" or "knowledgeable employees" as "Non-Retail Persons" and to define all other clients and investors as "Retail Persons." Similarly, we are proposing to define advertisements directed at Non-Retail Persons as "Non-Retail Advertisements" and all other advertisements as "Retail Advertisements."

disclosures solicitors would provide to investors. The proposed rule would also refine the existing provisions regarding disciplinary events that would disqualify a person or entity from acting as a solicitor.

Finally, we are proposing related amendments to Form ADV that are designed to provide additional information regarding advisers' advertising practices, and amendments to the Advisers Act books and records rule, rule 204-2, related to the proposed changes to the advertising and solicitation rules.

### A. Advertising Rule Background

Advertisements are a useful tool for investment advisers seeking to obtain new investors and to retain existing investors.[4] Investment advisers disseminate advertisements about their services to inform prospective investors and to persuade them to obtain and pay for those services or to learn more about the advisers. Similarly, advertisements can provide existing investors with information about new or revised services. Accordingly, advertisements can provide existing and prospective investors with useful information as they choose among investment advisers and advisory services. At the same time, advertisements present risks of misleading existing and prospective investors because the investment adviser's interest in attracting or retaining them may conflict with their interests, and the adviser is in control of the design, content, format, media, timing, and placement of its advertisements with a goal of obtaining or retaining business. This goal may create an incentive for advertisements to mislead existing and prospective investors about the advisory services they would receive, including indirectly through the services provided to pooled investment vehicles.

[4] As discussed below, we are proposing to apply the rule to advertisements disseminated by investment advisers to their clients and prospective clients as well as to investors and prospective investors in pooled investment vehicles that those advisers manage. For purposes of this release, we refer to any of these advertising recipients as "investors," unless we specify otherwise.

The Commission recognized the potential harm to investors from misleading advertisements when it adopted the current advertising rule in 1961.[5] The Commission explained when it proposed the current rule that investment advisers generally must adhere to a stricter standard of conduct in advertisements than that applicable to "ordinary merchants" because securities "are intricate merchandise," and investors "are frequently unskilled and unsophisticated in investment matters."[6] These concerns have motivated the Commission to adopt other rules on advertising investment services and products, including for registered investment companies ("RICs").[7]

In adopting the current rule, the Commission used its authority under section 206(4) of the Advisers Act to target advertising practices that it believed were likely to be misleading by imposing four *per se* prohibitions.[8] First, the current rule prohibits testimonials concerning the investment adviser or its services.[9] Second, the current rule prohibits direct or indirect references to specific profitable recommendations that the investment adviser has made in the past ("past specific recommendations").[10] Third, the current rule prohibits representations that any graph or

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5 Advertisements by Investment Advisers, Release No. IA-121 (Nov. 1, 1961) [26 FR 10548 (Nov. 9, 1961)] ("Advertising Rule Adopting Release").

6 Investment Advisers Notice of Proposed Rulemaking, Release No. IA-113 (Apr. 4, 1961) [26 FR 3070, 3071 (Apr. 11, 1961)] ("Advertising Rule Proposing Release").

7 *See* 17 CFR 230.482 (regulating advertising with respect to securities of RICs and business development companies ("BDCs")); 17 CFR 230.156 (regulating investment company sales literature).

8 *See* Section 206(4) of the Advisers Act (authorizing the Commission to define and prescribe "means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative").

9 Rule 206(4)-1(a)(1) (prohibiting publication, circulation, or distribution of any advertisement "which refers, directly or indirectly, to any testimonial of any kind concerning the investment adviser or concerning any advice, analysis, report or other service rendered by such investment adviser").

10 Rule 206(4)-1(a)(2) (prohibiting publication, circulation, or distribution of any advertisement "which refers, directly or indirectly, to past specific recommendations of such investment adviser which were or would have been profitable to any person" but providing that an advertisement may set out or offer to furnish a list of all recommendations within the immediately preceding period of not less than one year under certain conditions).

other device being offered can by itself be used to determine which securities to buy and sell or when to buy and sell them.[11] Fourth, the current rule prohibits any statement to the effect that any service will be furnished free of charge, unless such service actually is or will be furnished entirely free and without any condition or obligation.[12]

In addition to the four *per se* prohibitions, the current rule prohibits any advertisement which contains any untrue statement of a material fact, or which is otherwise false or misleading.[13] This prohibition operates more generally than the specific prohibitions to address advertisements that do not violate any *per se* prohibition but still may be fraudulent, deceptive, or manipulative and, accordingly, be misleading.

The concerns that motivated the Commission to adopt the current rule still exist today and are echoed in the rules adopted under other regulatory and self-regulatory regimes governing the use of communications by financial professionals.[14] However, in the nearly 60 years since

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11 Rule 206(4)-1(a)(3) (prohibiting publication, circulation, or distribution of any advertisement "which represents, directly or indirectly, that any graph, chart, formula or other device being offered can in and of itself be used to determine which securities to buy or sell, or when to buy or sell them; or which represents directly or indirectly, that any graph, chart, formula or other device being offered will assist any person in making his own decisions as to which securities to buy, sell, or when to buy or sell them, without prominently disclosing in such advertisement the limitations thereof and the difficulties with respect to its use").

12 Rule 206(4)-1(a)(4) (prohibiting publication, circulation, or distribution of any advertisement "which contains any statement to the effect that any report, analysis, or other service will be furnished free or without charge, unless such report, analysis or other service actually is or will be furnished entirely free and without any condition or obligation, directly or indirectly").

13 Rule 206(4)-1(a)(5).

14 For example, the Financial Industry Regulatory Authority's ("FINRA") rule 2210 governs broker-dealers' communications with the public, including communications with retail and institutional investors, and provides standards for the content, approval, recordkeeping, and filing of communications with FINRA. *See* Advertising Regulation, *available at* http://www.finra.org/industry/advertising-regulation. The Commodity Futures Trading Commission likewise regulates certain types of advertising by commodity pool operators, commodity trading advisors, and their respective principals. 17 CFR 4.41 Advertising by Commodity Pool Operators, Commodity Trading Advisors, and the Principals Thereof (prohibiting, in part, any advertisements that employ any device, scheme or artifice to defraud any client or prospective client). The Municipal Securities Rulemaking Board regulates advertisements concerning the products or services of certain brokers, dealers, and municipal securities dealers, and, beginning in 2019, will regulate advertisements by municipal advisers. Self-Regulatory Organizations; Municipal Securities Rulemaking

the current rule's adoption, issues and questions have arisen about the current rule's application, particularly the application of the prohibitions of testimonials and past specific recommendations. Additionally, some of the most common questions related to the current rule (and the anti-fraud provisions of the Advisers Act) relate to the appropriate presentation of performance in advertisements, which the current rule does not explicitly address. The breadth of the current rule's prohibitions, as well as the lack of explicit prescriptions related to the presentation of performance in the rule, can present compliance challenges and potentially have a chilling effect on advisers' ability to provide useful information in communications that are considered advertisements.

Moreover, changes that have occurred since the current rule's adoption lead us to believe providing a more principles-based approach would be beneficial. Specifically, in our development of the proposed rule, we have considered changes in the technology used for communications, the expectations of investors shopping for advisory services, and the nature of the investment advisory industry, including the types of investors seeking and receiving investment advisory services. These changes have informed not only how we propose to update the rule to address current technology, expectations, and market practice but also our general approach of proposing principles-based rules in order to accommodate the continual evolution and interplay of technology and advice.[15]

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Board; Order Granting Approval of a Proposed Rule Change, Consisting to Amendments to Rule G-21, on Advertising, Proposed New Rule G-40, on Advertising by Municipal Advisers, and a Technical Amendment to Rule G-42, on Duties of Non-Solicitor Municipal Advisers, Release No. 34-83177 (May 7, 2018) [83 FR 21794 (May 10, 2018)]. MSRB Rule G-40 became effective on August 23, 2019.

[15] *See, e.g.,* Modernization of Regulation S-K Items 101, 103, and 105, Release No. 33-10668 (Aug. 8, 2019) [84 FR 44358 (Aug. 23, 2019)] (discussing the role of "principles-based" disclosure requirements in articulating a disclosure concept rather than a specific line-item requirement).

*Advances in Technology.* Advances in technology have altered the ways in which service providers, including advisers, interface with consumers generally, including with existing and prospective investors. These advances have also changed the manner in which those consumers evaluate products and services. In the decades since the current rule was adopted, the use of the internet, mobile applications, and social media[16] has become an integral part of business communications. These advances in technology have led to significant growth in the nature and volume of information available to individuals and businesses,[17] for example, by allowing them to access and share user reviews. However, websites and social media can create challenges in complying with the current rule's prohibition on testimonials, particularly for advisers that rely heavily on electronic platforms to communicate with existing and prospective investors.[18]

*Expectations of Consumers Shopping for Services.* Consumers today often rely on the internet to obtain information when considering buying goods and services across the world, including advisory services and those of other financial professionals. Many websites allow potential buyers to compare and contrast the goods and services being offered, including through reviews and ratings provided by those who have previously bought the relevant goods and

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16 "Social media" is an umbrella term that encompasses various activities that integrate technology, social interaction, and content creation. Social media may use many technologies, including, but not limited to, blogs, microblogs, wikis, photos and video sharing, podcasts, social networking, and virtual worlds. The terms "social media," "social media sites," "sites," and "social networking sites" are used interchangeably in this release.

17 *See* Report on the Review of the Definition of "Accredited Investor" (Dec. 18, 2015) ("Accredited Investor Staff Report"), *available at* https://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf, at 5 (noting "increased informational availability" and "changes in the way investors communicate" since adoption of the "accredited investor" definition in 1982).

18 *See also* Guidance on the Testimonial Rule and Social Media, Division of Investment Management Guidance Update No. 2014-04 (Mar. 2014) ("IM Staff Social Media Guidance"), in which our staff discussed its views on application of the current rule to various situations involving social media. Any staff guidance or no-action letters discussed in this release represent the views of the staff of the Division of Investment Management. They are not a rule, regulation, or statement of the Commission. Furthermore, the Commission has neither approved nor disapproved their content. Staff guidance has no legal force or effect; it does not alter or amend applicable law, and it creates no new or additional obligations for any person.

services. We believe that consumers' ability to seek out reviews and other information, as well as their interest in doing so, when evaluating products and services has changed since the adoption of the current rule.

*Profiles of the Investment Advisory Industry.* The variety of advisers subject to the advertising rule has changed since the current rule's adoption. Specifically, the type of advisory services provided by advisers generally has changed over time, from impersonal investment advice distributed to many prospective investors in the form of newsletters and other periodicals to more personalized advisory services. The ways advisers and investors interact and engage has also changed; some investors today rely on digital investment advisory programs, sometimes referred to as "robo-advisers," for investment advice, which is provided exclusively through electronic platforms using algorithmic-based programs.[19] In addition, passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[20] required many investment advisers to private funds[21] that were previously exempt from registration to register with the Commission and become subject to more provisions of the Advisers Act.[22]

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19 *See, e.g.*, Robo-Advisers, Division of Investment Management Guidance Update No. 2017-02 (Feb. 2017); s*ee also* Concept Release on Harmonization of Securities Offering Exemptions, Release No. IA-5256 (June 18, 2019) [84 FR 30460 (June 26, 2019)] ("2019 Concept Release") (describing the use of robo-advisers as part of the broad availability "in recent years" of investment advisory services to retirement investors).

20 *See* the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (the "Dodd-Frank Act").

21 *See* 15 U.S.C. 80b-2(a)(29) (defining a "private fund" as "an issuer that would be an investment company, as defined in section 3 of the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of that Act").

22 As part of the Dodd-Frank Act, the Private Fund Investment Advisers Registration Act of 2010 (enacted as Title IV of the Dodd-Frank Act) repealed the "private fund adviser exemption" from registration under section 203(b)(3) of the Advisers Act, on which many advisers to private funds had relied to remain outside the purview of the Advisers Act. As a result, the Commission saw an increase in the number of registered investment advisers servicing private funds. Based on a review of Form ADV data between June 2012 and August 2019, the number of investment advisers to private funds registered with the Commission increased from approximately 4,050 to approximately 4,856. The number of private funds advised by registered investment advisers has increased during that same time period, from 24,476 in June 2012 to 37,004 in August 2019. The Dodd-Frank Act created a narrower set of exemptions for advisers that advise

Additionally, the diversity in types of investors seeking and receiving advisory services has increased since the current rule's adoption.[23] When adopting the current rule, the Commission stated "clients or prospective clients of investment advisers are frequently unskilled and unsophisticated in investment matters."[24] Changes in the investor population since the current rule's adoption suggest we should reconsider some specific provisions of the current rule and consider how best to address new issues. For example, assets under management for institutional clients have increased in recent years.[25] These types of investors often have their own teams of in-house investment professionals to manage their assets or oversee the retention of outside managers. They therefore often want and have the resources to evaluate information that the current rule may restrict. At the same time, household and individual participation in the capital markets through intermediaries, like investment advisers, has increased. As a result, more individuals who are not themselves professional investors may be seeking or receiving advertisements for these services. Accordingly, rather than the "one-size-fits-all" approach of the current rule, we believe it is appropriate for the rule to reflect the intended audience of the advertisement, including investors' access to resources for assessing advertising content for advisory services, such as presentation of hypothetical performance.

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exclusively venture capital funds and advisers solely to private funds with less than $150 million in assets under management in the United States. *See* section 203(l) and section 203(m) of the Advisers Act.

23 We have previously indicated the diversity in types of clients that receive investment advisory services. *See, e.g.,* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248 (June 5, 2019) ("Standard of Conduct Release") (noting the large variety of clients served by investment advisers "from retail clients with limited assets and investment knowledge and experience to institutional clients with very large portfolios and substantial knowledge, experience, and analytical resources").

24 Advertising Rule Adopting Release, *supra* footnote 5.

25 As discussed below, *see infra* section III.B.1, a substantial percentage of assets under management at investment advisers is held by institutional clients.

In light of the Commission's decades of experience in administering the current rule and the other developments described above, as well as extensive outreach by Commission staff to investor advocacy groups, adviser groups, legal practitioners, and others, we are proposing significant changes to the current rule as discussed below. Specifically, we are proposing a restructured and more tailored rule that: (i) modifies the definition of "advertisement" to be more "evergreen" in light of ever-changing technology; (ii) replaces the current four *per se* prohibitions with a set of principles that are reasonably designed to prevent fraudulent or misleading conduct and practices; (iii) provides certain additional restrictions and conditions on testimonials, endorsements, and third-party ratings; and (iv) includes tailored requirements for the presentation of performance results, based on an advertisement's intended audience. The proposed rule also would require internal review and approval of most advertisements and require each adviser to report additional information regarding its advertising practices in its Form ADV.

### B. Cash Solicitation Rule Background

Another way that advisers attract clients and investors,[26] beyond advertising communications, is through compensating firms or individuals to solicit new investors. Some investment advisers directly employ individuals to solicit new investors on their behalf, and some investment advisers arrange for related entities or third parties, such as broker-dealers, to solicit new investors. The person or entity compensated, commonly called the "solicitor," has a financial incentive to recommend the adviser to the investor. Without appropriate disclosure, this compensation creates a risk that the investor would mistakenly view the solicitor's

[26] As discussed below, we are proposing to apply the rule to compensation by investment advisers to solicitors to obtain clients and prospective clients as well as investors and prospective investors in private funds that those advisers manage. For purposes of this release, we refer to any of these persons as "investors," unless we specify otherwise.

recommendation as being an unbiased opinion about the adviser's ability to manage the investor's assets and would rely on that recommendation more than he or she otherwise would if the investor knew of the incentive.

We adopted rule 206(4)-3, the cash solicitation rule, in 1979 to help ensure that clients become aware that paid solicitors have a conflict of interest.[27] The current rule makes the adviser's payment of a cash fee for referrals of advisory clients unlawful unless the solicitor and the adviser enter into a written agreement that, among other provisions, requires the solicitor to provide the client with a current copy of the investment adviser's Form ADV brochure and a separate written solicitor disclosure document.[28] The solicitor disclosure must contain information highlighting the solicitor's financial interest in the client's choice of an investment adviser.[29] In addition, the rule prescribes certain methods of compliance, such as requiring an adviser to receive a signed and dated client acknowledgment of receipt of the required disclosures.[30] The current rule also prohibits advisers from making cash payments to solicitors

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[27] *See* Requirements Governing Payments of Cash Referral Fees by Investment Advisers, Release No. 688 (July 12, 1979) [44 FR 42126 (Jul. 18, 1979)] (the "1979 Adopting Release"). When we proposed the rule, we noted that referral arrangements in the investment advisory industry are "fraught with possible abuses" and we considered prohibiting investment advisers from making referral payments to persons not directly employed by the firm. *See* Requirements Governing Payments of Cash Referral Fees by Investment Advisers, Release No. 615 (Feb. 11, 1978) [43 FR 6095 (Feb. 13, 1978)] (the "1978 Proposing Release"), at 6096; 1979 Adoption Release, *id.*, at 42126. However, we concluded that investors' interests could be protected if the conflicts of interest are properly disclosed to advisory clients and certain other regulatory safeguards are met. *See* 1979 Adopting Release, *id.*, at 42126.

[28] *See* rule 206(4)-3(a)(2)(iii)(A). When the Commission proposed the solicitation rule, it did not include non-cash compensation in the rule. However, when the Commission adopted the rule, it noted that commenters suggested that a prohibition of cash solicitation fees altogether might lead to use of other, possibly undisclosed, methods of compensation, such as directed brokerage. 1979 Adopting Release, *supra* footnote 27, at n.6.

[29] 1978 Proposing Release, *supra* footnote 27. *See* rule 206(4)-3(b)(1) through (6). The solicitor disclosure must also include prescribed information about the cost that the client would bear in the advisory relationship as a result of the compensated referral.

[30] *See* rule 206(4)-3(a)(2)(iii)(B). Referrals by solicitors for impersonal advisory services and certain solicitors that are affiliated with the adviser are exempt from these requirements. *See* rule 206(4)-3(a)(2)(i) and (ii).

that have previously been found to have violated the Federal securities laws or have been convicted of a crime.[31]

The current solicitation rule has not been amended since adoption 40 years ago. In this time, advisory and referral practices have evolved, as has the regulatory framework for investment advisers. For example, advisers use various types of compensation, including non-cash compensation, in referral arrangements. Over time, we have gained a greater understanding of these arrangements, causing us to re-evaluate whether the rule should apply to all forms of compensation for referrals. In addition, as discussed above, the passage of the Dodd-Frank Act required many investment advisers to private funds that were previously exempt from registration to register with the Commission and become subject to additional provisions of the Advisers Act and the rules thereunder. Private funds and their advisers often hire solicitors to obtain investors in the funds.[32]

Additionally, the Commission has adopted other regulatory requirements for advisers since the current rule's adoption that are more principles-based. For example, the Act's compliance rule could broadly replace some of the rule's prescriptive requirements, such as the requirement to obtain written and signed acknowledgments of each solicitor disclosure.[33] In addition, the Act's brochure delivery rule may duplicate the current cash solicitation rule's

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31 *See* rule 206(4)-3(a)(1)(ii).

32 *See* Section 7.B.(1)(A).28 (Private Fund Reporting) of Schedule D to Form ADV Part 1A (requiring advisers to private funds to list, among other things, the name of their marketer (including any solicitor)). As of September 30, 2019, approximately 33% of registered investment advisers that report that they advise one or more private funds on Form ADV also report that the private fund uses the services of someone other than the adviser or its employees for marketing purposes.

33 *See* rule 206(4)-7; Compliance Programs of Investment Companies and Investment Advisers, Release No. IA-2204 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)] ("Compliance Program Adopting Release").

requirement that the solicitor also deliver the adviser's brochure.[34] Finally, we believe it is appropriate to consider revising the solicitor disqualification provision to address certain types of conduct.

Therefore, we are proposing to expand the rule to cover solicitation arrangements involving all forms of compensation, rather than only cash compensation. We are proposing to expand the rule to apply to the solicitation of current and prospective investors in any private fund, rather than only to "clients" (including prospective clients) of the investment adviser. Our proposal would require solicitor disclosure to investors, which alerts investors to the effect of this compensation on the solicitor's incentive in making the referral. In addition, we are proposing changes to eliminate: (i) the requirement that solicitors provide the client with the adviser's Form ADV brochure; and (ii) the explicit reminders of advisers' requirements under the Act's special rule for solicitation of government entity clients and their fiduciary and other legal obligations. Our proposal would also eliminate the requirement that an adviser obtain a signed and dated acknowledgment from the client that the client has received the solicitor's disclosure, and instead would afford advisers the flexibility in developing their own policies and procedures to ascertain whether the solicitor has complied with the rule's required written agreement. We are also proposing two new exceptions to the solicitation rule, an exception for *de minimis* payments (less than $100 in any 12 month period) and one for nonprofit programs designed to provide a list of advisers to interested parties. Finally, we are proposing to refine the rule's solicitor disqualification provision to expand the types of disciplinary events that would

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[34] The same year we adopted the cash solicitation rule, we adopted for the first time the Form ADV brochure, which we have significantly amended over time. *See* 1979 Adopting Release, *supra* footnote 27, at n.14 and accompanying text. *See* Amendments to Form ADV, Release No. IA-3060 (July 28, 2010) [75 FR 155 (Aug. 12, 2010)] ("2010 Form ADV Amendments Release"), at section I. The Commission noted in the 1979 adopting release that "delivery of a brochure by the solicitor will, in most cases, satisfy the investment adviser's obligation to deliver a brochure to the client under Rule 204-3." *See* 1979 Adopting Release, *supra* footnote 27.

trigger the rule's disqualification provision, while also providing a conditional carve-out for certain types of Commission actions.

## II. DISCUSSION

### A. Proposed Amendments to the Advertising Rule

#### 1. Structure of the Rule

The proposed advertising rule is organized as follows, as a means reasonably designed to prohibit fraudulent, deceptive or manipulative acts: (i) general prohibitions of certain advertising practices applicable to all advertisements;[35] (ii) tailored restrictions or conditions on certain practices (testimonials, endorsements, and third-party ratings) applicable to all advertisements;[36] (iii) tailored requirements for the presentation of performance results, based on the advertisement's intended audience;[37] and (iv) a compliance requirement that most advertisements be reviewed and approved in writing by a designated employee before dissemination.[38] The proposed rule would apply to all investment advisers registered, or required to be registered, with the Commission.[39]

#### 2. Scope of the Rule: Definition of "Advertisement"

##### a. *Proposed Definition*

The proposed rule would define "advertisement" as "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

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35 *See* proposed rule 206(4)-1(a).

36 *See* proposed rule 206(4)-1(b).

37 *See* proposed rule 206(4)-1(c).

38 *See* proposed rule 206(4)-1(d).

39 The proposed rule would not apply to advisers that are not required to register as investment advisers with the Commission, such as exempt reporting advisers or state-registered advisers.

advisory clients or investors in any pooled investment vehicle advised by the investment adviser." The proposed definition of "advertisement" would not include the following four categories of communications:

(A) Live oral communications that are not broadcast on radio, television, the internet, or any other similar medium;

(B) A communication by an investment adviser that does no more than respond to an unsolicited request for specified information about the investment adviser or its services, other than (i) any communication to a Retail Person that includes performance results or (ii) any communication that includes hypothetical performance;

(C) An advertisement, other sales material, or sales literature that is about an investment company registered under the Investment Company Act of 1940 (the "Investment Company Act") or about a business development company ("BDC") and that is within the scope of rule 482 or rule 156 under the Securities Act of 1933 (the "Securities Act"); or

(D) Any information required to be contained in a statutory or regulatory notice, filing, or other communication.

The proposed rule is intended to define "advertisement" so that it is flexible enough to remain relevant and effective in the face of advances in technology and evolving industry practices.[40] This proposed definition reflects several differences from the current rule. One

[40] The proposed definition of "advertisement" is distinct from a communication that would be considered general solicitation or general advertising of an offering for purposes of Regulation D under the Securities Act. *See* 17 CFR 230.502(c) (describing limitations on the manner of offering or selling securities under Regulation D). The proposed definition would also be distinct from a communication that would be considered a public offering for purposes of section 4(a)(2) of the Securities Act. *See* 17 U.S.C. 77d(a)(2).

difference is the expansion of the types of communications addressed to reflect evolving methods of communication, rather than the methods that were most common when the current rule was adopted (*e.g.*, newspapers, television, and radio).[41] Second, the proposed definition applies explicitly to advertisements disseminated to investors in pooled investment vehicles, with a carve-out for publicly offered investment companies. Third, the proposed definition does not retain the current rule's "more than one person" element, but, consistent with the effect of that element, does not apply to non-broadcast live oral communications or responses to certain unsolicited requests.[42] Finally, the rule carves out information required by existing statutory or regulatory requirements. These differences are intended to update the current rule to reflect modern methods of communication and to be sufficiently flexible to address future methods of dissemination, as well as clarify investment advisers' obligations with respect to all communications intended to obtain or retain investors in pooled investment vehicles. We discuss below the specific provisions of and specific exclusions from the proposed rule's definition.

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However, in determining whether a communication would constitute a general solicitation, the Commission has historically interpreted the term "offer" broadly, and has explained that "the publication of information and publicity efforts, made in advance of a proposed financing which have the effect of conditioning the public mind or arousing public interest in the issuer or in its securities constitutes an offer." *See* Securities Offering Reform, Release No. 33-8591 (July 19, 2005) [70 FR 44722 (Aug. 3, 2005)], at n. 88. Thus an advertisement under the proposed rule would need to be assessed to determine whether it may be a communication that is considered a general solicitation, advertising, or a public offering for purposes of Regulation D or section 4(a)(2).

41 *See* proposed rule 206(4)-1(e)(1) (defining "advertisement" as, in part, "any communication, disseminated by any means"). In contrast, the current rule defines "advertisement," in part, to include "any notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television." Rule 206(4)-1(b).

42 *See* proposed rule 206(4)-1(e)(1) (defining "advertisement" as, in part, any communication "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"). In contrast, the current rule defines "advertisement," in part, to include "any notice, circular, letter or other written communication addressed to more than one person." Rule 206(4)-1(b).

We request comment generally on the proposed rule's definition of "advertisement," with more specific requests on particular elements of the proposed definition in the sections that follow.

- Generally, does the proposed rule's definition of "advertisement" sufficiently describe the types of communications that should be subject to the requirements of the proposed rule? Are there types of communications that should be subject to the requirements of the proposed rule but are excluded from the proposed definition?
- Conversely, does the proposed rule's definition of "advertisement" include communications that should not be subject to the requirements of the proposed rule?

**b.** ***Specific Provisions***

i. Dissemination by any means.

The proposed rule would define "advertisement" to include communications "disseminated by any means." This would replace the current rule's requirement that it be a "written" communication or a notice or other announcement "by radio or television." This proposed revision would change the scope of the rule to encompass all promotional communications regardless of how they are disseminated, with the exception of certain communications discussed below. Communications may be disseminated through emails, text messages, instant messages, electronic presentations, videos, films, podcasts, digital audio or video files, blogs, billboards, and all manner of social media, as well as by paper, including in newspapers, magazines and the mail. We recognize that electronic media (including social media and other internet communications) and mobile communications play a significant role in current advertising practices. While we considered including specific references to such media in the proposed definition, we believe that "by any means" incorporates such media while better focusing the proposed rule on the goal of the communication, and not its method of delivery.

We also believe this revision will help the proposed definition remain evergreen in the face of evolving technology and methods of communication.

We request comment on the proposed definition's inclusion of a communication disseminated by any means.

- Would the proposed definition's approach have our intended effect of being evergreen in the face of changing technologies? Is there an alternative approach that would better produce this intended effect?
- The proposed rule's restrictions would not distinguish between, for example, a print advertisement and a social media post. Is our approach in this respect appropriate or should we treat communications differently depending on the medium? If so, how should we reflect that treatment? Would additional definitions be appropriate or useful? If we adopt a definition that lists specific media, how should we address our goal of having the definition apply to new media in the future?
- The proposed definition would capture advertisements that are nominally directed at one person but in fact widely disseminated (such as robo-calls or emails), in order to prevent any evasion of a rule covering communications "addressed to" one person. Would the proposed rule's approach have this intended anti-evasion effect? Is there an alternative approach to the proposed definition that would better produce this intended effect?
- Should we have different requirements for advertisements depending on how broadly the adviser disseminates them? For example, the FINRA communications rule differentiates between "retail communications," which are those available to more than 25 investors, and "correspondence," which are those available to 25 or fewer investors. Would this kind of differentiation be useful or appropriate in rule 206(4)-1?

ii. By or on behalf of an investment adviser.

The proposed rule would define "advertisement" to include all communications "by or on behalf of an investment adviser."[43] We understand that investment advisers often provide to intermediaries, such as consultants and solicitors, advertisements for dissemination,[44] and the proposed rule would treat those as communications "by or on behalf of" the advisers.[45] Communications disseminated by an affiliate of the investment adviser would similarly be treated as communications "by or on behalf of" the adviser. For example, a communication prepared by the adviser to an affiliated private fund but disseminated for the adviser by the private fund through its consultants would be a communication "by or on behalf of" the adviser for purposes of the proposed rule. If an advertisement were disseminated without the adviser's authorization, however, such an unauthorized communication would not be "by or on behalf" of the adviser.[46]

We believe communications that investment advisers use to offer or promote their services have an equal potential to mislead – and should be subject to the proposed rule – regardless of whether the adviser disseminates such communications directly or through an intermediary. Including communications "on behalf of" an investment adviser also is intended to reflect the application of the current rule to communications provided by investment advisers

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43 Proposed rule 206(4)-1(e)(1).

44 *See, e.g.*, Investment Company Institute, SEC Staff No-Action Letter (Sept. 23, 1988) ("ICI Letter") (staff stated that it would not recommend enforcement action regarding an investment adviser's provision of performance information to consultants for advisory clients under certain conditions).

45 *See infra* section II.B for a discussion of the proposed solicitation rule. In many cases, a compensated testimonial or endorsement would be subject to both the proposed advertising rule and the proposed solicitation rule. This could be the case even if the adviser does not give the adviser's advertising content to the person providing the testimonial or endorsement. *See infra* section II.B.

46 That is, we intend "by or on behalf of" to require affirmative steps by the adviser.

through intermediaries.[47] Accordingly, we believe that investment advisers should be able to comply with this element of the proposed rule through the practices they currently use in communicating with prospective clients through intermediaries.[48]

Additionally, content created by or attributable to unaffiliated third parties, such as investors, could be considered by or on behalf of an investment adviser, depending on the investment adviser's involvement. Whether a communication is "by or on behalf of" an investment adviser when the communication involves content from an unaffiliated third party would require a facts and circumstances analysis. We believe that whether third-party information is attributable to an adviser under the "by or on behalf of" standard depends upon whether the adviser has involved itself in the preparation of the information or explicitly or implicitly endorsed or approved the information.

This issue may commonly arise in the context of an adviser's use of its website or other social media. For example, an adviser might incorporate third-party content into the adviser's communication by including a hyperlink to an independent webpage on which third-party content sits in the adviser's communication. Or an adviser might allow third parties to post commentary on the adviser's website or social media page. In both cases, the third-party content may be a communication "by or on behalf of" the adviser, and therefore an "advertisement" subject to the restrictions in the proposed rule.

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47 *See, e.g.*, *In re* Profitek, Inc., Release No. IA-1764 (Sept. 29, 1998) (settled order) (the Commission brought an enforcement action against an investment adviser, asserting that it directly or indirectly distributed materially false and misleading advertisements, including by submitting performance information in questionnaires submitted to online databases that were made available to subscribers nationwide and by providing misleading performance information to newspaper that reported the performance in article); *see also* ICI Letter.

48 The Commission has previously indicated an expectation that an adviser's policies and procedures, at a minimum, should address certain issues to the extent they are relevant to that adviser, which may include marketing advisory services, including the use of solicitors. *See* Compliance Program Adopting Release, *supra* footnote 33.

We believe third-party content is "by or on behalf of" an adviser when the adviser takes affirmative steps with respect to the third-party content. For example, third-party content could be by or on behalf of the investment adviser if the investment adviser: (i) drafts, submits, or is otherwise involved substantively in the preparation of the content; (ii) exercises its ability to influence or control the content, including editing, suppressing, organizing, or prioritizing the presentation of the content; or (iii) pays for the content. If an investment adviser helps draft comments that an investor posts on a third-party website or social media page, the comments could be an advertisement under the proposed definition, and the proposed rule's requirements could apply. For instance, if the adviser edits a third party's discussion of the adviser on a third-party website, then the content could be a communication by or on behalf of the adviser. As noted above, if the adviser pays for the content – including if the adviser provides non-cash compensation such as rewards or other incentives for a third party to provide content – the content could be considered to be by or on behalf of the adviser.[49] Such incentives could include, for example, compensated advisory services and cross-referrals (*e.g.*, the adviser refers investors to the third-party site).

On the other hand, there are several circumstances in which we generally would not view third-party content as by or on behalf of an adviser, and therefore the content would not be within the proposed rule's scope. For example, an adviser's hyperlink to third-party content within the adviser's press release generally would not, by itself, make the hyperlinked content part of the advertisement, provided that the third party, and not the adviser or its affiliate, drafted

[49] For many advertisements, paid content also may be considered a paid testimonial or endorsement, which would be subject to specific disclosure requirements (*see* proposed rule 206(4)-1(b)(1)). *See infra* section II.A.4.b.

the hyperlinked content and is free to modify it.[50] At the same time, an adviser's hyperlink to third-party content that the adviser knows or has reason to know contains an untrue statement of material fact or materially misleading information would be fraudulent or deceptive under section 206 of the Act.

Content regarding the investment adviser on third-party hosted platforms that solicit users to post information, including positive and negative reviews of the adviser, generally would not be "by or on behalf of" the investment adviser unless the adviser took affirmative steps to influence the content of those reviews or posts, such as providing a user with wording to submit as a review or editing the content of a post.[51]

Determining whether content posted by third parties on an adviser's own website or social media page is by or on behalf of the investment adviser will thus turn on the extent to which the adviser has involved itself in the presentation of such content.[52] For example, the fact that an adviser permits all third parties to post public commentary to the adviser's website or social media page would not, by itself, render such content attributable to the investment adviser, so long as the adviser does not selectively delete or alter the comments or their presentation. We believe such treatment for third-party content on the adviser's own website or social media page is appropriate even if the adviser has the ability to influence control over the commentary but

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50 We previously stated that an adviser should consider the application of rule 206(4)-1, including the prohibition on testimonials, before including hyperlinks to third-party websites on its website or in its electronic communications. *See* Interpretive Guidance on the Use of Company Web Sites, Release No. IC-28351 (Aug. 1, 2008) [73 FR 45862 (Aug. 7, 2008)]. The proposed rule would provide an approach that is more flexible than our 2008 interpretive guidance to evaluating the use of hyperlinks to third-party content, as the proposed rule would not prohibit testimonials.

51 The provision of investment advisory services would not constitute such affirmative steps.

52 Other content on an adviser's own website or social media page would likely meet the definition of "advertisement" in the proposed rule.

does not exercise it.[53] Likewise, we would not consider an adviser that merely permits the use of "like," "share," or "endorse" features on a third-party website or social media platform to implicate the proposed rule.

Conversely, if the investment adviser took affirmative steps to involve itself in the preparation of the comments or to endorse or approve the comments, those comments could be communications "by or on behalf of" the adviser. For example, if an adviser substantively modifies the presentation of comments posted by others by deleting negative comments or prioritizing the display of positive comments, then we believe the adviser is exercising sufficient control over third-party comments with the goal of promoting its advisory business that the content would be "by or on behalf of" the investment adviser and would likely be considered an advertisement under the proposed rule. We request comment on the proposed definition's inclusion of communications "on behalf of" an investment adviser, including our views above on when third-party content would be considered a communication by or on behalf of an investment adviser.

- Is the "on behalf of" element of the proposed definition sufficiently clear based on our description above? Should we further clarify any specific indicia to determine when a communication is disseminated "on behalf of" an investment adviser, particularly circumstances when an adviser might have exercised sufficient influence over third-party content? Should we use a different standard such as, for example, the prohibition in rule 156 under the Securities Act of "directly or indirectly" using sales literature?

[53] For example, if the social media platform allows the investment adviser to sort the third-party content in such a way that more favorable content appears more prominently, but the investment adviser does not actually do such sorting, then the ability to sort content would not render such content attributable to the adviser.

- Should the proposed rule explicitly define or provide examples when third-party content would be considered an advertisement for which the investment adviser is responsible and when it is not? How should we incorporate such provisions?
- Do investment advisers routinely use intermediaries or other third parties to disseminate communications to the advisers' clients and prospective clients? How do investment advisers to private funds and other pooled investment vehicles currently use intermediaries, for example through capital introduction programs, to advertise those vehicles? Do commenters agree that investment advisers would be able to comply with the "on behalf of" element through practices they currently use in communicating through intermediaries?
- Should the proposed rule apply specific criteria to circumstances where investment advisers provide information to third-party news organizations? Are there circumstances under which investment advisers interact with third-party news organizations under the current rule that should be addressed specifically in the proposed rule? Are there specific challenges that investment advisers have encountered under the current rule in providing information to third-party news organizations? To what extent do investors rely on information provided by third-party news organizations in assessing the capabilities and experience of investment advisers that may be hired?
- In our view, if an adviser were to modify the presentation of third-party comments, such an action would likely make the communication by or on behalf of the adviser. Should we consider providing additional guidance to allow an adviser to edit third-party content solely on the basis that it is profane or unlawful without such editing

causing the content to be "by or on behalf" of the adviser? If so, how should we define profane or unlawful content? Would it be necessary to give an audience notice that such third-party content had been edited in such a way, and if so, how would such notice best be provided? Would such guidance have the effect of evading the intent of the proposed rule, considering that comments with profane content may indicate negative views of the adviser?

- Should we provide that editing the presentation of third-party comments pursuant to a set of neutral pre-established policies and procedures would not make such content "by or on behalf of the adviser"? For example, should we allow an adviser to determine in advance that it will delete all comments that are older than five years, or that include spam, threats, personally identifiable information, or demonstrably factually incorrect information? If so, should we require advisers to publically disclose the pre-established criteria for editing such comments?

iii. Offer or promote advisory services or seek to obtain or retain clients or investors

The proposed rule would define "advertisement" to include communications that are disseminated "to offer or promote" the investment adviser's investment advisory services or that seek to "obtain or retain" investors.[54] The "offer or promote" clause is meant to focus the proposed definition on the goal of the communication and on communications that we believe are commonly considered advertisements. The "offer or promote" clause reflects the current rule's application, which has excluded communications that do not "offer" advisory services

[54] *See supra* footnote 4.

from advertisements under rule 206(4)-1.[55] Such communications are still subject to the anti-fraud provisions in sections 206(1), (2), and (4) and rule 206(4)-8.

Unlike the "offer" clause, the "promote" clause is not included in the text of the current rule. We believe that it is appropriate to include in the proposed definition communications that promote advisory services because we believe that advertisements are generally considered to be promotional materials, even if the communication does not explicitly "offer" services.[56] Other rules governing financial firms similarly regulate "promotional" communications.[57]

Additionally, we believe that defining an "advertisement" as a communication that "offers or promotes" services would allow investment advisers to continue to deliver to existing investors account statements or transaction reports that are intended to provide only details regarding those accounts and investments without those communications being considered advertisements.[58] In the usual course, a communication to an existing investor about the

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55 For example, our staff has indicated that it would not recommend enforcement action under the current rule with respect to written communications by an adviser to an existing client about the performance of securities in the client's account because such communications would not be "offers" of advisory services, and instead are "part of" those advisory services (unless the context in which the communication is provided suggests otherwise). *See* Investment Counsel Association of America, Inc., SEC Staff No-Action Letter (Mar. 1, 2004) ("ICAA Letter").

56 *See SEC v. C.R. Richmond & Co.*, 565 F.2d 1101, 1105 (9th Cir. 1977) ("SEC v Richmond") ("Investment advisory material which promotes advisory services for the purpose of inducing potential clients to subscribe to those services is advertising material within [the current rule]."); s*ee also* Denver Investment Advisors, Inc., SEC Staff No-Action Letter (July 30, 1993) (indicating the staff's view that a communication provided to consultants, but not necessarily to prospective clients, to allow the consultants to evaluate the adviser as part of the consultants' own services to their own clients is an "advertisement" under the current rule because the communication is provided "for the ultimate purpose of maintaining existing clients and soliciting new ones"). *See also infra* section II.D (regarding the potential withdrawal of this letter).

57 *See, e.g.,* FINRA rule 2210(c)(3)(A) (requiring a member to file retail communications that "promote or recommend" certain investment companies); MSRB rule G-21(a) (defining "advertisement" as, in part, "any written or electronic promotional literature"); *see also* Amendments to Investment Company Advertising Rules, Release No. IC-26195 (Oct. 3, 2003) [68 FR 57760 (Oct. 6, 2003)] ("Final Investment Company Advertising Release") (noting that when an investment company offers its shares to the public, "its promotional efforts become subject to the advertising restrictions of the Securities Act").

58 Their exclusion from the proposed definition would not prevent these account statements or transaction reports from being subject to the other provisions of the Federal securities laws, including section 17(a) of

performance of the investor's account would not be for promoting the adviser's services or be used to obtain or retain investors.[59] Accordingly, we would not view information typically included in an account statement, such as inflows, outflows, and account performance, as qualifying as advertisements under the proposed rule.

In addition, we would not view materials that provide general educational information about investing or the markets as offering or promoting an adviser's services or seeking to obtain or retain investors. For example, an adviser that disseminates a newspaper article about the operation of investment funds or the risks of certain emerging markets would generally be circulating educational materials and not offering or promoting the adviser's own services.

However, investment advisers also may choose to deliver to existing investors communications that include promotional information that is neither account information nor educational material. Such additional promotional information may make the communication an advertisement, if that additional information "offers or promotes" the adviser's advisory services under the facts and circumstances. For example, a communication to existing investors that includes the adviser's own market commentary or a discussion of the adviser's investing thesis may be considered to be "offering or promoting" the adviser's services depending on the facts and circumstances of the relevant communication.[60]

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the Securities Act or section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") (and rule 10b-5 thereunder), to the extent those provisions would otherwise apply.

59 *See also* ICAA Letter (stating the staff's view that, "[i]n general, written communications by advisers to their existing clients about the performance of the securities in their accounts are not offers of investment advisory services but are part of the adviser's advisory services."). A communication to an existing investor in a pooled investment vehicle about the performance of the pooled investment vehicle would not be treated as promoting the adviser's services or be used to obtain or retain investors for purposes of rule 206(4)-1.

60 *See* ICAA Letter (indicating that where an adviser writes a letter that discussed its past specific recommendations concerning securities not held or not recently held by some of the clients to whom the letter was directed "would suggest that a purpose of the communication was to promote the advisory services of the adviser").

The proposed definition of "advertisement" includes communications disseminated "to obtain or retain" investors. We would expressly include communications that are intended to retain existing investors because communications to existing investors may be used to mislead or deceive in the same manner as communications to prospective investors.[61] Accordingly, we believe it is appropriate to regulate the use of such communications as a means reasonably designed to prevent fraudulent, deceptive, or misleading acts, practices, or courses of business.[62]

We request comment on this aspect of the proposed definition:

- Are there types of communications that "offer or promote" investment advisory services or that seek to "obtain or retain" investors that should not be treated as "advertisements"?
- Should the proposed rule address communications that "offer or promote" anything besides investment advisory services? Do investment advisers seek to "offer or promote" other goods or services that should be addressed explicitly in the proposed rule as an exclusion from the definition or otherwise? Should the definition be further limited to communications that offer or promote investment advisory services that "relate to securities"?

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61 Our staff has indicated its view that materials designed to maintain existing clients should be considered to be advertisements under the current rule's definition, *see* Munder Capital Management, SEC Staff No-Action Letter (May 17, 1996), and we are proposing to incorporate this approach in the proposed rule. *See also In re* Spear & Staff, Inc., Release No. IA-188 (Mar. 25, 1965) (settled order) ("Spear") (the Commission brought an enforcement action against investment adviser, asserting, in part, that the current rule applied to direct mail and newspaper advertising that the adviser conducted "[t]o induce persons to enter *or renew* subscriptions" for market letters containing the adviser's securities recommendations) (emphasis added); *SEC v. Richmond & Co.*, 565 F.2d at 1106 ("The court below found that [the adviser] advertised in a manner which led *clients and prospective clients* to believe that the use of [the adviser's] services would lead to imminent and sizable profits with minimum risks.") (emphasis added).

62 *See* Advertising Rule Adopting Release, *supra* footnote 5 ("The Commission believes that this rule, foreclosing the use of advertisements which have a tendency to mislead or deceive *clients or prospective clients*, is necessary to implement the statutory mandate contained in Section 206(4) of the Act, as amended.") (emphasis added).

- Should we clarify any specific indicia to determine whether investment advisory services are being "offered" or "promoted"? Are there any challenges that investment advisers might face in determining whether a communication is "offering or promoting" advisory services?
- The proposed rule would explicitly include communications meant to "retain" existing clients. Is it appropriate to treat communications as "advertisements" when the persons receiving them already are "clients" of the investment adviser and benefit from the other protections of the Federal securities laws? Similarly, is it appropriate to treat communications as "advertisements" when the persons receiving them already are investors in pooled investment vehicles advised by the investment adviser and benefit from applicable protections of the Federal securities laws?
- Should the proposed rule treat communications to existing investors differently from communications to prospective investors?
- Does the definition provide sufficient clarity to permit advisers to communicate with their existing investors about their accounts or about pooled investment vehicles in which they are invested, in the usual course of business without those communications being considered advertisements?

iv. Investors in pooled investment vehicles.

The proposed rule's definition would expressly include communications that are intended to offer or promote the investment adviser's investment advisory services provided indirectly to existing and prospective investors in a pooled investment vehicle advised by the investment

adviser,[63] subject to the exclusion for RICs and BDCs discussed below. This express inclusion of pooled investment vehicles is generally consistent with our approach in rule 206(4)-8 under the Advisers Act.[64] In particular, section 206(4) of the Advisers Act authorizes the Commission to adopt rules and regulations that "define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative."[65] We believe expressly applying the proposed rule to advertisements concerning pooled investment vehicles when used to obtain or retain investors in those vehicles would help expand protections to such investors, and not just to the adviser's "clients," which are the pooled investment vehicles themselves.[66]

We recognize that advisers to pooled investment vehicles are prohibited from making misstatements or materially misleading statements to investors in those vehicles under rule 206(4)-8,[67] and accordingly there may be some overlap between the prohibition in rule 206(4)-8 and the proposed rule. The proposed rule provides more specificity, however, regarding what we believe to be false or misleading statements that advisers to pooled investment vehicles must

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63 For this purpose, "pooled investment vehicle" would be defined in the same way as the definition in rule 206(4)-8 under the Investment Advisers Act of 1940. *See* proposed rule 206(4)-1(e)(9). Rule 206(4)-8 defines "pooled investment vehicle" 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." Rule 206(4)-8(b).

64 *See* Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Release No. IA-2628 (Aug. 3, 2007) [72 FR 44756 (Aug. 9, 2007)] ("Rule 206(4)-8 Adopting Release") ("The rule clarifies that an adviser's duty to refrain from fraudulent conduct under the federal securities laws extends to the relationship with ultimate investors and that the Commission may bring enforcement actions under the Advisers Act against investment advisers who defraud investors or prospective investors in those pooled investment vehicles.").

65 15 U.S.C. 80b-6(4).

66 *See Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006). There are circumstances under which an investor in a pooled investment vehicle is also a client of the investment adviser – for example, when the investor has its own investment advisory agreement with the investment adviser. Under those circumstances, communications to that person would also be addressed as "advertisements" under the proposed rule.

67 Rule 206(4)-8(a)(1).

avoid in their advertisements.[68] In particular, the proposed rule contains certain protective requirements, including for Non-Retail Persons that are invested in private funds.[69] We believe that these requirements, such as those regarding presentation of performance, would protect private fund investors. We believe that any additional costs to advisers to pooled investment vehicles as a result of potential overlap between the proposed rule and rule 206(4)-8 with respect to advertisements will be minimal, as an advertisement that would raise issues under rule 206(4)-8 might also raise issues under a specific provision of the proposed rule. We are proposing this rule under the same authority of section 206(4) of the Advisers Act on which we relied in adopting rule 206(4)-8.[70]

The proposed rule would exclude advertisements, other sales materials, or sales literature about RICs and BDCs that are within the scope of rule 482 or rule 156 under the Securities Act, as described below.[71] This would result in a departure from rule 206(4)-8, which applies to investment advisers with respect to any "pooled investment vehicle," including RICs and

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68 For example, rule 206(4)-8 prohibits investment advisers to pooled investment vehicles from engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle. The proposed rule would include more specific provisions in the context of advertisements. *See* proposed rule 206(4)-1(b) and 206(4)-1(c). To the extent that an advertising practice would violate a specific restriction imposed by the proposed rule, it is possible that such a practice may already be prohibited under rule 206(4)-8. Investment advisers to pooled investment vehicles may benefit from the clarity provided by the proposed rule, to the extent that it prohibits conduct that may otherwise be prohibited under the general principles of rule 206(4)-8. We request comment below on whether rule 206(4)-8 itself should be amended.

69 One commenter addressed private fund advertising in connection with the Commission's recent concept release on exempt offerings. *See* 2019 Concept Release, *supra* footnote 19; *see also* Comment Letter of the Investment Company Institute on the 2019 Concept Release (Sept. 24, 2019), at n.62 ("We recommend that the Commission adopt restrictions for private fund advertising beyond the anti-fraud requirements of Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder. If those regulations alone were enough to dispel investor confusion and prevent misleading solicitation, then the myriad rules and staff guidance applicable to regulated funds that the Commission and staff as well as FINRA have developed over decades would not be necessary.").

70 *See* Rule 206(4)-8 Adopting Release, *supra* footnote 64.

71 S*ee infra* section II.A.2.c.iii. The proposed rule would exclude from the "advertisement" definition only those communications within the scope of rule 482 or rule 156 under the Securities Act.

BDCs.[72] We are proposing to exclude certain communications about RICs and BDCs, which are already subject to specific restrictions and requirements for communications to their investors under the Securities Act and the Investment Company Act, including rules that cover the same areas addressed by the proposed rule and that are designed to protect investors in those funds. For example, rule 482 under the Securities Act and the applicable registration form impose specific requirements on the presentation and computation of performance results for certain registered funds.[73] Rule 156 under the Securities Act describes certain practices that may be misleading when used in sales literature in connection with the offer or sale of securities issued by an investment company.[74]

When we adopted rule 206(4)-8, we noted its similarity to existing anti-fraud laws and rules that "depending upon the circumstances, may also be applicable to the same investor communications," including those applicable to RICs and BDCs.[75] We expressed assurance that investment advisers to pooled investment vehicles would be able to comply with rule 206(4)-8 and those existing laws and rules, in part because rule 206(4)-8 was adopted to impose obligations similar to those imposed under sections 206(1) and 206(2) of the Advisers Act.[76] We also noted that "the nature of the duty to communicate without false statements [was] so well

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72 *See supra* footnote 63.

73 17 CFR 230.482(b)(3) (imposing disclosure requirements on advertisements that include performance data of an open-end management investment company or a trust account); 17 CFR 230.482(d) (imposing requirements on performance information in the case of an open-end management investment company or a trust account); 17 CFR 230.482(e) (imposing requirements on performance data for money market funds); 17 CFR 230.482(g) (establishing standards for the timeliness of performance data in advertisements).

74 17 CFR 230.156. *See also* 17 CFR 270.34b-1 (imposing requirements on sales literature for investment companies).

75 *See* Rule 206(4)-8 Adopting Release, *supra* footnote 64 (citing, in part, rule 156 under the Securities Act and section 34 of the Investment Company Act).

76 Rule 206(4)-8 Adopting Release, *supra* footnote 64 (noting that sections 206(1) and 206(2) were "commonly accepted as imposing similar requirements on communications with investors in a fund").

developed in current law" that the similar duty imposed by rule 206(4)-8 would neither be unduly broad nor have a "chilling effect" on investor communications.[77]

Rule 206(4)-8 establishes a broad anti-fraud standard on communications with investors in pooled investment vehicles, whether publicly or privately offered, that we believe can exist comfortably alongside the specific prohibitions and restrictions that govern the public offering of funds. The proposed rule, in contrast, applies specific prohibitions and restrictions that address the same areas already governed by specific requirements in rule 482 and rule 156. Accordingly, we believe excluding from the proposed rule certain communications about RICs and BDCs, as described below, is appropriate.

We request comment on the proposed definition of "advertisement" expressly including communications that are disseminated to obtain or retain "investors in pooled investment vehicles."

- Are there any particular burdens or difficulties that investment advisers may bear in treating as "advertisements" communications designed for investors in pooled investment vehicles – that is, investors who may not be clients of the investment advisers?
- Are there communications that investment advisers currently disseminate to investors in pooled investment vehicles that otherwise satisfy the proposed definition of "advertisement" but should not be treated as such? What types of communications, and why should they not be treated as advertisements?
- Would investment advisers to pooled investment vehicles prefer that we address our concerns regarding advertisements through an amendment to rule 206(4)-8 instead of through the proposed rule? For example, should we incorporate the proposed rule's

[77] *Id.*

requirements and prohibitions into rule 206(4)-8? Would there be any costs or benefits if we used that approach or a similar approach instead?

- Should the proposed rule apply to communications to investors in pooled investment vehicles other than those that are "pooled investment vehicles" as defined in rule 206(4)-8 – *e.g.*, funds that are excluded from the definition of "investment company" by reason of section 3(c)(5) or 3(c)(11) of the Investment Company Act? Which other vehicles, and why or why not? Should we consider not defining "pooled investment vehicle" for purposes of the proposed rule?[78] Why or why not?

### c. *Specific Exclusions*

The proposed rule would specifically exclude four types of communications from the definition of "advertisement": (i) non-broadcast live oral communications; (ii) responses to certain unsolicited requests; (iii) communications relating to RICs and BDCs; and (iv) information required by statute or regulation. Although these types of communications would not be "advertisements" for purposes of the proposed rule, they would remain subject to all other applicable provisions in the Advisers Act and the rules thereunder and other applicable provisions of the Federal securities laws.[79]

#### i. Non-broadcast live oral communications

We are proposing to exclude from the definition of "advertisement" live oral communications that are not broadcast on radio, television, the internet, or any other similar

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78 *See, e.g.,* rule 206(4)-2(a)(5).

79 In particular, any such communication to a client or prospective client would remain subject to the general anti-fraud prohibitions of section 206 of the Advisers Act. In addition, communications that are excluded from the definition of "advertisement" would remain subject to any other applicable provisions in the Federal securities laws. *See, e.g.*, 15 U.S.C. 77q(a); 15 U.S.C. 78(j)(b); 17 CFR 240.10b-5.

medium. If such communications are broadcast, for example by webcast, social media, video blog, or similar media, they would be "advertisements" under the proposed rule's definition.

This proposed exclusion is generally consistent with the approach under the current rule's definition of "advertisement," which also excludes oral communications that are not "on radio or television."[80] However, the proposed definition of "advertisement" is broader than the current rule's definition because it would capture oral communications that are widely disseminated, or "broadcast," not just via radio or television (as under the current rule), but also via "the internet or any other similar medium."[81] We believe this broader definition is appropriate in light of the continuously evolving means of mass communication available to advisers and should allow the proposed rule to remain evergreen in light of changing technologies. Accordingly, the proposed exclusion would not apply to communications that are "broadcast," or widely disseminated. For example, an adviser that engages in a "Facebook Live" Q-and-A session that is available to the general public would be "broadcasting" the communication on the internet and that communication would not qualify for the proposed exclusion. Alternatively, a "Facebook Live" Q-and-A session that is available only to one person or a small group of people invited by the adviser would not be "broadcast" and so would qualify for the proposed exclusion.

We have also proposed to limit the exclusion to "live" oral communications to ensure that previously recorded oral communications are included in the proposed definition of

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80 *See, e.g.,* rule 206(4)-(1)(b).

81 Rule 206(4)-1(b) (defining as an advertisement certain notices or other announcements "by radio or television"). *See* ICAA Letter (stating the staff's view that "[t]he rule also applies to announcements in publications and to radio and television broadcasts, but does not apply to any other oral communications"). For the reasons discussed in this release, the Commission is proposing a different approach. As discussed in Section II.D., staff in the Division of Investment Management is reviewing staff no-action and interpretative letters to determine whether any such letters should be withdrawn in connection with any adoption of this proposal. If the rule is adopted, some of the letters may be moot, superseded, or otherwise inconsistent with the rule and, therefore, would be withdrawn.

"advertisement." The live oral communication exclusion is designed to address situations where advisers are communicating to investors directly and where employee review and the other provisions of the proposed rule cannot be practically applied.[82] In cases where an adviser pre-records a message and then disseminates it, such a message would not be "live" and thus should be treated as an advertisement if it otherwise meets the requirements of the proposed definition.[83] Similarly, any script or storyboards, or other written materials prepared in advance for use during a live oral communication, as well as any slides or other written materials presented alongside or distributed as part of the live oral communication, would fall within the proposed definition of "advertisement" if those materials otherwise meet the definition of "advertisement."[84] We believe that prepared written materials intended for use during a live oral communication are eligible for pre-use review and approval and should be subject to the other requirements of the proposed rule.

The proposed rule's definition of "advertisement" would include any communication that meets the proposed definition's criteria without regard to the number of people to whom the communication is addressed. This differs from the definition in the current rule, which includes written communications "addressed to more than one person." The Commission limited the definition of "advertisement" in the current rule because of concerns that a broad definition could encompass even "face to face conversations between an investment counsel and his prospective

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82 *See infra* section II.A.7 (discussing proposed employee review requirements). Communication need not be made "face-to-face" to qualify for the exclusion so long as it is live and oral. For example, a phone call or FaceTime communication between an adviser and a client could qualify for this exclusion.

83 However, a voicemail message would qualify for the proposed exclusion (and thus would not be an advertisement), if the voicemail message was made "live" and the recording is not further disseminated by or on behalf of the adviser.

84 This approach would mirror that under FINRA rule 2210(f), which distinguishes between certain public communications, including any "radio or television interview," and the "scripts, slides, handouts or other written (including electronic) materials used in connection with" such communications. *See* FINRA Rule 2210(f)(1) and (f)(4); *see also supra* footnote 57 and accompanying text.

client."[85] The Commission stated in proposing the current rule's definition that it would not include a "personal conversation" with a client or prospective client.[86] As discussed above, we believe that by excluding live oral communications that are not broadcast, the proposed rule would retain advisers' ability to have these face-to-face communications with investors.[87]

At the same time, we recognize that the proposed rule could affect the ability of advisers to communicate directly with investors in writing, to the extent those writings are promotional. We considered excluding from the definition of "advertisement" any communication disseminated to only one person. However, we are concerned that this approach could allow the types of misleading communications we seek to prevent. For example, changes in technology now permit advisers to create communications that appear to be personalized to single clients and are "addressed to" only one person, but are actually widely disseminated to multiple persons.[88] The proposed rule therefore would prevent an adviser from communicating performance advertising solely to one person in writing outside the scope of the rule. To address the potential burdens that would arise from the proposed definition's inclusion of all one-on-one written communications that meet the proposed definition of advertisement, the proposed rule's internal review and approval requirements would not apply to these written communications.[89]

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85 *See* Prohibited Advertisements, Release No. IA-119 (Aug. 8, 1961) [26 FR 7552, 7553 (Nov. 15, 1961)].

86 *Id.*

87 In addition, we believe an adviser's ability to communicate directly with existing clients and investors would be preserved to the extent such communications do not "offer or promote" the adviser's services. *See supra* footnote 59 and accompanying text.

88 For example, advisers today, like any other marketers, may be able to identify a group of prospective investors who have searched online for specific information about investment advice and then craft communications for those prospective investors that nominally are addressed to individual persons despite being otherwise identical to communications disseminated to the rest of the group. These types of communications, such as bulk emails or algorithm-based messages, are widely disseminated in the aggregate even though individually each is nominally directed at or "addressed to" one person.

89 *See* proposed rule 206(4)-1(d)(1) (excepting "communications that are disseminated only to a single person or household or to a single investor in a pooled investment vehicle"); *see also infra* section II.A.7. Widely

In addition, we recognize that applying the employee review and approval provisions of the proposed rule to live oral communications that are broadcast may not be practical. Accordingly, as discussed below, we are proposing to except live oral communications that are broadcast from the employee review and approval provisions, much as we are proposing to except one-on-one communications.[90] However, as discussed above, any script, storyboards, or other written materials prepared in advance for use during a broadcast live oral communication would fall within the proposed definition of "advertisement" if those materials otherwise meet the definition of "advertisement," and we are not proposing to except such materials from the review process.

We considered including in the proposed definition of "advertisement" oral communications made by an investment adviser in non-broadcast public appearances, for example, an unscripted talk at a luncheon or a conference appearance. We recognize that excluding such public oral communications from the proposed definition of "advertisement" may result in many commonly used forms of promotional communication not being subject to the protections and requirements of the proposed rule. However, we believe that including such public appearances as advertisements could pose compliance difficulties, for example, maintaining records of the speech or applying the other substantive requirements of the proposed rule to such unscripted remarks.[91] Accordingly, the proposed rule would exclude these public

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disseminated communications (even if they appear to be personalized), however, would not qualify for the one-on-one exception to the review requirement. *See supra* footnote 88 and accompanying text.

90 *See infra* section II.A.7.

91 In addition, although not included within the proposed definition of "advertisement," statements made during such live broadcasts would continue to be subject to the general anti-fraud prohibitions of section 206 of the Advisers Act and the relevant Federal securities laws.

appearances only to the extent they satisfy the requirements of the non-broadcast live oral communication exclusion.

We request comment on the proposed exclusion for non-broadcast live oral communications.

- As proposed, should we exclude live oral communications that are not broadcast from the definition of "advertisement"? Should we extend the exclusion to live oral communications that are broadcast?
- As proposed, should we expand the types of broadcast communication methods included to the internet and other similar methods (along with radio and TV as under the current rule)?
- Are we correct that "broadcast" should be interpreted as "widely disseminated"? Why or why not? Should we further define what qualifies as a "broadcast" communication? If so, how should we define it?
- What issues may result from the proposed exclusion of live oral communications that are not broadcast? In particular, what issues may result with respect to unscripted public appearances? If we were to include such unscripted public appearances in the definition of "advertisement," would that create unique compliance difficulties, such as recordkeeping issues? If so, should we address those difficulties through an exception to the recordkeeping requirement for unscripted public appearances? How should we define such an unscripted public appearance?

- We believe our approach to oral communications is conceptually similar to FINRA's approach to "public appearances" in rule 2210,[92] which generally subjects members' unscripted public appearances to only the rule's general content standards,[93] and requires members to comply with all applicable provisions of the rule for any scripts, slides, handouts, or other written materials used in connection with the public appearance. Do commenters agree? Should the rules apply more similarly in this respect? Would another existing regulation provide an approach to such "public appearance" communications that we should consider for such an exclusion?
- Should we subject public appearance communications to the content provisions of the proposed rule, even if they are not defined as "advertisements"? Should we define such public appearance communications as "advertisements," but subject them only to a more limited set of requirements, such as just the proposed rule's general prohibitions but not the review requirement?

ii. Response to unsolicited request.

The proposed rule would exclude from the definition of "advertisement" any communication by an investment adviser "that does no more than respond to an unsolicited request" for "information, specified in such request, about the investment adviser or its services" other than a communication to a Retail Person that includes performance results or a communication that includes hypothetical performance. Specifically, neither a communication to a Retail Person that includes performance results nor a communication to any person that

92 FINRA rule 2210(f)(1).

93 FINRA rule 2210(d)(1).

includes hypothetical performance would qualify for this exclusion.[94] We believe this exclusion would appropriately allow persons affirmatively seeking specified information about an investment adviser or services to obtain that information when the investment adviser has not directly or indirectly solicited the request.[95]

In the case of an unsolicited request, an investor seeks specified information for that requester's own purposes, rather than responding to a communication disseminated by an adviser for the adviser's purpose of offering or promoting its services. The proposed exclusion would recognize this difference in the goal of the communication. In addition, the investment adviser's communication would be limited by the information requested and the fact that the investor has already established the parameters of the information he or she needs.[96]

The unsolicited request exclusion would not apply to a communication to a Retail Person to the extent it contains performance results.[97] As discussed below, the proposed rule would provide additional requirements and restrictions for presenting performance results because performance advertising raises special concerns.[98] To help ensure that Retail Persons receive the benefits of those requirements and restrictions, any communication to Retail Persons containing performance results would not qualify for the unsolicited request exclusion with respect to such

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94 Proposed rule 206(4)-1(e)(1)(ii).

95 Persons may seek information through, for example, requests for proposal, due diligence questionnaires, and requests for information. Information under this exclusion could also include unsolicited requests for information about an adviser's services, such as information about funds that it advises or its non-security related planning services.

96 Our approach to this proposed exclusion is consistent with our staff's past approach when considering whether or not to take a no-action position in the context of past specific recommendations and testimonials. *See, e.g.,* ICAA Letter.

97 Proposed rule 206(4)-1(e)(1)(ii)(A).

98 *See infra* section II.A.5.

results.[99] Accordingly, any such performance results that also met the definition of "advertisement" would be subject to the requirements of the proposed rule. Similarly, because of the specific concerns raised by hypothetical performance, communications to any person that contain hypothetical performance would not qualify for the unsolicited request exclusion to the extent it contains such results. Instead, communications with hypothetical performance must be presented in accordance with the requirements discussed below.

In addition, if the adviser were to include additional information beyond what was specifically requested, that additional information would not qualify for the exclusion if the additional information met the definition of "advertisement." However, if the only additional information the adviser includes is information necessary to make the requested specified information not misleading, the additional information would not render the communication or that additional information an advertisement.

Finally, the unsolicited request exclusion would not apply to requests for information that are solicited by the investment adviser.[100] For example, any affirmative effort by the investment adviser intended or designed to induce an existing or prospective client or investor to request specified information would render the request solicited. In that case, a person requesting the information would be acting out of interest raised by the investment adviser, and the request would not be "unsolicited." And, if the investment adviser subsequently disseminates a

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99 The unsolicited request exclusion would not oblige the investment adviser to generate the requested information. The exclusion simply would allow investment advisers to provide requested information, if available, in response to unsolicited requests, without such information being considered an "advertisement."

100 It is not our intent to disqualify from this exclusion every inquiry from an investor who was referred to the adviser by a solicitor *because* the investor was solicited. The act of soliciting under our proposed solicitation rule is separate and distinct from a client making an unsolicited request for information under the proposed advertising rule. Thus a client who was solicited to be a client may still make requests for specified information so long as that *specific request* was not solicited by the adviser or solicitor.

communication that qualifies for this exclusion to one or more other persons who do not make their own unsolicited requests, that same communication would not meet the exclusion's requirements with respect to those other persons.

We request comment on the proposed unsolicited request exclusion.

- Would the proposed unsolicited request exclusion have our intended effect of allowing persons requesting specified information from an investment adviser to receive that information? Is there an alternative approach to this exclusion that would better produce this intended effect? Would an alternative approach be more successful in preventing investment advisers from disseminating misleading or deceiving information?
- Are there types of information that an investment adviser should be prohibited from disseminating even in response to an unsolicited request? For example, should an adviser be prohibited from disseminating any advertisement that would, but for this exclusion, be prohibited by the proposed rule or the current rule? Should an adviser be prohibited from disseminating materials that are subject to any of the *per se* prohibitions in the current rule?
- Should the unsolicited request exclusion apply to communications presenting performance results to Retail Persons? Should it apply to communications presenting performance results to any person, not just Retail Persons? Why or why not? Would it be appropriate to exclude such communications from certain requirements of the proposed rule? Why or why not?
- Should the unsolicited request exclusion apply to communications that include hypothetical performance? Why or why not? Alternatively, should communications including hypothetical performance qualify for the unsolicited request exclusion if such

communications are provided only to Non-Retail Persons or only to Retail Persons? Why or why not? Would it be appropriate to exclude such communications from certain requirements of the proposed rule? Why or why not?

- Are there other specific types of information that should be treated as an "advertisement" even in response to an unsolicited request?
- Should we provide in this exclusion additional flexibility for advisers to provide information in addition to the "specified information" sought by the requester, when the adviser determines that such information would be necessary to prevent the information provided from being false or misleading? Should we provide additional guidance regarding the term "specified information"? If so, what additional guidance should we provide?
- Should we clarify any specific criteria by which an investment adviser can determine whether a request is "unsolicited" for purposes of the unsolicited request exclusion?
- Should we take the position that an existing or prospective client or investor may submit an unsolicited request to an investment adviser through an intermediary – for example, a consultant for the investment adviser or the requester?

iii. Advertisements, other sales materials, and sales literature of RICs and BDCs.

We are proposing to exclude from the definition of "advertisement" any advertisement, other sales material, or sales literature about a RIC or a BDC that is within the scope of rule 482 or rule 156 under the Securities Act.[101] As discussed above, this RIC and BDC exclusion would

[101] Proposed rule 206(4)-1(e)(1)(iii). For example, to the extent that a RIC's statutory and summary prospectus, annual and semi-annual report, and statement of additional information are within the scope of rule 156 under the Securities Act, they would not be advertisements under the proposed definition.

acknowledge that advertisements, other sales materials, and sales literature about RICs and BDCs are regulated under the Securities Act and Investment Company Act and subject to the specific prescriptions of the rules and forms adopted thereunder.[102] Those rules generally are consistent with the principles underlying the proposed rule.

The RIC and BDC exclusion would not encompass any communication by an investment adviser of a RIC or a BDC with respect to other advisory services or products offered by that adviser. Thus, a communication that does not satisfy the RIC and BDC exclusion but is otherwise an "advertisement" would still be subject to the proposed rule's requirements. For example, the exclusion would not extend to a communication by an investment adviser of a RIC or BDC if that communication is not within the scope of rule 482 or rule 156. Similarly, the exclusion would not extend to a communication by an investment adviser of a RIC or BDC to an investor in a pooled investment vehicle advised by the investment adviser when that communication is not within the scope of rule 482 or rule 156. The RIC and BDC exclusion is intended simply to allow advisers to RICs and BDCs, and affiliates of those advisers, to prepare their advertisements, other sales materials, and sales literature in connection with RICs and BDCs in accordance with the relevant rules and forms under the Securities Act and Investment Company Act.

We request comment on the proposed RIC and BDC exclusion.

- Are there communications with respect to RICs and BDCs that should be subject to the proposed rule? If so which communications and why?

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[102] *See* Request for Comment on Fund Retail Investor Experience and Disclosure, Release No. 33-10503 (June 5, 2018) [83 FR 26904 (June 11, 2018)]. We recently sought public comment from individual investors and other interested parties on enhancing investment company disclosures to improve the investor experience and to help investor make more informed investment decisions. *Id.* In that request for comment, we specifically sought comments with respect to rule 482 under the Securities Act.

- Is the description of the materials that are eligible for this RIC and BDC exclusion clear?
- Are there any restrictions that apply to RICs or BDCs under the Securities Act or the Investment Company Act and the rules thereunder that should be incorporated into the proposed rule?
- Should the scope of the exclusion include other fund communications that may not be subject to rule 156 or 482? For example should the annual reports of a closed-end fund that is not offering shares be included as an advertisement or excluded? Should we extend the scope to specifically exclude from the definition of "advertisement" any fund communication that is filed or deemed filed with the Commission for any reason?

iv. Information Required by Statute or Regulation

We are proposing to exclude from the definition of "advertisement" any information required to be contained in a statutory or regulatory notice, filing, or other communication – for example, information required by Part 2 of Form ADV or Form CRS.[103] This exclusion would apply to information that an adviser is required to provide to an investor under any statute or regulation under Federal or state law.[104] We do not generally believe that communications that are prepared as a requirement of statutes or regulations[105] should be viewed as advertisements under the proposed rule.[106] However, if an adviser includes in such a communication

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103 *See* proposed rule 206(4)-1(e)(1)(iv).

104 To the extent information is required by regulation to be provided in a non-public filing with a regulatory agency, then this exclusion may not apply. At the same time, such information would not be an "advertisement" under the proposed rule if the information does not offer or promote the adviser's services or seek to obtain or retain investors – and so the adviser would not need to rely on the exclusion.

105 *See, e.g.,* rule 204-3 (requiring registered investment advisers to deliver a brochure and one or more brochure supplements to each client or prospective client).

106 However, information that is required to be provided or offered by the proposed advertising rule would not qualify for this proposed exclusion. For example, the schedule of fees and expenses required to be provided under the proposed rule would be part of the advertisement and subject to the proposed rule. *See,*

information that is neither required under applicable law nor required by the proposed rule, and such additional information "offers or promotes" the adviser's services, then that information would be considered an "advertisement" for purposes of the proposed rule.[107] We request comment on this proposed exclusion.

- Is the description of the information eligible for this exclusion clear?
- Should any information required to be contained in a statutory or regulatory notice, filing, or other communication be advertisements under the rule? Should any such documents or other communications be considered to "offer or promote" advisory services?
- Would this proposed exclusion create any compliance difficulties for investment advisers? What types of difficulties and how should we address them? Are there specific notices, filings, or other communications that are required of investment advisers by statute or regulation and that would be affected by this proposed exclusion?
- Considering that there may be additional legal duties or liability that attach to documents filed with regulatory bodies, should we exclude from the definition of "advertisement" all legally required filings regardless of content?

We also request comment on all aspects of the proposed exclusions from the definition of "advertisement."

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*e.g.,* proposed rule 206(4)-1(c)(1)(i) (requiring an advertisement to provide or offer to provide promptly a schedule of certain fees and expenses as a condition of presenting gross performance).

[107] For example, Item 5.A of Part 2 of Form ADV requires investment advisers to describe how they are compensated for their advisory services. If an investment adviser completes that requirement by describing how its fee structure compares favorably to the fee structure of other investment advisers, then we would view that comparison as information "offering or promoting" the investment adviser's services. Such a comparison to other investment advisers is not required by the terms of Item 5.A., even though such a comparison is permitted in responding to Item 5.A. *See* Instructions for Part 2A of Form ADV, Instruction 12 (permitting the inclusion of information not required by an Item as long as the response does not include so much additional information that the required information is obscured).

- Do the proposed exclusions sufficiently describe the types of communications that should not be subject to the requirements of the proposed rule? Are there types of communications that should not be subject to the requirements of the proposed rule but do not satisfy the conditions of any of the proposed exclusions? For example, should we provide an exclusion for all one-on-one communications made by an adviser to its clients, including communications in writing? Conversely, do the listed exclusions exclude communications that should be subject to the requirements of the proposed rule?
- Would any of the proposed rule's exclusions allow communications that are subject to the current rule's definition of "advertisement" to be excluded from the proposed rule's definition of "advertisement"? Conversely, are there communications that commenters believe are not subject to the current rule's definition of "advertisement" that would not satisfy the conditions of any of the proposed exclusions?

### 3. General Prohibitions

The proposed rule contains general prohibitions of certain advertising practices as a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts.[108] To establish a violation of the proposed rule, the Commission would not need to demonstrate that an investment adviser acted with scienter; negligence is sufficient.[109]

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108 Proposed rule 206(4)-1(a).

109 *See* SEC v. Steadman, 967 F.2d 636, 647 (D.C. Cir. 1992). As we noted when we adopted rule 206(4)-8, the court in *Steadman* analogized section 206(4) of the Advisers Act to section 17(a)(3) of the Securities Act, which the Supreme Court had held did not require a finding of scienter (*citing* Aaron v. SEC, 446 U.S. 680 (1980)). *See also Steadman* at 643, n.5. In discussing section 17(a)(3) and its lack of a scienter requirement, the *Steadman* court observed that, similarly, a violation of section 206(2) of the Advisers Act could rest on a finding of simple negligence. *See also* Standard of Conduct Release, *supra* footnote 23, at n.20.

We discuss below each of these practices, and the reasons we believe they should be prohibited.[110] We developed the proposed list of prohibited practices from our experience with the current rule, our review and consideration of investment adviser advertisements, FINRA rule 2210,[111] Securities Act rule 156, and our experience with private fund advertising practices. Rule 156 identifies certain pertinent factors that may be relevant to the question of whether a particular statement is, or might be, misleading in investment company sales literature.[112]

### a. *Untrue statements and omissions*

The proposed rule prohibits advertisements that include any untrue statements of a material fact, or that omit a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading.[113] This provision of the proposed rule retains the substance of current rule 206(4)-1(a)(5), which prohibits an advertisement that contains any untrue statement of a material fact and uses similar wording as other anti-fraud provisions in the Federal securities laws.[114] As with similar anti-fraud provisions in the securities laws, whether a statement is false or misleading depends on the context in which the statement or omission is made. For example, as under the current rule, advertising that an

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110 We believe these practices, which are each discussed in detail below, are associated with a significant risk of being false or misleading. We therefore believe it is in the public interest to prohibit these practices, rather than permit them subject to specified conditions.

111 FINRA rule 2210 contains content standards that prohibit misleading claims or statements in certain communications.

112 Rule 156 describes statements, representations, illustrations, and other information found in fund sales literature that could be considered false or misleading in violation of the anti-fraud provisions in the securities laws applicable to sales of funds. 17 CFR 230.156. In the proposing and adopting releases for rule 156, the Commission explained that rule 156 is not a "legislative rule designed to prescribe law or policy." The releases emphasize that the rule's general prohibition against the use of misleading sales literature "merely reiterated pertinent statutory provisions of the federal securities laws applicable to sales literature" and that the factors found in rule 156 are "particular factors which could be among those considered" when determining whether a statement is false or misleading. Mutual Fund Sales Literature Interpretive Rule, Release Nos. 33-6140 and 34-16299 (Nov. 6. 1979).

113 *See* proposed rule 206(4)-1(a)(1).

114 *See, e.g.*, 17 CFR 240.10b-5; 15 U.S.C. 77q(a)(2); 17 CFR 230.156(a); rule 206(4)-8.

adviser's performance was positive during the last fiscal year may be misleading if the adviser omitted that an index or benchmark consisting of a substantively comparable portfolio of securities experienced significantly higher returns during the same time period. To avoid making a misleading statement, the adviser in this example could include the relevant index or benchmark or otherwise disclose that the adviser's performance, although positive, significantly underperformed the market.

The current rule contains an explicit prohibition on advertisements that contain statements to the effect that a report, analysis, or other service will be furnished free of charge, unless the analysis or service is actually free and without condition.[115] We believe that this practice would be captured by the proposed rule's prohibition on untrue statements or omissions. As a result, the proposed rule would not contain a separate explicit prohibition of such statements.

We request comment on this proposed prohibition of untrue statements and omissions.

- As discussed above, such provisions appear in other areas of the securities laws, including rule 206(4)-8. Are there any particular aspects specific to its application to the proposed advertising rule that would need clarification?
- Do commenters agree that the proposed rule's prohibition of untrue statements or omissions captures the current rule's explicit prohibition of advertisements that contain statements to the effect that a report, analysis, or other service will be furnished free of charge, unless the analysis or service is actually free and without condition, or should such prohibition continue to be explicit? If not, why?

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115 *See* current rule 206(4)-1(a)(4); *see also* Dow Theory Forecasts, Inc., SEC Staff No-Action Letter (May 21, 1986) ("Dow Theory Letter") (staff declined to provide no-action recommendation where an offer for "free" subscription was subject to conditions).

### b. *Unsubstantiated material claims and statements*

The proposed rule also prohibits advertisements that include any material claim or statement that is unsubstantiated.[116] This provision would prohibit as misleading, for example, statements about guaranteed returns and claims about the adviser's skills or experience that the adviser cannot substantiate. Rule 156 and FINRA rule 2210 both contain a similar provision.[117] In particular, rule 156 provides that a statement about the characteristics of an investment company could be misleading because of exaggerated or unsubstantiated claims about management skill or techniques, characteristics of the investment company or an investment in securities issued by such company, service, security of investment or fund, effects of government supervision, or other attributes.[118] We believe that prohibiting advisers from making any material claim that is unsubstantiated when promoting their services is appropriate and not overly broad or burdensome.

Today an adviser's use of graphs, charts, or formulas is explicitly prohibited in the current rule absent certain disclosures.[119] Under the proposed rule's prohibition against unsubstantiated material claims and statements, it may be false or misleading to imply or state in an advertisement that any graph, chart, or formula can by itself be used to determine which securities to buy or sell, depending on the disclosures provided and the extent to which an adviser in fact does provide investment advice solely based on such materials.[120]

We request comment on this application of the general prohibition.

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116 Proposed rule 206(4)-1(a)(2).

117 Rule 156(b)(3)(ii). FINRA rule 2210(d)(1)(A) (stating that no member may make any false, exaggerated, unwarranted, promissory, or misleading statement or claim in any communication).

118 Rule 156(b)(3)(ii).

119 *See* current rule 206(4)-1(a)(3) (requiring that the investment adviser also disclose in any such advertisements the limitations and difficulties with regard to such use).

120 *Id*.

- Should we take a similar approach to rule 156 and specify the particular attributes to which the standard would apply (*e.g.*, claims about an investment adviser's management skills or techniques, services, or other attributes)? If so, why? To which particular characteristics or attributes should the provision apply and how?
- Do commenters believe that statements about the characteristics of an investment adviser are useful in advertisements? How difficult is it to substantiate these types of statements?
- Is the prohibition on unsubstantiated claims necessary?
- We believe exaggerated claims or statements of material fact would be prohibited under the proposed rule.[121] However, should we explicitly prohibit exaggerated claims or statements, consistent with rule 156 and FINRA rule 2210?
- Should we retain the current rule's explicit prohibition on advertisements that represent that any graph, chart, or formula can by itself be used to determine which securities to buy or sell, or when to buy or sell them? If so, should we modify it? Are there practices that are prohibited under the current provision that would not be covered by the proposed prohibition or other prohibitions in the proposed rule?
- Should we modify this application of the general prohibition in any way for advisers with algorithms or other methodologies that may be considered formulas?

#### c. *Untrue or misleading implications or inferences*

We are also proposing to prohibit any advertisement that includes an untrue or misleading implication about, or is reasonably likely to cause an untrue or misleading inference

[121] *See* proposed rule 206(4)-1(a)(1) and (3).

to be drawn concerning, a material fact relating to an investment adviser.[122] For example, this provision would prohibit an adviser from making a series of statements in an advertisement that are literally true when read individually, but whose overall effect creates an untrue or misleading implication about the investment adviser.[123] Another example of an untrue or misleading inference would be an advertisement that includes a single investor testimonial stating that investor's account was profitable, which is factually true for that particular investor but nonetheless atypical among all the adviser's investors. If the communication did not disclose the extent to which most other investor accounts were not profitable, this testimonial would create an untrue or misleading impression about the adviser's performance history.[124] Additionally, an advertisement that states an adviser was rated "the top investment adviser" by a publication would create a misleading inference if the adviser omitted the fact that this was a group rating, and several other investment advisers rated by the publication achieved the same rating. As discussed in further detail in section II.A.3.e. below, we believe this provision (along with other provisions discussed below) would prohibit "cherry picking" of past investments or investment

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122 Proposed rule 206(4)-1(a)(3). Staff has previously provided its views regarding when an advertisement would be otherwise false or misleading under section (a)(5) of the current rule. *See, e.g.,* Clover Capital Mgmt., Inc., SEC Staff No-Action Letter (Oct. 28, 1986) (stating the use of performance results in an advertisement in the staff's view would be false or misleading if it implies, or a reader would infer from it, something about the adviser's competence or about future investment results that would not be true had the advertisement included all material facts) ("Clover Letter"); Stalker Advisory Services, SEC Staff No-Action Letter (Jan. 18, 1994) (stating that copies of articles printed in independent publications that contain performance information of an adviser would be prohibited if they implied false or misleading information absent additional facts) ("Stalker Letter"); F. Eberstadt & Co., Inc., SEC Staff No-Action Letter (Jul. 2, 1978) (stating that advertisements could be misleading if they imply positive facts about the adviser when additional facts, if also provided, would cause the implication not to arise) ("Eberstadt Letter").

123 *See* Spear, *supra* footnote 61 (the Commission brought an enforcement action against an investment adviser, asserting, in part, that the adviser's advertisements, which recounted a number of factually accurate stories highlighting the outstanding investment success of certain selected clients collectively created "illusory hopes of immediate and substantial profit").

124 *See infra* section II.A.4.b.

strategies of the adviser – that is, including favorable results while omitting unfavorable ones in a manner that is not fair and balanced.

We request comment on this provision.

- Do commenters agree with including this provision? Is this provision necessary, or do the other provisions of section 206(4)-1(a) of the proposed rule effectively prohibit conduct such as cherry picking?
- Should we consider limiting this provision? For example, should the prohibition be limited to untrue statements or misleading inferences concerning the adviser's competence or skills or the experience of investors?
- Do commenters agree that this proposed prohibition would help limit cherry picking in advertisements? If not, how should the proposed prohibition be modified to limit cherry picking in advertisements?

#### d. *Failure to disclose material risks or other limitations.*

The proposed rule prohibits advertisements that discuss or imply any potential benefits connected with or resulting from the investment adviser's services or methods of operation without clearly and prominently[125] discussing associated material risks or other limitations associated with the potential benefits.[126] Rule 156 and FINRA rule 2210 contain similar provisions.[127] We believe that in advertising their services, advisers might be incentivized to make, and investors might be misled by, statements that highlight financial upside and gain,

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125 The Commission has used a similar "prominent" standard in other rules and forms. For example, Form N-1A requires that open-end management companies disclose certain information on their websites in a "clear and prominent format." *See* Form N-1A Item 12(a)(5).

126 *See* proposed rule 206(4)-1(a)(4).

127 *See* rule 156(b)(3)(i); FINRA rule 2210 (d)(1).

without discussing the attendant risks or other limitations. Accordingly, we believe it is appropriate to prohibit the practice under the proposed rule.

The proposed requirement to "clearly and prominently" disclose material risks would necessitate formatting and tailoring based on the form of the communication. For example, an advertisement intended to be viewed on a mobile device may meet the standard in a different way than one intended to be seen as a print advertisement. For instance, a person viewing a mobile device could be automatically redirected to the required disclosure before viewing the substance of an advertisement. However, it would not be consistent with the clear and prominent standard to merely include a hyperlink to disclosures available elsewhere.[128] For example, a post on social media advertising the benefits of an adviser's investment methods, but which only included relevant disclosures about the material risks in a hyperlinked "additional information available here" or similar web link, would not meet this standard. Such hyperlinked disclosures may not be seen or read by investors, as they may not click through to the additional information necessary to make an informed decision.

We request comment on this aspect of the proposed prohibitions.

- Should the proposed rule contain additional specifications regarding the required disclosure (*e.g.*, requiring the disclosure to be of equal prominence in size and location to discussion of potential benefits)?
- The proposed rule would require that investment advisers disclose "associated material risks or other limitations associated with the potential benefits." Is the

[128] However, it may be consistent with the clear and prominent standard if the adviser has reasonable assurance that the investor will access or otherwise view the disclosures, such as by providing them before the relevant content and requiring the investor to acknowledge their review before accessing the substance of the advertisement.

proposed approach too narrow? For example, should the provision require advisers to disclose all material risks, and not just those associated with potential benefits?

- Should the rule identify specific risks that any advertisement must address to be considered not misleading? For example, should it require disclosure that provides balanced treatment of risks and potential benefits, consistent with the risks related to fluctuating prices and the uncertainty of dividends, rates of return and yield, as is required by FINRA rule 2210(d)(1)(D)?
- Should the rule provide additional details on how an advertisement could meet the clear and prominent standard?
- Should the rule permit hyperlinked disclosures in cases where the adviser can be assured that the investor has accessed the information? How should an adviser be able to do so?
- Should the rule permit hyperlinked disclosures subject to other conditions? If so, what types of conditions could ensure that the disclosure meets the clear and prominent standard? How do advisers believe they could meet the clear and prominent standard in mobile communications, social media posts, or other space-limited media? The FTC provides guidance on how to make effective disclosures through hyperlinks, which provide that if a hyperlink: (i) is obvious; (ii) is labeled to appropriately convey the importance, nature, and relevance of the disclosures it leads to; (iii) is placed as close as possible to the relevant information it qualifies; and (iv) takes investors directly to the relevant disclosures on the click-through

page, that such hyperlinked disclosures may be effective.[129] Should we consider imposing similar requirements on an adviser's use of hyperlinked disclosures?

### e. *Anti-Cherry Picking Provisions: References to Specific Investment Advice and Presentation of Performance Results*

The proposed rule contains two other provisions designed to address concerns about investment advisers' potentially cherry-picking information that is presented to investors in advertisements.

#### i. References to Specific Investment Advice

The proposed rule would prohibit a reference to specific investment advice where such investment advice is not presented in a manner that is fair and balanced.[130] The factors relevant to when a presentation of specific investment advice is fair and balanced, as well as certain examples, are discussed below.

Consistent with the current rule, this prohibition is intended to address concerns of advisers presenting "cherry-picked" advice that they have provided on specific investments. When the Commission adopted the current rule's general prohibition of past specific recommendations, it expressed concern about the "inherently misleading" nature of advertisements that include references to past specific profitable recommendations, while omitting other recommendations that were not profitable.[131] The Commission believed that

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129 *See* Federal Trade Commission, ".com Disclosures: How to Make Effective Disclosures in Digital Advertising," press release (March 2013), *available at* https://www.ftc.gov/sites/default/files/attachments/press-releases/ftc-staff-revises-online-advertising-disclosure-guidelines/130312dotcomdisclosures.pdf

130 *See* proposed rule 206(4)-1(a)(5). The wording "fair and balanced "is also used in FINRA rule 2210, which requires, among other things, that broker-dealer communications "must be fair and balanced and must provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry, or service." See FINRA rule 2210(d)(1)(A).

131 *See* Advertising Rule Adopting Release, *supra* footnote 5.

cherry picking profitable recommendations implied that the selected recommendations were representative of the experiences of all of the investment adviser's clients.[132] For this reason, the rule prohibited investment advisers from distributing advertisements that refer directly or indirectly to past specific recommendations which were, or would have been, profitable to anyone unless the advertisement sets out or offers to furnish information about all recommendations made by the adviser during the preceding period of not less than one year.

Over the years since the advertising rule was adopted, however, our experience has led us to believe that some information about an adviser's past advice could be presented without misleading investors. For instance, we understand that some investment advisers may produce communications such as "thought pieces," which are intended to illustrate the investment adviser's philosophy and process to investors and prospective investors and often contain references to specific investments, such as their largest holdings within a given strategy or recommendations during a certain time period, as well as general views about the market. These advisers may hesitate to share such thought pieces with investors in light of the current rule's prohibition on past specific recommendations. Out of the same concerns, an adviser may also hesitate to illustrate in an advertisement the investment adviser's specific investment advice in response to a major market event or crisis, such as a natural disaster in a region where the adviser made or suggested investments for its investors.

The proposed rule would replace the current prohibition with a principles-based restriction on the presentation of specific investment advice. In particular, the proposed rule would require advertisements that include specific investment advice to be presented by the investment adviser in a manner that is fair and balanced. The factors that are relevant to whether

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132 *See id*.

a reference to specific investment advice is presented in a fair and balanced manner for purposes of paragraph (a)(5) will vary based on the facts and circumstances. The proposed rule would not include specific requirements regarding disclosure about specific recommendations. We believe the proposed approach would allow investment advisers to better tailor the information that they include in advertisements that contain references to specific investment advice in a manner that does not mislead investors. While we are not prescribing any particular presentation or specific disclosure, which we believe would be unduly limiting on advisers, we believe several factors, discussed below, may be relevant to whether an adviser should be considered to have presented specific investment advice in a fair and balanced manner.[133] A reference to specific investment advice may also be prohibited under other provisions of the general prohibition of false or misleading advertisements.

We believe an advertisement that references favorable or profitable specific investment advice without providing sufficient information and context to evaluate the merits of that advice would not be fair and balanced. The current rule identifies particular information that must be disclosed when furnishing a list of all past specific recommendations made by the adviser within the immediately preceding period of not less than one year: (i) the name of each such security recommended, the date and nature of each such recommendation (*e.g.*, whether to buy, sell or hold), the market price at that time, the price at which the recommendation was to be acted upon, and the market price of each such security as of the most recent practicable date, and (ii) a specific cautionary legend on the first page of the advertisement.[134] An adviser may find this list

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133 For selecting and presenting performance information, these factors are in addition to the requirements and restrictions on presentation of performance, which are discussed in Section II.A.5. *See* proposed rule 206(4)-1(c).

134 *See* rule 206(4)-1(a)(2).

to be helpful guidance; however, the proposed rule would not require these disclosures, and the inclusion of such disclosures would not be the only way of satisfying paragraph (a)(5).

We believe that instead of including a requirement for a particular presentation, advisers, when determining how to present this information in a fair and balanced manner, should consider the facts and circumstances of the advertisement, including the nature and sophistication of the audience. For example, our staff has stated that it would not recommend enforcement action under the current rule with respect to charts in an advertisement containing an adviser's best and worst performers if: (i) the adviser's calculation takes into account consistently the weighting of every holding in the relevant account that contributed to the account's performance during the measurement period, and the charts reflect consistently the results of the calculation; (ii) the charts' presentation of information and number of holdings is consistent from measurement period to measurement period; and (iii) the charts include the holdings that contributed most positively and negatively to the relevant account's performance during the measurement period.[135] We are not prescribing these factors under the proposed rule. Although we believe that an advertisement that includes this information would likely meet the proposed fair and balanced standard, we do not believe this is the only way to present specific investment advice in a manner that would comply with this provision of the proposed rule.

Under the proposed rule, unlike under the current rule, the adviser may be able to describe the specific investment advice it provided to an investor in response to a previous major market event, provided the investment recommendations included in the advertisement were fair and balanced illustrations of the adviser's ability to respond to major market events and accompanying disclosures provided investors with appropriate contextual information to

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135 *See* the TCW Group, SEC Staff No-Action Letter (Nov. 7, 2008) ("TCW Letter").

evaluate those recommendations (*e.g.*, the circumstances of the market event, such as its nature and timing, and any relevant investment constraints, such as liquidity constraints, during that time). However, we believe that an advertisement that contains this specific investment advice without disclosing contextual information would not be consistent with the proposed rule's fair and balanced standard.

We recognize that an investment adviser might provide a list of certain investments it recommended based upon certain selection criteria, such as the top holdings by value in a given strategy at a given point in time. The criteria investment advisers use to determine such lists in an advertisement, as well as how the criteria are applied, should produce fair and balanced results. We believe that consistent application of the same selection criteria across measurement periods limits an investment adviser's ability to reference specific investment advice in a manner that unfairly reflects only positive or favorable results.

Our staff has stated that under current rule 206(4)-1 it would not recommend enforcement action relating to an advertisement that includes performance-based past specific recommendations if: (i) the adviser uses objective, non-performance based criteria to select the specific securities that it lists and discusses in the advertisement; (ii) the adviser uses the same selection criteria for each quarter for each particular investment category; (iii) the advertisements do not discuss, directly or indirectly, the amount of the profits or losses, realized or unrealized, of any of the specific securities; and (iv) the adviser maintains appropriate records, which would be available for inspection by Commission staff.[136] An adviser may find these criteria helpful guidance in complying with the proposed rule, but the proposal would not require them.

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136 *See* Franklin Management, Inc., SEC Staff No-Action Letter (Dec. 10, 1998) ("Franklin Letter").

The current rule prohibits references to past specific recommendations in an advertisement that do not set out or offer to furnish a list of all recommendations made by such investment adviser in the last year.[137] We considered, but are not proposing, to maintain this requirement from the current rule. We believe that it may not be practical for many investment advisers to disclose all purchases, sales, or recommendations made during the preceding one-year period (*e.g.,* including in such a list potentially thousands of investments). For example, we understand that the current requirement of offering to provide all investments has a chilling effect on adviser communications with pooled investment vehicle investors because providing such information would reveal proprietary strategies. Therefore, we believe that requiring presentations of references to specific investment advice in an advertisement to be fair and balanced could provide more useful information to investors than the current requirement of a comprehensive list of investments.[138] However, if an adviser chooses to provide a list of all specific investment advice made in a period of no shorter than the preceding year, we believe that such a list would meet the proposed rule's "fair and balanced" standard.

Finally, the proposed rule uses the phrase "reference to specific investment advice" rather than the current rule's reference to "past specific recommendations . . . which were or would have been profitable . . . ."[139] This change substantively broadens the scope of the provision and eliminates confusion that we understand may exist in interpreting the current rule.[140] The

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137 *See* current rule 206(4)-1(a)(2).

138 In some instances, however, an investment adviser should consider listing some, or all, of the specific investment advice of the same type, kind, grade, or classification as those specific investments presented in the advertisement in order for a presentation to be fair and balanced.

139 *Compare* proposed rule 206(4)-1(a)(5) *with* current rule 206(4)-1(a)(2).

140 *See, e.g.,* Comment letter of Investment Counsel Association of America (Aug. 2001). We understand that industry participants have raised concerns regarding what qualifies as a *past* recommendation versus a *current* recommendation and whether there is a meaningful distinction. We also understand that industry participants have questioned the meaning of *recommendation* in the current rule and whether this phrasing

proposed provision applies to any reference to specific investment advice given by the investment adviser, regardless of whether the investment advice remains current or occurred in the past. This provision applies regardless of whether the advice was acted upon, or reflected actual portfolio holdings, or was profitable. Finally, the modified provision includes investments in discretionary portfolios, even if an adviser is not making a non-discretionary "recommendation" to the investor. We believe that including current or past references to specific investment advice in the scope of the proposed rule is appropriate because it avoids questions about when a current recommendation becomes past. In addition, we believe that selective references to current investment recommendations could mislead investors in the same manner as selective references to past recommendations.

ii. Presentation of Performance Results.

The proposed rule would prohibit any investment adviser from including or excluding performance results, or presenting time periods for performance, in a manner that is not fair and balanced.[141] This prohibition responds to concerns similar to the Commission's concerns discussed above regarding "cherry-picking" of investments for inclusion in advertisements.[142] Similarly, the potential exists for an adviser to "cherry-pick" the time periods used to generate performance results in advertisements. In addition, an advertisement that includes only favorable

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includes portfolio holdings more generally. Finally, we do not believe it is necessary to limit the provision to "profitable" recommendations. We believe that there may be instances where an investment adviser seeks to reference investments for reasons other than to demonstrate its ability to generate profits (*e.g.,* ability to select low volatility investments).

141 Proposed rule 206(4)-1(a)(6).

142 *See* Advertising Rule Adopting Release, *supra* footnote 5 (stating that "material of this nature, which may refer only to recommendations which were or would have been profitable and ignore those which were or would have been unprofitable, is inherently misleading and deceptive"); *see also* Clover Letter (stating that, in the staff's view, an advertisement containing performance results would be false or misleading if it failed to disclose prominently, if applicable, that the results portrayed relate only to a select group of the adviser's clients, the basis on which the selection was made, and the effect of this practice on the results portrayed, if material).

performance results or excludes only unfavorable performance results would be "misleading" to the extent that such an advertisement implies something about or is likely to cause an inference to be drawn concerning the investment adviser that would not be implied or inferred were certain additional facts – *i.e.*, any performance results excluded from the advertisement – disclosed.[143]

As with specific investment advice, the factors that are relevant to whether a reference to performance information is presented in a fair and balanced manner for purposes of the rule's general prohibition will vary based on the facts and circumstances. For example, presenting performance results over a very short period of time, or over inconsistent periods of time, may result in performance portrayals that are not reflective of the adviser's general results and thus generally would not be fair and balanced.[144] Portrayals of performance results that do not include sufficient information for an investor to assess how the results were determined, or which do not provide sufficient context for the investor to evaluate the utility of the results, would not be consistent with the fair and balanced standard we are proposing here.

In section II.A.4 below we discuss further specific requirements and conditions for portrayals of certain types of performance to different audiences that we are also proposing here. In those cases, however, the fair and balanced standard for performance that we are proposing here would also apply.

We request comment on the proposed rule's provision regarding references to specific investment advice and presentation of performance:

- Do commenters agree with the proposed treatment of references to specific investment advice in advertisements? Is fair and balanced an appropriate standard?

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143 *See* proposed rule 206(4)-1(a)(3).

144 However, such information may be presented in response to specific requests from Non-Retail Persons under the proposed exclusion for responses to unsolicited requests. *See supra* section II.A.2.c.ii.

Can advisers apply this standard? Are there other standards we should use? Are there alternative or additional requirements that would reduce the risk of cherry picking or other misleading or deceitful practices while providing advisers the ability to appropriately include such information?

- Should the proposed rule include specific presentation requirements, such as requiring advertisements with references to specific investment advice to include an equal number of best- and worst-performing holdings, or use an objective, non-performance based criterion, such as the largest dollar amount of purchases or sales? Are there additional presentation requirements we should consider? Should the presentation requirements be the same for advertisements for which an adviser has adopted and implemented policies and procedures reasonably designed to ensure that the advertisements are disseminated solely to "qualified purchasers" and certain "knowledgeable employees" (defined as "Non-Retail Advertisements" in paragraph (e)(7) of the proposed rule) and all other advertisements (defined as "Retail Advertisements" in paragraph (e)(13) of the proposed rule)?
- Should advertisements including a reference to specific investment advice be required to disclose or offer to provide a complete list of specific investments? If so, should the list be limited to investments of the same type, kind, grade, or classification as those specific investments presented in the advertisements? If not, how else should this list be limited?
- Should we require investment advisers that include a reference to specific investment advice to disclose the criteria used to select the specific investment?

- While the proposed rule does not contain a list of prescriptive requirements, to provide additional guidance the proposal discusses several factors that advisers should consider when determining whether a presentation is fair and balanced. Should we include any or all of these factors in the rule text itself? Do any of these factors need further clarification? Are the factors we discussed relevant? Are there any additional or alternative factors we should discuss?
- Does using the term "reference to specific investment advice" instead of "past specific recommendations" clarify the scope of the provision? If not, is there another term that should be used?
- Should the rule have separate requirements for references to specific investment advice in Retail Advertisements and Non-Retail Advertisements?
- Should the rule have separate general provisions for advisers advertising to different types of investors (*e.g.*, separate provisions for advertisements to Retail Persons and Non-Retail Persons)? Why or why not? If so, what different requirements should apply to what types of investors? Should the requirements for Retail Advertisements include additional restrictions and/or prescribed disclosures? If so, what should they be? Would additional restrictions and prescribed disclosures be meaningful to Retail Persons but not Non-Retail Persons? Would additional restrictions and prescribed disclosures be meaningful to only a subset of Non-Retail Persons? Why or why not?
- Should the proposed requirement for fair and balanced presentation for references to specific investment advice vary based on the type of communications?
- Should we specify in some way what "favorable" or "unfavorable" mean? Why or why not?

### f. *Otherwise Materially Misleading*

Finally, we are proposing to prohibit any advertisement that is otherwise materially misleading.[145] Rule 206(4)-1 currently has a broad catch-all provision prohibiting advertisements that are "otherwise false or misleading."[146] We are generally proposing to retain a catch-all provision like this aspect of the current rule. We believe this catch-all would ensure that certain materially misleading practices that are not specifically covered by the other prohibitions would be addressed. For example, if an adviser provided accurate disclosures, but presented them in an unreadable font, such an advertisement would be materially misleading and prohibited under this catch-all.

However, because we are also prohibiting a variety of specific types of advertisement practices within the general prohibitions, most of which include an element of materiality, as discussed above, we are proposing to focus the catch-all provision on only those advertisements that are otherwise *materially* misleading. We believe that limiting the catch-all to materially misleading advertisements would be more appropriate within the overall structure of the proposed prohibitions while still achieving our goal of prohibiting misleading conduct that may affect an investor's decision-making process. We also believe that, in light of the proposed rule's prohibitions on making untrue statements and omissions of material fact, including "false" is unnecessary in the catch-all provision as it is already covered by the previous prohibition.[147] We request comment on this provision of the proposed rule.

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145 Proposed rule 206(4)-1(a)(7).

146 Rule 206(4)-1(a)(5).

147 Rule 156 under the Securities Act similarly prohibits investment company sales literature which is "materially misleading."

- Should we include this catch-all provision? If not, why not? Would the other general prohibitions capture all types of conduct that would otherwise result in an advertisement being materially misleading? If not, should we instead seek to specifically identify all potentially misleading conduct that an adviser might seek to engage in within the rule rather than include such a catch-all?
- Should the provision prohibit all false and misleading advertisements as under the current rule, not just materially misleading ones, as proposed? Are there situations where an advertisement would be immaterially false or misleading?
- Does the proposed rule's prohibitions on making untrue statements and omissions of material fact make the term "false" unnecessary in the catch-all? Should the proposed provision also apply to materially false advertisements?

#### g. *General Request for Comment and Alternate Approaches*

We request comment on the proposed prohibitions discussed above.

- The proposed rule prohibits certain advertising practices as a means reasonably designed to prevent fraud within the meaning of section 206(4) of the Act. Is this approach effective? Would the list of practices in the proposed rule be helpful for investment advisers in evaluating whether their advertisements are or might be misleading?
- Are there other practices that we should include, such as any additional factors listed in rule 156? Or should we extend all of the anti-fraud guidance in rule 156 to investment adviser advertisements?
- Should any of the practices that we are proposing to prohibit instead be reframed as factors to consider similar to the approach in rule 156? Should we modify the rule to

incorporate any of these factors to consider in lieu of the prohibitions under the proposed rule?

- Should we include any specific prohibitions related to the presentation of information in advertisements? For example, should we prohibit including disclosures in too small of a font? Should we specifically require that information be presented in Plain English?
- Do commenters agree with the proposed prohibitions? Should we modify the language or scope of any of the prohibitions? Is each of the practices described in this provision sufficiently likely to be misleading that it should be prohibited, or is it possible that any of these provisions could encompass statements or presentations that are not misleading and provide investors with valuable information?
- Should these provisions apply to all advertisements, regardless of whether the advertisement is directed to Retail Persons or Non-Retail Persons? Should any of them apply only to Retail Advertisements or vice versa?

We also request comment on other approaches to the regulation of advertising by advisers. For example, we are proposing an approach where, as a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts, practices, and courses of business, we would amend rule 206(4)-1 generally to prohibit certain conduct, as discussed above, *and* restrict certain specific identified advertising practices, as discussed below. Instead, we could not identify any specific restricted practices and rely on the general prohibitions against fraud or

deceit in section 206 of the Advisers Act and certain rules thereunder.[148] Under such an approach, a rule specifically targeting adviser advertising practices might be unnecessary.

- Should we repeal the current rule 206(4)-1 and rely instead solely on section 206 of the Act and such rules thereunder to regulate adviser advertising practices?
- Alternatively, should we identify general prohibited conduct, such as discussed above?
- Should we only restrict certain specific practices, or include a narrower set of restricted practices? If so, which practices should still be covered in an advertising rule? For example, should the rule target the presentation of performance or certain other specific practices such as the use of testimonials?
- Would such approaches provide advisers with sufficient clarity and guidance on whether certain advertising practices would likely be fraudulent or deceptive?
- Would such approaches provide sufficient clarity for an adviser of its legal obligations and potential liabilities in crafting advertisements?

#### 4. Testimonials, Endorsements, and Third Party Ratings.

The proposed rule specifically addresses the use of testimonials, endorsements, and third-party ratings in advertisements. The proposed rule would define "testimonial," "endorsement," and "third-party rating," and would permit advisers to use them in advertisements, subject to the rule's general prohibitions of certain advertising practices and additional conditions. The current advertising rule outright prohibits the use of "testimonials," and does not expressly address

[148] For example, rule 206(4)-8 would continue to apply to advertisements directed to investors in private funds under such an approach.

endorsements and third-party ratings.[149] When the Commission adopted the advertising rule in 1961, it stated that testimonials "…by their very nature emphasize the comments and activities favorable to the investment adviser and ignore those that are unfavorable. This is true even when the testimonials are unsolicited and printed in full."[150] We are proposing a provision that would address testimonials, endorsements, and third-party ratings in a nuanced manner.[151] Unlike the current rule's broad restrictions on the use of testimonials, the proposed provision would permit testimonials, endorsements, and third-party ratings, subject to disclosures and other tailored conditions. Our proposal would recognize that while consumers and businesses often look to the experiences and recommendations of others in making informed decisions, there may be times when these tools are less credible or less valuable than they appear to be.

Testimonials, endorsements, and third-party ratings are widely used and accepted in today's marketplace for various consumer goods and services outside of the securities and investment industry. Technological advances, including the development of the internet and social media platforms, have made the use and dissemination of testimonials easier and more widespread, and they continue to be an important resource for consumers and businesses. In

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149 *See* rule 206(4)-1(a)(1) for the prohibition on testimonials.

150 *See* Advertising Rule Adopting Release, *supra* footnote 5.

151 Our proposed approach is somewhat informed by the approach taken by FINRA, which permits testimonials about broker-dealers, subject to limitations, though we recognize that advisers and brokers have different business models, and are subject to different regulation. FINRA requires a testimonial about a technical aspect of investing that appears in any communication (regardless of investor sophistication) be offered by a person that has the "knowledge and experience to form a valid opinion." *See* FINRA rule 2210(d)(6)(A). FINRA's rule does not define the term "testimonial." With regard to any testimonial in retail communications (or correspondence as defined in the FINRA rule), the communication must make certain prominent disclosures, including, for example, if more than $100 in value is paid for the testimonial, the fact that it is a paid testimonial. *See* FINRA rule 2210(d)(6)(B); *see also* FINRA's Regulatory Notice 17-18: Social Media and Digital Communications: Guidance on Social Networking Websites and Business Communications, April 2017 (stating that for broker-dealers, among other things, "third-party posts on a firm or associated person's business website may constitute communications with the public by the firm or an associated person under Rule 2210 if the firm or an associated person has (1) paid for or been involved in the preparation of the content (which FINRA would deem to be 'entanglement') or (2) explicitly or implicitly endorsed or approved the content (which FINRA would deem to be 'adoption').").

addition, those selling goods and services also seek endorsements about their product or service from trade and consumer groups or particular individuals. Like testimonials and endorsements, third-party ratings often provide information to consumers to help them evaluate a business relative to its peers or based on certain factors that may be important to the consumer. People continue to seek out and consider the views of others when making a multitude of transactions or decisions – from purchasing a coffee maker to finding the right medical expert to consult. Consumers that make purchases in online marketplaces may be experienced in reading reviews and evaluating any accompanying qualifications, such as reviews marked as "verified purchaser" or "verified review."

We believe that testimonials, endorsements, and third-party ratings can be useful and important for investors when evaluating investment advisers. Yet, we recognize that there are circumstances in which this type of information might mislead investors by, for example, failing to provide important context in which the statement or rating was made. With tailored disclosures and other safeguards discussed below, we believe that advisers could use testimonials, endorsements, and third-party ratings in advertisements to promote their accomplishments with less risk of misleading retail investors.

**a. *Definition of testimonial, endorsement, and third-party rating.***

The proposed rule defines "testimonial" as "any statement of a client's or investor's experience with the investment adviser or its advisory affiliates, as defined in the Form ADV Glossary of Terms."[152] It defines "endorsement" as "any statement by a person other than a

[152] *See* proposed rule 206(4)-1(e)(15). An adviser's "advisory affiliate" is defined in Form ADV's Glossary of Terms as "(1) all of your officers, partners, or directors (or any *person* performing similar functions); (2) all *persons* directly or indirectly *controlling* or *controlled* by you; and (3) all of your current *employees* (other than *employees* performing only clerical, administrative, support or similar functions)." Form ADV Glossary of Terms. In addition, if an adviser is a "separately identifiable department or division" (SID) of a bank, the term "advisory affiliate" is defined in Form ADV Glossary of Terms as: "(1) all of your bank's

client or investor indicating approval, support, or recommendation of the investment adviser or its advisory affiliates, as defined in the Form ADV Glossary of Terms."[153]

The proposed definitions of testimonial and endorsement would broadly cover an investor's experience with the adviser or its advisory affiliates (testimonial), and a non-investor's approval, support, or recommendation of the adviser or its advisory affiliates (endorsement). Testimonials and endorsements would both include, for example, opinions or statements by persons about the investment advisory expertise or capabilities of the adviser or its advisory affiliates. To the extent that a statement does not cover an investor's experience with the adviser or its advisory affiliates, or a non-investor's approval, support or recommendation of the adviser or its advisory affiliates, it would not be treated as a testimonial or endorsement. For example, complete or partial client lists that do no more than identify certain of the adviser's investors would not be treated as a testimonial.[154] Testimonials and endorsements could include character-based or other statements that more indirectly implicate the expertise or capabilities of the

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*employees* who perform your investment advisory activities (other than clerical or administrative *employees*); (2) all *persons* designated by your bank's board of directors as responsible for the day-to-day conduct of your investment advisory activities (including supervising the *employees* who perform investment advisory activities); (3) all *persons* who directly or indirectly *control* your bank, and all *persons* whom you *control* in connection with your investment advisory activities; and (4) all other *persons* who directly manage any of your investment advisory activities (including directing, supervising or performing your advisory activities), all *persons* who directly or indirectly *control* those management functions, and all *persons* whom you *control* in connection with those management functions." *Id*. The terms "person," "employee," and "control" are also defined in Form ADV's Glossary of Terms, and would be incorporated in the proposed rule to the extent they are used in the rule's definition of "testimonial" and "endorsement." *Id*.

153 *See* proposed rule 206(4)-1(e)(2). Even though the current rule prohibits testimonials, it does not define the term, and it does not address endorsements.

154 Similarly, in the context of stating it would not recommend enforcement action when the adviser proposed to use partial client lists that do no more than identify certain clients of the adviser, the Commission staff stated its view that partial client lists would not be testimonials because they do not include statements of a client's experience with, or endorsement of, an investment adviser. *See* Cambiar Investors, Inc., SEC Staff No-Action Letter (Aug. 28, 1997).

adviser or its advisory affiliates, such as their trustworthiness, diligence, or judgment.[155] We believe that these types of statements typically should be treated as testimonials and endorsements, depending on the specific facts and circumstances, because an investor would likely perceive them as relevant to the adviser's investment advisory services. In the infrequent event that such statements are not relevant to an investment adviser or its advisory affiliates' investment advisory services, however, such statements would not be treated as testimonials or endorsements.

We considered, but are not proposing that the definitions of testimonial and endorsement include certain types of statements about an adviser's *related persons*, which are an adviser's advisory affiliates and any person that is under common control with the adviser.[156] We believe that applying the testimonial and endorsement provision to persons under common control with the adviser would be overly broad, because statements about such persons would not be relevant to an investor's assessment of an investment adviser. For similar reasons, we are not proposing to use the term "affiliated person," as defined in the Investment Company Act and incorporated into the Act, as that term also would apply, among other things, to persons under common control with the adviser.[157]

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155 Even though the proposed rule treats testimonials and endorsements similarly, we are providing a distinct definition for each so that we can tailor the disclosure requirements for each and request comment on whether the rule should treat them differently, as discussed below.

156 An adviser's "related person" is defined in Form ADV's Glossary of Terms as "[a]ny *advisory affiliate* and any *person* that is under common *control* with your firm." Italicized terms are defined in the Form ADV Glossary.

157 As defined in the Investment Company Act, ''[a]ffiliated person'' of another person means: (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a

Our proposed rule defines "third-party rating" as a "rating or ranking of an investment adviser provided by a person who is not a related person, as defined in the Form ADV Glossary of Terms, and such person provides such ratings or rankings in the ordinary course of its business."[158] The proposed definition is intended to permit advisers to use third-party ratings, subject to conditions, when the ratings are conducted in the ordinary course of business. We believe that the ordinary course of business requirement would largely correspond to persons with the experience to develop and promote ratings based on relevant criteria. It would also distinguish third-party ratings from testimonials and endorsements that may include statements that resemble third-party ratings, but that are not made by persons who are in the business of providing ratings or rankings. The requirement that the provider not be an adviser's related person would avoid the risk that certain affiliations could result in a biased rating.[159] However, we request comment below on whether the proposed definition of "third-party rating" should include affiliated parties under certain circumstances, such as when the rating is at arm's length and not designed to favor the affiliate. Under our proposal, we believe that a rating by an affiliated person might otherwise be prohibited under the proposed rule's general prohibitions of certain advertising practices, depending on the facts and circumstances, such as if it includes an

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board of directors, the depositor thereof. Section 2(a)(3) of the Investment Company Act. Such term is incorporated into section 202(a)(12) of the Act.

158 Proposed rule 206(4)-1(e)(16). *See supra* footnote 156 for the definition of "related person."[159] In the third-party rating provision, we are proposing to use the term "related person," as opposed to "advisory affiliate," which we are proposing to use in the definition of "testimonial" and "endorsement." As discussed above, the term "related person" includes persons under common control with the adviser, and we believe that a rating by a person under common control with the adviser could present the same bias towards the adviser as a rating by an adviser's other advisory affiliates.

159 In the third-party rating provision, we are proposing to use the term "related person," as opposed to "advisory affiliate," which we are proposing to use in the definition of "testimonial" and "endorsement." As discussed above, the term "related person" includes persons under common control with the adviser, and we believe that a rating by a person under common control with the adviser could present the same bias towards the adviser as a rating by an adviser's other advisory affiliates.

untrue or misleading implication about, or is reasonably likely to cause an untrue or misleading inference to be drawn concerning, a material fact relating to the investment adviser.[160]

Testimonials, endorsements, and third-party ratings would only be subject to the proposed rule to the extent they themselves are "advertisements" or they appear within an advertisement. Whether they are themselves advertisements requires a facts and circumstances analysis of whether a communication is "by or on behalf of" an investment adviser.[161] While some third-party statements or ratings that appear in a third-party hosted platform may meet the proposed rule's definition of "advertisement," we generally believe that many of these statements or ratings would fall outside of the scope of the proposed rule.[162] For example, as discussed above, statements regarding the investment adviser on a third-party hosted platform, such as a social media site other than the adviser's site, that solicits users to post information, including positive and negative reviews of the adviser, would not fall within the scope of the proposed rule's definition of "advertisement" unless the adviser took some steps to influence such reviews or posts, and thus the statement was made by or on the adviser's behalf. For example, if the adviser paid the third party website to promote certain statements or reviews or to hide or "downrank" others, the adviser would be taking steps to influence the content of the reviews or posts.[163] Likewise, a third-party statement or rating may meet the definition of

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160 *See* proposed rule 206(4)-1(a).

161 *See* proposed rule 206(4)-1(e)(1) (defining advertisement, in part, as any communication… "by or on behalf of an investment adviser"…). As discussed in detail *supra* section II.A.2.b.ii, content created by or attributed to third parties, such as investors, could be considered by or on behalf of an investment adviser, depending on the investment adviser's involvement. *See supra* section II.A.2 (discussing the proposed definition of "advertisement").

162 *See supra* section II.A.2.b.ii.

163 *Id*. However, merely letting an investor know about the availability of a third party review site without suggesting that the investor leave a positive review or not leave a negative review may not qualify as taking steps to influence the third party content.

"testimonial," "endorsement," or "third-party rating," but could fall outside of the rule's scope because it does not fall under the proposed rule's definition of "advertisement." For example, as discussed above, the fact that an adviser permits all third parties to post public commentary to the adviser's website or social media page generally would not, by itself, render such commentary attributable to the investment adviser, unless the adviser took some steps to influence the content of the commentary.[164]

Compensated testimonials and endorsements would generally be "by or on behalf of" an adviser and would make the statements subject to the rule.[165] In these cases, and in all instances where a testimonial, endorsement, or third-party rating would be an advertisement or would be part of an adviser's advertisement, the adviser would be required to comply with both the tailored conditions of the proposed rule with respect to testimonials, endorsements, and third-party ratings, and the proposed rule's general prohibitions on certain advertising practices (*e.g.*, that the advertisement not imply something untrue or misleading about, or that is reasonably likely to cause an untrue or misleading inference to be drawn concerning, a material fact relating to the investment adviser).

Statements made by an adviser that would be prohibited under the proposed rule's general prohibitions of certain advertising practices would also be prohibited in an adviser's advertisement if made by a third-party in a covered testimonial, endorsement, or third-party

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164 *See supra* footnotes 50-52 and accompanying text.

165 *See supra* section II.A.2.b. (discussing when a statement is "by or on behalf of" an adviser, and stating that compensation includes any cash or non-cash compensation such as rewards or other incentives for a third-party to provide content). In many cases, a person providing a compensated testimonial or endorsement under the proposed advertising rule (a "promoter") will also be a solicitor, and both the proposed advertising and solicitation rules would apply. *See infra* section II.B.1.

rating.[166] An adviser therefore would be prohibited from using any such statement or rating in an advertisement if, for example, the content, presentation or any other aspect of the statement or rating would be materially misleading if the adviser communicated it itself. For example, some advisers may wish to include in their advertisements testimonials about an adviser's performance results (including performance achieved by a particular investor --*e.g.,* "XYZ Adviser's investment strategy has returned over 10% per year for my account in each of the last five years" or "ABC Adviser invested all of my assets in the health care sector and made me a fortune"). Such statements without additional disclosure would not overcome the proposed rule's general prohibitions, to the extent that they are not typical of the adviser's investors' experiences.[167] In such cases, they would give rise to a fraudulent or deceptive implication, or mistaken inference, that the experience of the person giving the testimonial is typical of the experience of the adviser's clients.[168] Such statement may also implicate the provisions related to performance and specific investment advice, respectively, discussed below as they may not meet the requirements to be fair and balanced.[169]

Under our proposed rule, in all instances where a testimonial, endorsement, or third-party rating would be an advertisement, the adviser would be required to comply with both the tailored conditions of the proposed rule that are discussed below as well as the proposed rule's general prohibitions on certain advertising practices. Therefore, for example, an adviser could not

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166 As discussed above, the proposed rule contains general prohibitions of certain advertising practices. *See* proposed rule 206-4(1)(a). Therefore, an adviser may not use in an advertisement any endorsement or testimonial if it would be a prohibited statement if made directly by the adviser.

167 General disclaimer language (*e.g.*, "these results may not be typical of all investors") would not be sufficient to overcome the proposed rule's general prohibitions. *See generally infra* footnote 180. However, disclosure could be sufficient if, for example, the advertisement states that the performance advertised is representative of a subset of clients who follow the particular strategy (if applicable).

168 Proposed rule 206(4)-1(a).

169 *Id*.

include an endorsement in an advertisement that makes a material claim or statement that is unsubstantiated or that is likely to create a misleading implication about a material fact.[170] Further, we believe that cherry picking testimonials, or otherwise selectively only using the most positive testimonials available about an adviser, would not be consistent with the general prohibition in the proposed rule. For example, if an adviser were to select a single positive testimonial to highlight in an advertisement, while excluding all negative testimonials, it is likely to create a misleading inference that the adviser has only received positive testimonials.

Similarly, statements about performance or specific investment advice made in the context of an endorsement or third-party rating would be subject to the proposed rule's general prohibitions. In all cases, we believe performance information or specific investment advice stated by persons other than the adviser or its representatives may be particularly compelling to an investor. For this reason, we would generally view an advertisement as unlikely to be presented in a manner that is fair and balanced under the proposed rule if the testimonial, endorsement, or third-party rating references performance information or specific investment advice provided by the investment adviser that was profitable that is not representative of the experience of the adviser's investors.

We request comment on this aspect of the proposed rule:

- Are our proposed definitions of "testimonial," "endorsement," and "third-party ratings" clear? Are there ways in which the proposed definitions are over- or under-inclusive?
- Do commenters agree that the provision regarding "testimonials" and "endorsements" should apply to statements about an adviser's advisory affiliates?

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170 *See* proposed rule 206(4)-1(a).

Why or why not? If not, which persons associated with an adviser, if any, should be included in the provision? Should we instead use the term "related persons," which would pick up persons under common control with the adviser? Why or why not?

- Do commenters agree with the scope of opinions or statements about the adviser and its advisory affiliates that would be included in the proposed definitions of testimonial and endorsement? Do commenters favor a broader or narrower scope, and why? For example, the scope of the proposed definitions of testimonial and endorsement would include statements about an adviser's or its advisory affiliates' trustworthiness, diligence, or judgment to the extent that they are statements of an investor's experience with the investment adviser, or are statements by others that indicate approval, support, or recommendation of the investment adviser. Should we more narrowly capture only the opinions or statements that are explicitly about the investment advisory expertise or capabilities of the adviser? Why or why not, and if so, how should we narrow the scope? Alternatively, how should we broaden the scope?
- A rating provided by a related person of the investment adviser would be evaluated under the proposed rule's general prohibitions of certain advertising practices, and might be prohibited thereunder, depending on the facts and circumstances. Do commenters agree with this approach? Should the proposed definition use a term other than "related person" to capture persons who are affiliated with the adviser and would be likely to produce a biased rating? If so, what term should we use, and what universe of persons should the term capture?

For example, should the term include or exclude ratings provided by an adviser's investors, because of the potential for an investor to provide a more favorable rating of the adviser in order to receive preferential treatment by the adviser? Should the proposed definition of "third-party rating" exclude related persons in certain instances, such as when a related person's rating would be at arm's length and not designed to favor the adviser? Should it include or exclude any other persons based on the nature of the relationship between the adviser and the person providing the rating or ranking? Why or why not?

- Do commenters believe that the proposed definition of "third-party rating," including the requirement that the rating be provided by a person who "does so in the ordinary course of its business," distinguishes adequately between testimonials or endorsements that may include statements that resemble third-party ratings, from the types of ratings or rankings that we intend to capture within the scope of the definition (*i.e.*, they are made by persons who are in the business of providing ratings or rankings)? If not, how should we draw this distinction? Or, do commenters believe that such a distinction is unnecessary? Why?
- Do commenters agree or disagree that investors afford additional weight to statements about performance and specific investment advice when presented in the context of a testimonial, endorsement, or third-party rating? Should the rule specifically address any of these practices, or other practices, in the testimonial, endorsement, and third-party rating provisions? If so, why, and how? Are there disclosures that would cure any misleading inferences about an adviser's

performance or return of an investor's account or profitable investment advice of the adviser when made in the testimonial, endorsement, or third-party rating context? If so, what are they, and should we incorporate them as a condition for testimonials, endorsements, and third-party ratings? If so, should we incorporate them into conditions for Retail Advertisements or Non-Retail Advertisements (each as defined and discussed below), or both, and why?

- Do commenters agree that if an adviser links to a third-party website that contains a testimonial or endorsement, only the testimonial or endorsement on such third-party website should be viewed as the adviser's advertisement subject to proposed rule 206(4)-1? For an adviser linking to a third-party website that contains only educational information about investing, or a third-party tool such as an investing calculator, how would advisers signal to investors that, if applicable, the third-party content does not relate to the adviser's services or otherwise meet the definition of "testimonial" or "endorsement"?
- As discussed below, testimonials and endorsements under the proposed rule could also be deemed to be solicitations under the proposed solicitation rule. Should the rule define "testimonials" and "endorsements" to distinguish them from solicitations?

### b. *Conditions on testimonials, endorsements, and third-party ratings*

The proposed rule would require that an investment adviser clearly and prominently disclose, or the investment adviser reasonably believe that the *testimonial* or *endorsement* clearly and prominently discloses, that the testimonial was given by a client or investor, and the endorsement was given by a non-client or non-investor, as applicable.[171] Disclosure about the status of the person making the testimonial or endorsement (*e.g.,* investor or non-investor) would provide investors with important context for weighing the relevance of the statement. For example, an investor might give more weight to a statement made about an adviser by another investor than a non-investor. An endorsement that is not clearly attributed to a non-investor could mislead investors who may assume the endorsement reflects the endorser's experience as an investor.

The proposed rule would also require that the investment adviser clearly and prominently disclose, or the investment adviser reasonably believe that the *testimonial, endorsement, or third-party rating* clearly and prominently discloses, that cash or non-cash compensation has been provided by or on behalf of the adviser in connection with the testimonial, endorsement, or third-party rating, if applicable.[172] In order to be clear and prominent, the disclosure must be at least as prominent as the testimonial, endorsement or third-party rating. For third-party ratings, this provision would apply to cash or non-cash compensation provided by or on behalf of the adviser to the party providing the rating (*e.g.*, the rating agency). Importantly, it also would apply to cash or non-cash compensation provided by or on behalf of the adviser to any person participating in the rating (*e.g.*, any investor that completes a questionnaire about the adviser in

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171 *See* proposed rule 206(4)-1(b)(1).

172 *See* proposed rule 206(4)-1(b)(1)(ii) and (b)(2)(iii).

connection with the rating). The disclosure requirements would apply to third-party statements or ratings that appear in a third-party hosted platform that meet the proposed rule's definition of "advertisement" as well as to advertisements that the adviser publishes on its own platform. In the case of an advertisement on a third-party hosted platform to which investors' access is only through the adviser, the adviser could provide a pop-up webpage including the required clear and prominent disclosures for third-party statements and ratings when the client or investor links to the third-party site. In other cases where investors may access through other channels an adviser's advertisement on a third-party hosted platform, and the adviser itself cannot provide the required disclosures, the adviser must form a reasonable belief that the third-party statement or rating includes the required clear and prominent disclosures.

These proposed requirements to disclose that cash or non-cash compensation has been provided would provide important context for weighing the relevance of the statement. Consumers understand that compensation provided by or on behalf of a company in connection with reviews, testimonials, and ratings can incentivize the reviewer or the party providing the rating to provide a positive statement about, or positive rating of, the adviser. Cash or non-cash compensation provided in connection with a testimonial, endorsement, or third-party rating can include, for example, an adviser paying for the review or rating with cash, or providing the third-party with non-cash benefits or rewards that would incentivize it to make a positive statement about, or provide a positive rating of, the adviser or its advisory affiliates or related persons. Non-cash benefits or rewards could include, for example, reduced-fee or no-fee advisory services and cross-referrals (*e.g.*, the adviser refers its investors to the third-party's business platform). Without clear and prominent disclosure that cash or non-cash compensation or is provided, the conflict of interest may be hidden. A testimonial, endorsement, or third-party rating that is not

clearly labeled as compensated could mislead investors, who may assume that the person making the statement or rating is not receiving compensation. Our proposed disclosure would permit investors to decide, based on relevant information, how much weight to give a compensated testimonial, endorsement, or third-party rating.

We considered, but are not proposing, prohibiting in Retail Advertisements compensated testimonials, endorsements, and third-party ratings (*i.e.*, testimonials, endorsements, and third-party ratings in connection with which cash or non-cash compensation has been provided by or on behalf of the adviser). However, we believe that we can more narrowly tailor our approach with disclosures and other conditions (that are discussed below) to reduce the risk that such statements and ratings mislead retail investors. In addition, our proposal would apply certain requirements to testimonials, endorsements, and third-party ratings in both Retail and Non-Retail Advertisements – rather than only Retail Advertisements – because we believe that the proposed provisions would reduce the risk of such advertisements misleading investors regardless of the analytical and other resources or financial sophistication of the investor. With respect to compensated testimonials, endorsements, and third-party ratings, we believe that Retail Persons and Non-Retail Persons are similarly positioned to evaluate the proposed disclosures in a way that would make a third-party statement or rating less likely to be misleading.

Our proposal is consistent with other regulatory regimes that permit paid testimonials and endorsements if the payment is clearly and prominently disclosed. For example, FINRA permits paid testimonials in the retail context for certain broker-dealer communications, subject to certain conditions, including that the broker-dealer discloses the fact that the testimonial is paid

for if the payment is more than $100 in value.[173] In addition, the Federal Trade Commission's guidelines for endorsements promote full disclosure of connections between the endorser and the seller of the advertised product that might materially affect the weight or credibility of the endorsement, including disclosure of compensation arrangements between sellers and many endorsers.[174]

Unlike FINRA, we are not proposing a *de minimis* exception for the proposed disclosure because we believe that investors should be made aware when advisers provide even a small amount of compensation in connection with testimonials, endorsements, and third-party ratings in advertisements. We believe that smaller amounts can also influence a third party to make a favorable statement or a positive rating. We are not prohibiting an adviser from indicating the amount of compensation provided if it prefers to make that additional disclosure. We request comment on a *de minimis* exception below.

Our proposal for third-party ratings in advertisements would be subject to two additional disclosure requirements to provide context for evaluating the merits of the third-party rating. Specifically, it would require that the investment adviser clearly and prominently disclose, or the investment adviser must form a reasonable belief, that the *third-party rating* clearly and

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173 *See* FINRA rule 2210(d)(6)(B)(iii). The FINRA rule also requires that the person making the testimonial must have the "knowledge and experience to form a valid opinion" if the testimonial in a communication concerns a technical aspect of investing. FINRA rule 2210(d)(6)(A).

174 *See, e.g.,* Federal Trade Commission Guides Concerning the Use of Endorsements and Testimonials in Advertising, 16 CFR Part 255, at n.1 *available at* https://www.ftc.gov/sites/default/files/attachments/press-releases/ftc-publishes-final-guides-governing-endorsements-testimonials/091005revisedendorsementguides.pdf ("FTC Guides") (the FTC Guides, as revised in October, 2009) (discussing circumstances in which disclosure of compensation should be made). The FTC Guides provide, among other things, that (i) the advertiser must possess and rely upon adequate substantiation including, when appropriate, competent and reliable scientific evidence, to support such claims made through endorsements in the same manner the advertiser would be required to do if it had made the representation directly, *i.e.*, without using endorsements, and (ii) advertisers are subject to liability for false or unsubstantiated statements made through endorsements, or for failing to disclose material connections between themselves and their endorsers. *Id*.

prominently discloses: (i) the date on which the rating was given and the period of time upon which the rating was based; and (ii) the identity of the third party that created and tabulated the rating.[175] An adviser that uses third-party ratings in advertisements should develop policies and procedures to implement this "reasonable belief" provision as part of its compliance program. They could, for example, require the adviser to maintain records of the third-party rating containing the required disclosures. As with testimonials and endorsements, we believe that the proposed disclosures for third-party ratings would provide context for evaluating the information provided and reduce the risk of it misleading investors. The first proposed disclosure – the date on which the rating was given and the period of time upon which the rating was based – would assist investors in evaluating the relevance of the rating. Ratings from an earlier date, or that are based on information from an earlier time period, may not reflect the current state of an investment adviser's business. An advertisement that includes an older rating would be misleading without clear and prominent disclosure of the rating's date.[176] The second proposed disclosure – the identity of the third party that created the rating – is important because it would provide investors with the opportunity to assess the qualifications and credibility of the rating provider. Investors can look up a third-party by name and find relevant information, if available, about the third-party's qualifications and can form their own opinions about credibility. While these disclosures are explicitly required under the proposed rule, they would not cure a rating that could otherwise be false or misleading under the proposed rule's general prohibitions of certain advertising practices or under the general anti-fraud provisions of the Federal securities

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175 *See* proposed rule 206(4)-1(b)(2)(i) and (ii).

176 In addition, an adviser would be required to provide contextual disclosures of subsequent, less-favorable performance in the rating, if applicable. *See* proposed rule 206(4)-1(a) (the proposed rule's general prohibitions).

laws. For example, where an adviser's advertisement references a recent rating and discloses the date, but its advisory business has sharply declined shortly thereafter, the advertisement would be misleading. Likewise, an adviser's advertisement would be misleading if it indicates that the adviser is rated highly without disclosing that the rating is based solely on a criterion, such as assets under management that may not relate to the quality of the investment advice.

Finally, we are proposing additional requirements for third-party ratings in advertisements that we believe would increase the integrity of the rating and reduce the risk that it misleads investors. In many cases, third-party ratings are developed by relying significantly on questionnaires or client surveys. Our proposed rule would require that the investment adviser reasonably believe that any questionnaire or survey used in the preparation of the third-party 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. Third-party ratings not designed in this manner may be misleading. Our proposed approach would update the current rule by permitting advisers to promote their accomplishments by referencing third-party ratings, while prohibiting certain misleading or fraudulent practices.[177] For an adviser to satisfy the proposed reasonable belief requirement, it would likely need to have access to the questionnaire or survey that was used in the preparation of the rating. We request comment on this aspect of the proposed rule:

- Would our proposed required disclosures for testimonials, endorsements, and third-party ratings provide useful information to investors? If not, why? Would our proposed disclosures provide useful information to both Retail Persons and Non-Retail Persons? Are Non-Retail Persons and Retail Persons similarly

[177] The current rule does not specifically address third-party ratings.

positioned to use the information that would be provided in the disclosures to obtain important contextual information about the third-party statements? If not, what approach do commenters advocate and why?

- Should the current rule's flat prohibition on testimonials of any kind be retained in an amended rule? If so, should it apply to testimonials, endorsements, and third-party ratings in Retail Advertisements or Non-Retail Advertisements, or both?
- Should testimonials, endorsements, and third-party ratings be treated differently from each other under the rule? If so, how? For example, should compensation be permitted (with disclosure) for one type of third-party statement but prohibited for another? Should we add different conditions to each type of advertisement depending upon, for example, the person making the statement or the content of the statement?
- For testimonials that the adviser includes in Retail Advertisements, should the rule text expressly prohibit the adviser from selectively including positive testimonials without providing an equal number of negative testimonials (if applicable)? If so, what would be the benefits of such a prohibition, in light of the proposed rule's general prohibition and tailored conditions that would also apply to testimonials in advertisements (*e.g.*, the prohibition from including any untrue statement of a material fact, or omitting to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading)? If we included such an express prohibition, should we apply a carve-out for testimonials that appear on an adviser's website, or a third-

party site, over which the adviser does not have any influence or control (*e.g.*, the adviser cannot delete, rank or affect the display or presentation of any particular testimonial)? Why or why not? Is there any other method we should specifically prescribe in the rule for testimonials in Retail Advertisements (and/or advertisements, generally) other than the proposed rule's general prohibitions, to prevent an adviser from selectively presenting certain favorable testimonials in a way that is not misleading? If so, what method should we prescribe, and why?

- Should we prohibit testimonials, endorsements, or third-party ratings for which an adviser pays more than a *de minimis* amount in value in return for the statement or rating? If so, what should an appropriate value be? Should a prohibition be limited to Retail Advertisements?

- Do commenters believe we should also adopt a "knowledge and experience" requirement for testimonials, endorsements and third-party ratings, like FINRA's requirement for certain testimonials concerning a technical aspect of investing? Should we adopt such requirement instead of, or in addition to, our proposed disclosures and conditions?

- FINRA's filing and regulatory review process of broker-dealer communications provides an additional assurance that a testimonial in a broker-dealer communication is used in a manner that complies with the rule's standards.[178] Given that we do not have a review process like FINRA's, and that the adviser is promoting its own services, should we allow advisers to use testimonials,

[178] *See* FINRA rule 2210(b) and (c).

endorsements, and third-party ratings in Retail and Non-Retail Advertisements, subject to the rule's anti-fraud provision and the additional conditions?

- FINRA rule 2210 also requires additional disclosures when testimonials are included in retail communications.[179] The additional disclosures include disclosing prominently that the testimonial may not be representative of the experience of other customers and that the testimonial is no guarantee of future performance or success.[180] Should we require such disclosures? Do commenters believe that such disclosures provide meaningful information to investors? Would other disclosures or requirements for presentation to investors reduce the risk that a testimonial or endorsement might lead investors to make inferences about an adviser that are inappropriate or inaccurate?
- As noted above, statements that would be prohibited by the adviser under the proposed rule's general prohibitions of certain advertising practices would also be prohibited if made by a third party in a testimonial, endorsement, or third-party rating that an adviser uses in its advertisement. Should we also explicitly state in the rule text, similar to the FTC's Guides for endorsements, that (i) advisers are subject to liability for false or unsubstantiated statements made through endorsements, testimonials, and third-party ratings, and (ii) the adviser must

179 *See generally* FINRA rule 2210(d)(6).

180 *See also* FTC Guides, *supra* footnote 174 and accompanying text (discussing the FTC Guides' adequate substantiation provision). However, the FTC Guides state that the FTC tested the communication of advertisements containing testimonials that clearly and prominently disclosed either "Results not typical" or "These testimonials are based on the experiences of a few people and you are not likely to have similar results," and concluded that neither disclosure adequately reduced the communication that the experiences depicted are generally representative. The FTC Guides further noted that based upon this research, the FTC believes that similar disclaimers regarding the limited applicability of an endorser's experience to what consumers may generally expect to achieve are unlikely to be effective.

possess and rely upon adequate substantiation to support the claims made through endorsements, testimonials and third-party ratings in the same manner the adviser would be required to do if it had made the representation directly? Given that the proposed general anti-fraud principles would apply to testimonials, endorsements, or third-party ratings in advertisements, are such explicit requirements necessary? Why or why not?

- Do commenters believe that our proposed disclosures appropriately reduce the risk that compensated testimonials, endorsements, and third-party ratings could mislead investors, and that any remaining risk is justified by the potential benefits of such statements? If not, should we instead prohibit compensated testimonials, endorsements, and third-party ratings in Retail or Non-Retail Advertisements? Why or why not? Alternately, should we require disclosure of the amount of compensation provided by or on behalf of the adviser for a testimonial, endorsement, or third-party rating? Why or why not?
- In circumstances where advisers themselves cannot provide the disclosures required for testimonials, endorsements, and third-party ratings in advertisements, should we require that the advisers form a reasonable belief that the advertisements contain the required clear and prominent disclosures, as proposed? Why or why not? In what types of situations should advisers be required to form such a reasonable belief?

- Should we establish a *de minimis* exception to disclosing that compensation was paid for a testimonial, endorsement, or third-party rating, if compensation is under a certain amount, similar to the "more than $100 in value" threshold imposed by

FINRA? What would be the threshold and why is that threshold appropriate? Should such a *de minimis* be adjusted for inflation over time? How would firms value any non-cash compensation? Should any such exception be limited to Non-Retail Advertisements? Please explain your answer.

- Do commenters believe it would or would not be difficult for investment advisers to form a reasonable belief of whether a questionnaire or survey used to create a third-party rating is structured in a way that makes it easy for participants to provide favorable and unfavorable responses and is not designed to produce any predetermined result? Why or why not? Would an adviser more easily have access to, and editorial control over, questionnaires or surveys used in a rating when the adviser (or someone on its behalf) solicits a third-party to conduct the rating, as opposed to when an adviser is approached by a third-party to participate in its rating? If so, should our rule address this difference?
- Should our rule prescribe how the adviser should seek to form a reasonable belief that the questionnaire or survey used to create a third-party rating is structured in a way that makes it easy for participants to provide favorable and unfavorable responses and is not designed to produce any predetermined result? For example, should an adviser be required to conduct due inquiry (*e.g.*, obtaining a representation from the third-party about the structure of the questionnaire, or obtaining copies of the questionnaires and maintaining them in their books and records)? Why or why not?
- Are there additional disclosures that might provide investors with useful context to evaluate the merits of a third-party rating? For example, would it be useful for

investors to know the number of survey participants or the percentage of participating advisers who received each designation or rating? Should investment advisers be required to disclose the criteria upon which the rating was based, including, for example: (i) assets under management; (ii) performance (both realized and unrealized); (iii) number of years in operation; or (iv) size of the adviser based on other metrics such as number of employees or number of offices?

- Are the proposed disclosure requirements for third-party ratings sufficiently broad to capture references to independent third-party ratings, regardless of whether such ratings are based entirely, or in part, on investor surveys or questionnaires, rather than other analysis (*e.g.,* performance)?

### 5. Performance Advertising

Advertisements containing performance results ("performance advertising") can be a useful source of information for investors when such advertisements are presented in a manner that is neither false nor misleading. An investment adviser advertising performance results typically does so to demonstrate its competence and experience and to provide evidence of how the adviser's strategies and methods have worked in the past. A prospective investor may reasonably wish to see performance results attributable to an adviser that the prospective investor may consider hiring.

Performance advertising would be subject to the proposed rule's general prohibitions. These prohibitions would address the risk of performance advertising containing any untrue statements of material fact or being otherwise materially misleading. Performance advertising raises special concerns, however, that warrant additional requirements and restrictions under the

proposed rule. In particular, the presentation of performance could lead reasonable investors to unwarranted assumptions and thus would result in a misleading advertisement. For example, a prospective investor could reasonably believe that the advertised performance results are similar to those that the investor could achieve under the adviser's management. We believe that prospective investors may rely particularly heavily on advertised performance results in choosing whether to hire or retain an investment adviser.[181] This reliance may be misplaced to the extent that an investor considers past performance achieved by an investment adviser to be predictive of the results that the investment adviser will achieve for the investor.[182] Similarly, we believe that investors may be influenced heavily by the manner in which past performance is presented. For example, recent research indicates that a change in the presentation of Israeli retirement funds' past performance could have significantly affected households' investment decisions.[183] As a result, we believe there is a heightened risk that the presentation of performance results may be

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181 *See also* Proposed Amendments to Investment Company Advertising Rules, Release No. IC-25575 (May 17, 2002) [67 FR 36712 (May 24, 2002)] ("Proposed Investment Company Advertising Release") (noting studies finding retail investors in mutual funds rely heavily on performance results in advertisements).

182 For example, research has indicated that, with respect to mutual funds, there is "weak and controversial evidence that past performance has much, if any, predictive ability for future returns." *See* Alan R. Palmiter & Ahmed E. Taha, *Mutual Fund Performance Advertising: Inherently and Materially Misleading?*, 46 GA. L. REV. 289, 300 (2012) (quoting Ronald T. Wilcox, *Bargain Hunting or Star Gazing? Investors' Preferences for Stock Mutual Funds*, 76 J. BUS. 645, 651 (2003)).

183 *See* Shaton, Maya (2017). "The Display of Information and Household Investment Behavior," Finance and Economics Discussion Series 2017-043. Washington: Board of Governors of the Federal Reserve System, *available at* https://www.federalreserve.gov/econres/feds/files/2017043pap.pdf. This paper examined the effects on Israeli households' trade volume and risk-portfolio allocation following a regulatory change in the presentation of retirement funds' past performance. Specifically, starting in 2010, Israel's retirement funds were prohibited from displaying returns for any period shorter than 12 months. The "default performance measure" of retirement funds changed from 1-month returns to 12-month returns, although investors were still able to view 1-month returns. This paper found that fund flow sensitivity to past 1-month returns significantly decreased after the regulatory change, which suggests the "default performance measure" could have been a significant factor in their investment decisions.

made in a manner that may mislead prospective investors, including by creating in those prospective investors unrealistic expectations.[184]

Further, we believe that certain types of performance advertising raise special concerns because of many prospective investors' limited ability to analyze and verify the advertised performance due to a lack of access to analytical and other resources.[185] In the absence of specific standards for computation and presentation such as those we have promulgated for RICs and BDCs,[186] performance advertising allows investment advisers to take advantage of their access to the results and the underlying data and make specific choices over how to select and portray them. Investors without sufficient access to analytical resources may not be in a position to question or challenge how relevant or useful the advertised results are in light of the underlying assumptions and limitations. Other, and potentially much greater, concerns are raised when advisers present hypothetical performance – that is, performance results that were not actually achieved by any portfolio of any client of the investment adviser – which typically reflects assumptions made by the adviser. The more assumptions the adviser uses in preparing

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184 *See* Proposed Investment Company Advertising Release, *supra* footnote 181 (proposing amendments to rule 482 and citing concerns that that some funds, when advertising their performance, may resort to techniques that create unrealistic investor expectations or may mislead potential investors); *see also* Anametrics Investment Management, SEC Staff No-Action Letter (Apr. 5, 1977) (indicating the staff's view that "[i]nformation concerning performance is misleading if it implies something about, or is likely to cause an inference to be drawn concerning, the experience of advisory clients, the possibilities of a prospective client having an investment experience similar to that which the performance data suggests was enjoyed by the adviser's clients, or the advisor's [*sic*] competence when there are additional facts known to the provider of the information, or which he ought to know, which if also provided would cause the implication not to arise or prevent the inference being drawn.").

185 For example, some investors may hire or otherwise have access to investment personnel that analyze and conduct due diligence of investments and investment opportunities based on extensive information collected from a variety of sources.

186 *See* Advertising by Investment Companies, Release No. IC-16245 (Feb. 2, 1988) [53 FR 3868 (Feb. 10, 1988)] (adopting specific rules regarding the advertising of performance because of Commission concerns that investors could not compare performance claims because no prescribed methods of calculating fund performance existed (except for money market funds), and because funds were being advertised on the basis of different types of performance data).

the presentation, the more opportunities the adviser has to select assumptions to improve the result, and the better the investor must understand the assumptions and their effect on the result. Reflecting our concerns about the advertising of performance results, we have separately imposed particular requirements on such advertising by RICs and BDCs.[187] Likewise, we are proposing particularized requirements in the proposed rule, as discussed below.

### a. *Application of the General Prohibitions to Performance Advertising*

Paragraph (a) of the proposed rule contains a list of advertising practices that we believe should be prohibited, rather than permitted subject to specified conditions, and these prohibitions would also apply to performance advertising. In particular, the proposed rule would prohibit an advertisement if it "omits to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading."[188] The proposed rule would also prohibit an advertisement if it "include[s] an untrue or misleading implication about, or [would] reasonably be likely to cause an untrue or misleading inference to be drawn concerning, a material fact relating to the investment adviser."[189] We believe that investment advisers generally would include in their performance advertising certain disclosures to avoid these types of omissions, implications, and inferences. Such disclosures could provide important

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187 *See* 17 CFR 230.482; *see also* Final Investment Company Advertising Release, *supra* footnote 57, at 57760 ("Like most issuers of securities, when an investment company ('fund') offers its shares to the public, its promotional efforts become subject to the advertising restrictions of the Securities Act.…The advertising restrictions of the Securities Act cause special problems for many investment companies…. In recognition of these problems, the Commission has adopted special advertising rules for investment companies. The most important of these is rule 482 under the Securities Act…"); Securities Offering Reform for Closed-End Investment Companies, Release No. IC-33427 (Mar. 20, 2019) [84 FR 14448 (Apr. 10, 2019)].

188 Proposed rule 206(4)-1(a)(1).

189 Proposed rule 206(4)-1(a)(3).

information and prompt the audience to seek additional information, resulting in improved investment decisions.

We recognize that the Commission staff, in stating it would not recommend enforcement action regarding presentation of performance under the current rule, has discussed a number of disclosures that advisers may consider including in such a presentation.[190] Accordingly, many investment advisers may already include such disclosures in their performance advertising or consider such disclosures to be useful in preparing performance advertising that is neither false nor misleading. These include disclosure of: (1) the material conditions, objectives, and investment strategies used to obtain the results portrayed;[191] (2) whether and to what extent the results portrayed reflect the reinvestment of dividends and other earnings;[192] (3) the effect of material market or economic conditions on the results portrayed;[193] (4) the possibility of loss;[194] and (5) the material facts relevant to any comparison made to the results of an index or other

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190 In some letters, our staff has stated that a failure to disclose certain information could be considered misleading. That information includes how material market conditions, advisory fee expenses, brokerage commissions, and the reinvestment of dividends affect the advertised performance results. *See, e.g.,* Clover Letter.

191 For example, an advertisement presenting performance results of a composite of portfolios targeting growth in international biotechnology companies might disclose whether those results were attributable to strong performance of a few large holdings or strong performance in the industry overall.

192 Such disclosure could inform the audience that amounts other than those originally invested contributed (positively or negatively) to the overall performance. The reinvestment of dividends and other earnings may have a powerful compounding effect on investment performance, and the audience might infer something about the adviser's abilities that is not true without such reinvestment.

193 For example, such disclosure could include the effect of an increase in interest rates on the results or the fact that the broader market increased by a certain amount during the same period as used in the results. Advisers might also consider whether the audience has sufficient information to understand that absence of those particular market or economic conditions in the future could cause future performance to differ significantly.

194 Such disclosure might alert the audience to the limitations of relying on performance data for investment decisions, as well as the relationship between rewards and risk. *See also* 17 CFR 230.482(b)(3)(i); Final Investment Company Advertising Release, *supra* footnote 57 (requiring certain RIC advertisements presenting performance figures to include a legend stating that past performance does not guarantee future results and that current performance may be lower or higher than the performance data quoted).

benchmark.[195] We are not proposing to require these specific disclosures or a legend containing specified disclosures in advertisements presenting performance results.[196] Instead, as discussed above, the proposed rule reflects a principles-based approach.[197] In addition, we understand that requiring standard disclosures in all performance advertising prepared by investment advisers may be of limited utility to investors, given their diversity and the diversity of the advisory services they seek. That is, a set of standard disclosures, such as those we require in certain advertisements for RICs,[198] may be either over-inclusive or under-inclusive for purposes of advertisements disseminated with respect to investment advisory services. In addition, we believe that requiring a list of disclosures that may not be properly tailored to the relevant services being offered or the performance being presented could result in a prospective investor receiving irrelevant information or being unable to determine which information is most relevant. We believe that advisers generally should evaluate the particular facts and circumstances of the advertised performance, including the assumptions, factors, and conditions that contributed to the performance, and include appropriate disclosures or other information

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195 Such disclosure might explain that the index has a different level of volatility, represents a fixed group of securities, is not managed, and involves no shorting activity. These material facts could provide a context for the audience to evaluate the significance of the comparison to the index. A favorable comparison to an index would not provide the audience with a clear assessment of the adviser's value if the favorable comparison is a result of factors related to the index and having nothing to do with the adviser. Similarly, a favorable comparison to an index may not be useful if the results presented reflect the adviser having taken on more risk of loss than by investing in the index.

196 *See, e.g.,* 17 CFR 230.482(b)(3)(i) (requiring legends containing specific disclosures in certain RIC advertisements including performance figures, including a disclosure that "past performance does not guarantee future results"); *see also* 17 CFR 230.482(b)(1) (requiring specific statements about availability of additional information); 17 CFR 230.482(b)(2) (requiring specific legend); 17 CFR 230.482(b)(4) (requiring specific statement in advertisements for certain money market funds).

197 *See supra* section I.A.

198 Some research has called into question the utility of these standard disclaimers. *See, e.g.,* Molly Mercer, Alan R. Palmiter, and Ahmed E. Taha, *Worthless Warnings? Testing the Effectiveness of Disclaimers in Mutual Fund Advertisements*, 7 J. EMPIRICAL LEGAL STUD. 429 (2010) (presenting the results of a controlled experiment that indicated that disclaimers required by rule 482 regarding the importance of advertised performance data did not reduce reliance on advertised past returns by participants in the experiment).

such that the advertisement does not violate the prohibitions in paragraph (a) of the proposed rule or other applicable law.[199]

We request comment on the approach we are taking to disclosures in performance advertising.

- The proposed rule addresses some disclosures by reference to the prohibitions in paragraph (a). As an alternative, should we require in rule text any specific disclosures or other information to be included in performance advertising?[200] Why or why not? Should we require any of the disclosures described above? For example, should we require disclosure of the material conditions, objectives, and investment strategies used to obtain the results portrayed; whether and to what extent the results portrayed reflect the reinvestment of dividends and other earnings; the effect of material market or economic conditions on the results portrayed; the possibility of loss; or the material facts relevant to any comparison made to the results of an index or other benchmark? Why or why not? Should our disclosure requirements differ based on the intended audience for the performance advertising?
- Are there specific disclosures that we should require to prevent performance advertising from being misleading – *e.g.,* how material market conditions, advisory fee expenses, brokerage commissions, and the reinvestment of dividends affect the

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199 We believe that investment advisers might include these disclosures in any performance advertising because in their absence the advertisement otherwise might violate the provisions of paragraph (a) of the proposed rule or the general anti-fraud provisions of the Federal securities laws. For example, the absence of disclosures such as those discussed above could result in an untrue or misleading implication about, or could reasonably be likely to cause an untrue or misleading inference to be drawn concerning, a material fact relating to the investment adviser, in violation of the proposed rule. *See* proposed rule 206(4)-1(a)(3). Similarly, the absence of these disclosures could constitute omissions of material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. *See* proposed rule 206(4)-1(a)(1); *see also supra* footnote 79 and accompanying text.

200 *See* Clover Letter.

advertised performance results? If so, should we identify those and specifically require their disclosure?

- Are there specific disclosures that we should require to prevent prospective investors from placing too much importance on performance advertising? Should we require disclosures similar to or different from those required in RIC advertisements, such as a disclosure that past performance neither guarantees nor predicts future results, or a disclosure that past performance may not be an accurate indication of the investment adviser's competence or experience?
- If we adopt a rule that requires specific disclosures, should we specify how those disclosures are presented? For example, should we specify the proximity of the disclosure to the claim it qualifies or other relevant information? Should we specify how prominent such disclosure should be – *e.g.,* with respect to size, color, or use of graphics – in order to increase the likelihood that a prospective investor reviews the disclosure? Would specifying such characteristics impede investment advisers from using non-paper media for advertising? Are there other elements of presentation that we should consider if we adopt a rule requiring specific disclosures?
- Are there specific disclosures that investment advisers include in their advertisements in order to comply with the current rule that they believe would be unnecessary in order to comply with the proposed rule?
- Have investment advisers experienced any specific compliance challenges in preparing and presenting appropriate disclosures for performance advertising? What types of compliance challenges and how might we address them in the proposed rule?

- Are there specific disclosures that should be required in presenting the performance results of separate accounts but not pooled investment vehicles? Or in presenting the performance results of pooled investment vehicles but not separate accounts? What sorts of issues do investment advisers face in advertising performance results of pooled investment vehicles that they do not face in advertising performance results of separate accounts? Should the proposed rule address those issues? And if so, how? Are there similar or other issues that would apply to presenting the performance results of other investment structures, for example side pockets of illiquid investments?

### b. *Requirements for Gross and Net Performance*

We recognize that the audiences viewing an advertisement may have differing levels of access to analytical and other resources to analyze information in performance advertising. Based on our experience and outreach, we believe that some advertising practices that are likely to be misleading with respect to retail investors may not be misleading for investors with the resources to consider and analyze the performance information. We are therefore proposing certain requirements that are designed specifically to empower Retail Persons, as defined below, to understand better the presentation of performance results and the limitations inherent in such presentations. In particular, we are proposing to require advisers to include net performance results in any Retail Advertisements, as defined in the proposed rule, that include gross performance results. We are also proposing to require the performance results in Retail Advertisements to cover certain prescribed time periods. We believe these requirements will prevent investment advisers from presenting performance results in a way that is likely to

mislead Retail Persons, including by creating unrealistic expectations or undue implications that the advertised performance will likely be achieved or is guaranteed to be achieved.

i. Proposed Definition of "Retail Advertisement"

Rather than establish a new qualification for investment advisers to use in determining whether a person has access to analytical and other resources for independent analysis of performance results, the proposed rule would rely on existing statutory and regulatory definitions. Specifically, the proposed rule distinguishes between advertisements for which an adviser has adopted and implemented policies and procedures reasonably designed to ensure that the advertisements are disseminated solely to qualified purchasers and certain knowledgeable employees (defined as "Non-Retail Advertisements" in the proposed rule) and all other advertisements (defined as "Retail Advertisements" in the proposed rule).[201]

The proposed rule would treat each investor in a pooled investment vehicle, including in a private fund, as a Retail Person or Non-Retail Person, depending on whether the investor is a qualified purchaser or knowledgeable employee. An investment adviser to a pooled investment vehicle would be required to "look through" the vehicle to its investors in order to comply with the proposed rule. If a pooled investment vehicle has as investors both Non-Retail Persons and Retail Persons, then the investment adviser could choose to disseminate a Retail Advertisement to the Retail Persons and a Non-Retail Advertisement to the Non-Retail Persons in the same pooled investment vehicle. Alternatively, to ensure that all investors receive the same information, the investment adviser could choose to disseminate only a Retail Advertisement to

[201] FINRA's communications rule similarly distinguishes types of communications on the basis of audience, with more prescriptive content requirements applying to "correspondence" and "retail communications" than to "institutional communications." *See*, *e.g.*, FINRA rule 2210(d)(2); FINRA rule 2210(d)(3); and FINRA rule 2210(d)(4)(A).

all investors in the pooled investment vehicle. We believe this approach is appropriate to address the difference in access to analytical and other resources among types of investors. That is, we seek to differentiate between types of investors, and not types of advisory services or investment opportunities.

The proposed rule would require certain additional disclosures for Retail Advertisements. Specifically, an adviser would be required to include net performance in certain Retail Advertisements and to present performance results using 1-, 5-, and 10-year period presentations. As discussed below, an adviser would also be subject to certain additional conditions when providing hypothetical performance.[202]

ii. Proposed Definition of "Non-Retail Advertisement."

The proposed rule would define a "Non-Retail Advertisement" to mean any advertisement for which an adviser has adopted and implemented policies and procedures reasonably designed to ensure that the advertisement is disseminated solely to non-retail persons."[203] "Non-Retail Person" would be defined as two types of investors: "qualified purchasers,"[204] and "knowledgeable employees."[205]

Qualified purchasers are investors that are eligible to invest in private funds such as hedge funds and private equity funds that rely on section 3(c)(7) of the Investment Company Act. The statute presumes them to have the financial sophistication to invest in these types of

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202 *See infra* section II.A.5.c.iv.

203 Proposed rule 206(4)-1(e)(7).

204 *See* proposed rule 206(4)-1(e)(8)(i). *See* 15 U.S.C. 80a-2(a)(51).

205 *See* proposed rule 206(4)-1(e)(8)(ii). *See* rule 3c-5 under the Investment Company Act. For purposes of the proposed rule, a knowledgeable employee would be treated as a Non-Retail Person with respect to a company that would be an investment company but for the exclusion provided by section 3(c)(7) of the Investment Company Act, if the "knowledgeable employee" otherwise satisfied the terms of that definition. *See infra* footnotes 214-216 and accompanying text.

investment vehicles, which, because they are not registered, do not provide the protections of the Investment Company Act.[206] The "qualified purchaser" definition generally captures entities with $25 million in "investments" and natural persons with $5 million in "investments," as defined by rule 2a51-1 under the Investment Company Act.[207] As we have stated previously, the "qualified purchaser" definition articulates the types of investors that "are likely to be able to evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage and redemption or withdrawal rights."[208]

We believe that treating a qualified purchaser as a Non-Retail Person would provide an appropriate standard for purposes of determining whether the person has sufficient resources to consider and analyze certain types of performance information without additional disclosures and conditions. We understand also that qualified purchasers are regularly in a position to negotiate the terms of their arrangements with investment advisers, whether as separate account

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206 *See generally* 15 U.S.C. 80a-3(c)(7). Section 3(c)(7) excludes from the definition of "investment company" an issuer that is not making a public offering of its securities and is owned exclusively by qualified purchasers. *See* Privately Offered Investment Companies, Release No. IC-22597 (Apr. 3, 1997) [62 FR 17512 (Apr. 9, 1997)] ("Qualified Purchaser Adopting Release") (indicating that qualified purchasers are the types of investors that Congress determined do not need the protections of the Investment Company Act); *see also* 2019 Concept Release, *supra* footnote 19.

207 *See* 15 U.S.C. 80a-2(a)(51). "Investments" is defined in rule 2a51-1 under the Investment Company Act and generally includes securities and other assets held for investment purposes. 17 CFR 270.2a51-1. *See* Qualified Purchaser Adopting Release, *supra* footnote 206, at 17515 (noting the Commission's belief that the legislative history of the "qualified purchaser" standard suggested that Congress intended "investments" for these purposes to be assets held for investment purposes and having a nature that "indicate[s] that [the assets'] holder has the investment experience and sophistication necessary to evaluate the risks of investing in unregulated investment pools," such as 3(c)(7) funds).

208 *See* Private Investment Companies, Release No. IC-22405 (Dec. 18, 1996) [61 FR 68102 (Dec. 26, 1996)] (referring to legislative history indicating that funds relying on the exclusion under section 3(c)(7) of the Investment Company Act "are to be limited to investors with a high degree of financial sophistication who are in a position to appreciate the risks associated with investment pools that do not have the protections afforded by the Investment Company Act"). Issuers relying on the exclusion under section 3(c)(7) of the Investment Company Act cannot make or propose to make a public offering of securities, a limitation that the Commission stated "appears to reflect Congress's concerns that unsophisticated individuals not be inadvertently drawn into" such a vehicle. Qualified Purchaser Adopting Release, *supra* footnote 206, at n. 5.

clients or as fund investors. Their access to analytical and other resources generally provides them with the opportunity to ask questions of, and receive information from, the appropriate advisory personnel, and enables them to assess that information before making investment decisions. Accordingly, if an adviser has policies and procedures reasonably designed to ensure that certain advertisements are disseminated solely to qualified purchasers, we believe it would be appropriate to apply fewer requirements regarding the presentation of performance in such advertisements.[209]

In treating as Non-Retail Persons any qualified purchaser, the proposed rule would take into account the provisions of rule 2a51-1 under the Investment Company Act, which clarifies when certain investors may be deemed "qualified purchasers." For example, rule 2a51-1(g)(1) clarifies the circumstances under which certain qualified institutional buyers (QIB) under rule 144A under the Securities Act may be deemed "qualified purchasers."[210] The proposed rule would adopt this approach and treat any such QIB as a Non-Retail Person to which Non-Retail Advertisements could be disseminated.[211]

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209 Proposed rule 206(4)-1(c)(2)(i) (prohibiting a Retail Advertisement from presenting gross performance unless it also presents net performance with at least equal prominence and in a format designed to facilitate comparison).

210 *See* Qualified Purchaser Adopting Release, *supra* footnote 206, at 17514 ("The Commission believes that it is generally appropriate to treat [QIBs] as qualified purchasers for section 3(c)(7) in light of the high threshold of securities ownership that these institutions must meet under rule 144A, a threshold much higher than the investment ownership threshold required for qualified purchasers under section 2(a)(51)(A) of the [Investment Company Act].") A QIB generally includes certain institutions that, in the aggregate, own and invest on a discretionary basis at least $100 million in securities of issuers that are not affiliated with such institutions. *See generally* 17 CFR 230.144A(a)(1). Banks and other specified financial institutions must also have a net worth of at least $25 million. A QIB is a person to whom persons other than the issuer may sell securities that are not registered under the Securities Act pursuant to a safe harbor exemption contained in rule 144A.

211 Although a QIB is generally a qualified purchaser, there are two exceptions. One exception requires a dealer (other than a dealer acting for a QIB in a riskless principal transaction) to own and invest on a discretionary basis a greater amount of securities of unaffiliated issuers to be a qualified purchaser than to be a QIB. 17 CFR 270.2a51-1(g)(1)(i). The Commission established this greater amount for qualified purchasers in order to coordinate the QIB definition with the statutory definition of "qualified purchaser." *See* Qualified Purchaser Adopting Release, *supra* footnote 206, at 17514. The other exception excludes

Rule 2a51-1(h) also defines "qualified purchaser" to include any person that the issuer or a person acting on its behalf "reasonably believes" meets such definition.[212] The proposed rule would adopt this approach as well and allow an investment adviser to provide a Non-Retail Advertisement to an investor that the investment adviser reasonably believes is a qualified purchaser. Rule 2a51-1 has existed for twenty years, and we believe that many investment advisers have developed policies and procedures to implement this "reasonable belief" provision. Accordingly, we believe that advisers would utilize or modify those same policies and procedures as necessary to comply with the proposed rule. We recognize, however, that the application of this "reasonable belief" provision might differ for evaluating the audience for advertisements, where often the adviser has not yet had an opportunity to perform the due diligence that might be common for evaluating whether an investor is qualified to invest. Accordingly, we request comment below on any additional procedures or standards we should require in the rule text for evaluating whether such advertisements are directed only to Non-Retail Persons.

The proposed rule also would treat as a Non-Retail Person any "knowledgeable employee," as defined in rule 3c-5 under the Investment Company Act, with respect to a company that would be an investment company but for the exclusion provided by section 3(c)(7)

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self-directed employee benefit plans or trust funds holding the assets of employee benefit plans from the qualified purchaser definition unless the beneficiaries making the investment decisions are themselves qualified purchasers. 17 CFR 270.2a51-1(g)(1)(ii). The Commission established this "look through" requirement citing legislative history indicating that the relevant factor was the amount of investments owned by the person making the investment decision. *See* Qualified Purchaser Adopting Release, *supra* footnote 206, at 17519.

212 17 CFR 270.2a51-1(h). In adopting this "reasonable belief" prong of rule 2a51-1, the Commission noted that it was reflecting the approach of other rules establishing "certain categories of sophisticated investors" for engaging in transactions and allowed those categories to focus on whether an issuer "reasonably believes" that a prospective investor satisfies certain criteria. Qualified Purchaser Adopting Release, *supra* footnote 206, at 17519.

of the Investment Company Act (a "Section 3(c)(7) Company") that is advised by the investment adviser.[213] The "knowledgeable employee" standard was adopted in order to allow certain employees of a Section 3(c)(7) Company and certain of its affiliates to acquire securities issued by the fund even though they do not meet the definition of "qualified purchaser."[214] The "knowledgeable employee" definition requires an employee to have a significant amount of investment experience in order to qualify – whether the employee has oversight or management responsibility with respect to the Section 3(c)(7) Company or its affiliate,[215] or participates in the investment activities of the Section 3(c)(7) Company in connection with their regular functions or duties.[216] We believe that a "knowledgeable employee" has the relevant investment experience to enable him or her to evaluate a Non-Retail Advertisement with respect to the Section 3(c)(7) Company for which he or she satisfies the definition of "knowledgeable employee". We believe that, as employees actively participating in the investment activities of the Section 3(c)(7) Company or its affiliates, knowledgeable employees will be in a position to bargain for and obtain additional information or ask questions of advisory personnel to help them consider and analyze the type of performance information available in a Non-Retail

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213 As long as a person satisfies the definition of "knowledgeable employee" with respect to the relevant Section 3(c)(7) Company, that person could be treated as a Non-Retail Person to whom a Non-Retail Advertisement with respect to that Section 3(c)(7) Company could be disseminated under the proposed rule.

214 *See* Qualified Purchaser Adopting Release, *supra* footnote 206, at 17524.

215 The first prong of the "knowledgeable employee" definition applies to any Executive Officer (as defined in 17 CFR 270.3c-5(a)(3)), director, trustee, general partner, advisory board member, or person serving in a similar capacity. 17 CFR 270.3c-5(a)(4)(i).

216 The second prong of the "knowledgeable employee" definition applies to employees and Affiliated Management Persons (as defined in 17 CFR 270.3c-5(a)(1)). *See* 17 CFR 270.3c-5(a)(4)(ii). Employees who do not perform "solely clerical, secretarial or administrative functions" with regard to the Section 3(c)(7) Company or its investments may qualify under this prong of the definition if they have participated in the investment activities of the Section 3(c)(7) Company or its investments and have been performing their functions or duties "or substantially similar" functions or duties for at least 12 months. 17 CFR 270.3c-5(a)(4)(ii).

Advertisement. In addition, because many Section 3(c)(7) Companies already include knowledgeable employees as investors, and investment advisers to Section 3(c)(7) Companies may seek to provide these investment opportunities to their knowledgeable employees, we believe that it is appropriate to permit those employees to be treated as Non-Retail Persons to whom Non-Retail Advertisements with respect to the relevant Section 3(c)(7) Companies could be disseminated under the proposed rule.

We considered treating as Non-Retail Persons other categories of investors meeting other standards existing in the Federal securities laws, but are not proposing to include those categories. Three such standards are: (a) "accredited investor," as defined in rule 501(a) of Regulation D under the Securities Act; (b) "qualified client," as defined in rule 205-3(d)(1) under the Advisers Act; and (c) investors that do not meet the definition of "retail investor" for purposes of the Form CRS relationship summary required by rule 204-5 under the Advisers Act. These definitions were adopted by the Commission for particular purposes and including these categories as Non-Retail Persons may not achieve the goals of the proposed rule.[217]

The definition of "accredited investor" generally includes entities with at least $5 million in total assets and natural persons with at least $1 million in net worth[218] or income in excess of $200,000 (or $300,000 jointly with a spouse) in each of the two most recent years with a

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217 In general, investors who meet the "accredited investor" definition are eligible to invest in private funds, such as hedge funds and private equity funds, that are excluded from the definition of "investment company" in reliance on section 3(c)(1) of the Investment Company Act, and investors who meet the "qualified client" definition are eligible to be charged a performance-based fee by their investment advisers. Section 3(c)(1) excludes from the definition of "investment company" an issuer that is not making (and does not presently propose to make) a public offering of its securities and whose outstanding securities are beneficially owned by not more than one hundred persons. *See* 2019 Concept Release, *supra* footnote 19.

218 17 CFR 230.501(a)(5). *See also* 15 U.S.C. 77b(a)(15(ii) (defining certain institutions as "accredited investors" and directing the Commission to establish additional definitions "on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management").

reasonable expectation of reaching the same income level in the current year.[219] Accredited investors are "persons who can bear the economic risk of an investment in unregistered securities, including the ability to hold unregistered (and therefore less liquid) securities for an indefinite period and, if necessary to afford a complete loss of such investment."[220] The accredited investor standard serves as a proxy for being "capable of evaluating the merits and risks of the prospective investment" without the specific protections afforded by the Securities Act with respect to public offerings of securities.[221]

The "accredited investor" standard therefore seeks to identify which investors are able to make certain types of investments in unregistered offerings and balances the considerations of investor choice in investment opportunities and investor ability to bear risks. In contrast, the standard for Non-Retail Person under the proposed rule seeks to provide a proxy for an investor's ability to access the kinds of resources and analyze information that would allow the investor to subject the information presented in Non-Retail Advertisements to independent

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219 17 CFR 230.501(a)(6). The accredited investor standards are measured "at the time of the sale of the securities." 17 CFR 230.501(a). Natural persons serving as directors, executive officers, or general partners of an issuer, or of a general partner of an issuer, also qualify as "accredited investors." 17 CFR 230.501(a)(4).

220 Net Worth Standard for Accredited Investors, Release No. IA-3341 (Dec. 21, 2011) [76 FR 81793, 81794 (Dec. 29, 2011)]. When adopting the definition, the Commission agreed that "accredited investors can fend for themselves without the protections afforded by registration" of securities offerings. Proposed Revision of Certain Exemptions from the Registration Provisions of the Securities Act of 1933 for Transactions Involving Limited Offers and Sales, Release No. 33-6339 (Aug. 7, 1981) [46 FR 41791 (Aug. 18, 1981)], at 41802. *See also* 2019 Concept Release, *supra* footnote 19; Accredited Investor Staff Report, *supra* footnote 17, at 88 ("The accredited investor concept in Regulation D was designed to identify, with bright-line standards, a category of investors whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of registration unnecessary.").

221 17 CFR 230.506(b)(2)(ii) (requiring that any purchaser in a rule 506 offering who is not an accredited investor must possess, or be reasonably believed by the issuer to possess, these characteristics, whereas such a verification is not required for any purchaser who is an accredited investor). If securities are sold to any non-accredited investors, specified information requirements apply; in contrast, accredited investors may purchase such securities without receiving specific information. *See* 17 CFR 230.502(b). A purchaser may rely on his or her purchaser representative(s) to demonstrate these characteristics. 17 CFR 230.506(b)(ii).

scrutiny without the aid of additional disclosures or conditions.[222] We believe that analyzing certain performance information requires access to more specialized and extensive analytical and other resources than would be required to evaluate the merits and risks of an investment in an unregistered offering. In our view, accredited investors are less likely to have the kind of access to these resources and information.

We also considered treating as a Non-Retail Person any person meeting the definition of "qualified client." The definition of "qualified client" generally includes entities and natural persons having at least $1 million under the management of an investment adviser or a net worth (jointly with a spouse in the case of a natural person) of more than $2.1 million.[223] A qualified client is a person with whom a registered investment adviser may enter into an advisory contract that provides for compensation based on a share of capital gains on, or capital appreciation of, the funds of a client (also known as performance compensation or performance fees).[224] Congress generally prohibited these compensation arrangements in 1940 to protect advisory clients from arrangements that Congress believed might encourage advisers to take undue risks with client funds to increase advisory fees.[225] However, clients having the "financial experience and ability to bear the risks of performance fee arrangements," including the "risks of loss that

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222 The "accredited investor" definition at one time included a proxy for bargaining power – an amount of securities being purchased in an offering – on the premise that "individuals capable of investing large amounts of capital in an offering should be considered accredited investors because of their bargaining power." Accredited Investor Staff Report, *supra* footnote 17, at 17. We rescinded that provision in part out of a concern that it "[did] not assure sophistication *or access to information*." Regulation D Revisions, Release No. 33-6758 (Mar. 3, 1988) [53 FR 7866 (Mar. 10, 1988)] (emphasis added).

223 *See generally* rule 205-3(d)(1).

224 A qualified client is also a person who is eligible to invest in a pooled investment vehicle that is managed by a registered investment adviser and that compensates the adviser based on a share of capital gains on, or capital appreciation of, the funds of the pooled investment vehicle.

225 Investment Adviser Performance Compensation, Release No. IA-3372 (Feb. 15, 2012) [77 FR 10361 (Feb. 22, 2012)].

are inherent" in those arrangements,[226] may enter into them. In our view, this status does not necessarily mean that qualified clients generally have the kind of access to more specialized and extensive analytical resources necessary to obtain and analyze information sufficient to evaluate the types of performance information that would be permitted only in a Non-Retail Advertisement without additional requirements.

While we recognize that some qualified clients and accredited investors may have the necessary access to resources, we believe that the qualified purchaser and knowledgeable employee standards are the most appropriate standards to distinguish the persons having sufficient access to analytical and other resources to evaluate the complex and nuanced performance information that would be permitted only in Non-Retail Advertisements under the proposed rule without additional requirements. In balancing access to analytical and other resources needed to evaluate this type of information effectively, with its utility to financially sophisticated investors, we have determined, in our judgment, to propose the qualified purchaser and knowledgeable employee standards as our dividing line for Non-Retail Persons.

Finally, we also considered treating as a Non-Retail Person any person that falls outside the definition of "retail investor" under Form CRS.[227] We believe that this definition of "retail investor" is inappropriate for purposes of the proposed rule as it does not take into account whether an investor has the analytical or other resources to consider and analyze the type of performance information that the proposed rule would permit in Non-Retail Advertisements.

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226 *Id.*

227 Form CRS is a relationship summary that provides succinct information about the relationships and services offered to retail investors (as defined in rule 204-5(d)(2)), fees and costs that retail investors will pay, specified conflicts of interest and standards of conduct, and disciplinary history, among other things. *See* Form CRS Relationship Summary; Amendments to Form ADV, Release No. IA-5247 (June 5, 2019) [84 FR 33492 (Jul. 12, 2019)] ("Form CRS Release"). Form CRS must be delivered by registered investment advisers to each retail investor at specified times. *See* rule 204-5.

The definition of "retail investor" for purposes of Form CRS generally includes all natural persons who seek to receive or receive services primarily for personal, family, or household purposes.[228] This definition imposes no other requirements and does not distinguish between natural persons other than the purposes for which advisory services are sought.[229] Form CRS is designed to provide "clear and succinct disclosure regarding key aspects of available brokerage and advisory relationships" that would benefit "all individual investors."[230] In contrast, the proposed rule is designed to provide additional disclosures for investors where there is a heightened risk of performance results being misused or misleading if the results are not subject to scrutiny and further analysis. We believe that natural persons who are qualified purchasers or knowledgeable employees are likely to have the analytical or other resources to consider and analyze these presentations of performance. Accordingly, we do not believe that falling outside the Form CRS definition would serve as a proxy for the access to analytical or other resources that we believe are necessary for persons receiving Non-Retail Advertisements.

iii. Reasonably Designed Policies and Procedures.

The proposed rule would define "Non-Retail Advertisement" to mean any advertisement for which an adviser "has adopted and implemented policies and procedures reasonably designed" to ensure that the advertisement is disseminated solely to qualified purchasers or

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228 Rule 204-5(d)(2). "Retail investor" for this purpose also includes the "legal representative" of such natural persons. *Id.* We have established definitions by reference to "natural persons" in other contexts as well. For example, we have defined "retail money market funds" to mean, in part, funds the beneficial owners of which are only natural persons. *See* 17 CFR 270.2a-7(a)(21).

229 *See* Form CRS Release, *supra* footnote 227 ("We continue to believe that the retail investor definition should not distinguish based on a net worth or other asset threshold test."). In addition, the definition of "retail client" in Form CRS reflected the definition used in the statute that authorized adoption of that form. *See id.* ("[S]ection 913 of the Dodd-Frank Act defines 'retail customer' to include natural persons and legal representatives of natural persons without distinction based on assets or net worth.").

230 *See* Form CRS Release, *supra* footnote 227.

knowledgeable employees.[231] Such policies and procedures would be reasonably designed to ensure that Non-Retail Advertisements are disseminated by or on behalf of the investment adviser solely to qualified purchasers and knowledgeable employees. We would not prescribe the ways in which an investment adviser may seek to satisfy the "Non-Retail Advertisement" definition, including how the investment adviser will establish a reasonable belief that persons receiving the advertisement are qualified purchasers or knowledgeable employees. The proposed rule's use of policies and procedures to establish a defined audience is an approach we have used previously.[232] We believe that this approach would provide investment advisers with the flexibility to develop policies and procedures that best suit its investor base and its operations, including any use of intermediaries to disseminate advertisements.

Such policies and procedures might include disseminating Non-Retail Advertisements to persons that the investment adviser knows are qualified purchasers on the basis of the amount of "investments" held by that person in an account managed by the investment adviser. Policies and procedures for purposes of the proposed rule might take into account any policies and procedures that an adviser may have adopted as a result of rule 2a51-1(h) under the Investment Company Act, which defines "qualified purchaser" to include any person that the issuer or a person acting on its behalf reasonably believes meets such definition. Similarly, these policies and procedures might reflect the ability of an investment adviser to a particular Section 3(c)(7)

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231 *See* proposed rule 206(4)-1(e)(7).

232 We have defined "retail money market fund" to mean "a money market fund that has policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons." *See* 17 CFR 270.2a-7(a)(21); *see also Money Market Fund Reform; Amendments to Form PF*, Release No. IA-3879 (Jul. 23, 2014) [79 FR 47736 (Aug. 14, 2014)] ("SEC Money Market Fund Reform Release"), at nn. 715-716 and accompanying text.

Company to determine which employees satisfy the definition of "knowledgeable employee" with respect to that Section 3(c)(7) Company.[233]

Regardless of the specific policies and procedures followed by an investment adviser in reasonably concluding that persons receiving Non-Retail Advertisements are qualified purchasers and knowledgeable employees, an adviser must periodically review the adequacy of such policies and procedures and the effectiveness of their implementation.[234] Accordingly, such periodic reviews would assist investment advisers in detecting and correcting any gaps in their policies and procedures, including an adviser's ability to reasonably conclude that its Non-Retail Advertisements are being disseminated solely to qualified purchasers and knowledgeable employees.

iv. Presentation of Gross and Net Performance

The proposed rule would prohibit in any Retail Advertisement any presentation of gross performance unless the advertisement also presents net performance with at least equal prominence and in a format designed to facilitate comparison with gross performance.[235] Gross performance does not indicate all fees and expenses that the adviser's existing investors have borne or that prospective investors would bear, which can be relevant to an evaluation of the investment experience of the adviser's advisory clients and investors in pooled investment vehicles advised by the investment adviser.

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233 For example, such policies and procedures might reflect the methods by which the investment adviser, as the adviser to the Section 3(c)(7) Company, identifies all directors and trustees of the Section 3(c)(7) Company, who would be "knowledgeable employees" by the terms of rule 3c-5 under the Investment Company Act. *See* 17 CFR 270.3c-5(a)(4)(i).

234 *See* rule 206(4)-7(b); *see also* Compliance Program Adopting Release, *supra* footnote 33 ("Annual reviews are integral to detecting and correcting any gaps in the [compliance] program before irrevocable or widespread harm is inflicted upon investors.").

235 Proposed rule 206(4)-1(c)(2)(i)(A).

We believe the proposed requirement is reasonably designed to prevent Retail Persons from being misled by the presentation of gross performance. Presenting gross performance alone may imply that investors received the full amount of the presented returns, when in fact the fees and expenses paid to the investment adviser and other service providers would reduce the returns to investors. Presenting gross performance alone may be misleading as well to the extent that amounts paid in fees and expenses are not deducted and thus not compounded in calculating the returns.

We believe that requiring Retail Advertisements that show performance results to present net performance would help illustrate for Retail Persons the effect of fees and expenses on the advertised performance results.[236] In particular, we believe that the burden of demonstrating the compounding effect of fees and expenses belongs properly on the investment advisers, rather than requiring Retail Persons to make that determination on their own. Advertisements presenting both gross performance and net performance would remain subject to the proposed rule's other requirements as well, including the prohibition on including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced.[237]

We believe that Non-Retail Persons do not need this requirement because they have access to analytical and other resources, and therefore the capacity to evaluate gross performance as advertised. Based on staff outreach, we also believe that Non-Retail Persons often do not find advisers' presentation of net performance useful and prefer to apply to gross performance their own assumptions and calculations of fees and expenses on performance presentations. Non-

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236 *See* proposed rule 206(4)-1(e)(6) (defining "net performance").

237 Proposed rule 206(4)-1(a)(6).

Retail Persons have access to analytical and other resources that allow them to calculate a net performance figure that is relevant to them.[238] Access to analytical and other resources may enable these persons to scrutinize and to assess independently the information provided in advisers' advertisements and allow these persons to decide whether to obtain or retain the offered or promoted services. In addition, we believe Non-Retail Persons are regularly in a position to bargain for and obtain additional information when considering performance information in an advertisement and to negotiate the terms of their agreements with investment advisers, including the amount of fees and expenses that they may reasonably expect to incur.[239] To the extent that those negotiated fees and expenses are different from those that the investment adviser would otherwise reflect in its presentation of net performance, we believe that Non-Retail Persons would be able to calculate the effect on performance of those negotiated fees and expenses. As discussed below, however, we are proposing to require advisers to provide or offer to provide promptly a schedule of fees and expenses to ensure that Non-Retail Persons receiving gross performance calculations will receive such information and may calculate net performance if they desire it.[240]

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238 Investment advisers may be particularly willing to spend time and resources in responding to requests for information from prospective investors when those prospective investors have investment portfolios that are large enough to justify the advisers' efforts or when those prospective investors have investment or finance experience that enables them to analyze information efficiently. Our staff has indicated that it would not recommend enforcement action under the current rule where an investment adviser would present gross performance and not net performance in one-on-one presentations to "certain prospective clients, e.g., wealthy individuals, pension funds, universities and other institutions, who have sufficient assets to justify the cost of the presentations." ICI Letter. The proposed rule similarly would assume that the access to resources of an advertisement's audience can play a role in determining the extent to which an advertisement may be misleading.

239 For example, investors in new private funds may negotiate with the private fund's investment adviser regarding which private fund expenses will be borne by the private fund and its investors and which private fund expenses will be borne by the adviser.

240 Proposed rule 206(4)-1(c)(1)(i).

The proposed rule would require advisers to calculate both gross performance and net performance over the same time period and using the same type of return and methodology.[241] This proposed requirement is designed to help ensure that net performance effectively conveys to the audience information about the effect of fees and expenses on the relevant performance. A calculation of net performance over a different time period or using a different type of return or methodology would not necessarily provide information about the effect of fees and expenses. That is, if differences in calculation were permitted, then any contrast between gross performance and net performance could be attributed simply to those differences and not demonstrate the effect of the deducted fees or expenses.

At the same time, the proposed rule does not prescribe any particular calculation of gross performance or net performance. Because of the variation among types of advisers and investments about which they provide advice, we believe prescribing the calculation could unduly limit the ability of advisers to present performance information that they believe would be most relevant and useful to an advertisement's audience.[242] We understand, however, that an absence of prescribed standards may increase the risk of different advisers presenting different performance figures that are not comparable. Accordingly, we request comment below on any additional guidance we should provide or requirements we should specify in rule text regarding such calculations.

Under the prohibitions in paragraph (a) of the proposed rule, it would be misleading to present certain performance information without providing appropriate disclosure or other information about gross performance or net performance, taking into account the particular facts

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241 *See* proposed rule 206(4)-1(c)(2)(i)(B).

242 In contrast, in Form N-1A, we prescribe the calculation of performance for open-end management investment companies because the performance relates to a single type of investment product.

and circumstances of the advertised performance.[243] For example, to avoid misleading portrayals of performance, advisers generally should describe the type of performance return being presented. Depending on the facts and circumstances, this disclosure may be necessary to avoid misleading the audience as to the elements comprising the presented performance. For example, an advertisement may present the performance of a portfolio using a return that accounts for the cash flows into and out of the portfolio, or instead a return that does not account for such cash flows. In either case, an adviser generally should disclose what elements are included in the return presented so that the audience can understand, for example, how it reflects cash flow and other relevant factors, including the method of calculation and weighting of portfolios and returns in a composite.

The proposed rule would define "gross performance" as "the performance results of a portfolio before the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investment adviser's investment advisory services to the relevant portfolio." The proposed rule would define "net performance" to mean "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 the investment adviser's investment advisory services to the relevant portfolio" and includes a non-exhaustive list of the types of fees and expenses to be considered in preparing net performance. This list includes, if applicable, advisory fees, advisory fees paid to underlying investment vehicles, and payments by the investment adviser for which the client or investor reimburses the adviser, and is meant to illustrate fees and expenses that clients or investors bear in connection with the services they receive. Under the proposed definitions, "net performance" would be calculated after deducting

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243 *See supra* footnote 199 and accompanying text.

"all fees and expenses," while "gross performance" might be calculated after deducting some (but not all) fees or expenses.[244]

The fees and expenses to be deducted in calculating net performance are those that an investor "has paid or would have paid" in connection with the services provided. That is, where hypothetical performance is permissibly advertised under the proposed rule, net performance should reflect the fees and expenses that "would have been paid" if the hypothetical performance had been actually achieved by an actual portfolio.[245]

Both "gross performance" and "net performance" would be defined by reference to a "portfolio," which would be defined as "an individually managed group of investments" and can include "an account or pooled investment vehicle."[246] Once an adviser establishes the "portfolio" for which performance results are presented, the adviser would determine the fees and expenses borne by the owner of the portfolio and then deduct those to establish the "net performance."

The "net performance" definition allows an adviser to apply three possible modifications when it deducts the relevant fees and expenses. First, "net performance" may reflect the deduction of a model fee when doing so would result in performance figures that are no higher

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244 For example, if an investment adviser calculates the performance of a portfolio in part by deducting the fees and expenses charged when buying, selling, or exchanging investments (including, if applicable, brokerage commissions and exchange fees), but deducts no other fees or expenses, then such performance would be "gross performance" under the proposed rule. In order to present that gross performance in a Retail Advertisement, the advertisement must also present "net performance." Because the proposed definition of "net performance" includes the deduction of "all fees and expenses" (subject to the proposed modifications described in the definition), the calculation of net performance would necessarily require the deduction of those types of trading expenses.

245 *See infra* section II.A.5.c.ii (discussing the presentation of net performance with respect to representative performance).

246 This proposed definition is identical to the definition used in the Global Investment Performance Standards adopted by the CFA Institute. *See* Global Investment Performance Standards (GIPS), 2010, *available at*: https://www.gipsstandards.org/standards/pages/currentedition.aspx. The 2020 GIPS standards will be effective on January 1, 2020.

than if the actual fee had been deducted.[247] In this case, the adviser may deduct the highest fee charged in respect of the portfolio giving rise to the performance and, accordingly, present performance that is lower than it would be if the actual fees had been deducted. We understand that advisers may choose this modification for the ease of calculating net performance. When an adviser advertises net performance that is no higher than that reflecting the deduction of actual fees, there appears to be little chance of the audience being misled.[248]

Second, "net performance" may reflect the deduction of a model fee that is equal to the highest fee charged to the relevant audience of the advertisement.[249] For example, an adviser presenting performance information in a Retail Advertisement may choose to present net performance using a model fee that is equal to the highest fee charged to a Retail Person. This modification could also allow the adviser to calculate net performance easily, while using a fee that is relevant to the target audience. We believe this presentation of performance results would not cause investors to mistakenly believe that similar investors received returns higher than those investors actually did. Net performance that reflects a model fee that is not available to the audience – *e.g.*, because the model fee is offered only to persons having a certain amount of assets under management by the adviser – may imply that the audience can expect future performance to be reduced by that same fee and would not be permitted under this modification.

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247 Proposed rule 206(4)-1(e)(6)(i).

248 That is, the audience would not be misled into believing that investors received better returns than they actually did, because the advertised net performance would be lower than or equal to the net performance calculated using actual fees and expenses.

249 Proposed rule 206(4)-1(e)(6)(ii).

We understand that this proposed modification may be useful for advisers who manage a particular strategy for different types of investors.[250]

Third, "net performance" may exclude custodian fees paid to a bank or other third-party organization for safekeeping funds and securities.[251] We understand that custodians are commonly selected and frequently paid directly by advisory clients, and in such cases advisers may not have knowledge of the amount of such custodian fees to deduct for purposes of establishing net performance.[252] To the extent that net performance can demonstrate the kind of investment experience that advisory clients might have experienced with an adviser, the amount of custodian fees paid directly by an advisory client to a custodian that was selected by the advisory client may not be relevant. We believe that this approach is appropriate even where advisers know the amount of custodian fees – *e.g.,* where the adviser recommended the custodian. However, to the extent the adviser provides custodial services with respect to funds or securities for which the performance is presented and charges a separate fee for those services, or when custodial fees are included in a single fee paid to the adviser, such as in wrap programs, then the adviser must deduct the custodial fee in calculating net performance.[253]

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250 For example, an adviser managing several accounts, each using the same investment strategy, could present in a Retail Advertisement the gross performance and net performance of all such accounts. To calculate net performance, the adviser may elect to deduct a model fee that is equal to the highest fee charged to Retail Persons (that is, the audience of the Retail Advertisement), even if that model fee is different from the actual fee charged to any of the accounts.

251 Proposed rule 206(4)-1(e)(6)(iii).

252 *See, e.g.*, Investment Company Institute, SEC Staff No-Action Letter (Aug. 24, 1987) (indicating the staff's view that "the costs charged by custodians, which ordinarily are selected by clients and frequently are paid directly by the clients" need not be deducted in calculating net performance).

253 The proposed rule would permit the exclusion of only custodian fees that are "paid to a bank or other third-party organization."

We are not including a definition of "equal prominence." We believe, however, that this "equal prominence" principle is consistent with investment advisers' current practice.[254] In addition, investment advisers may have experience interpreting "equal prominence" in other rules governing the use of communications by financial professionals.[255]

Finally, the proposed rule would prohibit in any advertisement any presentation of gross performance, unless the advertisement provides or offers to provide promptly a schedule of the specific fees and expenses deducted to calculate net performance.[256] Such a schedule must itemize the specific fees and expenses that were incurred in generating the performance of the specific portfolio being advertised.[257] Where an adviser presents net performance, whether because net performance is required under the proposed rule or because the adviser otherwise chooses to present it, the schedule should show the fees and expenses actually applied in calculating the net performance that is presented. Where an adviser does not otherwise present or calculate net performance, the schedule should show the fees and expenses that the adviser would apply in calculating net performance as though such adviser were presenting net

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254 *See, e.g.,* Global Investment Performance Standards, GIPS Advertising Guidelines, *available at* (indicating that advertisements may include information beyond what is required under the GIPS Advertising Guidelines, provided the information is shown "with equal or lesser prominence" relative to the required information).

255 *See, e.g.,* 17 CFR 230.482(d)(3)(iii); 17 CFR 230.482(d)(4)(v); 17 CFR 230.482(e)(1)(ii); *see also* Final Investment Company Advertising Release, *supra* footnote 57 (explaining that prominence requirements in rule 482 advertisements "are designed to prevent advertisements from marginalizing or minimizing the presentation of [ ] required disclosure" and "to encourage fair and balanced advertisements").

256 *See* proposed rule 206(4)-1(c)(1)(i). We would consider any such schedule provided upon request to be a part of the advertisement and therefore subject to the books and records rule. *See infra* section II.C. We would not consider such a schedule to be within the scope of the proposed rule's exclusion for information required to be contained in a statutory or regulatory notice, filing, or other communication, *see supra* section II.2.c.iv, as the schedule would be providing contextual information to understand the substance of the advertisement. *See supra* footnote 106 and accompanying text.

257 *See* proposed rule 206(4)-1(e)(6).

performance.[258] The proposed rule would require investment advisers to show each fee and expense "presented in percentage terms" – that is, as a percentage of the assets under management. The proposed rule otherwise would impose no specific restrictions on how those fees and expenses are categorized or determined, as different investment advisers may classify the same fee or type of fee differently.[259]

We believe that Non-Retail Persons routinely request breakdowns of fees and expenses in order to assess advertised performance results, but even with their increased bargaining power, they may struggle at times to negotiate for and receive transparent information.[260] This provision would require advisers to provide such information, to the extent that the adviser wants to advertise performance information. We recognize that, as a result, this fee and expense schedule may be utilized primarily by institutional investors because all Retail Advertisements that include gross performance results must also include performance results net of fees and expenses. However, we believe that the schedule should be available to all investors if they choose to request it as part of their analysis of an investment adviser.

The Commission has emphasized the importance of providing clear and meaningful disclosure to mutual fund investors about fees and expenses.[261] We believe advisory clients and

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258 In these circumstances, we would interpret the proposed rule's phrase "deducted to calculate net performance" to include "if such calculation were otherwise required."

259 Because any such schedule would be a part of the advertisement, *see supra* footnote 256, the provisions of paragraph (a) of the proposed rule would apply to the schedule.

260 *See, e.g.,* Letter of the Institutional Limited Partners Association (ILPA) to Jay Clayton, Chairman, Securities and Exchange Commission (May 24, 2017) ("The ILPA's members are sophisticated investors and supporters of free market principles. However, there are proven limits to what any investor can achieve through negotiation, particularly without strong oversight by the [Commission] to ensure that the rules of the market are followed and that contractual obligations are being met.").

261 *See* Item 3 of Form N-1A; Final Investment Company Advertising Release, *supra* footnote 57, at 57765 (agreeing with a commenter that "investors should consider a fund's objectives and risks, *and its charges and expenses*, before investing because these factors will directly affect future returns") (emphasis added); Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management

investors in private pooled investment vehicles should similarly have access to this type of important information to alert them to the types of fees and expenses that they may reasonably expect to incur in connection with receiving the adviser's services, and provide a basis for additional questions from advisory clients to the extent that the adviser seeks to charge additional or different fees and expenses in the future.[262]

v. Prescribed Time Periods

The proposed rule would prohibit any performance results in a Retail Advertisement, unless the advertisement includes performance results of the same portfolio for 1-, 5-, and 10-year periods, each presented with equal prominence and ending on the most recent practicable date, with an exception for portfolios not in existence during a particular prescribed period.[263] This time period requirement would apply to performance results of any composite aggregation of related portfolios as well.[264] Requiring performance results over these periods of time would provide the audience with insight into the experience of the investment adviser over set periods that are likely to reflect how the advertised portfolio(s) performed during different market or

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Investment Companies, Release No. 33-8998 (Jan. 13, 2009) [74 FR 4546, 4554 (Jan. 26, 2009)] (noting recent Commission steps to address "concerns that investors do not understand that they pay costs every year when they invest in mutual funds"). *See also* Bradford Hall, SEC Staff No-Action Letter (Jul. 19, 1991) (noting the staff's view that "the presentation of performance results on a gross basis may cause the average investor to infer something about the adviser's competence or about future results that may not be true had the performance results been presented net of advisory fees").

262 Similarly, investors in pooled investment vehicles would have a basis for additional questions if the pooled investment vehicle seeks to charge or agrees to bear additional or different fees and expenses in the future.

263 *See* proposed rule 206(4)-1(c)(2)(ii). This time period requirement would be imposed on all performance results, including gross performance and net performance. Accordingly, a Retail Advertisement presenting gross performance must include performance results of the same portfolio for the prescribed time periods, on both a gross and net basis.

264 *See id.*

economic conditions.[265] For portfolios in existence for at least ten years, performance for that period of time could be useful to Retail Persons to provide more complete information than only performance over the most recent year. That performance may prompt Retail Persons to seek additional information from advisers regarding the causes of significant changes in performance over longer periods of time.

This time period requirement would prevent investment advisers from including in Retail Advertisements only recent performance results or presenting only results or time periods with strong performance in the market generally, which could lead to Retail Persons being misled. An investment adviser would remain free to include in Retail Advertisements performance results for other periods of time as long as the advertisement presents results for the three prescribed periods (subject to the proposed exception). The advertised performance results for the other periods of time also must meet the other requirements of the proposed rule, including the prohibitions in paragraph (a).[266]

The proposed rule provides an exception from this time period requirement: if the relevant portfolio did not exist for a particular prescribed period, then the life of the portfolio must be substituted for that particular period. For example, if a portfolio has been in existence for seven years, then any performance results of that portfolio must be shown for 1- and 5-year periods, as well as for the 7-year period – that is, the life of the portfolio.

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265 We require average annual total return for 1-, 5-, and 10-year periods for advertisements with respect to securities of certain RICs and BDCs. *See* 17 CFR 230.482(d)(3). We believe a similar requirement for Retail Advertisements would provide useful reference points for Retail Persons, particularly when comparing two or more sets of performance results.

266 *See, e.g.,* proposed rule 206(4)-1(a)(6).

The time period requirement would require that the 1-, 5-, and 10-year periods each end on the most recent practicable date.[267] We believe that this requirement will provide insight into an investment adviser's management of the same portfolio over certain periods of time to reflect how the portfolio performed during different market or economic conditions. Allowing the 1-, 5-, and 10-year periods to end on different dates would undermine that goal, as an adviser could select the periods that show only the most favorable performance – *e.g.,* presenting a 5-year period ending on a particular date because that 5-year period showed growth while presenting a 10-year period ending on a different date because that 10-year period showed growth. In addition, requiring that each period end on "the most recent practicable date" is designed to help ensure that those receiving Retail Advertisements generally receive performance advertising from different advisers that shows performance over the same periods of time. Together with the other proposed requirements of this time period provision, this requirement would provide investors with a more complete basis for comparison between investment advisers and reduce any investment adviser's ability to cherry-pick performance periods.

The time period requirement would also require that the three prescribed time periods are presented with equal prominence. This "equal prominence" principle would help ensure that all three time periods are presented in such a manner that an investor can observe the history of the adviser's performance on a short-term and long-term basis. If these periods were not required to be presented with equal prominence, an adviser might seek to highlight the single 1-, 5-, or 10-year period that shows the best performance, instead of showing them in relation to each other.

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[267] Proposed rule 206(4)-1(c)(2)(ii).

The prohibitions in paragraph (a) of the proposed rule, including the prohibition on presenting performance time periods in a manner that is not fair and balanced,[268] would apply to presentations of performance across the required time periods. For example, it would be misleading to present certain performance information without appropriate disclosure or other information about the performance presented. That is, an advertisement presenting performance results should disclose whether more recent performance results for the same portfolio are available. Otherwise, the advertisement may reasonably be likely to cause an untrue or misleading inference to be drawn concerning the adviser's performance.[269]

We request comment on the proposed performance presentation requirements applicable to Retail Advertisements and Non-Retail Advertisements.

- Is our belief accurate that analyzing certain performance information requires access to more specialized and extensive analytical and other resources than would be required to evaluate the merits and risks of an investment? Are our beliefs correct that accredited investors and qualified clients generally do not have the access to resources for independent analysis in order to consider and analyze performance information without additional information that the proposed rule would require be provided to Retail Persons? Are there certain categories of accredited investors or qualified clients that, by definition, would have such access? Are there disclosures or conditions that we could require in performance advertising that could address our

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268 *See* proposed rule 206(4)-1(a)(6).

269 *See* proposed rule 206(4)-1(a)(3); *see also* Proposed Investment Company Advertising Release, *supra* footnote 181 ("Outdated fund performance that is relied on by an investor when, for example, the markets have generally entered a period of lower performance, may cause the investor to have an overly optimistic view of the fund's ability to outperform the markets.").

concerns? What are those disclosures or conditions and how would they address our concerns?

- Should we require additional disclosures based on the type of audience to which performance advertising is disseminated as proposed? Would such an approach place Retail Persons at an informational disadvantage? Should we instead impose on all advertisements the same requirements for presenting performance results that the proposed rule would impose only on Retail Advertisements? Would such an approach create difficulties where different audiences may need different amounts and types of disclosures to ensure that the performance information is not false or misleading? For instance, would the amount or type of disclosure necessary to make a Retail Advertisement not misleading overwhelm the disclosure and render it ineffective? Would treating all advertisements presenting performance results the same way make it harder for Non-Retail Persons to obtain information they find valuable?
- Instead of our approach to performance presentations, should we simply rely on an overarching prohibition against misleading advertisements? Would such an overarching prohibition achieve our objective in a less burdensome and more effective way than the approach we are proposing? Why or why not?
- If we do not include additional disclosure requirements for Retail Advertisements, should we require that advertisements directed to general audiences include more comprehensive disclosure than those directed to more financially sophisticated audiences? If so, should we consider providing guidance or promulgating disclosure requirements for how an adviser's disclosure may differ based on the investor's

financial sophistication or scope of mandate? What guidance should we provide or disclosure should we require? Would there be any types of performance presentations whose risks or limits could not be disclosed effectively to some audiences?

- Do commenters agree that defining "Non-Retail Person" as "qualified purchasers" and certain "knowledgeable employees" is appropriate? Why or why not?
- Are there investors other than qualified purchasers and knowledgeable employees that should be treated as Non-Retail Persons? If so, who and why? Are there criteria that we should consider instead of those underlying the "qualified purchaser" or "knowledgeable employee" definitions? Would the accredited investor or qualified client standard be more appropriate than the qualified purchaser standard? Why or why not?
- If we treated as Non-Retail Persons either accredited investors or qualified clients, should we consider imposing restrictions or requirements on Non-Retail Advertisements that under the proposed rule apply only to Retail Advertisements? Why or why not and, if so, which restrictions or requirements?
- Should we treat as Non-Retail Persons all investors other than natural persons? If so, should we change the treatment of Non-Retail Persons with respect to institutional investors – *e.g.,* treat as a Non-Retail Person any institutional investor that is also an accredited investor or qualified client? Why or why not? If so, should we consider adding requirements to Non-Retail Advertisements that under the proposed rule apply only to Retail Advertisements? Why or why not and, if so, which requirements?

- FINRA's communications rule treats as "institutional investors" any natural person with total assets of at least $50 million.[270] Should we consider a similar approach for defining "Non-Retail Person"? Why or why not? If we were to consider a similar approach, should we index the prescribed amount to inflation? Why or why not?
- In defining "Non-Retail Advertisement," should we consider an approach other than requiring the adoption and implementation of policies and procedures? What other approach should we consider and why? Is there an alternative approach we should consider to address the dissemination of Non-Retail Advertisements to an investor that an investment adviser may not know with certainty to be a qualified purchaser or knowledgeable employee? If we retain the proposed rule's approach, should the proposed rule specify any policies and procedures that investment advisers should adopt and implement in order to disseminate Non-Retail Advertisements? If so, what should be included in such policies and procedures and why?
- Would the "reasonable belief" prong of rule 2a51-1(h) be useful for purposes of determining whether an investor is a Non-Retail Person under the proposed rule? Do commenters agree that investment advisers to Section 3(c)(7) Companies already have policies and procedures necessary to implement the "reasonable belief" prong? Are there compliance or other challenges that investment advisers or others have faced in applying this "reasonable belief" prong under rule 2a51-1(h)? What steps do advisers and others associated with Section 3(c)(7) Companies take to obtain a "reasonable belief" for purposes of rule 2a51-1(h), and would such steps be feasible

[270] *See* FINRA rule 2210(a)(4)(A) and rule 4512(c)(3).

in the context of ensuring that Non-Retail Advertisements are disseminated only to qualified purchasers and knowledgeable employees?

- Should the proposed rule account for the risk of Non-Retail Advertisements disseminated only to Non-Retail Persons by or on behalf of the adviser also becoming available to Retail Persons? If so, how?
- How would requiring investment advisers to pooled investment vehicles to "look through" the vehicles to their investors in order to comply with the proposed rule affect investment advisers' ability to present advertisements to those investors in comparison to their approach under the current rule? Would such an approach place certain investors in the pooled investment vehicle at an informational disadvantage to others? How would this approach affect the ability of existing and prospective investors in pooled investment vehicles to receive information and make informed investment decisions? Is there an alternative approach we should consider? Should the proposed rule use different criteria for prospective advisory clients than for prospective investors in pooled investment vehicles? Should the proposed rule treat any person who is eligible to invest in a private fund as a Non-Retail Person for purposes of advertisements relating to that private fund? Why or why not?
- Should we change our approach with respect to knowledgeable employees so that an investor who is a knowledgeable employee with respect to a particular Section 3(c)(7) Company would be treated as a Non-Retail Person for advertisements for investment vehicles or services other than with respect to the particular Section 3(c)(7) Company?

- Are our beliefs correct that qualified purchasers generally do have the access to resources in order to consider and analyze performance information? If a qualified purchaser's access to resources fluctuates due to particular facts and circumstances, should we take that into account in treating qualified purchasers, or other categories of investors, as Non-Retail Persons? If so, how?
- Are there compliance or other challenges that investment advisers believe they would face if the proposed rule defines a "Retail Advertisement" and its audience in a way that is different from the definition of "retail investor" for purposes of Form CRS? Should we take those challenges into account and, if so, how?
- Do investment advisers to pooled investment vehicles other than Section 3(c)(7) Companies, including private funds that rely on section 3(c)(1) of the Investment Company Act, or investment advisers to separate accounts currently provide the kinds of performance information in advertisements that we propose to require in Retail Advertisements? Would the proposed rule create unique compliance difficulties for investment advisers to pooled investment vehicles other than Section 3(c)(7) Companies? What types of difficulties and how should we address them?
- Will requiring Retail Advertisements that present gross performance also to present net performance be effective in demonstrating the effect that fees and expenses had on past performance and may have on future performance? Is there an alternative approach that would better demonstrate this effect?
- Are there any instances when presenting net performance in accordance with the proposed rule would not be feasible or appropriate in a Retail Advertisement? Are there any exceptions to this requirement that we should consider?

- Is there additional information that we should require advisers to disclose when presenting gross performance?
- Should we clarify any specific criteria for "equal prominence"? Should we clarify any criteria for determining if net performance is presented "in a format designed to facilitate comparison"?
- Should we provide further guidance or specify requirements in the proposed rule on how to calculate gross performance or net performance? If so, what guidance or requirements should we provide? Should we look to the Global Investment Performance Standards adopted by the CFA Institute ("GIPS") or other standards? Should we require investment advisers to adopt policies and procedures prescribing specific methodologies for calculating gross performance and net performance? Why or why not?
- Are the proposed definitions of "gross performance," "net performance," and "portfolio" clear? Should we modify any of those proposed definitions? Do we need to define any other terms?
- For the proposed definition of "portfolio," should we modify the term "managed by the investment adviser" – *e.g.,* to specify how this term addresses sub-advisory relationships or other relationships? If so, how should we modify the term?
- For the proposed definition of "net performance," should we add or remove any item from the non-exhaustive list of fees and expenses to be considered? If so, which item and why? Are there particular items that might not be considered a "fee" or an "expense" that should nonetheless be deducted in calculating net performance? If so, which item and why?

- Are the proposed modifications to "net performance" appropriate? Are there particular changes to the proposed modifications that we should make? Should we include any other permitted deductions?
- Are there instances in which we should expressly require that "net performance" be calculated to reflect the deduction of a custodial fee – for example, in all circumstances other than where an advisory client selects its own custodian and directly negotiates the custodial fee? Are we correct in our understanding that if advisory clients select and pay directly their custodians, investment advisers may not know the amount of custodial fees? Are there other types of fees or expenses that investment advisers would be unable to deduct in calculating net performance and that the proposed rule should treat similarly to custodial fees?
- Are there circumstances under which investment advisers might seek to calculate gross performance and net performance using different types of returns or methodologies or to use different types of returns or methodologies for different portions of a presented period? What are those circumstances? Should we take those circumstances into account? If so, why and how?
- Should the proposed rule include different or additional criteria for Retail Advertisements in order to enable Retail Persons to compare performance between investment advisers? If so, what criteria and why?
- Instead of requiring Retail Advertisements presenting gross performance to provide or offer to provide promptly a schedule of fees and expenses, should we require that Retail Advertisements include disclosure about fees and expenses (*i.e.,* without an

itemized schedule)? What information about fees should the proposed rule require to be included in Retail Advertisements?

- Should the proposed requirement to provide or offer a schedule of fees and expenses apply differently to different types of fees and expenses (*e.g.*, custodial fees or other administrative fees as opposed to advisory fees)?
- Should the proposed requirement to provide or offer a schedule of fees and expenses apply differently to advertisements presenting the performance of pooled investment vehicles and advertisements presenting the performance of separate accounts? If so, why and how?
- Should we take the position that an investment adviser would "provide" the schedule of fees and expenses if the advertisement includes a hyperlink that enables the audience to obtain and review the schedule?
- As proposed, the schedule of fees and expenses would need to be presented in percentage terms and on the basis of assets under management in calculating net performance. Should we allow it to be presented in other formats as well? Alternatively, should we require the schedule to be presented in another format? For example, should advisers be required to present the schedule in terms of the actual dollar amount paid or borne on a portfolio of a specific size, or the actual dollar amount paid or borne on the actual portfolio being managed and advertised? Are there other formats that would work better than dollar or percentage terms? Would allowing an alternative presentation format, in addition to a format using percentage terms, be confusing or misleading? Is it clear how an adviser would calculate net performance if it does not charge asset-based fees?

- Are there any compliance challenges that investment advisers might face in preparing a schedule such as the type proposed? Under current law, have investment advisers included in their advertisements similar offers to provide schedules or other breakdowns of fees and expenses, or have investment advisers provided the fee and expense information? Have investors accepted those offers and requested those schedules or breakdowns? Are there types of fees and expenses for which providing a schedule would be particularly difficult? Do advisers expect that they would need to account for estimated, rather than actual, fees and expenses in certain cases?
- Have investors found there to be any difficulties in receiving such schedules or breakdowns, once requested? Have those schedules or breakdowns provided investors with useful information that has enabled them to make informed investment decisions? Why or why not?
- Would there be circumstances in which investment advisers might have to provide proprietary or sensitive information to comply with this proposed requirement? Should we take those circumstances into account? If so, how?
- Should we prescribe specific time periods as proposed? Are one, five, and ten years the right periods to be used? Instead, for example, should we require that performance always be presented since inception of a portfolio?
- Are there other time periods for which we should require the presentation of performance results? Are there any specific compliance issues that an investment adviser would face in generating and presenting performance results for the required time periods?

- Should we require an adviser without any performance results available for a particular period required in Retail Advertisements to disclose specifically that the adviser does not have those results? For example, should an adviser having a track record of only eight years for a portfolio be required to disclose that it does not have performance results for the required 10-year period?
- Should we impose any additional requirements for presentation of the time periods proposed? For example, beyond the proposed rule's requirement that the specified time periods end "on the most recent practicable date," should we require that performance results be current as of a particular date? For example, should we require that the specified time periods end on a date no greater than 90 days prior to dissemination of the advertisement? Would some period other than 90 days be appropriate? Should we provide guidance about the term "most recent practicable date"? If so, what guidance should we provide?
- Are there any modifications to the proposed time period requirement that commenters believe would be appropriate or useful? If so, what modifications and why?[271]

#### c. *Additional Requirements for Presentations of Performance in All Advertisements*

The proposed rule includes several additional requirements for advertisements containing performance results. The other requirements address: (i) statements about Commission review or approval of performance results; (ii) the presentation of performance results of portfolios with substantially similar investment policies, objectives, and strategies; (iii) the presentation of

[271] *See* 17 CFR 230.482(g).

performance results of an extracted subset of portfolio investments; and (iv) the presentation of performance results that were not actually achieved by a portfolio managed by an adviser.

i. Statements about Commission Approval

The proposed rule would prohibit "any statement, express or implied, that the calculation or presentation of performance results in the advertisement has been approved or reviewed by the Commission" (the "approval prohibition").[272] As described above, the proposed rule would address certain elements of the appropriate presentation of performance in advertisements, which the current rule does not explicitly address.[273] This approval prohibition is intended to prevent advisers from representing that the Commission has approved or reviewed the performance results, even when the adviser is presenting performance results in accordance with the proposed rule. Such a statement might imply that the Commission has determined that the advertised performance results neither are false or misleading, nor otherwise violate the proposed rule. Such a statement would itself be misleading because the Commission does not review or approve investment advisers' advertisements. Such a statement might also be misleading to the extent it suggests that an adviser is presenting performance results in accordance with particular methodologies or calculations, which the proposed rule would not prescribe. We believe in particular that performance results may lead to a heightened risk of creating unrealistic expectations in an advertisement's audience.[274] An express or implied statement that the Commission has approved the performance results could advance such unrealistic

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272 Proposed rule 206(4)-1(c)(1)(ii).

273 *See supra* section I.A.

274 *See supra* footnote 184.

expectations.[275] Such a statement would also be misleading to the extent it suggests that the Commission has reviewed or approved more generally of the investment adviser, its services, its personnel, its competence or experience, or its investment strategies and methods. We request comment on this proposed approval prohibition.

- Are there types of statements that would be prohibited under the proposed approval prohibition, but that commenters believe should be allowed in performance advertising? What types of statements and why should they be allowed?
- Instead of including a specific approval prohibition, should we take the view that a statement that would otherwise violate this prohibition is addressed through paragraph (a) of the proposed rule?

ii. Related Performance

The proposed rule would condition the presentation in any advertisement of "related performance" on the inclusion of all related portfolios. However, the proposed rule would generally allow related performance to exclude related portfolios as long as the advertised performance results are no higher than if all related portfolios had been included.[276] "Related performance" is defined as "the performance results of one or more related portfolios, either on a portfolio-by-portfolio basis or as one or more composite aggregations of all portfolios falling within stated criteria."[277] "Related portfolio" in turn is defined as "a portfolio, managed by the

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275 *See, e.g.,* Fake Seals and Phony Numbers: How Fraudsters Try to Look Legit (Dec. 2, 2009), *available at* https://www.sec.gov/reportspubs/investor-publications/investorpubsfakesealshtm.html (advising the investing public to "be skeptical of government 'approval'" in communications regarding securities offerings and noting that the Commission "does not evaluate the merits of any securities offering" or "determine whether a particular security is a 'good' investment").

276 Proposed rule 206(4)-1(c)(1)(iii)(A).

277 Proposed rule 206(4)-1(e)(11).

investment adviser, with substantially similar investment policies, objectives, and strategies as those of the services being offered or promoted in the advertisement."[278] We understand that related performance may be a useful source of information for investors. For example, a prospective investor considering whether to hire or retain an investment adviser to manage a portfolio having a particular investment strategy may reasonably wish to see performance results of portfolios previously managed by the investment adviser that have substantially similar investment strategies. The proposed requirement would allow advertisements to include related performance, as long as such performance includes all related portfolios. This requirement is intended to prevent investment advisers from including only related portfolios having favorable performance results or otherwise "cherry-picking."

The proposed rule otherwise does not identify or prescribe particular requirements for determining whether portfolios are "related" beyond whether there are "substantially similar" investment policies, objectives, and strategies as those of the services being offered in the advertisement.[279] The requirement that advisers include portfolios having "substantially similar" policies, objectives, and strategies may result in an investment adviser including an account that is otherwise subject to client-specific constraints. We request comment below on this approach. We understand that many investment advisers already have criteria governing their creation and presentation of composites and that in particular many advisers take into account GIPS. We believe that the same criteria used by investment advisers to construct any composites for GIPS

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278 Proposed rule 206(4)-1(e)(12).

279 The "substantially similar" standard has been used by our staff previously in describing its views as to whether the presentation of prior performance results of accounts managed by a predecessor entity would not, in and of itself, be misleading under the current rule. *See* Horizon Asset Management, LLC, SEC Staff No-Action Letter (Sept. 13, 1996) ("Horizon Letter") (describing, in relevant part, the presentation of prior performance results of accounts managed by a predecessor entity where "all accounts that were managed in a *substantially similar* manner are advertised unless the exclusion of any such account would not result in materially higher performance") (emphasis added).

purposes could be used for purposes of satisfying the "substantially similar" requirement of the proposed rule.[280] To the extent that an investment adviser excludes portfolios from a composite that is constructed for GIPS purposes, the proposed rule would allow those portfolios to be included in a separate composite. That is, "related performance" could be presented through more than one composite aggregation of all portfolios falling within the stated criteria.

The proposed rule would allow investment advisers to exclude from "related performance" one or more related portfolios so long as the advertised performance results are no higher than if all related portfolios had been included. This exclusion would generally provide advisers some flexibility in selecting the related portfolios to advertise, without permitting exclusion on the basis of poor performance. However, this exclusion would also be subject to the proposed time period requirement for Retail Advertisements, as discussed above.[281] Related performance in a Retail Advertisement could not exclude any related portfolio if doing so would alter the presentation of the proposed rule's prescribed time periods.[282]

The proposed rule would allow the investment adviser to present the performance of all related portfolios either on a portfolio-by-portfolio basis or as one or more composites of all such portfolios. This provision is intended in part to allow an adviser to illustrate for the audience the differences in performance achieved by the investment adviser in managing portfolios having substantially similar investment policies, objectives, and strategies. We believe that advisers

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280 For GIPS purposes, a composite is an aggregation of portfolios managed according to a similar investment mandate, objective, or strategy. Global Investment Performance Standards, GIPS Glossary (defining a "composite" as "an aggregation of one or more portfolios that are managed according to a similar investment mandate, objective, or strategy").

281 *See supra* section II.A.5.c.v.

282 Proposed rule 206(4)-1(c)(1)(iii)(B). *See* proposed rule 206(4)-1(c)(2)(ii) (requiring any performance results of any portfolio or any composite aggregation of related portfolios to include performance results of the same portfolio or composite aggregation for 1-, 5-, and 10- year periods).

may find it useful to present this information on a portfolio-by-portfolio basis if they believe that such presentation will make clear the range of performance results that the relevant portfolios experienced. Advisers that manage a small number of such portfolios particularly may find a portfolio-by-portfolio presentation to be the clearest way of demonstrating related performance.[283] Presenting related performance on a portfolio-by-portfolio basis would be subject to paragraph (a) of the proposed rule, including the prohibition on omitting material facts necessary to make the presentation, in light of the circumstances under which it was made, not misleading.[284] For example, an advertisement presenting related performance on a portfolio-by-portfolio basis could be potentially misleading if it does not disclose the size of the portfolios and the basis on which the portfolios were selected.

Presenting related performance in a composite can allow the relevant information – the investment adviser's experience in managing portfolios having specified criteria – to be presented in a streamlined fashion and without requiring every portfolio to be presented individually in the same advertisement, which may be unwieldy and difficult to comprehend. Advisers may find it useful to present related performance information in a composite particularly if presenting the information on a portfolio-by-portfolio basis could implicate privacy concerns by, for example, identifying implicitly particular clients even if the portfolios themselves are anonymized. The proposed rule would not prescribe specific criteria to define the relevant portfolios but would require that once the criteria are established, all related portfolios meeting the criteria are included in one or more composites. The presentation of composite performance would be subject to paragraph (a) of the proposed rule, including the prohibition on

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283 For example, advisers to some types of private funds may find a portfolio-by-portfolio presentation to be the most efficient approach in satisfying this requirement.

284 Proposed rule 206(4)-1(a)(1). *See also supra* footnote 199 and accompanying text.

the inclusion of favorable performance results or the exclusion of unfavorable performance results that provides a portrayal of the adviser's performance that is not fair and balanced.[285] For example, an advertisement presenting related performance in a composite would be false or misleading where the composite is represented as including all portfolios in the strategy being advertised but excludes some portfolios falling within the stated criteria or is otherwise manipulated by the adviser.[286] Presenting related performance in a composite would also be subject to the prohibition on omitting material facts necessary to make the presentation, in light of the circumstances in which it was made, not misleading.[287] We believe that omitting the criteria the adviser used in defining the related portfolios and crafting the composite could result in an advertisement presenting related performance that is misleading.

We understand that FINRA staff has not viewed rule 2210 as allowing inclusion of certain related performance information in communications used by FINRA members with retail investors in registered funds.[288] We believe that the utility of related performance in demonstrating the adviser's experience in managing portfolios having specified criteria, together

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285 *See* proposed rule 206(4)-1(a)(6); *see also supra* footnote 199 and accompanying text.

286 *See, e.g.,* In the Matter of Valicenti Advisory Services, Inc., Release No. IA-1774 (Nov. 18, 1998) (Commission opinion) (finding that, under the circumstances, when an adviser's sales literature states that the rates of return it is advertising are based on the combined performance of certain specified accounts, then "the plain meaning of that statement is that the rates reflect the performance of all accounts falling within the stated criteria, not merely a few chosen by the adviser"); *aff'd* Valicenti Advisory Services, Inc. v. Securities and Exchange Commission, 198 F. 3d 62 (2d Cir. 1999).

287 *See* proposed rule 206(4)-1(a)(1).

288 *See* letter from Joseph P. Savage, FINRA, to Clair Pagnano, K&L Gates LLP, dated June 9, 2017 (discussing FINRA's "longstanding position" that a registered fund's presentation of related performance information, other than certain performance of predecessor private accounts or funds, in communications used with retail investors does not comply with FINRA rule 2210(d)). FINRA staff has provided interpretive guidance that the use of "related performance information" in institutional communications concerning certain registered funds is consistent with the applicable standards of FINRA rule 2210. *Id.; see also* letter from Thomas M. Selman, Senior Vice President, NASD, to Yukako Kawata, Davis Polk & Wardwell, dated Dec. 30, 2003 (stating that NASD staff would not object to inclusion of related performance information in sales material for an unregistered private fund, provided that, among other conditions, all recipients are qualified purchasers).

with the provisions designed to prevent cherry-picking and the provisions of paragraph (a), support not prohibiting related performance in advisers' Retail Advertisements.

The definition of "related portfolio" also would include a portfolio managed by the investment adviser for its own account or for its advisory affiliate. This proposed definition is designed to apply so that all portfolios having substantially similar investment policies, objectives, and strategies are incorporated into the advertised performance. However, reporting the performance of accounts of the investment adviser or its advisory affiliates may present issues regarding fees and expenses in the event certain fees and expenses are waived or charged at a lower rate than those that would be applied to an unaffiliated client of the adviser. In such case, the amount of fees and expenses charged to such a portfolio would not reflect the amount actually available to the advertisement's audience of unaffiliated investors. Presenting net performance that is higher than it would be if calculated using the fees and expenses charged to unaffiliated investors would reasonably be likely to cause an untrue or misleading inference to be drawn about the adviser's competence and experience managing the portfolio generating the performance. Accordingly, to satisfy the "net performance" requirement in this circumstance, an adviser generally should apply the fees and expenses that an unaffiliated client would have paid in connection with the relevant portfolio whose performance is being advertised.

We request comment on the proposed requirements for presentation of related performance.

- Are the proposed definitions of "related performance" and "related portfolio" clear? Should we modify these proposed definitions? Should we provide further guidance as to what constitutes a "related portfolio"?

- Should we modify the proposed definition of "related portfolio" by changing the "substantially similar" criterion? If so, how and why? Should we modify the proposed definition by specifying how an adviser should account for portfolios that are non-discretionary accounts?
- Should we modify the proposed definition of "related portfolio" to take into account how client-specific constraints may have affected the performance of portfolios that otherwise have "substantially similar" policies, objectives, and strategies? Would investment advisers consider portfolios having such client-specific constraints to be portfolios that have policies, objectives, and strategies that are not "substantially similar"?
- Would the proposed rule's approach of allowing related performance to be presented on a portfolio-by-portfolio basis or as one or more composites have the intended effect of illustrating the differences in performance achieved in managing related portfolios? Are there other better approaches, including approaches that investment advisers use currently that we should consider? What approaches and why?
- Would the proposed rule's approach of allowing related performance to be presented in "one or more composite aggregations" be appropriate or should we require that related performance be presented in only one such composite? Why or why not?
- Rather than allowing related performance to exclude related portfolios as long as the advertised performance results are no higher than if all related portfolios had been included, should we require inclusion of all related portfolios? Why or why

not? Alternatively, should we permit exclusion of related portfolios as long as the advertised results are not "materially" higher than if all related portfolios had been included? Why or why not? As an alternative to any of those approaches, should we allow related performance without limitation and instead rely on the prohibitions in the rest of the proposed rule to ensure that performance of related portfolios is presented in a fair and balanced manner?

- Rather than requiring that the exclusion of any related portfolio does not alter the presentation of time periods prescribed for Retail Advertisements, should we allow the exclusion to alter such presentation? Why or why not? Should we provide additional guidance regarding this requirement? If so, what additional guidance should we provide?
- Are there particular disclosures we should require when an advertisement presents related performance? Should we require that an advertisement offer to provide additional information about the related performance? For example, if the investment adviser presents related performance as a composite, should the adviser be required to offer to provide the performance of the individual portfolios used to calculate that composite?
- Should we consider adopting FINRA's approach and prohibit the presentation of related performance in Retail Advertisements? Why or why not? If we do not adopt FINRA's approach, would it cause confusion for advisers or investors?
- Would investment advisers that seek to comply with GIPS face any compliance challenges in complying with the proposed rule's related performance provision? If so, what challenges and how would such advisers seek to address them?

Should we take those challenges into account and, if so, how? Are there particular provisions of GIPS that we should consider in addressing the presentation of related performance?

- Should we retain the proposed rule's inclusion in the definition of "related portfolio" of a portfolio managed by the investment adviser for its own account or for its advisory affiliate? Why or why not? We have indicated that to satisfy the "net performance" requirement when presenting performance of a portfolio that belongs to the adviser or its affiliate, the adviser generally should apply the fees and expenses that an unaffiliated client would have paid in connection with the relevant portfolio whose performance is being advertised. Do commenters agree with this approach? Do commenters believe this would be sufficient to make related performance not misleading if it includes the adviser's or its affiliate's portfolio? Why or why not?

### iii. Extracted Performance

Under the proposed rule, an adviser may include extracted performance in an advertisement only if the advertisement provides or offers to provide promptly the performance results of all investments in the portfolio from which the performance was extracted.[289] "Extracted performance" would be defined as "the performance results of a subset of investments extracted from a portfolio."[290] Similar to the proposed requirement for the presentation of related performance, the proposed rule would require that the advertisement

[289] Proposed rule 206(4)-1(c)(1)(iv).

[290] Proposed rule 206(4)-1(e)(3).

provide (or offer to provide promptly) the performance results of the entire portfolio in these circumstances to prevent investment advisers from cherry-picking certain performance results.

We understand that investment advisers commonly use extracted performance when they have experience managing several strategies and want to advertise performance only with respect to one strategy. For example, an investment adviser seeking to manage a new portfolio of only fixed-income investments may wish to advertise its performance results from managing fixed-income investments within a multi-strategy portfolio. An investment adviser seeking to advise a new client about future investments in European companies may wish to advertise its performance results from managing past investments in all non-U.S. companies.

This information could likewise be useful to prospective investors. For example, a prospective investor seeking a fixed income investment might be interested in seeing only the relevant performance (*i.e.*, the performance of fixed income assets) of an adviser that has experience in managing multi-strategy portfolios. If that prospective investor already has investments in fixed income assets, it may want to use the extracted performance to consider the effect of an additional fixed-income investment on the prospective investor's overall portfolio. That prospective investor may also use the presentation of extracted performance from several investment advisers as a means of comparing investment advisers' management capabilities in that specific strategy as well.

At the same time, extracted performance presents a risk of being misleading to investors. An adviser presenting extracted performance would necessarily have to select the relevant investments to extract and decide both the criteria defining the extracted investments and whether particular investments meet those criteria. The adviser could adjust those decisions in critical ways affecting the performance of the extract and imply something materially untrue

about the adviser's experience managing those investments. An investment adviser's experience managing a subset of an entire portfolio may reasonably be expected to be different from managing the entire portfolio: the investment adviser made investment decisions with respect to that subset taking into account the entire portfolio's investments and strategy.[291] Extracted performance therefore presents the opportunity for an investment adviser to claim credit for investment decisions that have been optimized through hindsight, and the selection of the extracted investments can be made with the knowledge of factors that may have positively affected their performance.

The proposed requirement to make available the results of the entire portfolio is intended to allow investors to evaluate the investment adviser's experience within a context broader than that of the extract. This context would include any particular differences in performance results between the entire portfolio and the extract, the data and assumptions underlying the extracted performance, and the investment adviser's process for generating the extracted performance. Requiring the performance results of the entire portfolio is intended to provide investors with the information necessary to evaluate this broader context.[292] Any differences between the performance of the entire portfolio and the extracted performance might be a basis for additional discussions between the investor and the adviser, which would themselves add to the information available for the investor in making its decision about whether to hire or retain the adviser.

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[291] Similarly, an investment adviser's investment decisions with respect to managing a subset of an entire portfolio could be different from those with respect to managing a pooled investment vehicle with the same objective as the subset.

[292] We would consider the performance results of the entire portfolio provided upon request to be a part of the advertisement and therefore subject to the books and records rule. *See infra* section II.C. If an investment adviser offered to provide the performance of the entire portfolio, rather than provide the performance in the advertisement, then such performance would not qualify for the unsolicited request exclusion from the definition of "advertisement." *See supra* text accompanying footnote; *see also supra* footnote 106 and accompanying text.

The provisions of paragraph (a) of the proposed rule would apply to any presentation of extracted performance, and thus advisers would be prohibited from presenting extracted performance in a misleading way.[293] For example, we would view it as misleading to present extracted performance of only one particular strategy when the entire portfolio from which such performance was extracted had multiple strategies, if the advertisement did not disclose that fact.[294] Similarly, we would view it as misleading to include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced.[295] In addition, under paragraph (a) of the proposed rule, we would view it as misleading to present extracted performance without disclosing whether the extracted performance reflects an allocation of the cash held by the entire portfolio from which the performance is extracted and the effect of such cash allocation, or of the absence of such an allocation, on the results portrayed.[296] Finally, an adviser should consider whether disclosure of the criteria defining the extracted investments is necessary to prevent the performance results from being misleading.

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293 *See supra* footnote 199 and accompanying text.

294 The absence of such disclosures could result in an untrue or misleading implication about, or could reasonably be likely to cause an untrue or misleading inference to be drawn concerning, a material fact relating to the investment adviser. *See* proposed rule 206(4)-1(a)(3). In this case, it would be material that the presented performance reflected only a single strategy of the portfolio's multiple strategies and that an investor could have invested in the single strategy only by investing through the entire portfolio.

295 In addition, an advertisement presenting extracted performance would likely be false or misleading where the extracted performance excludes investments that fall within the criteria the adviser represents it used to select the extract.

296 Decisions about cash allocation are common in presenting performance extracted from a subset of portfolio investments. An investment adviser's decisions with respect to the overall portfolio would necessarily consider how much of the portfolio to allocate to cash at any given time. That consideration would not necessarily be present with respect to the investments reflected in the extracted performance if those investments were managed as a standalone portfolio. At the same time, it is possible that presenting extracted performance without accounting for the allocation of cash, and in effect implying that the allocation of cash had no effect on the extracted performance, would be misleading. Similarly, it could be misleading to an audience if the presentation of extracted performance excludes an allocation to cash and implies that the adviser would not be making decisions with respect to cash allocations in managing a future portfolio focused on the strategy of the extracted performance. The proposed rule does not prescribe any particular treatment for cash allocation with respect to extracted performance; instead, such treatment would be subject to the provisions of paragraph (a).

We request comment on the proposed rule's approach to extracted performance in all advertisements.

- Are there circumstances under which extracted performance should be prohibited in Retail Advertisements? What types of circumstances?
- Are there specific disclosures that we should require to decrease the likelihood that extracted performance would be misleading in Retail Advertisements (*e.g.*, describing the fact that the performance does not represent the entire performance of any actual portfolio of an actual client of the investment adviser)? If so, should we identify those and specifically require their disclosure?
- Is the proposed definition of "extracted performance" sufficiently clear based on our description above? Should we modify any of the elements of the proposed definition? If so, which element and why?
- Under the current rule, have investment advisers taken the same approach that we take in the proposed rule with respect to extracted performance – *i.e.,* providing or offering to provide the performance results of the entire portfolio from which the performance is extracted? Have investors accepted any such offers and requested any such additional performance results? To what extent and under what circumstances have any such investors been misled by the presentation of extracted performance? Have investors who have requested additional performance results included persons other than qualified purchasers and knowledgeable employees?
- With respect to extracted performance, should we require the disclosure or offer of additional information, other than the performance results of the entire portfolio from which the performance is extracted? What additional information would be

appropriate to enable an audience to analyze extracted performance more fully? For example, should we require that an advertisement presenting extracted performance disclose the selection criteria and assumptions used by the adviser in selecting the relevant performance to be extracted? Should we require disclosure of the percentage of the overall portfolio represented by the investments included in the extracted performance? Should we require disclosure of investments included in the extracted performance and a list of all investments in the portfolio from which the extracted performance was selected, to enable the audience to evaluate how the adviser made its determination? Should we require any extracted performance to include an allocation to cash[297]?

- Should we include any other requirements for Non-Retail Advertisements presenting extracted performance? What other requirements and why should we require them?
- Instead of prescribing specific rules for the presentation of extracted performance, should we instead rely on the provisions of paragraph (a) of the proposed rule as we propose to do for cash allocations?

iv. Hypothetical Performance

The proposed rule would allow an adviser to provide hypothetical performance in an advertisement, provided that the adviser takes certain steps to address the misleading nature of hypothetical performance if its underlying assumptions are not subjected to further analysis.

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297 *See, e.g.,* Global Investment Performance Standards (GIPS) for Firms (2020), 3.A.15 (requiring any carve-out included in a composite to include cash and any related income, and indicating that cash may be accounted for separately or allocated synthetically to the carve-out on a timely and consistent basis), *available at* https://www.cfainstitute.org/en/ethics/codes/gips-standards.

An investment adviser may seek to advertise hypothetical performance results as a way to reflect the adviser's strategies or methods when such strategies or methods have not been implemented on actual portfolios of actual clients. There are various types of hypothetical performance that an adviser may seek to advertise. For example, an adviser may apply strategies to fictitious portfolios that it tracks and manages over time but without investing actual money. Or, an adviser employing a quantitative investment strategy using automated systems to make investment decisions may wish to present backtested performance showing simulated performance results of that strategy. An adviser also may wish to show the returns that it is seeking to achieve over a particular time period or that it projects based on certain estimates. Hypothetical performance presentations pose a high risk of misleading investors because, in many cases, this type of performance may be readily optimized through hindsight. Moreover, the absence of an actual client or actual money underlying hypothetical performance raises the risk of misleading investors, because there are no actual losses or other real-world consequences if an adviser makes a bad investment or takes on excessive risk. However, hypothetical performance may be useful to prospective investors that have the resources to analyze the underlying assumptions and qualifications of the presentation, as well as other information that may demonstrate the adviser's investment process. When subjected to this analysis, the information may allow an investor to evaluate an adviser's investment process over a wide range of time periods and market environments or form reasonable expectations about how the investment process might perform under different conditions.

The proposed rule therefore would condition the presentation of hypothetical performance on the adviser adopting policies and procedures reasonably designed to ensure that it is disseminated only to persons for which it is relevant to their financial situation and

investment objectives, and would further require the adviser to provide additional information about the hypothetical performance that is tailored to the audience receiving it, such that the recipient has sufficient information to understand the criteria, assumptions, risks, and limitations. We believe these conditions will result in the dissemination of hypothetical performance only to those investors who have access to the resources necessary to independently analyze this information, including by modifying the assumptions to test their effect on results, and who have the financial expertise to understand the risks and limitations of these types of presentations.

### A. Types of Hypothetical Performance

The proposed 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, but not be limited to, backtested performance, representative performance, and targeted or projected performance returns. We discuss each type of hypothetical performance under the proposed rule in the following sections.

***Backtested Performance.*** Backtested performance is achieved by application of an investment adviser's investment strategy to market data from prior periods when the strategy was not actually used during those periods.[298] Backtesting is intended to demonstrate how an investment strategy may have performed in the past if the strategy had existed or had been applied at that time. An investor conducting diligence on a newly launched quantitative

[298] *See* proposed rule 206(4)-1(e)(5)(ii). This generally would not include educational presentations of performance that reflect an allocation of assets by type or class, which we understand investment advisers may use to inform clients and to educate them about historical trends regarding asset classes. For example, a presentation of performance that illustrates how a portfolio composed of 60% allocated to equities and 40% allocated to bonds would have performed over the past 50 years as compared to a portfolio comprised of 40% allocated to equities and 60% to bonds would not be prohibited under the proposed rule. Our approach regarding educational presentations of performance would apply even if the investment adviser used one of the allocations in managing a strategy being advertised or illustrated such allocations by reference to relevant indices or other benchmarks.

investment strategy, for instance, may request backtested performance to further analyze the adviser's quantitative model as well as the assumptions, inputs, and quantitative parameters used by the adviser. The investor may request backtested performance to determine how the adviser adjusted its model to reflect new or changed data sources. An investor with the resources to assess the backtested performance may also gain an understanding of other aspects of the investment strategy, including exposures and risk tolerances in certain market conditions, and develop reasonable expectations of how the strategy might perform in the future under different market conditions.

Because backtested performance is calculated after the end of the relevant period, however, it presents the opportunity for an investment adviser to claim credit for investment decisions that may have been optimized through hindsight, rather than on a forward-looking application of stated investment methods or criteria and with investment decisions made in real time and with actual financial risk. For example, an investment adviser is able to modify its investment strategy or choice of parameters and assumptions until it can generate attractive results and then present those as evidence of how its strategy would have performed in the past.[299] In addition, backtested performance can be generated with the knowledge of factors that may have positively affected its performance. Also, an adviser can fail to take into account how one or more investments would have performed if the adviser had bought or sold those investments at a different time during the performance period.

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[299] *See, e.g.,* David H. Bailey, Jonathan M. Borwein, Marcos López de Prado, and Qiji Jim Zhu, *Pseudo-Mathematics and Financial Charlatanism: The Effects of Backtest Overfitting on Out-of-Sample Performance*, 61(5) NOTICES OF THE AM. MATHEMATICAL SOCIETY, 458, 466 (May 2014), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2308659 (describing the potential to overfit an investment strategy so that it performs well in-sample (the simulation over the sample used in the design of the strategy) but performs poorly out-of-sample (the simulation over a sample not used in the design of the strategy)).

Backtested performance presents a greater risk of misleading investors when an adviser uses proprietary trading models updated in light of past experiences to make investment allocation decisions. If the adviser updates the models to incorporate new market data, it could be misleading. The presentation of the performance could then suggest that the adviser's clients could have actually experienced the performance achieved through a model using updated market information, when in fact the model was changed on the basis of actual market experience that would not have been available at the time.

These risks highlight the potential for backtested performance to be misleading if additional analysis and due diligence is not performed by the target audience. We believe that investors who may consider this type of hypothetical performance to be a useful tool would need to conduct this additional analysis and due diligence. We also understand the potential value of such data to investors.

***Representative Performance.*** Representative performance, including performance derived from representative "model" portfolios managed contemporaneously alongside portfolios managed by the adviser for actual clients does not reflect decisions made by the investment adviser in managing actual accounts.[300] Model performance can help an investor gain an understanding of an adviser's investment process and management style if the investor has the resources to scrutinize that performance and the underlying assumptions. For instance, model

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300 *See* proposed rule 206(4)-1(e)(5)(i). Representative performance would include, among other things, the type of "model performance" described in the Clover Letter: performance results generated by a "model" portfolio managed with the same investment philosophy used by the adviser for actual client accounts and "consist[ing] of the same securities" recommended by the adviser to its clients during the same time period, "with variances in specific client objectives being addressed via the asset allocation process (*i.e.*, the relative weighting of stocks, bonds, and cash equivalents in each account)". *See* Clover Letter. The proposed rule would treat this as hypothetical performance because although the "model" consists of the same securities held by several portfolios, the asset allocation process would result in performance results that were not "actually achieved" by a portfolio of "any client."

performance may present a nuanced view of how an adviser would construct a portfolio without the impact of certain factors, such as the timing of cash flows or client-specific restrictions, that may not be relevant to the particular investor. Model performance also can help an investor assess the adviser's investment style for new strategies that have not yet been widely adopted by the adviser's clients.

Advances in computer technologies have enabled an adviser to generate hundreds or thousands of potential model portfolios alongside the ones it actually offers or manages. To the extent that an adviser thus generates a large number of potential model portfolios, the use of such a representative model portfolio poses a risk of survivorship bias where an adviser is incentivized to advertise only the results of the highest performing models and ignore others. The adviser could run numerous variations of its investment strategy, select the most attractive results, and then present those results as evidence of how well the strategy would have performed under prior market conditions. In addition, even in cases where an adviser generates only a single model portfolio, the fact that there is neither client nor adviser assets at risk may allow the adviser to manage that portfolio in a significantly different manner than if such risk existed.

***Targets and Projections.*** Targeted returns reflect an investment adviser's performance target – *i.e.*, the returns that the investment adviser is seeking to achieve over a particular period of time. Projected returns reflect an investment adviser's performance estimate – *i.e.*, the returns that the investment adviser believes can be achieved using the advertised investment services. Projected returns are commonly established through the use of mathematical modeling. The proposed rule does not define "targeted return" or "projected return." We believe that these terms are best defined by their commonly understood meanings, and do not intend to narrow or expand inadvertently the wide variety of returns that may be considered targets or projections.

We generally would consider a target or projection to be any type of performance that an advertisement presents as results that could be achieved, are likely to be achieved, or may be achieved in the future by the investment adviser with respect to an investor.

The proposed rule would apply to targeted or projected performance returns "with respect to any portfolio or to the investment services offered or promoted in the advertisement."[301] Accordingly, projections for general market performance or economic conditions in an advertisement would not be considered targeted or projected performance returns. Similarly, an interactive financial analysis tool that offers historical return information or investment analysis of a portfolio based on past market data but does not project such returns forward would not be deemed to be targeted or projected performance returns under the proposed rule. Interactive tools that allow an investor to select its own targeted or assumed rate of return and to project forward a portfolio using that investor's selected rate of return also would not be considered to be targeted or projected performance returns, provided that the tool does not suggest or imply a return rate. On the other hand, if the interactive tool provides anticipated returns for the investment strategy being presented, the tool would be considered to provide targeted or projected performance results and would be subject to the proposed rule's conditions regarding hypothetical performance.[302]

Targeted and projected performance returns can potentially mislead investors, particularly if they are based on assumptions that are not reasonably achievable. For example, an

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301 Proposed rule 206(4)-1(e)(5)(iii).

302 FINRA permits "investment analysis tools" as a limited exception from FINRA's general prohibition of projections of performance, subject to certain conditions and disclosures. FINRA rule 2214(b) defines "investment analysis tool" as "an interactive technological tool that produces simulations and statistical analyses that present the likelihood of various investment outcomes if certain investments are made or certain investment strategies or styles are undertaken, thereby serving as an additional resource to investors in the evaluation of the potential risks and returns of investment choices."

advertisement may present unwarranted claims based on assumptions that are virtually impossible to occur in reality, such as an assumption that three or four specific industries will experience decades of uninterrupted growth. Targets and projections can easily be presented in such a manner to raise unrealistic expectations of an advertisement's audience.[303]

Suitable reliance on targets or projections requires an analysis and diligence of such assumptions in order for an investor to not be misled into thinking that such targets or projections are guaranteed. We recognize that some investors want to consider targeted returns and projected returns (along with these underlying assumptions) when evaluating investment products, strategies, and services. For example, based on our staff's outreach and experience, we understand that Non-Retail Persons in particular may have specific return targets that they seek to achieve, and their planning processes may necessarily include reviewing and analyzing the targets advertised by investment advisers and the information underlying those targets.[304] Specifically, an analysis of these targets or projections can inform an investor about an adviser's risk tolerances when managing a particular strategy. Information about an adviser's targets or projections also can be useful to an investor when assessing how the adviser's strategy fits within the investor's overall portfolio.

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303 In a reflection of the risks posed by projected returns, FINRA's communications rule prohibits the prediction or projection of performance in most cases. *See* FINRA rule 2210(d)(1)(F). FINRA's prohibition does not apply to (i) a hypothetical illustration of mathematical principles, (ii) certain investment analysis tools, and (iii) a price target contained in a research report, under certain conditions. *See id.*

304 For example, knowing whether one type of private fund projects or targets a particular return over a particular time period may assist a pension plan in determining whether to invest in that type of private fund or to consider another type of private fund projecting a different return. *See, e.g.,* National Association of State Retirement Administrators (NASRA) Issue Brief: Public Pension Plan Investment Return Assumptions (Feb. 2019), *available at* https://www.nasra.org/files/Issue%20Briefs/NASRAInvReturnAssumptBrief.pdf ("Funding a pension benefit requires the use of projections, known as actuarial assumptions, about future events. Actuarial assumptions fall into one of two broad categories: demographics and economic.").

We request comment on the proposed definition of "hypothetical performance" and the specific types of hypothetical performance addressed in the proposed definition.

- Is the proposed definition of "hypothetical performance" clear? If not, how should we modify this definition? For example, should we clarify the treatment of indexes (including indexes sponsored by or created by the adviser or its affiliate) and benchmarks under the definition of hypothetical performance?
- Are there types of performance that investment advisers currently present in advertising that would meet the proposed rule's definition of "representative model performance" but should not be treated as hypothetical performance under the proposed rule? What types of performance and why should they not be treated as hypothetical performance?
- Do commenters agree with the proposed rule's treatment of targeted and projected returns as hypothetical performance? Should we treat targeted and projected returns differently from hypothetical performance? If so, why and how?
- Should we define "targeted returns" or "projected returns"? If so, how should we define them? Do commenters agree with our discussion above about what should be considered a target or projection? Should we provide in the rule exclusions for specific kinds of presentations that would not be considered target or projected returns? Why or why not?
- Should we prohibit hypothetical performance in advertisements? Should performance results of portfolios that are managed by an investment adviser, but without investing actual money, be treated differently than other types of performance results under the proposed rule?

- Are our beliefs correct about the risks of backtested and representative performance and of targeted and projected returns? Are there circumstances under which these types of hypothetical performance do not present the risks we identified? Are there other risks that we should consider?
- Are there types of performance that would meet the proposed rule's definition of "backtested performance" but should not be treated as such? What types and how should we modify the definition?
- Are there types of performance that would meet the proposed rule's definition of "representative performance" but should not be treated as such? What types and how should we modify the definition?
- How do investment advisers currently present targeted or projected returns in advertisements? Do investment advisers ever disclose to investors when targeted or projected returns are met or are not met, and the reasons why such returns are met or not met? Should we require such disclosure? Why or why not?
- FINRA's communications rule prohibits the projection of performance in most cases. Have broker-dealers had experience in interpreting FINRA's rule with respect to the projection of performance? Is there anything that we should consider in our treatment of projected returns?
- Should we provide a specific exception for interactive financial analysis tools from the proposed rule's approach to performance of projected returns? If so, should we consider FINRA's approach or another approach? What approach and why?

- In complying with the current rule, have investment advisers addressed any of the risks of hypothetical performance we describe above, or other risks of hypothetical performance? If so, how?
- Are there any specific disclosures that we should require to prevent any type of hypothetical performance from misleading the audience? If so, which disclosures should we require and why?
- Are there additional uses for hypothetical performance generally, or any type of hypothetical performance specifically, that benefit investors?

### B. Conditions on Presentation of Hypothetical Performance

Taking into account the risks and the potential utility of hypothetical performance when investors have a need for such performance and are able to subject it to sufficient independent analysis and due diligence, the proposed rule would permit the presentation of hypothetical performance in advertisements under certain conditions. Together, these conditions are intended to address the potential for hypothetical performance to be misleading. First, the adviser must adopt and implement policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the financial situation and investment objectives of the person to whom the advertisement is disseminated (the "recipient"). Second, the adviser must provide sufficient information to enable the recipient to understand the criteria used and assumptions made in calculating such hypothetical performance (the "calculation information"). Third, the adviser must provide (or, when the recipient is a Non-Retail Person, offer to provide promptly) sufficient information to enable the recipient to understand the risks and limitations of using

hypothetical performance in making investment decisions (the "risk information").[305] For purposes of this discussion, we refer to the calculation information and the risk information collectively as "underlying information."

***Policies and Procedures.*** The first condition for the presentation of hypothetical performance would require the adviser to adopt and implement policies and procedures "reasonably designed to ensure that the hypothetical performance is relevant to the financial situation and investment objectives" of the recipient.[306] This proposed condition is intended to ensure that the adviser provides hypothetical performance only where the recipient has the financial and analytical resources to assess the hypothetical performance and that the hypothetical performance would be relevant to the recipient's investment objective.

This condition would provide investment advisers with flexibility to develop policies and procedures that best suit their investor bases and operations and that target the types of hypothetical performance the adviser intends to use in its advertisements as well as the intended recipients of the hypothetical performance.[307] For example, an investment adviser that plans to advise a new private fund might develop policies and procedures that take into account its experience advising a prior fund for which it raised money from investors. That experience might indicate that the prior fund's investors valued a particular type of hypothetical performance because, for example, the investors used it to assess the adviser's strategy and investment process and had the resources to make that assessment. The adviser's policies and

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305 Proposed rule 206(4)-1(c)(1)(v)(C).

306 Proposed rule 206(4)-1(c)(1)(v)(A).

307 In this respect, this condition would mirror in part the proposed definition of "Non-Retail Advertisement," which would require an adviser to adopt and implement policies and procedures reasonably designed to ensure that Non-Retail Advertisements are disseminated solely to Non-Retail Persons, as discussed above. *See supra* footnotes 231-232 and accompanying text.

procedures could then reflect its determination that this type of hypothetical performance is relevant to the financial situation and investment objectives of those investors or investors of a similar type.

Reasonably designed policies and procedures need not require an adviser to inquire into the specific financial situation and investment objectives of each potential recipient. Instead, such policies and procedures could identify the characteristics of investors for which the adviser has determined that a particular type or particular presentation of hypothetical performance is relevant and a description of that determination. In many cases, that determination could be made on the basis of the adviser's past experience with investors belonging to that group. For example, an adviser could determine that certain hypothetical performance presentations are relevant to the financial situation and investment objectives of certain types of investors, based on routine requests from those types of investors in the past. An adviser's experience could similarly provide it with an understanding of the analytical resources available to investors of a particular type. The adviser could then incorporate its understanding into its policies and procedures.

We understand that Non-Retail Persons in particular routinely evaluate the types of performance that the proposed rule would treat as hypothetical performance as part of their due diligence in hiring investment advisers and that Non-Retail Persons believe that such performance is relevant to their financial situation and investment objectives.[308] With appropriate analytical and other resources, these investors may assess and conduct diligence on hypothetical performance and the underlying assumptions and methodologies in light of market

[308] *See* Comment Letter of ILPA on the 2019 Concept Release (Sept. 24, 2019) (stating that, in considering investments in private funds, "[l]arge institutional investors spend hours of due diligence in undergoing their own manager selection processes. Evaluating and considering the potential success of management and teams is critical.").

conditions, investment policies, objectives and strategies, leverage, and other factors that they believe to be important. For example, these investors may routinely analyze backtested performance to assess how a quantitative strategy would have performed under market conditions that such investors expect might occur in the near future. Non-Retail Persons also generally have the resources to obtain information that can inform their assessment, and would be provided additional information from the adviser under the conditions of the proposed rule.[309] Accordingly, an adviser could consider this experience when designing policies and procedures to provide hypothetical performance where it is relevant to the investor's financial situation and investment objectives.

On the other hand, hypothetical performance may be less relevant to the financial situation and investment objectives of investors that do not have access to analytical and other resources to enable them to analyze the hypothetical performance and underlying information. For example, analysis of hypothetical performance may require tools and/or other data to assess the impact of assumptions in driving hypothetical performance, such as factor or other performance attribution, fee compounding, or the probability of various outcomes. Without being able to subject hypothetical performance to additional analysis, this information would tell an investor little about an investment adviser's process or other information relevant to a decision to hire the adviser. Instead, viewing the hypothetical performance (without analyzing and performing the necessary due diligence on the underlying information) could mislead an investor to believe something about the adviser's experience or ability that is unwarranted. We

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[309] *See, e.g.,* proposed rule 206(4)-1(c)(1)(v)(B) (requiring an investment adviser to provide certain information as a condition of presenting hypothetical performance in an advertisement). The provisions of paragraph (a) of the proposed rule, including the prohibition of material claims or statements that are unsubstantiated, would apply to targets and projections, as would the general anti-fraud provisions of the Federal securities laws.

believe that advisers should give closer scrutiny as to whether hypothetical performance is relevant to those investors' financial situation and investment objectives.

An adviser could determine, based on its experience, that hypothetical performance is not relevant to the financial situation and investment objectives of Retail Persons and reflect such determination in its policies and procedures. However, we believe that in some cases an adviser may reasonably determine that hypothetical performance is relevant to a particular Retail Person. To determine whether hypothetical performance is relevant with respect to a Retail Person, reasonably designed policies and procedures should include parameters that address whether the Retail Person has the resources to analyze the underlying assumptions and qualifications of the hypothetical performance to assess the adviser's investment strategy or processes, as well as the investment objectives for which such performance would be applicable. In light of that, we believe that advisers generally would not be able to include hypothetical performance in advertisements that are directed to a mass audience or intended for general circulation because such an advertisement would be available to all investors, regardless of their financial situation or investment objectives.

***Calculation Information.*** The second condition for the presentation of hypothetical performance would require the adviser to provide sufficient information to enable the recipient to understand the criteria used and assumptions made in calculating the hypothetical performance.[310] With respect to criteria, investment advisers should provide information that includes the methodology used in calculating and generating the hypothetical performance. With respect to assumptions, investment advisers should provide information that includes any assumptions on which the hypothetical performance rests – *e.g.,* the likelihood of a given event

[310] Proposed rule 206(4)-1(c)(1)(v)(B).

occurring. We propose to require advisers to provide this calculation information so that the recipient is able to determine, in part, how much value to attribute to the hypothetical performance. This calculation information also would provide the recipient with insight into the adviser's operations. For example, this information could allow the recipient to understand how the adviser identifies the criteria and assumptions supporting the hypothetical performance and accounts for them in generating that performance. In addition, any disclosed calculation information might be a basis for additional discussions between the recipient and the investment adviser, which would add to the information available to the recipient. Finally, this calculation information might enable the recipient to attempt to replicate the hypothetical performance using its own analytical tools or other resources, which might allow the recipient to evaluate further the utility of the hypothetical performance.[311]

The proposed rule would require that calculation information be provided to all investors receiving hypothetical performance, even to Non-Retail Persons. We believe Non-Retail Persons should receive this information and understand that, even with their access to resources, Non-Retail Persons may struggle at times to receive sufficient information from investment advisers explaining the methodology by which hypothetical performance was calculated and generated.[312] Without calculation information, we believe that such performance would be

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311 We believe that an ability to replicate the hypothetical performance would be another indication of the adviser's operations and methods, assuming that the recipient of the information also has sufficient information about the risks and limitations of the performance. That is, the recipient could determine that applying the adviser's methodologies and assumptions can produce the same results reflected in the hypothetical performance, which could indicate the utility of those methodologies and assumptions and how the adviser applies them.

312 The proposed rule does not prescribe any particular methodology or calculation for the different categories of hypothetical performance, just as it does not prescribe methodologies or calculations for actual performance. Instead, the proposed rule would require investment advisers including hypothetical performance in an advertisement to provide the calculation information so that the recipient can understand how the hypothetical performance was calculated.

misleading even to an audience with the analytical or other resources necessary to evaluate it. Accordingly, the proposed rule would require an adviser presenting hypothetical performance to provide this calculation information to Non-Retail Persons.[313]

Calculation information should be tailored to the person receiving it, though such tailoring could apply to general categories of persons, such as Retail Persons or Non-Retail Persons. The amount of calculation information and level of detail provided to a Retail Person may differ significantly from the amount and level that would be sufficient to enable a Non-Retail Person to understand it. For example, a Retail Person may require additional explanations of certain key terms that may be familiar to a Non-Retail Person. To determine what calculation information to provide, an adviser would need to determine the type and amount of calculation information that could be understood by the recipient.[314]

***Risk Information.*** Finally, the proposed rule would require the adviser to provide – or, if the recipient is a Non-Retail Person, to provide or offer to provide promptly – information to understand the risks and limitations of using the hypothetical performance in making investment decisions.[315] With respect to risks and limitations, investment advisers should provide information that would apply to both hypothetical performance generally – *e.g.,* the fact that

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313 In addition, we would consider any calculation information provided alongside the hypothetical performance to be a part of the advertisement and therefore subject to the books and records rule. *See infra* section II.C.7; *see also supra* footnote 106 and accompanying text.

314 This obligation would be similar to an adviser's obligation to provide full and fair disclosure to its clients of all material facts relating to the advisory relationship and of conflicts of interest. *See* Standard of Conduct Release, *supra* footnote 23, at n. 70 (stating that institutional clients "generally have a greater capacity and more resources then retail clients to analyze and understand complex conflicts and their ramifications").

315 Proposed rule 206(4)-1(c)(1)(v)(C).

hypothetical performance does not reflect actual investments[316] – and to the specific hypothetical performance presented – *e.g.,* if applicable, the fact that the hypothetical performance represents the application of certain assumptions but that the adviser generated dozens of other, lower performance results representing the application of different assumptions. Risk information should also include any known reasons why the hypothetical performance would have differed from actual performance of a portfolio – *e.g.*, the fact that the hypothetical performance does not reflect cash flows in to or out of the portfolio. This risk information would, in part, enable the recipient to understand how much value to attribute to the hypothetical performance in deciding whether to hire or retain the investment adviser.[317]

Just as with calculation information, risk information should be tailored to the person receiving it, although it may be tailored to general categories of persons.[318] For example, sufficient information for a Retail Person to understand the risks and limitations of the advertised hypothetical performance may require charts, graphs, or other pictorial representations, which may be unnecessary for a Non-Retail Person.

In addition, the investment adviser must provide risk information to Retail Persons in all cases, but for Non-Retail Persons an adviser could either provide it or offer to provide it promptly. We believe risk information is essential in mitigating the risk that hypothetical performance may be misleading to Retail Persons. We believe that Non-Retail Persons are more likely aware of the risks and limitations of hypothetical performance, particularly when they are

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316 With respect to backtested performance, one such general risk and limitation would be the fact that backtested performance represents the application of a strategy that was created after the performance period shown in the results and, accordingly, was created with the benefit of hindsight.

317 In addition, we would consider any risk information provided in connection with the hypothetical performance to be a part of the advertisement and therefore subject to the books and records rule. *See infra* section II.C.7; *see also supra* footnote 106 and accompanying text.

318 *See supra* footnote 314.

provided with the calculation information that the proposed rule would require and could analyze the hypothetical performance using their own assumptions. Accordingly, the proposed rule would only require an adviser to provide this risk information to a Non-Retail Person if the Non-Retail Person accepts the offer for it.[319] A Non-Retail Person may determine that it has no use for the risk information and may decline to accept the offer. However, once the Non-Retail Person requests the risk information, the proposed rule would require that the adviser provide it.

In addition, any advertisement including hypothetical performance would be required to comply with the provisions in proposed rule 206(4)-1(a). As a result, the proposed rule would prohibit advisers from presenting hypothetical performance in a materially misleading way.[320] For example, we would view an advertisement as including an untrue statement of material fact if the advertised hypothetical performance reflected the application of methodologies, rules, criteria, or assumptions that were materially different from those stated or applied in the underlying information of such hypothetical performance. In addition, we would view it as materially misleading for an advertisement to present hypothetical performance that implies any potential benefits resulting from the adviser's methods of operation without clearly and prominently discussing any associated material risks or other limitations associated with the potential benefits.[321] Similarly, an advertisement presenting hypothetical performance that includes an offer to provide promptly risk information to a Non-Retail Person, pursuant to

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319 Proposed rule 206(4)-1(c)(1)(v)(C) (permitting an adviser to "offer to provide promptly" such information if the recipient is a Non-Retail Person). However, this advertisement would continue to be subject to the prohibitions in proposed rule 206(4)-1(a).

320 *See, e.g., supra* footnotes 188-199 and accompanying text.

321 Proposed rule 206(4)-1(a)(4). For example, if a presentation of hypothetical performance implies that an adviser's operations are structured so that the adviser can update its investment models quickly, then the advertisement must discuss any associated material risks from that implied benefit – *e.g.*, that quickly updating the investment model may result in the adviser over-interpreting recent data and missing subsequent growth that the adviser would have achieved if the model had not been updated.

proposed rule 206(4)-1(c)(1)(v)(C), would be materially false and misleading if the adviser subsequently failed to make efforts to provide such information upon the Non-Retail Person's request.[322]

We request comment on the proposed conditions to presenting hypothetical performance in advertisements.

- Should we prohibit the presentation of hypothetical performance in any advertisement? Why or why not? Instead of a complete prohibition, should we prohibit the presentation of hypothetical performance, or specific types of hypothetical performance, under specific circumstances? If so, what circumstances? Should we prohibit the presentation of hypothetical performance in Retail Advertisements but not in Non-Retail Advertisements (or vice versa)?
- Should we permit the presentation of hypothetical performance in any advertisement without condition? Why or why not?
- Should we require, as proposed, that advisers adopt and implement policies and procedures designed to ensure that hypothetical performance is relevant to a recipient's financial situation and investment objectives? Would such policies and procedures ensure that hypothetical performance is only provided to those for whom it is relevant? Would providing hypothetical performance only to those for whom it is relevant help prevent such performance from being misleading? Would advisers be able to make the determination that hypothetical performance is relevant?
- Should we consider another standard other than "relevant" to a recipient's "financial situation and investment objectives" to help protect against hypothetical performance

[322] Proposed rule 206(4)-1(c)(1)(v)(C).

being provided to persons who would be misled by it? For example, should we instead require that such performance be provided only to persons whom the adviser reasonably believes may use such performance in considering whether to hire or retain an adviser and that have sufficient access to analytical and other resources to evaluate or test the assumptions underlying the hypothetical performance so as to make the hypothetical performance not misleading? Alternatively, should we limit the distribution of this performance to persons whom the adviser reasonably believes would use it in evaluating whether to hire or retain the adviser? Alternatively, should we avoid limiting at all the distribution of hypothetical performance, which some investors may find useful?

- Should we instead consider categorical approaches – *e.g.,* should we instead allow hypothetical performance to be provided to Non-Retail Persons in all cases without requiring the adviser to adopt policies and procedures? Should we allow its presentation to Non-Retail Persons but prohibit its presentation to Retail Persons entirely?
- Are there specific disclosures that we should require to decrease the likelihood that hypothetical performance, or specific types of hypothetical performance, would be misleading – *e.g.*, describing the fact that the performance was not generated by actual portfolios of actual clients of the investment adviser and describing the limitations of hypothetical performance? If so, should we identify those and specifically require their disclosure?
- Are there specific disclosures that we should require to decrease the likelihood that hypothetical performance would be misleading to Retail Persons? If so, should we

identify those and specifically require those disclosures? Should we require different disclosures for Retail Persons and Non-Retail Persons, or is the tailoring implicitly permitted under the proposed rule's "sufficient information" standard enough?

- Should we include any other requirements or conditions for advertisements presenting hypothetical performance, or any specific type of hypothetical performance? What other requirements or conditions and why should we require them?
- Is there another approach that we should consider for hypothetical performance being provided to Retail Persons? Are there any types of hypothetical performance that are sufficiently similar to actual results of a portfolio of an actual client that we should permit their presentation in a Retail Advertisement or their dissemination to Retail Persons without conditions?
- Are the proposed "calculation information" and "risk information" provisions sufficiently clear based on our description above? Should we require specifically that such information be designed to allow the audience to replicate the hypothetical performance presented? Why or why not?
- Would investment advisers face any compliance challenges in complying with the proposed "calculation information" or "risk information" provisions? Would there be circumstances in which investment advisers might have to provide proprietary or sensitive information? Should we take those challenges or circumstances into account? If so, how?
- Should we require that the risk information be provided (not just offered to be provided) to Non-Retail Persons as well as to Retail Persons? Conversely, should we

allow the calculation information to be only offered to Non-Retail Persons (instead of requiring it to be provided)?

- Under the current rule, have investment advisers taken the same approach that we are proposing with respect to hypothetical performance – *i.e.,* providing or offering to provide specific information? Have investors accepted any such offers or requested any additional information? To what extent and under what circumstances have any such investors been misled by the presentation of hypothetical performance? Have investors who have requested additional performance results included persons other than qualified purchasers and knowledgeable employees?

#### d. *General request for comment on performance advertising.*

We believe that the proposed rule's requirements with respect to performance advertising are generally consistent with widely used, internationally recognized standards of performance reporting, such as GIPS. Accordingly, we believe that investment advisers will be able to comply with both the provisions of the proposed rule and the requirements of such standards, without undue burdens. We request comment below on this issue.

- Are our beliefs correct that the proposed rule's requirements are consistent with widely-used, internationally-recognized standards of performance presentation, such as GIPS? Would investment advisers find it difficult or impossible comply with both the provisions of the proposed rule and the requirements of any such standards in order to comply with the proposed rule's requirements? If so, which requirements would create such difficulty or impossibility and how? Should we address any such difficulty or impossibility? If so, how? Should we adopt a more principles-based approach to afford flexibility in the event that such private standards change?

We request general comment on the proposed rule's requirements for performance advertising.

- Are there specific concerns about performance advertising that the proposed rule does not take into account that we should consider? What specific concerns, and how should we take them into account? Conversely, are there provisions of the proposed rule's performance advertising provisions that address concerns you believe to be unfounded?
- Should we consider removing some of the proposed rule's requirements for performance advertising and instead rely on paragraph (a) of the proposed rule and the general anti-fraud provisions of the Federal securities laws to prevent the use of performance advertising that is false or misleading? Why or why not? Are there additional requirements that we should consider including in the proposed rule with respect to performance advertising in order to supplement paragraph (a)? What additional requirements and how would they supplement paragraph (a)?
- Taken as a whole, are the disclosures required by the proposed rule for performance advertising sufficient or insufficient? Are there changes to these disclosures that we should consider in order to make them more useful or meaningful for investors, whether natural persons or institutions? What changes and how would they improve the utility of the disclosures?
- Should we impose on Non-Retail Advertisements presenting performance results the same or similar requirements that the proposed rule imposes on Retail Advertisements? For example, should we require Non-Retail Advertisements to

present net performance or to present performance results for certain specified periods of time? Why or why not?

- Should we specify any types of information that advisers may refrain from disclosing when responding to prospective investors seeking the information that must be offered in advertisements? Are advisers concerned that their competitors may seek to acquire such information through requests responding to those offers? Do advisers have any other concerns regarding competition that the proposed rule may cause or should address?

### 6. Portability of Performance, Testimonials, Third Party Ratings, and Specific Investment Advice

Among the performance results that an investment adviser may seek to advertise are those of portfolios or accounts for which the adviser, its personnel, or its predecessor investment adviser firms have provided investment advice in the past as or at a different entity. In some cases, an investment adviser may seek to advertise the performance results of portfolios managed by the investment adviser before it was spun out from another adviser. Or an adviser may seek to advertise performance achieved by its investment personnel when they were employed by another investment adviser. This may occur, for example, when a portfolio manager or team of portfolio managers leaves one advisory firm and joins another advisory firm or begins a new advisory firm. These predecessor performance results may be directly relevant to an audience when the advertisement offers services to be provided by the personnel responsible for the predecessor performance, even when the personnel did not work during the period for which

performance is being advertised for the adviser disseminating the advertisement (the "advertising adviser").[323]

However, predecessor performance results achieved by another investment adviser, or by personnel of another investment adviser, may be presented in a false or misleading manner by the advertising adviser.[324] For example, predecessor performance may be misleading to the extent that the team that was primarily responsible for the predecessor performance is different from the team whose advisory services are being offered or promoted in the advertisement, including when an individual who played a significant part in achieving the predecessor performance is not a member of the advertising adviser's investment team.[325] Similarly, predecessor performance may be misleading if the advertisement does not disclose that the predecessor performance was achieved by different personnel, or by a different advisory entity, than the personnel or entity whose services are being offered or promoted. In some cases, the ability of an advertising adviser to present predecessor performance that is not misleading may be limited to the extent that that the advertising adviser lacks access to the books and records underlying the predecessor performance.[326]

Where an adviser selects portfolio securities by consensus or committee decision making, it may be difficult to attach relative significance to the role played by each group member, and so an advertising adviser may face difficulties in deciding how to portray performance results

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323 For purposes of this discussion, "predecessor performance results" refers to all situations where an advertisement of an investment adviser presents investment performance achieved by a portfolio that was not advised at all times during the period shown by the investment adviser.

324 *See* current rule 206(4)-1(a)(5) (prohibiting the publication, circulation, or distribution of any advertisement "which contains any untrue statement of a material fact, or which is otherwise false or misleading"). We have addressed this concern in the presentation of performance results by RICs. *See* Instruction 4 to Item 4(b)(2) of Form N-1A; Instruction 11 to Item 27(b)(7) of Form N-1A.

325 *See, e.g.,* Fiduciary Mgmt. Assocs., Inc., SEC Staff No-Action Letter (Feb. 2, 1984).

326 *See* Rule 204-2(a)(16).

achieved by an adviser's committee in a manner that is not misleading. Predecessor performance results may be misleading where they were achieved by an investment committee at the predecessor adviser, and the investment committee at the advertising adviser does not have a substantial identity of personnel with the old committee.[327]

Some circumstances under which predecessor performance results are misleading may be addressed through specific provisions we have included in the proposed rule. For example, depending on the facts and circumstances, predecessor performance results may be misleading where they exclude any accounts that were managed in a substantially similar manner, or where they include any accounts that were not managed in a substantially similar manner, at the predecessor firm. These presentations may result in the inclusion or exclusion of performance results in a manner that is neither accurate nor fair and balanced.[328] Predecessor performance results may be misleading where the advertisement omits relevant disclosures, including that the performance results were from accounts managed at another entity. Predecessor performance results also may be misleading where, following an internal restructuring of another adviser, an advertising adviser does not operate in the same manner and under the same brand name that existed before the restructuring.[329] These predecessor performance results may include an untrue or misleading implication about a material fact relating to the advertising adviser.[330]

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327 *See, e.g.,* Horizon Letter; *see also* Great Lakes Advisers, Inc., SEC Staff No-Action Letter (Apr. 3, 1992) (stating the staff's views that it may not be misleading for a successor adviser, composed of less than 100 percent of the predecessor's committee, to use the predecessor performance results so long as there is a "substantial identity" of personnel) ("Great Lakes Letter").

328 *See* proposed rule 206(4)-1(a)(6).

329 *See* South State Bank, SEC Staff No-Action Letter (May 8, 2018) (conditioning the staff's statement that it would not recommend enforcement action on representations including, for example, that the successor adviser would operate in the same manner and under the same brand name as the predecessor adviser). For purposes of the discussion in this section II.A.6., we do not consider a change of brand name, without more, by an investment adviser to render its past performance as "predecessor performance." Likewise, a

Accordingly, advertisements presenting predecessor performance would be subject to the requirements imposed by the proposed rule on all advertisements, including paragraph (a), and the more specific performance advertising restrictions.[331] We are requesting comment on whether it would be appropriate to include in the proposed rule additional provisions to address specifically the presentation of predecessor performance results.

Our staff has stated that it would not recommend that the Commission take any enforcement action under section 206 of the Advisers Act or the current rule if an advertising adviser presents performance results achieved at another firm under certain conditions, including on the basis of the adviser's representation that the advertising adviser will keep the books and records of the predecessor firm that are necessary to substantiate the performance results in accordance with rule 204-2.[332] We already require investment advisers to keep copies of all advertisements containing performance data and all documents necessary to form the basis of those calculations.[333] We are considering how the books and records requirements should apply to portability of performance and whether the revised rule should explicitly require advertising advisers to have and keep the books and records of a predecessor firm or consider instead other requirements with respect to the records of performance of a predecessor firm presented in an advertisement. For example, if books and records of a predecessor firm are unavailable to an advertising adviser, it may be possible for the advertising adviser to substantiate the performance

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mere change in form of legal organization (*e.g.*, from corporation to limited liability company) or a change in ownership of the adviser would likely not raise the concerns described in this section.

330 Proposed rule 206(4)-1(a)(3).

331 Proposed rule 206(4)-1(c). *See also supra* footnote 199 and accompanying text.

332 *See* Horizon Letter; *see also* Great Lakes Letter, at n.3 (stating that rule 204-2(a)(16) "applies also to a successor's use of a predecessor's performance data").

333 Rule 204-2(a)(16).

of the predecessor firm using information that was publicly available contemporaneously with such performance and verified or audited by or on behalf of the advertising adviser.

We request comment on this aspect of the proposed rule. In particular, we request comment on:

- Do commenters believe that we should include specific provisions in the proposed rule to address the presentation of predecessor performance results? Or do commenters believe that the proposed rule, including the provisions of paragraph (a), will sufficiently prevent the presentation of predecessor performance results that are false or misleading? If we include specific provisions to address the presentation of predecessor performance results, what specific provisions should we include? How would those specific provisions prevent the presentation of predecessor performance results that is false or misleading?
- Should we impose conditions on an advertising adviser seeking to present predecessor performance results achieved at a prior advisory firm? Should we require that the individual or individuals who currently manage accounts at the advertising adviser to have been "primarily responsible" for achieving the predecessor performance results at the prior firm? If so, should we specify how "primary responsibility" is determined?
- Should we address circumstances in which predecessor performance results were achieved by portfolios managed by a committee (as opposed to an individual) at the prior firm? Should we require that if the portfolios at the predecessor firm were managed by a committee, the accounts at the advertising adviser must be managed by a committee comprising a substantial identity of the membership? Should we define

or provide additional guidance regarding the "substantial identity" required, or require that the committee comprises a specific percentage or subset of members? Should we establish any specific requirements for how much of a role an individual has to play on the committee at the predecessor firm and on the committee at the advertising adviser?

- Is there any circumstance under which the membership of a committee at a predecessor firm is so different from the membership of a committee at the advertising adviser that any presentation of performance results from the predecessor firm should be prohibited? What are those circumstances?
- Should the proposed rule distinguish between predecessor performance results on the basis of strategy – for example, between fundamental and quantitative strategies? Are presentations of predecessor performance results less likely to be misleading to the extent that those results were generated by use of a proprietary, algorithmic strategy that the advertising adviser "owns" and expects to use going forward? Why or why not? Should the proposed rule distinguish between predecessor performance results on the basis of something other than strategy? What basis and why?
- Should we require any similarity between the accounts managed at the predecessor firm and the accounts presented by the advertising adviser – for example, having similar investment policies, objectives, and strategies? A presentation of predecessor performance results could be false or misleading if the accounts managed at the predecessor firm are not sufficiently similar to the accounts that the adviser currently manages such that the prior results would not provide relevant information to the

advertising adviser's prospective clients.[334] Should the Commission take this approach and include such provision in the rule? If the Commission were to adopt this approach, should we specify how that similarity should be determined? Should we allow advertising advisers to present any performance results from predecessor firms without requiring that the advertising adviser determine whether the accounts are similar or the results are relevant, and let investors evaluate the relevance themselves? Would this approach be appropriate in Non-Retail Advertisements and not Retail Advertisements? Why or why not?

- Should an investment adviser seeking to present predecessor performance results be required to make any specific representations or disclosures in the advertisement? Or elsewhere?
- Do commenters believe we should consider amendments to the books and records rule to address the substantiation of performance results from a predecessor firm? Do investment advisers encounter any difficulties in accessing and retaining the books and records substantiating the performance results of a predecessor firm? Are there alternative books and records or other information that we could allow advertising advisers to rely on or retain in order to satisfy their obligations under the books and records rule with respect to predecessor performance results? Are there other sources of records that advisers currently rely on to substantiate performance results of a predecessor firm?
- Do investment advisers encounter difficulties in determining who "owns" the relevant performance results? That is, are investment advisers able to agree who should be

[334] *See, e.g.,* Horizon Letter.

able to advertise the prior performance results from the predecessor firm? How do investment advisers make this determination? Should we adopt requirements to clarify under what circumstances an advertising adviser may present predecessor performance results?

- Should we clarify that an advertising adviser may continue to advertise predecessor performance even if the personnel who achieved the predecessor performance, and who are employed by the advertising adviser, subsequently leave the advertising adviser? Why or why not?

Our proposed rule would permit the use of testimonials and references to specific investment advice given by an investment adviser, unlike the blanket ban on their use under the current rule. As a consequence, similar questions to that of performance portability may arise about the use of testimonials and endorsements referring to a predecessor entity, past third-party ratings, or specific investment advice given at a previous firm. We believe that generally the same framework that advisers apply to whether predecessor performance can be carried forward, could also be applied when analyzing whether testimonials, endorsements, third-party ratings, or specific investment advice applicable to a predecessor entity could be used by an adviser in advertisements.

We request comment on issues related to the use of testimonials, endorsements, third-party ratings, and specific investment advice associated with predecessor entities.

- Should the same framework be used for these purposes as that applicable when analyzing use of predecessor performance? Why or why not? If advisers were not to use the existing performance portability framework, how should we

regulate the use of testimonials, endorsements, third-party ratings, and specific investment advice from a predecessor entity?

- Would maintaining books and records to substantiate the applicability and relevance of testimonials, endorsements, third-party ratings, and specific investment advice from a predecessor entity be feasible for advisers?
- Should an adviser that seeks to use testimonials, endorsements, third-party ratings, or specific investment advice from a predecessor entity be required to make any specific disclosures or representations in the advertisement explaining their source, limitations, or relevance?
- Should we include specific requirements in the advertising (or books and records) rule regarding the use of such predecessor information? If so, what should we require?

### 7. Review and Approval of Advertisements

The proposed rule would require an adviser to have an advertisement reviewed and approved for consistency with the requirements of the proposed rule by a designated employee before, directly or indirectly, disseminating the advertisement, except for advertisements that are: (i) communications that are disseminated only to a single person or household or to a single investor in a pooled investment vehicle; or (ii) live oral communications that are broadcast on radio, television, the internet, or any other similar medium.[335] We are proposing this requirement because we believe it may reduce the likelihood of advisers violating the proposed rule. We are not proposing to require that investment adviser advertisements be filed with or approved by the

[335] Proposed rule 206(4)-1(d).

Commission staff or a self-regulatory organization. Nonetheless, we believe it is important that investment advisers have a process in place designed to promote compliance with the proposed rule's requirements. Requiring a written record of the review and approval of the advertisement will allow our examination staff to better review adviser compliance with the rule.

The proposed rule would exclude communications that are disseminated only to a single person or household or to a single investor in a pooled investment vehicle from the review and approval requirement. The proposed rule would exclude these one-on-one communications, which may fall within the proposed definition of "advertisement," from the scope of the review and approval requirement to avoid placing a significant burden on an adviser's individual communications with its current or potential investors. For example, an employee of the adviser might otherwise submit each e-mail to a single investor for review before dissemination, to determine whether it is an advertisement, and if so, whether it complies with the proposed rule. We believe this could have an adverse effect on the adviser's business due to the delay in communicating with investors. In addition, we believe that requiring review and approval of each communication could impose significant costs on an adviser because of the staffing requirements such a requirement would entail. However, the other provisions of the proposed rule would continue to apply. For example, an adviser could not provide hypothetical performance to a client in a one-on-one communication unless it complies with the requirements of the proposed rule.[336]

Customizing a template presentation or mass mailing by filling in the name of an individual investor or including other basic information about the investor would not fall within

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[336] *See* proposed rule 206(4)-1(c)(1)(v).

the scope of this exception. In such a case the communication is not sent only to a single person because it is effectively a customized mass mailing.

The proposed rule also would except live oral communications that are broadcast on radio, television, the internet, or any other similar medium from the review and approval requirement. We are excepting live oral communications that are broadcast from the requirement because they are extemporaneous, and therefore they cannot effectively be reviewed and approved in advance. Nonetheless, to the extent live oral communications that are broadcast are also written or scripted, the scripts would be subject to the review and approval requirement. If a live oral communication that is broadcast is also recorded, and then later disseminated by or on behalf of the adviser, then the broadcast would qualify for the exception, but the recorded communication would not qualify. In addition, any prepared materials, such as slides, used in the live broadcast would not be subject to the exception and must be reviewed.

The proposed rule would allow any designated employee to conduct the review and provide approval. This provision of the proposed rule is intended to provide advisers with the flexibility to assign the responsibilities of advertising reviews to any qualified employee. The reviewer should be competent and knowledgeable regarding the proposed rule's requirements. Advisers may designate one or more employees to provide the required review and approval. We believe that designated employees generally should include legal or compliance personnel of the adviser. In general, we do not believe it would be appropriate for the person who creates the advertisement to be the same person who reviews and approves its use, as such overlap of personnel is likely to reduce the utility and effectiveness of the review requirement. Nonetheless, we recognize that certain small or single-person advisers may not have separate

personnel to create an advertisement and review it. We request comment below on potential approaches to the review requirement for such cases.

Under the proposal, similar to new advertisements, updates to existing advertisements would also require review and approval. It is our understanding that the internal policies and procedures of most advisers currently require such reviews for broadly disseminated communications. In complying with the review requirement, advisers may need to expand the scope of existing reviews to account for the additional communications that may be included within the definition of "advertisement" under the proposed rule as discussed above.

The proposed rule does not contain separate policy and procedure requirements other than this review and approval requirement.[337] Nonetheless, existing compliance policies and procedures requirements in Advisers Act rule 206(4)-7 would apply to investment adviser advertisements made pursuant to the proposed advertising rule.[338] In adopting rule 206(4)-7, the Commission stated that investment advisers should adopt policies and procedures that address "…..the accuracy of disclosures made to investors, clients, and regulators, including account statements and advertisements."[339] Investment advisers would continue to be required to include

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337 *Compare* FINRA rule 2210 which requires, in part, members to establish written procedures designed to ensure that communications comply with applicable standards; retail communications (distributed or made available to 25 or fewer retail investors within any 30 calendar-day period) be approved internally, and certain communications must be filed with FINRA at least 10 days prior to their first use. Rule 2210 does not require the review and approval of correspondence. *See* rule 2210(b)-(c).

338 Rule 206(4)-7 makes it unlawful for an investment adviser to provide investment advice unless the adviser has adopted and implemented written policies and procedures reasonably designed to prevent violation[s] of the Advisers Act and rules that the Commission has adopted under the Act, which would include revised rule 206(4)-1 and its specific requirements. *See* rule 206(4)-7(a). Rule 206(4)-7 also requires investment advisers to review, no less than annually, the adequacy of the policies and procedures and the effectiveness of their implementation, and to designate who is responsible for administering the policies and procedures adopted under the rule. *See* rule 206(4)-7(b)-(c).

339 *See* Compliance Program Adopting Release, *supra* footnote 33, at 74716.

policies and procedures designed to prevent violations of the advertising rule in their compliance programs if the proposed rule were adopted.

In considering their compliance policies and procedures, advisers should consider methods of preventing the dissemination of advertisements that might violate the rule. Advisers could document in their policies and procedures the process by which they determine that an advertisement complies with the proposed rule, as well as any significant changes to that process over time. For example, an adviser may wish to document the process by which it determines that advertisements that contain investment recommendations are fair and balanced and consistent with the rule (such as by using objective non-performance based standards) and if it changes that process, may wish to consider documenting the reasons for such changes.

We request comment on our approach to the proposed review and approval requirement.

- As proposed, should we require a designated employee of an investment adviser to review and approve advertisements? Should we require that this review be conducted by only legal or compliance personnel of the adviser? Should we require that only employees of an adviser that are senior management be eligible to be designated as reviewers? Should we permit outside third parties, such as law firms or compliance consultants, to conduct these reviews?
- Should the rule prohibit the same individual who created the advertisement from reviewing and approving it? If so, how would small advisers, which may only have one individual qualified to create and review advertisements, comply with this requirement? Should the rule except them from the approval requirement, similar to the exception under rule 204A-1(d) of the Advisers Act for small

advisers with only one access person from having that person approve his or her own personal security investments, provided they keep sufficient records?

- Should we include the proposed one-on-one communications exception to the requirement to review and approve advertisements? Is this necessary for advisers to communicate freely with investors? Is there another way to reduce the burden of reviewing individual communications before dissemination while reducing the likelihood that advisers may violate the proposed rule? Should the exception apply to communications with more than one investor? If so, how many?
- Should we except live oral communications that are broadcast from the review and approval requirement as proposed? Are there any other types of advertisements that we should except from the requirement?
- Should we require any specific compliance procedures in the advertising rule itself in addition to review and approval?
- Should we require that the review and approval process differ or be more or less comprehensive based on the audience that the advertisement is directed towards? If so, how?

### 8. Proposed Amendments to Form ADV

We are also proposing to amend Item 5 of Part 1A of Form ADV to improve information available to us and to the general public about advisers' advertising practices.[340] Item 5 currently

[340] This section discusses the Commission's proposed rule and form amendments that would affect advisers registered with the Commission. We understand that the state securities authorities intend to consider similar changes that affect advisers registered with the states, who are also required to complete Form ADV Part 1B as part of their state registrations. We will accept any comments and forward them to the North American Securities Administrators Association ("NASAA") for consideration by the state securities authorities. We request that you clearly indicate in your comment letter which of your comments relate to these items.

requires an adviser to provide information about its advisory business.[341] We propose to add a subsection L ("Advertising Activities") to require information about an adviser's use in its advertisements of performance results, testimonials, endorsements, third-party ratings, and its previous investment advice.

Specifically, we would require an adviser to state whether any of its advertisements contain performance results, and if so, whether all of the performance results were verified or reviewed by a person who is not a related person.[342] We would also require an adviser to state whether any of its advertisements includes testimonials or endorsements, or includes a third-party rating, and if so, whether the adviser pays or otherwise provides compensation or anything of value, directly or indirectly, in connection with their use.[343] Compensation or anything of value is not limited solely to cash, but could also include non-cash compensation. Finally, we would require an adviser to state whether any of its advertisements includes a reference to specific investment advice provided by the adviser.[344]

Our staff would use this information to help prepare for examinations of investment advisers. This information would be particularly useful for staff in reviewing an adviser's

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341 Exempt reporting advisers (that are not also registering with any state securities authority) are not required to complete Item 5 of Part 1A. Accordingly, our proposed subsection L of Item 5 of Part 1A would not be required for such advisers. *See, e.g.*, Instruction 3 to Form ADV: General Instructions ("How is Form ADV organized").

342 Proposed Form ADV, Part 1A, Item 5.L(1). The term "related person" would have the meaning currently ascribed to it in the Form ADV Glossary ("Any *advisory affiliate* and any *person* that is under common *control* with your firm.") Italicized terms are defined in the Form ADV Glossary.

343 Proposed Form ADV, Part 1A, Item 5.L(2) and (3). The Glossary to proposed Form ADV would define "testimonial" as "any statement of a client or investor's experience with the investment adviser;" "endorsement" as "any statement by a person other than a client or investor indicating approval, support, or recommendation of the investment adviser;" and "third-party rating" as "a rating or ranking of an investment adviser provided by a person who is not an affiliated person of the adviser and provides such ratings or rankings in the ordinary course of its business." These definitions would be consistent with our proposed amendments to rule 206(4)-1.

344 Proposed Form ADV, Part 1A, Item 5.L(4).

compliance with the proposed amendments to the advertising rule, including the proposed restrictions and conditions on advisers' use in advertisements of performance presentations and third-party statements.

We request comment on the proposed amendments to Part 1A of Form ADV.

- Should we require more or less detailed information about advisers' advertising practices? If so, what additional information should we require, or what should we remove from the disclosure requirement, and why?
- Should we require more information about advisers' use of performance results in advertisements? For example, for advisers that use performance results in advertisements that are verified or reviewed by someone other than a related person, should we require the advisers to provide the name and contact information of such reviewer on a corresponding schedule? Why or why not?
- For advisers that have their performance results verified or reviewed by a person who is not a *related person*, does such verification or review apply to all of the advisers' performance results, or only to some of the performance results? Please explain. Should we require that advisers state if they have any of their results verified by such a third party?
- Should we require advisers to state the particular types of performance results they use in advertisements, such as related performance, hypothetical performance, or another type of performance (and if so, what type of performance)? Should we require them to state to whom they direct specific types of advertisements (for example, Retail Persons or Non-Retail Persons)? Why or why not?

- Should we require advisers to disclose that they provide hypothetical performance to investors? If so, should we require advisers to provide descriptions of such hypothetical performance or any information about how they calculate hypothetical performance?
- Should we require advisers to state whether their use of performance, testimonials, endorsements, third-party ratings, or specific investment advice includes information from predecessor or other firms? If so, should we require any additional information about the predecessor or other firm, such as a name and contact, and an affirmation that such firm permits the adviser's use of the performance results (if applicable) and affirms its accuracy?
- Should we require advisers to state how they advertise performance results (*e.g.*, on social media, through testimonials, endorsements or third-party ratings, seminars, television advertisements, private placement materials, or through periodic client updates)? Why or why not, and if so, should we require advisers to provide more detail about the methods they use to advertise performance results, such as the name of the website or social media platform, or the name of the endorser? Why or why not?
- Should we require an adviser to state any other information about the compensation it provides in connection with the adviser's use of testimonials, endorsements, and third-party ratings in advertisements, such as the amount or range of compensation? If so, what type of information about the compensation should we require, and why? Would such additional information be helpful to investors? Why or why not?

- Should we require advisers to state the approximate percentage of their testimonials, endorsements, or third-party statements in advertisements that are current (within a specific time frame) versus not current (within a specific time frame)? Why or why not, and if so, what should those time frames be?
- Should we require advisers to state how they advertise testimonials, endorsements, third-party ratings, or specific investment advice (*e.g.*, on social media, through seminars, television advertisements, or through periodic client updates)? Why or why not, and if so, should we require advisers to provide more detail about the methods they use to advertise testimonials, endorsements, third-party ratings, or specific investment advice such as the name of the website or social media platform? Why or why not? Should we require any other information, and if so, what types of information should we require?
- Is it clear what "specific investment advice" means in the context of the proposed amendment to Form ADV?
- Even though Part 1A of Form ADV currently requires advisers to report information about client referrals, including the existence of cash and non-cash compensation that the adviser or a related person gives to or receives from any person in exchange for a client referral, should we also require additional information about client referrals and solicitation, as discussed *infra* Section II.B? If so, what additional information should we require, and why? For example, should we require all registered investment advisers to include the names of, and other specified information about, their current solicitors on a separate schedule, similar to our requirements for advisers to private funds to provide information

about their marketers (including solicitors)?[345] Should we require advisers to report the amount of compensation paid for referrals (on an aggregate basis, per referral, or based on another metric)? If a firm employs several solicitors, should we only require information about the firm's top 5 (or 10, or another number) solicitors, measured by number of client referrals made in the past year or some other measure, such as assets under management the referrals generate for the adviser? Please explain. Should we require advisers to private funds to provide additional information in Section 7.B of Schedule D of Form ADV about their private fund marketing arrangements? If yes, what additional information should we require, and why?

- Should we require advisers to describe their advertising practices in their Form ADV brochure in addition to, or instead of, the proposed Part 1A subsection L ("Advertising Activities")? Why or why not, and if so, what information should we require advisers to describe in their brochure about their advertising activities?

### B. Proposed Amendments to the Solicitation Rule

We are proposing to amend the solicitation rule, rule 206(4)-3, in part to reflect regulatory changes and the evolution of industry practices since we adopted the rule in 1979. Among other changes we discuss below, we are proposing to expand the rule to cover solicitation arrangements involving all forms of compensation, rather than only cash

345 *See* Section 7.B.(1) (Private Fund Reporting) of Schedule D to Form ADV Part 1A (requiring advisers to private funds to list, among other things, the name of their marketer (including any solicitor), whether the marketer is a related person of the advisers, whether the marketer is registered with the Commission, the location of the marketer's office used principally by the private fund, whether or not the marketer markets the private fund through one or more websites, and if so, the website address(es)).

compensation. It would also apply to the solicitation of existing and prospective clients and investors rather than only to "clients." Our proposal would also eliminate certain existing requirements where the purpose of the requirements can be achieved under other rules under the Act. Specifically, it would eliminate the requirements that the solicitor deliver the adviser's brochure and that the adviser obtain client acknowledgments of the solicitor disclosure. Our proposal would revise the rule's written agreement requirement and solicitor disclosure requirement, the partial exemptions for impersonal investment advice and affiliated solicitors, and the solicitor disqualification provision. It also would provide a conditional carve-out from the provision for certain disciplinary events, and it would add two additional exemptions to the rule for *de minimis* compensation and nonprofit programs. Accordingly, we propose to revise the title of rule 206(4)-3 from "Cash payments for client solicitations" to "Compensation for solicitations."

### 1. Scope of the Rule: Who is a Solicitor?

We propose to retain, with certain revisions, the current rule's definition of "solicitor," which is "any person who, directly or indirectly, solicits any client for, or refers any client to, an investment adviser."[346] In a change from the current definition, the proposed definition would

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[346] Rule 206(4)-3(d)(1); proposed rule 206(4)-3(c)(4). Depending on the facts and circumstances, a person providing advice as to the selection or retention of an investment adviser may be an "investment adviser" within the meaning of section 202(a)(11) of the Act and may also have an obligation to register under the Act. Accordingly, we are proposing to no longer take the position, as in 1979 when the Commission adopted the rule, that "a solicitor who engages in solicitation activities in accordance with paragraph (a)(2)(iii) of the rule … will be, at least with respect to those activities, an associated person of an investment adviser and therefore will not be required to register individually under the Advisers Act solely as a result of those activities." 1979 Adopting Release, *supra* footnote 27. We also stated in the 1979 Adopting Release that "[t]he staff of the Commission is prepared to consider no action inquiries regarding the registration of solicitors." *Id*. Subsequently, our staff has indicated in staff no-action letters that it would not recommend enforcement action if a solicitor performing solicitation activities pursuant to the solicitation rule did not register as an "investment adviser" under the Act. *See, e.g.*, Cunningham Advisory Services, Inc., SEC Staff No-Action Letter (Apr. 27, 1987) and Koyen, Clarke and Assoc. Inc., SEC Staff No-Action Letter (Nov. 10, 1986) (in both of these staff no-action letters, the staff cited the Commission's statement quoted in the text accompanying this footnote as support for the staff's position that would not

also include persons who solicit investors in private funds.[347] As with the current rule, a solicitor might be a firm (such as a broker-dealer or a bank), an individual at a firm who engages in solicitation activities for an adviser (such as a bank representative or an individual registered representative of a broker-dealer), or both. A solicitor may, in some circumstances, because of its solicitation activities, be acting as an investment adviser within the meaning of section 202(a)(11) of the Act, or as a broker or dealer within the meaning of section 202(a)(11) of the Act or section 3(a)(4) or 3(a)(5) of the Exchange Act, respectively. Such person may be subject to statutory or regulatory requirements under Federal law, including the requirement to register as an investment adviser or as a broker-dealer pursuant to the Act or section 15(a) of the Exchange Act, respectively, and/or state law and certain FINRA rules.[348] This is a facts and circumstances determination. Some solicitors may not be acting as investment advisers under the Act as a result of their solicitation activities. Others may be prohibited from registering with the Commission as an investment adviser, such as if they have insufficient assets under management,[349] or they may be able to rely on an exception from registration, such as for certain

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recommend enforcement action to the Commission if each solicitor proceeded as outlined in its letter without registering as an investment adviser). *See also* Charles Schwab & Co., SEC Staff No-Action Letter (Dec. 17, 1980) (solicitor's incoming letter to the staff referenced the Commission's statement quoted to in the text accompanying this footnote to support the solicitor's argument that it was not required to register as an adviser, and the Commission staff stated that it would not recommend enforcement action to the Commission if the solicitor proceeded as outlined in its letter without registering as an investment adviser). As discussed in section II.D., staff in the Division of Investment Management is reviewing staff no-action and interpretative letters to determine whether any such letters should be withdrawn in connection with any adoption of this proposal. If the rule is adopted, some of the letters may be moot, superseded, or otherwise inconsistent with the rule and, therefore, would be withdrawn.

347 *See infra* section II.B.3.

348 *See* Standard of Conduct Release, *supra* footnote 23 (stating that "[a]n adviser's fiduciary duty applies to all investment advice the investment adviser provides to clients, including advice about investment strategy, engaging a sub-adviser, and account type.").

349 *See* section 203A of the Act. These advisers may be required to register, instead, with one or more states, or they may be exempt from the prohibition, such as advisers who would be required to register in 15 or more States. *See* rule 203A-2(d).

advisers to private funds.[350] Similarly, a solicitor also may be able to rely on an exception or exemption from broker-dealer registration, including that provided by rule 3a4-1 under the Exchange Act.

Depending on the facts and circumstances, a person providing a compensated testimonial or endorsement in a registered investment adviser's advertisement (a "promoter") may also be a solicitor, and both the proposed advertising rule and solicitation rule may apply to person's promotional activities. In our view, relevant considerations might include compensation (*e.g.*, incentive-based compensation such as payment per referral would likely mean the promoter is also a solicitor); communication control (*e.g.*, the less control an adviser has over the content or dissemination of an promoter's communication, the more likely the promoter is also a solicitor); and the extent to which the referral to the adviser is directed to a particular client or private fund investor. For example, if the adviser pays a third-party promoter per referral to engage in a largely unscripted social media campaign to promote the adviser's services, or pays such a person to review and provide its view of the adviser's services on a blog, website, or social media page (*e.g.*, a social media "influencer"), we would consider the promoter to be providing an endorsement and acting as a solicitor and would apply both rules, including the proposed advertising rule's general prohibitions of certain advertising practices and its additional tailored requirements for testimonials and endorsements.[351] We believe that, as a practical matter, an adviser subject to both rules in such a situation would substantially satisfy its advertising rule disclosure obligation for testimonials and endorsements by adhering to the solicitation rule

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350 *See* sections 203(b) and (l) under the Act, as well as rules 203(l)-1 and rule 203(m)-1.

351 *See supra* section II.A.4 for a discussion of how an adviser may satisfy the disclosure requirements applicable to third-party statements and ratings in the context of a third-party promoters.

disclosure requirement (*e.g.*, the requirement to disclose the solicitor's compensation).[352] The overall effect, therefore, would be to apply a heightened set of safeguards where someone providing an endorsement crosses the line into solicitation. We believe heightened safeguards would generally be appropriate for a solicitation because a solicitor's incentives to defraud an investor would be greater than a promoter's.[353] This is because a solicitor typically will receive compensation based on the referrals made, while the compensation to a promoter for an advertisement containing an endorsement or testimonial may be less likely based on such incentive compensation.

We request comment on the above, particularly:

- Should the rule generally retain the current definition of "solicitor," as proposed, with some modifications to apply to persons who solicit investors in certain types of pooled investment vehicles, as discussed below? Why or why not? If not, how should the rule define "solicitor"? Have any interpretive issues arisen regarding the current rule's definition that we could clarify? If so, what are they and how should we address them?
- What factors or considerations should apply when evaluating a promoter's (such as a social media influencer's) status as either an endorser or solicitor or both, and why? Do commenters agree that relevant considerations should include

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352 The proposed solicitation would generally require that either the adviser or solicitor deliver the solicitor disclosure. *See infra* section II.B.4. If the solicitor (and not the adviser) delivers the solicitor disclosure, the adviser itself would still be required to make the disclosures required under the proposed advertising rule for testimonials and endorsements to the extent that the solicitor's referral also constitutes a testimonial or endorsement.

353 *But see* section II.B.7.c (discussing the proposed exemption for *de minimis* compensation).

compensation and communication control? Should we also consider the extent to which a communication is targeted to a particular investor? Why or why not?

- Should we modify the definition of "solicitor" so that it is limited to persons whose solicitation activities are directed at specific investors (*e.g.*, through one-on-one meetings and personalized communications)? Why or why not? Should we modify the definition of "solicitor" so that is limited to persons to whom the adviser provides incentive-based compensation, directly or indirectly, as compensation for solicitation activities? Why or why not? Should we add both of these modifications to the rule? Do these types of solicitations present greater conflicts of interest for the solicitor than other solicitation arrangements, necessitating greater disclosure to the investor? Should we distinguish testimonials and endorsements under the proposed advertising rule from solicitations under this proposed rule? If so, how?
- For compensated solicitation arrangements that would also be subject to the proposed advertising rule, would the application of both rules together result in any conflicting obligations or otherwise create practical difficulties in compliance with the rules? Or would advisers be able to leverage their compliance with one rule to satisfy the other rule's requirements?

### 2. Expanding the Rule to Address All Forms of Compensation

Rule 206(4)-3 currently prohibits an adviser from paying a cash fee, directly or indirectly, to a solicitor with respect to solicitation activities unless the adviser complies with the terms of

the rule.[354] The proposed rule would continue to apply to cash payments to a solicitor, including a percentage of assets under management, flat fees, retainers, hourly fees and other methods of cash compensation.

The proposed rule would also apply to non-cash compensation provided to solicitors – an adviser would be prohibited from paying a solicitor *any* form of compensation, directly or indirectly, for any solicitation activities unless the adviser complies with the terms of the rule.[355] Since the adoption of the current rule, we have gained a broader understanding of the different types of compensation that advisers use in referral arrangements, including compensation for referring investors to private fund advisers.[356] For example, advisers may direct client brokerage to reward brokers that refer them investors.[357] In addition, other solicitation arrangements, such as refer-a-friend programs in which advisers compensate current investors to solicit other

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354 Rule 206(4)-3(a).

355 Proposed rule 206(4)-3(a) ("As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts, practices, or courses of business within the meaning of section 206(4), it is unlawful for an investment adviser that is registered or required to be registered under section 203 of the Act to compensate a solicitor, directly or indirectly, for any solicitation activities, unless the investment adviser complies with paragraphs (1) through (3) of [paragraph (a)].").

356 We now require advisers to report to the Commission, and to disclose to clients, the existence of any cash or non-cash compensation they provide for client referrals, including sales awards or other prizes. *See* Item 8.H of Form ADV, Part lA; Item 14 of Form ADV, Part 2A. In addition, registered investment advisers that report to the Commission on Form ADV information about their private funds, are required to report information about marketers used for such private funds (*e.g.*, placement agents, consultants, finders, introducers, municipal advisers, other solicitors, or similar persons), but this information does not include the compensation paid to such marketers. *See* Item A.28 of Section 7.B.(1) of Schedule D to Form ADV Part 1A.

357 In 1979 when we adopted the rule, we limited the rule to cash payments, expressly reserving judgment about then-emerging arrangements under which broker-dealers might offer investment advisers certain services, including client referrals, in exchange for the adviser directing client trades to the broker-dealer. *See* 1978 Proposing Release, *supra* footnote 27, at text accompanying n.3; 1979 Adopting Release, *supra* footnote 27, at n.6 and accompanying text. Advisers are currently required to disclose to clients in the Form ADV brochure if they consider, in selecting or recommending broker-dealers, whether they or a related person receives client referrals from a broker-dealer or third party. *See* Item 12.A.2 of Form ADV Part 2A.

investors, can involve both cash and non-cash compensation.[358] The provision of non-cash compensation for referrals creates the same conflicts of interest as cash compensation for referrals – the solicitor has an economic interest in steering the investor to the adviser and may be biased by this interest. We believe that investors should be made aware of the solicitor's conflict of interest regardless of the form of compensation.[359]

The rule would, therefore, be applicable to non-cash compensation, including, but not limited to, directed brokerage, sales awards or other prizes, training or education meetings, outings, tours, or other forms of entertainment, and free or discounted advisory services.[360] Compensation could also include the adviser providing investment advice that directly or indirectly benefits the solicitor. For example, if the solicitor is a broker-dealer or affiliated with a broker-dealer, an adviser's payment for solicitation could be the adviser's recommendation that its investors purchase the solicitor's proprietary investment products or products that the adviser

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358 In refer-a-friend programs, advisers often provide soliciting investors cash and non-cash compensation such as free or lower-fee investment advisory services, investment adviser subscription services, and gift cards. However, we are proposing a *de minimis* exemption, as discussed below, which would exempt qualifying refer-a-friend arrangements from the rule.

359 Concerns underlying non-cash compensation in the context of sales activity are also reflected in other Commission rules. *See, e.g.,* Regulation Best Interest, Release No. 34-86031 (June 5, 2019) ("Regulation Best Interest Release") (adopting rule 15*l*-1 under the Exchange Act, requiring broker-dealers to establish written policies and procedures reasonably designed to identify and eliminate any sales contests, sales quotas, bonuses, and non-cash compensation that are based on the sale of specific securities or the sale of specific types of securities within a limited period of time, noting that these compensation practices create high-pressure situations for associated persons to increase the sales of specific securities or specific types of securities within a limited period of time and thus compromise the best interests of their retail customers).

360 We would not consider attendance at training and education meetings, including company-sponsored meetings such as annual conferences, to be non-cash compensation, provided that free attendance at these meetings or trainings is not provided in exchange for solicitation activities. For example, if free attendance at a conference is conditioned upon a solicitor referring a certain number of investors to an investment adviser, such attendance would be non-cash compensation.

Advisers already are required to identify non-cash referral arrangements pursuant to rule 206(4)-7, the compliance rule, and advisers' disclosure obligations. *See, e.g.* Item 8.H (1) of Form ADV, Part 1A (requiring advisers to disclose whether they or any related person, directly or indirectly, compensates any person that is not an employee for client referrals, and instructing advisers to consider all cash and non-cash compensation that the adviser or a related person gave to or received from any person in exchange for client referrals, including any bonus that is based, at least in part, on the number or amount of client referrals).

knows have revenue sharing or other pecuniary arrangements with the solicitor or its affiliate, if the adviser directly or indirectly makes these recommendations in exchange for the solicitor's solicitation activities. Broker-dealers or dual registrants that receive brokerage for solicitation of client accounts in wrap fee programs that they do not sponsor would be subject to the proposed solicitation rule if they solicit those clients to participate in the wrap fee program. Compensation provided by the adviser may occur before or after the solicitor engages in its referral activities, but regardless of when the compensation for solicitation is provided, such compensation would be within the scope of the proposed rule.

We request comment on our proposed treatment of compensation under the solicitation rule.

- Should the rule be extended to cover all forms of compensation (including non-cash), as proposed? Should some forms of non-cash compensation be excepted from the proposed rule? If so, which ones and why?
- Are there any forms of non-cash compensation paid for investor solicitations that should be specifically prohibited under the rule, or subject to additional conditions (in lieu of or in addition to the proposed rule's requirements)? If so, which forms of non-cash compensation should be prohibited under the rule, and/or what conditions should apply to their use in solicitations for investors?
- Should the rule define "compensation," or include examples of direct and indirect compensation for solicitation activities? If so, what should the definition include, and what examples should we include?

- How should the rule apply to an adviser that directs client brokerage in exchange for client referrals? Should the proposed rule apply any additional conditions in these circumstances?
- Does the proposed rule clearly distinguish compensation that is for solicitation from ordinary compensation an adviser pays to a broker-dealer for *bona fide* execution services for an adviser's clients and is unrelated to a solicitation arrangement between the adviser and the broker-dealer? If not, how should the rule clarify this distinction?
- Should the rule include any cap on the amount of compensation (cash or non-cash) paid to solicitors, and if so, what should that cap be? Why or why not? If so, should such a cap vary depending on the type of investor solicited (such as a Retail Person or a Non-Retail Person), or the type of compensation arrangement? For example, should there be a cap on the percentage of assets under management an adviser may pay a solicitor for solicitation, or an absolute cap per solicitation arrangement in terms of dollar amount, or both, and if so, what should they be? Should there be a cap on the amount of compensation for the solicitation of investors in private funds that is different from a cap on the amount of compensation for advisory clients, and if so what should they be? Should the rule include a cap on, or any other parameters regarding, the length of time over which they are paid (such that, for example, solicitors do not continue to receive fees even after they are no longer in business as a solicitor, or after they become subject to disciplinary action that would result in their disqualification as a solicitor under the rule)?

### 3. Compensation for the Solicitation of Existing and Prospective Investors

Our proposal would expand the scope of the rule to the solicitation of existing and prospective private fund investors.[361] We believe this would increase protections to such investors primarily by making them aware of a solicitor's financial interest in the investor's investment in a private fund and prohibiting the use of disqualified solicitors under the proposed rule. While investors in private funds may often be financially sophisticated, they may not be aware that the person engaging in the solicitation activity may be compensated by the adviser, and we believe investors in such funds should be informed of that fact and the related conflicts.

Our proposal to apply the solicitation rule to investors in private funds, and not just to the adviser's clients, which are generally the private funds themselves, would be consistent with the proposed advertising rule.[362] Similar to the scope of our proposed advertising rule, the proposed amendments would not apply the solicitation rule to solicitations of existing and prospective investors in RICs and BDCs.[363] Unlike for private funds, the primary policy goal of the proposed solicitation rule is already satisfied by other regulatory requirements applicable to RICs and BDCs: prospective investors in RICs and BDCs sold through a broker-dealer or other financial intermediary already receive disclosure about the conflicts of interest that may be created as a result of the fund or its related companies paying the intermediary for the sale of its shares and

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361 *See* proposed rule 206(4)-3(c)(2)-(4).

362 *See supra* footnote 66 (citing Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006)); *see also* Mayer Brown LLP, SEC Staff No-Action Letter (Jul. 28, 2008) (Commission staff stated, in the context of stating it would not recommend enforcement action under rule 206(4)-3, the staff's view that the cash solicitation rule generally does not apply to a registered investment adviser's cash payment to a person solely to compensate that person for soliciting investors or prospective investors for, or referring investors or prospective investors to, an investment pool managed by the adviser because such an investor is not a "client").

363 *See supra* footnote 63 and accompanying text. The advertising rule's proposed RIC and BDC exclusion would not apply to communications that are not subject to rule 156 or 482. *See supra* section II.A.2.c.iii.

related services.[364] Moreover, we believe RIC and BDC investors are typically sought through advertisements or investment advice, each of which is already subject to other regulatory requirements.[365] Finally, we believe that harmonizing the scope of the solicitation rule with the advertising rule to the extent possible should ease compliance burdens.

We request comment below on whether the proposed rule should apply to the solicitation of some or all investors in pooled investment vehicles:

- Should the proposed rule apply to solicitation of investors in private funds? Why or why not? If we do not apply the solicitation rule to solicitations for investments in private funds, would section 206(4) of the Act and rule 206(4)-8, together with section 17(a) of the Securities Act and section 10(b) of the Exchange Act and rule 10b-5 thereunder, sufficiently protect investors that are solicited to invest in private funds to the extent that section 206(4) and rule 206(4)-8 may not apply to the solicitation?[366] Why or why not?
- If we include solicitation of investors in private funds in the proposed solicitation rule, in order to comply with the proposed rule, either the solicitor or the adviser would deliver the solicitor disclosure directly to current and prospective investors in private funds and the solicitation arrangement would be subject to the proposed

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364 *See* Item 8 of Form N-1A; *see also* FINRA Rule 2341(l)(4) (generally prohibiting member firms from accepting any cash compensation from an investment company, an adviser to an investment company, a fund administrator, an underwriter or any affiliated person (as defined in section 2(a)(3) of the Investment Company Act) of such entities unless such compensation is described in a current prospectus of the investment company). For RICs and BDCs not sold through an intermediary, such as funds purchased directly by investors, the purchasing investors would not be "referred" or "solicited" and thus the solicitation rule would be inapplicable.

365 *See supra* footnote 7 (discussing rules 156 and 482); *see also* Standard of Conduct Release, *supra* footnote 23.

366 *See supra* footnote 67 and accompanying text (discussing rule 206(4)-8, which prohibits advisers from (i) making false or misleading statements to investors or prospective investors in hedge funds and other pooled investment vehicles they advise, or (ii) otherwise defrauding these investors or prospective investors).

rule's disqualification provisions. Are there other conditions that we should impose on such solicitations?

- Should we further extend the requirements of the proposed rule to apply to solicitation activities with respect to RICs and BDCs? Why or why not?
- Should the proposed rule apply to other types of pooled investment vehicles, such as funds that are excluded from the definition of "investment company" by reason of section 3(c)(5) of the Investment Company Act or rule 3a-7 thereunder?[367] Why or why not?

**4. Solicitor Disclosure**

Proposed rule 206(4)-3 would prohibit an adviser from compensating solicitors unless the adviser and solicitor have, in the written agreement, designated the solicitor or the adviser to provide to investors at the time of any solicitation activities (or in the case of a mass communication, as soon as reasonably practicable thereafter), a separate disclosure containing specified information (the "solicitor disclosure").[368] The proposal would require that the solicitor disclosure state: (A) the name of the investment adviser; (B) the name of the solicitor; (C) a description of the investment adviser's relationship with the solicitor; (D) the terms of any compensation arrangement, including a description of the compensation provided or to be

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367 15 U.S.C. 80a-3(c)(5)(C). Section 3(c)(5)(C) of the Investment Company Act generally excludes from the definition of "investment company" any person who is primarily engaged in, among other things, "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." The exclusion provided by section 3(c)(5)(C) sometimes is used by issuers of mortgage-backed securities. *See generally* Companies Engaged in the Business of Acquiring Mortgages and Mortgage-Related Instruments, Release No. IC-29778 (Aug. 31, 2011) [76 FR 55300 (Sept. 7, 2011)] (concept release and request for comment on interpretive issues under the Investment Company Act), at nn.4 and 5. Rule 3a-7 provides that certain issuers of asset-backed securities are not investment companies for purposes of the Investment Company Act.

368 Proposed rule 206(4)-3(a)(1)(iii). This section discusses the disclosure component of the proposed rule's written agreement requirement (other than disclosure of applicable disciplinary events). *See infra* sections II.B.5 (discussing the other components of the proposed rule's written agreement requirement); and II.B.8 (discussing the proposed rule's disqualification provisions).

provided to the solicitor; and (E) any potential material conflicts of interest on the part of the solicitor resulting from the investment adviser's relationship with the solicitor and/or the compensation arrangement.[369] It would also require disclosure of the amount of any additional cost to the investor as a result of solicitation.[370]

This proposed disclosure is derived from the current rule's required disclosure.[371] However, it would include a new requirement to disclose any potential material conflicts of interest on the part of the solicitor resulting from the investment adviser's relationship with the solicitor and/or the compensation arrangement. In addition, unlike the current rule, the proposed rule would permit either the solicitor or the adviser to deliver the solicitor disclosure, rather than requiring that the solicitor deliver it, provided the written agreement designates the party responsible for delivering the disclosure. We are also proposing to remove the current rule's requirement that the solicitor disclosure be "written." These proposed changes are discussed below.

When we adopted the cash solicitation rule, we noted our belief that separate solicitor disclosure was necessary to ensure that the investor's attention would be directed to the fact that the adviser pays the solicitor a cash referral fee and the incentives it may create.[372] We continue to believe that separate, targeted disclosure of the salient terms of the compensated arrangement provided at the time of the solicitation, would draw the investor's attention to the solicitor's bias in recommending an adviser directly or indirectly compensating it for the referral. While advisers themselves are required to disclose to clients their compensation arrangements,

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369 Proposed rule 206(4)-3(a)(1)(iii).

370 Proposed rule 206(4)-3(a)(1)(iii)(F).

371 Rule 206(4)-3(a)(2)(iii)(A)(3) and (b).

372 1979 Adopting Release, *supra* footnote 27, at n.14.

including compensation for client referrals and the related conflicts of interest, we believe that the separate solicitor disclosure to investors would put investors on notice of the solicitor's conflict of interest in the compensated solicitation arrangement.[373]

We support firms wishing to use electronic and recorded media in preparing disclosure for investors, including electronic formatting and graphical, text, audio, video, and online features.[374] Under our proposal, if the solicitor disclosure states the information required by the proposed rule, it could be presented in a written format or any other electronic or recorded media format.[375] Irrespective of the format, however, the adviser would be required, under the Act's books and records rule, to make and keep true, accurate and current copies of the solicitor disclosure delivered to investors under the solicitation rule. Accordingly, under the proposed rule the solicitor disclosure could not be delivered orally unless the oral disclosure is recorded and retained.

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373 *See, e.g.,* Item 14 of Form ADV Part 2A (requiring advisers to disclose to advisory clients information about their referral arrangements, including a description of the arrangement and the compensation); Item 12 (requiring advisers to disclose to advisory clients their conflicts of interest regarding brokerage for client referrals); *see also* Item 10.C Form ADV Part 2A (requiring advisers to disclose to advisory clients their conflicts of interest regarding certain relationships with related persons). Advisers are not required to deliver Form ADV to private fund investors that are not otherwise advisory clients. Therefore, private fund investors may not receive the information required in these items of Form ADV. However, to satisfy advisers' obligations as fiduciaries or address potential liabilities under the antifraud provisions of the securities laws, advisers may also need to disclose to clients and private fund investors information not specifically required by Part 2 of Form ADV or in more detail than the brochure items might otherwise require.

374 *See* Form CRS Release, *supra* footnote 227, at n.144 and accompanying text.

375 If the disclosure is made in writing, we have stated that an "in writing" requirement could be satisfied either through paper or electronic means consistent with existing Commission guidance on electronic delivery of documents. *See* Regulation Best Interest Release, *supra* footnote 359, at text accompanying footnotes 499-500. If delivery of the solicitor disclosure is made electronically, it should be done in accordance with the Commission's guidance regarding electronic delivery. *See* Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information; Additional Examples Under the Securities Act of 1933, Securities Exchange Act of 1934, and Investment Company Act of 1940, Release No. 34-37182 (May 9, 1996) [61 FR 24644 (May 15, 1996)]; *see also* Use of Electronic Media, Release No. 34-42728 (Apr. 28, 2000) [65 FR 25843 (May 4, 2000)]; and Use of Electronic Media for Delivery Purposes, Release No. 34-36345 (Oct. 6, 1995) [60 FR 53458 (Oct. 13, 1995)]. *See also* Form CRS Release, *supra* footnote 227, at nn.678 and 153 and accompanying text.

Our proposal would continue to require that the disclosure be separate. Because solicitors may prefer to deliver multiple communications to investors at once, we believe that this requirement would preserve the salience and impact of the disclosure to investors. Under our proposed rule, therefore, a solicitor could deliver the required solicitor disclosure with other communications, provided that the content and presentation of the solicitor disclosure is not combined with other content, such as any legal disclaimers and marketing messages. For example, a firm could deliver a solicitor disclosure to an investor via an e-mail that contains other information by attaching the solicitor disclosure as a separate attachment. However, it would not be effective disclosure to merely include a hyperlink to disclosures available elsewhere.

We are proposing to permit either the adviser or the solicitor to deliver the solicitor disclosure, rather than requiring the solicitor to deliver the disclosure, provided that the written agreement designates the party responsible for its delivery. We believe that this provision would continue to promote investor protection, while providing firms with greater flexibility in meeting the rule's requirements. It would place the fact of the solicitor's interest in front of the investor at the time the investor is solicited so that the investor is provided the necessary tools to evaluate any potential bias on the part of the solicitor.

The proposed rule would require the solicitor disclosure to include the investment adviser's name, the solicitor's name, and a description of the investment adviser's relationship with the solicitor.[376] The current rule requires similar disclosures.[377] We are proposing these

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376 Proposed rule 206(4)-3(a)(1)(iii)(A)-(C).

377 The current rule requires disclosure of the name of the solicitor; the name of the investment adviser; and the nature of the relationship, including any affiliation, between the solicitor and the investment adviser. Rule 206(4)-3(b)(1)-(3).

requirements because they provide important information and context to investors. The name of the adviser is a key part of any solicitation: without disclosing the adviser's name, investors would not know to whom they are being referred. The name of the solicitor is important so the investor can seek to assess the reputation or other qualifications of the solicitor. Disclosure of the relationship between the adviser and the solicitor is important to give the investor context– that – when combined with the other proposed disclosures about the compensated nature of the solicitation – would inform investors about the solicitor's bias in referring the adviser. For example, this disclosure would inform an investor that the solicitor is an employee of the adviser, or an employee or person associated with the adviser's affiliate, or is an unaffiliated third party, as applicable in each case. If the solicitor is a current client, as for example in refer-a-friend solicitation arrangements that would exceed the proposed *de minimis* exemption, the solicitor disclosure would need to state this fact.

The proposed rule would also require disclosure of the terms of any compensation arrangement, including a description of the compensation provided or to be provided to the solicitor.[378] The current rule requires similar disclosure.[379] As required under the current rule, if a specific amount of cash compensation were being paid, that amount would be required to be disclosed.[380] As we stated when we adopted the rule and as we would continue to require for cash compensation: "if, instead of a specific amount, the solicitor's compensation was to take the

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[378] Proposed rule 206(4)-3(a)(1)(iii)(D). The appropriateness of the compensation should be determined by the adviser, in light of the fiduciary duties an adviser owes its clients, based upon a general standard of reasonableness under the circumstances. *See, e.g.*, Mid-States Capital Planning, Inc. SEC Staff No-Action Letter (pub. avail. Apr. 11, 1983); Shareholder Service Corporation SEC Staff No-Action Letter (pub. avail. Feb. 3, 1989).

[379] The current rule requires that the solicitor disclosure contain a statement that the solicitor will be compensated for his solicitation services by the investment adviser, and the terms of such compensation arrangement, including a description of the compensation paid or to be paid to the solicitor. Rule 206(4)-3(b)(4) and (5).

[380] 1979 Adopting Release, *supra* footnote 27, at text accompanying nn.15 and 16.

form of a percentage of the total advisory fee over a period of time, that percentage and the time period would have to be disclosed."[381] Furthermore: "[i]f all, or part, of the solicitor's compensation is deferred or is contingent upon some future event, such as the client's continuation or renewal of the advisory relationship or agreement, such terms would also have to be disclosed."[382] For compensation that is non-cash, the solicitor disclosure should describe the terms of any compensation arrangement, including a description of the compensation provided or to be provided to the solicitor. If the value of the non-cash compensation is readily ascertainable, the solicitor disclosure generally should include that amount. We discuss examples below.

We believe that disclosure of the terms of the compensation, including a description of the compensation provided or to be provided to the solicitor, would be important to convey to the investor the solicitor's incentive to refer it to the adviser, whether the compensation is cash or non-cash. The incentive to solicit investors is often more or less material to an investor's evaluation of the referral depending on the type and magnitude of the compensation. Solicitors that receive little compensation may have less incentive to make referrals than a solicitor that receives higher compensation for the referrals. The incentive might also vary based on the structure of the compensation arrangement. A solicitor that receives a flat or fixed fee from an adviser for a set number of referrals might have a different incentive in referring to the adviser than a solicitor that receives a fee, such as a percentage of the investor's assets under management, for each investor that becomes a client of, or an investor with, the adviser. Furthermore, trailing fees (*i.e.*, fees that are continuing) that are contingent on the investor's relationship with the adviser continuing for a specified period of time present additional

381 *Id*.

382 *Id*.

considerations in evaluating the solicitor's incentives. The proposed rule's requirement to disclose "the terms of any compensation arrangement, including a description of the compensation provided or to be provided to the solicitor" should include, for trailing fee arrangements, disclosure of not only the fact that the solicitor continues to be compensated after the investor becomes a client of, or investor with, the adviser, but also the period of time over which the solicitor continues to receive compensation for such solicitation. A longer trailing period can present a greater incentive to solicit the investor, as a solicitor may be more inclined to refer an investor that will continue to pay the solicitor for a longer period of time.

In some directed brokerage arrangements, the solicitor and the adviser have arranged for the adviser to direct brokerage to the solicitor as compensation for solicitation of investors for, or referral of investors to, the adviser. In these cases, the solicitor disclosure should state the terms of this arrangement, including a description of the compensation provided or to be provided to the solicitor. As part of the disclosure of the terms of the compensation, the solicitor disclosure should state the range of commissions that the solicitor charges for investors directed to it by the adviser. Furthermore, if the solicitation is contingent upon the solicitor receiving a particular threshold of directed brokerage (and other services, if applicable) from the adviser, the disclosure should say so. Additional disclosure would be required, for example, if the solicitor and the adviser agree that as compensation for the solicitor's solicitation activities on behalf of the adviser, the adviser's directed brokerage activities would extend to other investors such as the solicited investor's friends and family.

In refer-a-friend solicitation arrangements that would be subject to the proposed rule, the compensation component of the solicitor disclosure would include the amount the solicitor receives per solicitation (*e.g.*, $10 or an equivalent gift card). The proposed rule's requirement

to disclose "the terms of any compensation arrangement, including a description of the compensation provided or to be provided to the solicitor" should include, for refer-a-friend and other solicitation arrangements, disclosure of the time at which the solicitor would receive compensation for solicitation activities (*e.g.*, upon solicitation of the investor or upon the solicited investor becoming a client of, or an investor with, the adviser).

The solicitor disclosure would be required to include compensation that the adviser provides directly or *indirectly* to the solicitor for any solicitation activities.[383] For example, if an individual solicits an investor, and the adviser compensates another person for such solicitation (such as an employer or another entity that is associated with the individual), the solicitor disclosure would need to include this compensation. If a solicitor, such as a broker-dealer, refers investors to advisers that recommend the solicitor's or its affiliate's proprietary investment products or recommend products that have revenue sharing or other pecuniary arrangements with the solicitor or its affiliate, the solicitor disclosure should say so.[384] Regardless of whether the adviser enters into a solicitation agreement with an individual or the individual's firm, compensation to the firm for solicitation would constitute compensation for solicitation under the rule, as it would be likely to affect the solicitor's salary, bonus, commission or continued association with the firm.

Our proposal would newly require that the solicitor disclosure specifically include any potential material conflicts of interest of the solicitor resulting from the investment adviser's

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383 *See* proposed rule 206(4)-3(a), stating that "As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts, practices, or courses of business within the meaning of section 206(4), it is unlawful for an investment adviser that is registered or required to be registered under section 203 of the Act to compensate a solicitor, *directly or indirectly*, for any solicitation activities, unless the investment adviser complies with paragraphs (1) through (3) [of paragraph (a)]." (emphasis added).

384 *See also* Standard of Conduct Release, *supra* footnote 23, at 23 ("an adviser must eliminate or at least expose through full and fair disclosure all conflicts of interest which might incline an investment adviser – consciously or unconsciously – to render advice which was not disinterested.").

relationship with the solicitor and/or the compensation arrangement. Therefore, in addition to stating the facts that give the solicitor an incentive to solicit the adviser (*e.g.*, that the solicitor is compensated, the terms and description of the compensation, and the relationship between the solicitor and the adviser), the solicitor disclosure would also state that such incentives present a conflict of interest for the solicitor. We believe that this addition would enhance the solicitor disclosure by directly stating that there is a conflict of interest. It would alert the investor of the relevant conflict of interest in the solicitation arrangement at the time of solicitation or, in the case of a mass communication, as soon as practicable thereafter.[385]

For example, when advisers direct brokerage as compensation for solicitation, it presents a conflict of interest for the solicitor.[386] The solicitor's conflict is present to varying degrees in many types of directed brokerage referral arrangements, such as when the solicitation is contingent upon a specified amount (*e.g.*, certain thresholds) of directed brokerage, and when the broker-dealer more generally considers the receipt of directed brokerage as the primary factor or one of many factors that motivate it to refer investors to an adviser. Similarly, a solicitor associated with a commercial bank may refer investors in exchange for the adviser's referral of other investors to the firm's banking services, which is also a conflict of interest for the solicitor.

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385 Information about an adviser's conflict of interest is required to be disclosed in the adviser's brochure, which is provided to the client prior to entering into an investment advisory relationship with the adviser. *See supra* footnote 373 (referencing the Form ADV brochure required disclosures about compensated referral arrangements, including with respect to conflicts of interests). We believe it is important to state the solicitor's conflict of interest in the solicitor disclosure.

386 The Commission adopted changes to an adviser's brochure in 2010 to require additional disclosure about the practice of using directed brokerage, including disclosure about the conflicts of interest it creates. *See* 2010 Form ADV Amendments Release, *supra* footnote 34, at n.143 and accompanying text (new required disclosure included that the adviser may have an incentive to select or recommend a broker-dealer based on its interest in receiving client referrals, rather than on its clients' interest in receiving most favorable execution).

Other types of solicitation relationships between solicitors and advisers can also create conflicts of interest for the solicitor that would need to be disclosed under the proposed solicitor disclosure. For example, a broker-dealer that is a solicitor may refer investors to advisers that compensate it for the referrals by recommending the solicitor's proprietary investment products or products that have revenue sharing or other pecuniary arrangements with the solicitor.[387] This solicitation arrangement would be a conflict of interest for the solicitor that would be required to be disclosed in the solicitor disclosure.

Our proposal would also require disclosure of the amount of any additional cost to the investor as a result of solicitation.[388] This provision would revise the current rule's requirement that the solicitor state whether the client will pay a specific fee to the adviser in addition to the advisory fee, and whether the client will pay higher advisory fees than other clients (and the difference in such fees) because the client was referred by the solicitor.[389] We believe that it is important for investors to understand whether they will bear any additional costs as a result of the solicitation. For investors that are advisory clients, the additional cost could be that they will pay a higher investment advisory fee. In such case, the solicitor disclosure would need to say so and state the amount of such additional fee. For investors that are private fund investors, we request comment below on whether investors would indirectly incur any additional costs as a result of the adviser's use of a solicitor, such as through the adviser charging the private fund a

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387 *See also* Regulation Best Interest Release, *supra* footnote 359, at text accompanying nn.193-194 (discussing the Commission's view that "Regulation Best Interest should apply broadly to recommendations of securities transactions and investment strategies involving securities.").

388 *See* proposed rule 206(4)-3(a)(1)(iii)(F).

389 Rule 206(4)-3(b)(6) (requiring disclosure of "[t]he amount, if any, for the cost of obtaining his account the client will be charged in addition to the advisory fee, and the differential, if any, among clients with respect to the amount or level of advisory fees charged by the investment adviser if such differential is attributable to the existence of any arrangement pursuant to which the investment adviser has agreed to compensate the solicitor for soliciting clients for, or referring clients to, the investment adviser").

higher fee than another private fund it manages without using a solicitor and whether the solicitor disclosure should state such additional amounts, if applicable. In some contexts, there may not be any differences in fees to the investor. In directed brokerage arrangements, for example, the adviser's duty to seek best execution should mitigate against the risk that the directed brokerage arrangement would result in higher execution costs for the investor, but the rule would still require disclosure of the magnitude of any increased costs such as increased commissions (or higher custodian fees) as a result of the solicitation.

In addition, we are proposing a modification to the timing of the delivery of the solicitor disclosure for solicitations that are conducted through mass communications. Mass communications include communications that appear to be personalized to a single investor (and nominally addressed to only one person), but are actually widely disseminated to multiple investors, as well as impersonal outreach to large numbers of persons.[390] In these cases, we are proposing to permit the solicitor disclosure to be delivered at the time of solicitation or as soon as reasonably practicable thereafter, because it may not be practicable to deliver the solicitor disclosure at the time of initial solicitation.[391] Under the proposed rule, we would view delivery of the solicitor disclosure to be made be as soon as reasonably practicable after the time of a mass solicitation if it is provided promptly after the investor expresses an initial interest in the

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390 *See supra* footnote 88 and accompanying text (discussing template presentations and mass mailings).

391 From time to time, solicitors that make their initial contact with prospective clients through mass mailings have asked whether they can forgo delivery of the solicitor's disclosure statement and the adviser's brochure until recipients of the mass mailings indicate preliminary interest by returning a reply card or telephoning the solicitor's call center. *See, e.g.*, E.F. Hutton & Company, Inc., SEC Staff No-Action Letter (Sept. 21, 1987) ("Hutton Letter"); AMA Investment Advisers, Inc., SEC Staff No-Action Letter (Oct. 28, 1993) ("AMA Letter"); and Moneta Group Investment Advisers, Inc., SEC Staff No-Action Letter (Oct. 12, 1993) ("Moneta Letter").

adviser's services.[392] If the adviser, rather than the solicitor, has agreed to deliver the disclosure, we would view "as soon as reasonably practicable thereafter" as being at the time the investor first reaches out in any manner to the adviser in response to the solicitation. We believe that this modification for mass communications would continue to promote investor protection, while providing firms with greater flexibility in meeting the rule's requirements.

We request comment on our proposal to revise the rule's solicitor disclosure requirement.

- Should we require a solicitor disclosure be delivered to investors at the time of any solicitation activities (or in the case of a mass communication, as soon as reasonably practicable thereafter)? If not, when should the solicitor disclosure be delivered to investors?
- Should we remove the current requirement that the solicitor disclosure be "written"? Why or why not?
- Do commenters agree with the proposal to require the solicitor disclosure be separate disclosure? If not, what requirement(s) would make the presentation of solicitor disclosure salient and impactful? Should we include a specific requirement that if the solicitor delivers multiple communications to the investor, the solicitor disclosure must be presented first so that it is clearly and prominently disclosed? Are there any practical issues that arise with the requirement to deliver the solicitor disclosure *separately* in the context of delivery through electronic

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392 Commission staff has stated that it would not recommend enforcement action to the Commission under rule 206(4)-3 if a registered investment adviser, rather than its solicitor, delivers the solicitor disclosure, provided the adviser meets several other conditions. *See*, *e.g.*, Hutton Letter; AMA Letter; Moneta Letter, *id*.

media or other forms of delivery? If so, what are they and how should we treat them?

- Do solicitors employ mass communications to solicit investors, and if so, what types of mass communications? For example, do solicitors send mass mailing via the postal service or electronic mail delivery? Do they provide mass communications in the form of compensated blog posts referring investors to an adviser?
- Do commenters agree that for solicitors that make their initial contact to investors by mass communications, delivery of the solicitor disclosure should be permitted to occur at, or as soon as reasonably practicable after, the time of the solicitation? Why or why not? Do commenters believe that solicitor disclosure provided promptly after the investor expresses an initial interest in the adviser's services would be effectively timed disclosure for investors solicited by mass communications? Would it provide such investor the necessary tools at an appropriate time to evaluate any potential bias on the part of the solicitor? Why or why not? In order for an adviser to deliver the solicitor disclosure at the time the investor first reaches out to the adviser in response to a solicitation made by mass communication, would it be clear to the adviser when the investor makes such contact?
- If delivery of the solicitor disclosure is made as soon as reasonably practicable after the time of solicitation, should we require that the mass communication include a statement alerting the investor of the solicitor disclosure to come? Why

or why not? What disclosure, if any, would be sufficient to alert the investor of the disclosure to come?

- Are there specific types of mass communications that require similar, or different, treatment under the rule? For example, some solicitors may provide a mass communication in the form of a compensated blog post referring investors to an adviser. Should these solicitors be required to provide the solicitor disclosures at the time of solicitation (*i.e.*, as part of their blog posts)? Or, should we permit such a solicitor or the adviser engaging the solicitor to provide the solicitor disclosure when an investor clicks through the solicitor's blog post to learn more information about the adviser? By what other methods could disclosure be provided, for mass communications, to ensure that the disclosure is provided at the time of solicitation or as soon as reasonably practicable thereafter?
- Should the solicitor disclosure include more, or fewer, disclosures? If so, which disclosures should be omitted, or what disclosures should we add, and why? For example, should the solicitor disclosure require additional information about the nature of the relationship between the adviser and the solicitor, or about compensation?
- Do commenters agree that we should include the proposed additional disclosure requiring a statement of any potential material conflicts of interest resulting from the investment adviser's relationship with the solicitor and/or the compensation arrangement? Why or why not? Or should it be sufficient for the disclosure to state the relationship between the solicitor and the adviser (including any affiliation), and the terms of such compensation arrangement, including a

description of the compensation paid or to be paid to the solicitor? Would the proposed additional disclosure requirement result in disclosure that is too lengthy? If so, how should we ensure that the conflict of interest in the solicitation relationship is effectively conveyed to the investor?

- Should we include an exception to the proposed disclosure requirement when the solicitor itself is registered with the Commission as an investment adviser and discloses the relevant conflicts of interest concerning the compensation for solicitation in its brochure and/or brochure supplements? In such a case would it be sufficient for the solicitor disclosure to briefly disclose that there is cash or non-cash compensation for the solicitation, and to state that the details of that compensation and any conflicts it creates are described in the brochure and/or brochure supplement?
- Should we include an exception to the proposed disclosure requirement when the solicitor itself is registered with the Commission as a broker-dealer and discloses the relevant conflicts of interest concerning the compensation for solicitation under the Commission's regulations, such as under Regulation Best Interest or Form CRS Relationship Summary? In such a case would it be sufficient for the solicitor disclosure to briefly disclose that there is a cash or non-cash compensation for the solicitation, and to state that the details of that compensation and any conflicts it creates are described in Form CRS or where applicable pursuant to Regulation Best Interest?

- In addition to the solicitor disclosure, should we require the solicitor or the adviser to deliver to the investor, at the time of solicitation, the adviser's Form

CRS relationship summary, which would inform the investor about, among other things, the types of customer relationships and services provided? Why or why not?

- Should we continue to require that the solicitor disclosure describe the terms of the compensation arrangement, including a description of the compensation paid or to be paid to the solicitor? Why or why not? Should we require a different disclosure for cash or for non-cash compensation? Why or why not, and if so, what disclosure requirement should apply for cash or for non-cash compensation?

- Should we explicitly require that the solicitor disclose any compensation it receives indirectly? Why or why not?

- Should we, as proposed, replace the current rule's requirements that the solicitor disclosure include whether the client will pay a specific fee to the adviser and whether the client will pay higher advisory fees because the client was referred by the solicitor, with the requirement that the solicitor disclosure include the amount of any additional cost to the investor as a result of solicitation? Would such a proposed requirement result in disclosure that would effectively inform the investor of any increased costs to it as a result of the solicitation? What direct or indirect additional costs to investors that are private fund investors would be included in this disclosure?

- Would private fund investors indirectly incur any additional costs as a result of the adviser's use of a solicitor, such as through the adviser charging the private fund a higher fee than another private fund it manages without using a solicitor?

Why or why not? If so, should the solicitor disclosure state such additional amounts, if applicable?

- Do commenters agree with the proposal that either the solicitor or the adviser could deliver the solicitor disclosure (as long as the contract designates the responsible party) at the time of the solicitation or, in the case of a mass communication, as soon as reasonably practical thereafter? Alternatively, should we continue to require the solicitor to deliver the disclosure? Why or why not, and if so, should we require that the adviser deliver a disclosure template to the solicitor, as a means reasonably designed to ensure that the solicitor has all of the information required to be disclosed (*e.g.*, the solicitor may be unaware of the amount of additional costs to the investor as a result of solicitation)? Why or why not?

### 5. Written Agreement

The proposed rule would require that the investment adviser's compensation to the solicitor be made pursuant to a written agreement with the solicitor, as is required under the current rule.[393] The written agreement would be required to: (*i*) describe with specificity the solicitation activities of the solicitor and the terms of the compensation for the solicitation activities; (*ii*) require that the solicitor perform its solicitation activities in accordance with sections 206(1), (2), and (4) of the Act; and (*iii*) as discussed above, require and designate the solicitor or the adviser to provide the investor, at the time of any solicitation activities or, in the case of a mass communication, as soon as reasonably practicable thereafter, with a separate

[393] Proposed rule 206(4)-3(a)(1); rule 206(4)-3(a)(iii)(A). Under our proposal, the written agreement requirement would not apply with respect to solicitation activities by the adviser's in-house personnel and certain affiliated persons or for the solicitation of impersonal investment advice. *See infra* section II.B.7.

disclosure meeting the conditions of the rule.[394] While these requirements are similar to the requirements of the current rule, we are proposing to eliminate some of the current written agreement requirements, *i.e.,* the requirement that the solicitor deliver the adviser's brochure, and the requirement that the solicitor undertake to perform its duties consistent with the instructions of the adviser.[395] Our proposal would also modify the current requirement that the written agreement contain an undertaking by the solicitor to perform his duties under the agreement in a manner consistent with the provisions of the Act and the rules thereunder, replacing it with the requirement that the solicitor agree to perform its solicitation activities in accordance with sections 206(1), (2), and (4) of the Act.

We continue to believe the written agreement requirement is appropriate for unaffiliated solicitors.[396] Although an investment adviser may not be able to exercise control over a third party in the same manner as it could control its own employee, having the contours of the solicitation relationship spelled out in the written agreement between the adviser and solicitor would establish some degree of control over aspects of the arrangement. The current rule achieves this by requiring that the solicitor agree to perform its duties consistent with the instructions of the adviser.[397] We believe this requirement could be difficult or impractical to implement in a number of contexts, however, such as when advisers enter into solicitation

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394 *See supra* section II.B.4.

395 *See* rule 206(4)-3(a)(2)(iii)(A)(3) (requiring that the written agreement "requires that the solicitor, at the time of any solicitation activities for which compensation is paid or to be paid by the investment adviser, provide the client with a current copy of the investment adviser's written disclosure statement required by [§275.204-3] of this chapter ('brochure rule')…"); rule 206(4)-3(a)(2)(iii)(A)(2) (requiring that the written agreement "contains an undertaking by the solicitor to perform his duties under the agreement in a manner consistent with the instructions of the investment adviser and the provisions of the Act and the rules thereunder").

396 *See supra* footnote 393 (referencing the proposed exemption from the written agreement requirement for certain solicitation arrangements).

397 Rule 206(4)-3(a)(2)(iii)(A).

agreements with many different solicitors or the solicitor is a much larger institution than the adviser. Instead, under our proposal, the solicitor would be required to meet the specific requirements of the written agreement, including the solicitor's agreement to perform its solicitation activities in a manner consistent with sections 206(1), (2), and (4) of the Act.

Our proposed rule would eliminate the current rule's written agreement requirement that the solicitor deliver to clients a copy of the adviser's Form ADV brochure. We are proposing this change because the current requirement is duplicative of an adviser's delivery requirement under rule 204-3, the Act's brochure rule. Under the brochure rule, an adviser must provide its prospective clients with a current firm brochure before or at the time it enters into an advisory contract with them.[398] The same year we adopted the cash solicitation rule, we adopted for the first time the Form ADV brochure and rule 204-3.[399] We stated that the solicitor's delivery of the adviser's brochure could satisfy the investment adviser's obligation to deliver it under rule 204-3.[400] However, to the extent both the adviser and the solicitor deliver the adviser's brochure, clients may find this disclosure confusing or overwhelming, and it also could undermine disclosure effectiveness by taking away the spotlight from the conflict of interest disclosure.

In addition, since 1979, we have significantly amended the form and content of the brochure to better correspond to advisers' businesses and to be more accessible to investors.[401]

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398 Rule 204-3. The rule does not require advisers to deliver brochures to certain advisory clients receiving only impersonal investment advice for which the adviser charges less than $500 per year, or to clients that are RICs or BDCs provided that the advisory contract with such a company meets the requirements of section 15(c) of the Investment Company Act.

399 *See* 1979 Adopting Release, *supra* footnote 27, at n.14 and accompanying text.

400 *See id*. We stated that the solicitor's delivery of the brochure "will be useful to clients and will not impose an undue burden upon solicitors or investment advisers" and that "[f]urthermore, delivery of a brochure by the solicitor will, in most cases, satisfy the investment adviser's obligation to deliver a brochure to the client under Rule 204-3." *Id*.

401 *See* 2010 Form ADV Amendments Release, *supra* footnote 34, at section I. In the past, Form ADV Part 2 had required advisers to respond to a series of multiple-choice and fill-in-the-blank questions organized in a

Many advisers with multiple types of advisory services have developed different versions of their brochures for each type of service. The adviser is in the best position to ensure that the correct version of the brochure is delivered to the client.

We believe that our proposed solicitor disclosure and written agreement requirements would be adaptable to different types of solicitation arrangements, including refer-a-friend programs and other solicitation arrangements that may involve smaller amounts of compensation, to the extent advisers could not take advantage of the proposed *de minimis* exemption. Under refer-a-friend arrangements, current investors may solicit multiple investors for their adviser through social media or other electronic communications.[402] The adviser and solicitor could employ electronic media and communications to satisfy the rule's written agreement and disclosure requirements (*e.g.*, by entering into the required written agreement electronically). Solicitors could also provide the required concise disclosure in a format appropriate for the nature of the relationship, such as electronically via pop-ups or other electronic means.

We request comment on the proposed written agreement requirement.

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"check-the-box" format, supplemented in some cases with brief narrative responses. Advisers had the option of providing information required by Part 2 in an entirely narrative format, but few had done so. Form ADV Part 2 currently requires the "brochure," which contains 18 narrative disclosure items about the advisory firm, and the "brochure supplement," which contains information about certain advisory personnel on whom clients rely for investment advice.

402 Refer-a-friend solicitation arrangements can often involve small amount of compensation, such as the adviser paying $10.00 to a current client for each client the current client solicits to enter into an investment advisory relationship with the adviser (some such solicitation arrangements are contingent upon the solicited client successfully entering into an investment advisory relationship with the adviser; others are not). Such compensation can also be, for example, free or lower-fee investment advisory services for a defined period of time, investment adviser subscription services, and gift cards.

- Should the adviser be required to enter into written agreements with solicitors who are engaged in solicitation activities (subject to certain exemptions such as for in-house solicitors, discussed *infra* section II.B.7)?
- Should the written agreement include more, or fewer, specific requirements? If so, what requirements should be added and/or what requirements should be removed, and why?
- Should we retain the current rule's written agreement requirement that the solicitor undertake to perform its duties consistent with the instructions of the adviser? Why or why not? Should the written agreement require that the solicitor perform its solicitation activities in accordance with sections 206(1), (2), and (4) of the Act, rather than more generally in accordance with the provisions of the Act and the rules thereunder? Why or why not? Or, are there other provisions of the Act and the rules thereunder that we should add to the solicitor's required undertakings? If so, what are they, and why?
- Should we require that the agreement include a provision under which the solicitor agrees to provide relevant books and records to the Commission or the adviser upon request?
- Should we retain the current rule's written agreement requirement for solicitors to deliver the adviser's brochure, in light of the adviser's brochure delivery requirement? Why or why not?
- Are there instances where an adviser would enter into a written solicitation agreement with an individual rather than the individual's associated firm or

employer?[403] Should we specify that in such instances, an adviser must enter into a written agreement with a firm (as opposed to any individual solicitor at the firm)? Why or why not?

### 6. Adviser Oversight and Compliance; Elimination of Additional Provisions

Our proposal would require that the investment adviser must have a reasonable basis for believing that the solicitor has complied with the agreement.[404] In addition, the proposed rule would eliminate the current rule's requirement for the adviser to obtain a signed and dated acknowledgment from the client that the client has received the solicitor's disclosure.[405] Our proposal would also eliminate the current rule's explicit reminders of advisers' requirements under the Act's special rule for solicitation of government entity clients and their fiduciary and other legal obligations, which we believe are covered by other provisions of the Act and the rules thereunder.

#### a. *Adviser oversight and compliance.*

Our proposed requirement that the investment adviser must have a reasonable basis for believing that the solicitor has complied with the rule's written agreement would replace the current requirement that "the investment adviser makes a bona fide effort to ascertain whether the solicitor has complied with the agreement, and has a reasonable basis for believing that the

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403 An individual associated with a registered broker-dealer who enters into a solicitation agreement in her individual capacity may, under some circumstances, be an investment adviser or a broker or dealer within the meaning of section 202(a)(11) of the Act or section 3(a)(4)(A) or 3(a)(5) of the Exchange Act, respectively, and may be subject to statutory or regulatory requirements under Federal law, including the requirement to register as an investment adviser or as a broker-dealer pursuant to section 15(a) of the Exchange Act, and/or state law and certain FINRA rules.

404 Proposed rule 206(4)-3(a)(2).

405 *See* rule 206(4)-3(a)(2)(iii)(B).

solicitor has so complied."[406] We believe that this provision would protect investors' interests by requiring advisers to monitor their compensated solicitors for compliance with the rule's written agreement requirements. The question of what would constitute a reasonable basis would depend upon the circumstances. However, we believe that a reasonable basis generally should involve periodically making inquiries of a sample of investors referred by the solicitor in order to ascertain whether the solicitor has made improper representations or has otherwise violated the agreement with the investment adviser.[407] For example, depending on the facts and circumstances, an adviser could satisfy the proposed rule's compliance requirement by making the inquiries described above and being copied on any emails the solicitor sends to investors with the solicitor disclosure.

Under our proposal, the rule's compliance requirement would replace the current rule's requirement that an adviser obtain a signed and dated acknowledgment from the client that the client has received the solicitor's disclosure.[408] The proposed rule would allow advisers to tailor their compliance with the solicitation rule as appropriate for each adviser and the risks and operations in their particular solicitation relationships. We believe that advisers are better situated than most solicitors to determine appropriate policies and procedures to ensure that their solicitors comply with their written agreement (including, if applicable, the agreement that the solicitor deliver the solicitor disclosure to investors at the time of solicitation or as soon as

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406 Rule 206(4)-3(a)(2)(iii)(C).

407 1979 Adopting Release, *supra* footnote 27, at text accompanying nn.14 and 15.

408 *See* rule 206(4)-3(a)(iii)(B) (the investment adviser must receive from the client, prior to, or at the time of, entering into any written or oral investment advisory contract with such client, a signed and dated acknowledgment of receipt of the investment adviser's written disclosure statement and the solicitor's written disclosure document). Under the current rule, certain solicitors (*e.g.*, in-house solicitors, certain affiliates of the adviser, and solicitors for impersonal investment advice) are exempt from such requirement.

reasonably practical thereafter). Some advisers may find that written acknowledgements from all solicited investors are most appropriate, but others may rely on other methods to satisfy themselves of the solicitor's compliance, such as making inquiries of investors referred by the solicitor in order to ascertain whether the solicitor disclosure has been delivered or whether the solicitor has made improper representations or has otherwise violated the agreement with the investment adviser.

Our principles-based proposal relating to compliance is consistent with the Act's compliance rule, adopted in 2003,[409] which contains requirements for advisers to adopt compliance policies and procedures.[410] When an adviser utilizes a solicitor as part of its business, the adviser must have in place compliance policies and procedures that address this relationship and are reasonably designed to ensure that the adviser is in compliance with rule 206(4)-3. Our proposed approach is also similar to recently adopted rules under the Investment Company Act.[411]

### b. *Elimination of additional provisions*

We are also proposing to eliminate the current rule's explicit reminders of advisers' requirements under the Act's special rule for solicitation of government entity clients and their fiduciary and other legal obligations.[412] We believe these cross references to advisers' other

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409 Rule 206(4)-7. *See* Compliance Program Adopting Release, *supra* footnote 33.

410 Under the compliance rule, each adviser that is registered or required to be registered under the Act is required to adopt and implement written policies and procedures reasonably designed to prevent the adviser and its personnel from violating the Advisers Act. *Id*.

411 For example, rule 2a-7 under the Investment Company Act leverages rule 38a-1, the compliance rule under that statute, rather than prescribing requirements for how a retail money market fund determines that its beneficial owners are natural persons. *See* SEC Money Market Fund Reform Release, *supra* footnote 232 at text accompanying nn.715-716; *see also* Compliance Rule Adopting Release, *supra* footnote 33, at nn.24-28 and accompanying text. The Investment Company Act compliance rule also requires that the fund's procedures provide for the oversight of compliance by specified service providers.

412 Rule 206(4)-3(c) and (e).

obligations are not necessary under the solicitation rule because they are addressed by other provisions under the Act.

The current rule's paragraph (e) states that "[s]olicitation activities involving a government entity, as defined in [the pay-to-play rule], shall be subject to the additional limitations set forth in that section."[413] The Commission added this provision when it adopted the pay-to-play rule in 2010, and explained that the provision "alerts advisers and others that special prohibitions apply to solicitation activities involving government entity clients under rule 206(4)-5."[414] We believe that this provision is no longer necessary in light of the fact that advisers should now be well aware of their obligations under the pay-to-play rule.

We are also proposing to remove the current rule's provision that "[n]othing in this section relieves any person of any fiduciary or other legal obligation."[415] When we adopted the solicitation rule, we included this provision as a reminder to investment advisers and solicitors.[416] We noted that it was not intended to suggest the scope and nature of any obligations an adviser or solicitor might have under the securities laws or under other laws.[417]

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413 Rule 206(4)-3(e).

414 *See Political Contributions by Certain Investment Advisers*, Release No. IA-3043 (July 1, 2010) [75 FR 41018 (July 14, 2010)], at nn.429 and 430 and accompanying text.

415 Rule 206(4)-3(c).

416 *See* 1979 Adopting Release, *supra* footnote 27, at n.16 and accompanying text. With respect to the possible relevance of other laws, the Commission noted that, "where the solicited client is a pension plan or other employee benefit plan, payment of a fee to the solicitor might, depending upon the circumstances, result in a prohibited transaction under the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code of 1954 (Code). The rule being adopted of course provides no relief from ERISA or the Code." *Id*.

417 *Id*. ("The rule is not intended to suggest the scope and nature of any obligations an adviser or solicitor might have under the securities laws or under other laws. For this reason, and in response to a comment, the rule as adopted omits the proposed rule's reference to a solicitor's obligation to recommend an adviser 'best suited' to a client."). It would continue to be the case that an adviser that is subject to the solicitation rule would be subject to any other applicable provisions in the Federal securities laws.

We request comment on our proposed adviser oversight and compliance provisions. We also request comment on the proposed elimination of the current rule's provisions that cross-reference other provisions under the Act.

- Do commenters believe that advisers should be required to have a reasonable basis for believing that the solicitor has complied with the written agreement required by the proposed rule? Why or why not? Should we maintain the current requirement that an adviser make a *bona fide* effort to ascertain whether the solicitor is in compliance with the terms of the agreement and has a reasonable basis for believing that the solicitor is in compliance? Why or why not?
- Should the rule include a specific method or methods of demonstrating a solicitor's compliance with the rule's written agreement requirements, such as the current rule's requirement for an adviser to obtain a signed and dated acknowledgment of the solicitor disclosure statement? Why or why not? If not, what methods should advisers use to satisfy their compliance and oversight provision to form a reasonable basis for believing that the solicitor is in compliance? Would methods such as inquiring with some or all of its solicited investors reasonably ensure that an adviser's solicitor is in compliance with the rule's written agreement requirements? Are there other methods that would be more effective at assessing whether a solicitor is in compliance with its obligations under the required written agreement?
- Should the rule include a requirement for advisers to adopt and implement policies and procedures governing their use of solicitors, even though advisers are

also required to do so under the Act's separate compliance rule? Why or why not?

- Should the rule continue to include a provision reminding advisers that solicitation activities involving a government entity, as defined in rule 206(4)-5 are subject to additional limitations in that rule? Why or why not?
- Should the rule continue to include a provision reminding advisers and solicitors that nothing in the rule is to be deemed to relieve any investment adviser or solicitor of any fiduciary or other obligation which he may have under any law? Why or why not?

### 7. Exemptions

#### a. *Impersonal investment advice*

The proposed rule would partially exempt from the rule solicitors that refer investors for the provision of impersonal investment advice.[418] This exemption would cover solicitation activities for investment advisory services that do not purport to meet the objectives or needs of specific individuals or accounts.[419] We propose to incorporate into the rule the Form ADV definition of "impersonal investment advice," which would replace the current rule's definition of "impersonal advisory services," to achieve consistency with Form ADV.[420] We do not believe, however, that modifying the definition for consistency would change the types of

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418 Proposed rule 206(4)-3(b)(1).

419 *Id*. The proposed rule incorporates the Form ADV definition of "impersonal investment advice," which reads: "investment advisory services that do not purport to meet the objectives or needs of specific individuals or accounts." Form ADV: Glossary of Terms.

420 The Form ADV definition of "impersonal investment advice" would replace the current rule's definition of "impersonal advisory services," which is "investment advisory services provided solely by means of (i) written materials or oral statements which do not purport to meet the objectives or needs of the specific client, (ii) statistical information containing no expressions of opinions as to the investment merits of particular securities, or (iii) any combination of the foregoing services." Rule 206(4)-(3)(d)(3).

persons to whom the exemption would apply. For example, the proposed exemption would generally continue to apply to solicitations of subscribers to publishers of market newsletters and subscription services containing investment advice, when the adviser's services do not purport to meet the objectives or needs of specific individuals or accounts. The proposed exemption would be inapplicable to automated advisers (often colloquially referred to as "robo-advisers"), which are registered investment advisers that use technologies to provide discretionary asset management services to their clients through online algorithmic-based programs.[421] This is because robo-advisers generate client portfolios for clients based on personal information and other data that clients enter into interactive platforms.[422] Internet advisers – another type of automated adviser – would also fall outside of the exemption for impersonal investment advice. Internet advisers provide investment advice to their clients through interactive websites based on personal information that clients enter into the website.[423]

When we adopted the cash solicitation rule, we added a partial exemption from the rule with respect to solicitation activities for the provision of impersonal advisory services only, because we understood that "prospective clients normally would be aware that a person selling such services was a salesman who was paid to do so."[424] We continue to hold this belief.

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421 *See generally Division of Investment Management, SEC, Staff Guidance on Robo-Advisers* (February 2017), *available at* https://www.sec.gov/investment/im-guidance-2017-02.pdf.

422 *See id*. ("A client that wishes to utilize a robo-adviser enters personal information and other data into an interactive, digital platform (*e.g.*, a website and/or mobile application). Based on such information, the robo-adviser generates a portfolio for the client and subsequently manages the client's account.")

423 *See* Exemption for Certain Investment Advisers Operating Through the Internet, Release No. IA-2091 (December 12, 2002) [67 FR 77619 (Dec. 18, 2002)]. In order to be eligible for registration with the Commission pursuant to rule 203A-2, an Internet adviser must provide investment advice to its clients through an interactive website, which the rule defines as "a website in which computer software-based models or applications provide investment advice to clients based on personal information each client supplies through the website." *Id*. Unlike typical robo-advisers, Internet advisers do not manage the assets of their Internet clients. *See id*.

424 *See* 1979 Adopting Release, *supra* footnote 27, at text accompanying nn.12-13.

However, even though we are proposing to continue the partial exemption for such solicitors, advisers could not, under the proposed rule, compensate a solicitor for the solicitation of impersonal investment advice if the solicitor is disqualified under the rule.

Under the current rule, advisers making cash payments for solicitation for impersonal advisory services must have a written agreement with the solicitor and comply with the rule's disqualification provision.[425] However, they are exempt from the rule's disclosure requirements, the specific requirements of the written agreement, and the supervision provisions.[426] The proposed rule would maintain the current rule's partial exemption for compensated solicitors of impersonal investment advice, with one modification: such solicitors would not be required to enter into a written agreement with the investment adviser.[427] We believe that applying the written agreement provision to such solicitors could result in an expense without a sufficient corresponding benefit. This is because the exemption would exempt the solicitor and the adviser from the substantive requirements of the written agreement, and the agreement itself without the requirements would not add any meaningful investor protections.

The partial exemption would continue to be available only to solicitation that is *solely* for impersonal investment advice.[428] A registered investment adviser that offers a full line of advisory services, including personal and impersonal investment advice, may only rely on the partial exemption when the solicitation activities relate exclusively to the investment adviser's impersonal investment advice. It would not be permitted to rely on the partial exemption under

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425 Rule 206(4)-3(a)(2)(i) and (iii).

426 *Id*.

427 Proposed rule 206(4)-3(b)(1). Under the current rule, an adviser and a solicitor of impersonal investment advice are required to enter into a written agreement, although the rule does not specify any required provisions.

428 *Id*.

the proposed rule when an investor is solicited for both impersonal and personal investment advice, even if that investor receives only impersonal investment advice.

We request comment on our proposal to revise the rule's partial exemption for solicitors for the provision of impersonal investment advice.

- Should solicitors of investors for the provision of impersonal investment advice be subject to any or all of the requirements of the rule? If so, which requirements, and why? For example, should we continue to require that these solicitors enter into written agreements with the advisers? As another example, should we exempt these solicitors from the solicitor disqualification provisions? Why or why not?
- Should the rule include additional requirements specifically for such solicitors? If so, what should these requirements be?
- Should we replace the current definition of "impersonal advisory services" with the Form ADV definition of "impersonal investment advice," as proposed? Would this definitional change have any practical effects in terms of the applicability of proposed rule 206(4)-3? If so, what would they be?
- Can commenters provide examples of investment advisory services that are offered today that would be "impersonal investment advice" (*i.e.*, the activities do not purport to meet the objectives or needs of specific individuals or accounts), other than, or in addition to, market newsletters or other periodicals and recommended lists? Do advisers that offer such impersonal investment advice typically provide it directly to investors? Do they typically provide it in addition to personalized investment advice? If so, do they provide impersonal investment

advice as an add-on service to investors to whom they provide personalized investment advice, or do they provide it to a different set of investors, or do some (but not all) investors receive both types of investment advice?

- Do commenters agree that robo-advisers and Internet advisers should not be eligible for the exemption for impersonal investment advice, because they typically provide personalized investment advice?

#### b. *Advisers' in-house solicitors and other affiliated solicitors*

The current rule provides a partial exemption for an adviser's solicitation relationship with any person that is an adviser's partner, officer, director and employee (sometimes referred to as in-house solicitors), and any partner, officer, director, or employee of a person which controls, is controlled by, or is under common control with the adviser (sometimes referred to as affiliated solicitors), provided that the affiliation is disclosed to the client at the time of the solicitation or referral.[429] Under the current rule, an adviser is exempt from the following requirements with respect to such solicitors: (i) the detailed provisions of the written agreement requirement (*e.g.*, to provide the solicitor disclosure and perform solicitation activities in accordance with the adviser's instructions and the Act), and (ii) the rule's other compliance and oversight provisions (*e.g.*, the client acknowledgement requirement and the adviser's supervisory requirement).[430] However, under the current rule, an adviser is subject to the following

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429 Rule 206(4)-3(a)(2)(ii).

430 *See id.*; Rule 206(4)-3(a)(2)(iii). Our proposed rule would cover "[a] solicitor [that] is a person which controls, is controlled by, or is under common control with the investment adviser, or is a partner, officer, director or employee of such a person…" subject to the provisions therein. Proposed rule 206(4)-3(b)(2). The current rule's exemption only covers solicitors who are principals or employees of certain related firms, but our staff has previously stated it would not recommend enforcement if, a solicitor which is a person (rather than an officer, director or employee of such person) which controls, is controlled by, or is under common control with, the investment adviser that is paying a cash referral fee to the solicitor pursuant to the cash solicitation rule comes within, and is subject to, the terms of clause (ii) of paragraph

requirements with respect to such solicitors: (i) the rule's statutory disqualification provision; and (ii) the rule's requirement to enter into a written agreement with the adviser (although not the written agreement's detailed requirements).[431] Under the current rule, in order to rely on the partial exemption, any affiliation between the investment adviser and such other person must be disclosed to the client at the time of the solicitation or referral.[432]

We propose to generally maintain the central elements of the current rule's partial exemption for affiliated solicitors: that the solicitor disclosure, adviser oversight and the detailed provisions of the written agreement are not required with respect to affiliated solicitors under certain conditions. We would generally continue the partial exemption, with some modifications, provided that the status of such solicitor as in-house or affiliated is disclosed to the investor at the time of the solicitation unless such relationship is readily apparent, and the adviser documents such solicitor's status at the time of entering into the solicitation arrangement.[433]

We believe that when an investor is aware that a solicitor is an adviser's in-house solicitor or its affiliate, the solicitor disclosure is not necessary to inform the investor of the solicitor's bias in recommending such adviser. In these instances with respect to in-house solicitors, an investor is on notice that the solicitor has a stake in soliciting the investor for its own firm. Similarly, investors solicited by persons they know to be affiliated with the adviser would also be likely to be aware that the solicitor has a business interest in seeing its affiliate

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(a)(2) of such rule. *See, e.g.,* Allen Isaacson, SEC Staff No-Action Letter (pub. avail. Dec. 17, 1979); Stein, Roe and Farnham Inc., SEC Staff No-Action Letter (pub. avail. May 26, 1987).

431 *Id.* The current rule requires solicitation payments to in-house and affiliated solicitors to be paid pursuant to a written agreement (although the rule does not specify the terms of that agreement).

432 Rule 206(4)-3(a)(2)(ii).

433 Proposed rule 206(4)-3(b)(2).

gain additional investors, and that the recommendation is not coming from a neutral party. We are proposing to modify the current rule's requirement, however, to permit an adviser to rely on the rule's partial exemption for in-house and affiliated solicitors not only when the status of such solicitor as in-house or an affiliate is disclosed to the investor at the time of the solicitation or referral, but also when such relationship is readily apparent to the investor at the time of solicitation. In some cases, the relationship between the in-house or affiliated solicitor and the adviser may be readily apparent to the investor, such as when the in-house solicitor shares the same name as the advisory firm, or clearly identifies itself as related to the adviser in its communications with the investor. For example, in the latter case, even if the solicitor does not share the same name as the adviser, its affiliation would be readily apparent if a business card distributed to investors at the time of the solicitation clearly and prominently states that the solicitor is a representative of the adviser. In these cases, we believe that an additional requirement under the proposed rule to disclose the solicitor's status as an in-house or affiliated solicitor would not result in a benefit to the investor, and would create additional compliance burdens for the adviser and solicitor.

In other situations, the relationship with an in-house solicitor is not readily apparent, such as when the solicitor is a representative of the adviser but operates its solicitation activities through its own DBA name or brand, and the legal name of the adviser is omitted or less prominent.[434] In these cases when the relationship is not readily apparent the adviser or solicitor would be required under the proposed rule to disclose the solicitor's status with respect to such investment adviser as its in-house solicitor or affiliated solicitor in order to avail itself of the

[434] Such solicitors could be employees, but are likely to more often be independent contractors. We request comment below on whether the rule should specifically address independent contractors.

rule's partial exemption. Similarly, for affiliated solicitors, when the affiliation is not disclosed or otherwise readily apparent to the investor, the adviser would not be permitted to rely on the proposed partial exemption. This could be the case, for example, when the soliciting affiliate does not share a company name with the adviser, and neither the adviser nor the solicitor discloses such affiliation at the time of solicitation. It could also be the case when the affiliation between two different company names is not commonly known, and neither the adviser nor the solicitor discloses such affiliation at the time of solicitation.

Another modification we are proposing to the current rule is to expand the partial exemption to cover any solicitor which is a person which controls, is controlled by, or is under common control with, the investment adviser that is compensating the solicitor pursuant to the solicitation rule.[435] This is because we believe that a person that controls, is controlled by, or is under common control with, the investment adviser, should be treated similarly under the proposed rule to any officers, directors or employees of such affiliated person. We are not proposing to continue the current rule's requirement that advisers and their in-house and affiliated solicitors enter into a written agreement.[436] Unlike the current rule's detailed requirements for the written agreement with unaffiliated solicitors (*i.e.*, that the solicitor perform

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435 *See supra* footnote 430 (describing the specific proposed change in the rule text).

436 Under the current rule, advisers and their in-house and affiliated solicitors are required to enter into written agreements, but they are not required to comply with the current rule's detailed requirements for the written agreements. From time to time, advisers have asked whether they can forego the written agreement requirement for employees of the adviser to refer business to the adviser for cash compensation. *See, e.g.*, Merchants Capital Management, Incorporated, SEC Staff No-Action Letter (Oct. 4, 1991) (stating that the staff cannot assure the requestor that it would not recommend any enforcement action to the Commission under rule 206(4)–3 if the requestor proceeds as described in the letter).

436 Under the current rule, advisers and their in-house and affiliated solicitors are required to enter into written agreements, but they are not required to comply with the current rule's detailed requirements for the written agreements. From time to time, advisers have asked whether they can forego the written agreement requirement for employees of the adviser to refer business to the adviser for cash compensation. *See, e.g.*, Merchants Capital Management, Incorporated, SEC Staff No-Action Letter (Oct. 4, 1991) (stating that the staff cannot assure the requestor that it would not recommend any enforcement action to the Commission under rule 206(4)–3 if the requestor proceeds as described in the letter).

its activities in a manner consistent with the adviser's instructions and the provisions of the Act and the rules thereunder), the current rule does not specify what a written agreement between an adviser and in-house solicitor must include.[437] We continue to believe that the detailed provisions of the written agreement are not necessary for in-house solicitors because this kind of oversight and authority over the solicitor already applies in the context of in-house solicitors and is addressed by the adviser's power to oversee its own personnel. Likewise, we do not believe we should continue to require advisers to enter into written agreements with their own affiliates in order to avail themselves of the proposed rule's partial exemption. Advisers and their affiliated solicitors may wish to enter into agreements, or they may find it more convenient and effective to delineate their responsibilities to one another in other ways. Such methods might include, for example, policies and procedures regarding such affiliated personnel. We are also proposing that the rule no longer require any written agreement between an adviser and its in-house personnel under the solicitation rule because we believe this requirement creates additional compliance obligations for the adviser and its in-house and affiliated solicitor that are not justified by any corresponding benefit.

We are proposing to continue to apply, with respect to in-house and affiliated solicitors, the exemption from the rule's separate compliance requirement, which would require that investment adviser have a reasonable basis for believing that the solicitor has complied with the agreement. As with the written agreement requirement, we believe that this kind of oversight over the solicitor already applies in the context of in-house solicitors, and is addressed by the adviser's power to oversee and supervise its own personnel. We also believe advisers and their

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437 *See supra* footnotes 393-395 and accompanying text regarding the written agreement requirement under the proposed rule.

affiliates are well positioned to determine how best to achieve an affiliated solicitor's compliance with the Act, and do not need the protections of the rule's compliance and oversight provision.

Finally, we are proposing to continue the application of the rule's disqualification provisions to in-house and affiliated solicitors. Some in-house solicitors with disciplinary events under the proposed rule would be disqualified from association with an investment adviser independent of the solicitation rule, if the Commission has barred or suspended that person from association with an investment adviser under section 203(f) of the Act. Other in-house or affiliated solicitors with such disciplinary events may not be subject to such Commission action and, absent the application of the rule's disqualification provision, would be permitted to solicit for the adviser in-house, notwithstanding their disqualifying event. Without the disqualification provision applicable to such solicitors, the adviser would risk that the Commission may bar or suspend that person from association with an investment adviser after the solicitation activities have commenced. We continue to believe that investors should be protected from solicitation by persons with certain disciplinary events, regardless of whether the solicitation is conducted in-house, by an affiliate or by a person unaffiliated with the adviser.

We are proposing a new requirement that in order to avail itself of the proposed partial exemption, each adviser must document such person's status as an in-house or affiliated solicitor contemporaneously with the solicitation arrangement.[438] We are proposing to add this requirement to the rule so that advisers do not make after-the-fact determinations as to whether or not a solicitor qualifies for the partial exemption.

We request comment on our proposal to revise the rule's requirements governing solicitation arrangements by in-house and affiliated solicitors.

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[438] Proposed rule 206(4)-3(b)(2)(ii).

- Should the proposed rule partially exempt the adviser's partners, officers, directors, and employees who are engaged in solicitation activities, or any solicitor that controls, is controlled by or that is under common control with the adviser or is a partner, officer, director, or employee of such person, from certain of the provisions of the solicitation rule? Why or why not? If so, which provisions of the rule should we exempt such solicitors from, and why? For example, should the proposed rule continue to exempt advisers and their in-house and affiliated solicitors from the detailed requirements of the written agreement (but not the requirement to enter into a written agreement) and the rule's oversight and compliance requirements? Alternatively, should we fully exempt such solicitations from the rule (including, for example, the rule's disqualification provisions)? Why or why not?
- Should the proposed rule exempt in-house and affiliated solicitors from the rule's solicitor disqualification provision, as discussed in detail below?[439] Without the application of the disciplinary provision, would investors be made aware in all cases of an in-house or affiliated solicitor's disqualifying events?[440] If we were to exempt affiliated solicitors from the rule's disqualification provision, should we

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439 *See infra* section II.B.7.c.

440 An adviser is required to disclose to clients in its Form ADV brochure disciplinary information about the firm and its management persons, which likely do not include a solicitor that controls, is controlled by or that is under common control with the adviser or is a partner, officer, director, or employee of such person. *See* Form ADV Part 2A, Item 9 and Form ADV General Instructions. Some advisers are also required to deliver to clients brochure supplements containing disciplinary information about certain of their supervised persons. *See* Form ADV Part 2B. However, solicitors likely would not be considered to be providing advice that would trigger delivery at the time of solicitation. An adviser to a private fund, however, is not required to deliver the Form ADV brochure or brochure supplement to investors in the fund.

nevertheless require some affiliated solicitors (such as affiliated solicitors that solicit investors in private funds) to be subject to the rule's disqualification provision (because private fund investors may not otherwise be aware of in-house solicitors' disciplinary events since advisers are not required to deliver Form ADV to them)? Do in-house and affiliated solicitors with disciplinary histories present less risk of misleading investors or otherwise conducting solicitations in a fraudulent manner than solicitors without disciplinary histories?

- Do commenters agree with the types of persons that would be covered by the partial exemption (*i.e.*, the adviser's partners, officers, directors, and employees, and any solicitor that controls, is controlled by or that is under common control with the adviser or is a partner, officer, director, or employee of such person)? If not, how should we adjust the rule's description of affiliated solicitors?

- Should the proposed rule's partial exemption for in-house and affiliated solicitors be conditioned on any factors or requirements (*e.g.*, as proposed, that the relationship is disclosed to the investor at the time of solicitation or is readily apparent to the investor at the time of solicitation)? What other conditions or factors, if any, should apply?
- Would advisers and solicitors have difficulty in interpreting or applying the "readily apparent" standard? Should we instead require in house solicitors to disclose to investors, as applicable, their relationship at the time of the solicitation or as soon as reasonably practicable thereafter in all cases?
- Do commenters agree that the proposed rule should apply the written agreement and compliance requirements to every in-house and affiliated solicitor

relationship, where the conditions of the proposed rule are not met? If so, why? If not, which of these in-house and affiliated solicitor relationships should be exempt from the proposed rule's written agreement and compliance requirements, and why?

- Should advisers' relationships with certain affiliated solicitors be subject to different provisions under the proposed rule from its solicitation relationships with other affiliated solicitors? For example, should an adviser, with respect to an affiliated solicitor that is itself a Commission-registered investment adviser, be exempt from some or all of the rule's provisions for such solicitor? Conversely, for advisers that do not use SEC-registered affiliated solicitors, should we require an oversight provision, such as, for example, that the registered adviser take reasonable steps to ensure that its affiliated solicitor complies with provisions of the Act and the rules thereunder with respect to its solicitation activities? Is appropriate oversight otherwise achieved by an adviser's relationship with its affiliate?

- If the rule, as proposed, does not require in-house and affiliated solicitors that meet the rule's conditions to deliver to investors the solicitor disclosure, should we require in-house or affiliated solicitors (or the adviser) to deliver to investors another form of disclosure? For example, should we require a Form ADV brochure supplement for in-house and affiliated solicitors, even if the firm is not otherwise required to deliver one for such person? If so, why, and what additional information, if any, should we require the brochure supplement to include? Should we require the adviser to give investors, at the time of solicitation or as

soon as reasonably practicable thereafter, its Form ADV disclosure, pursuant to which advisers are required to disclose any compensation to in-house and affiliated solicitors and any fee differential and the conflict of interest? If so, what disclosure should we require advisers to provide to investors (given that the relevant Form ADV provision does not require specific information about compensation by advisers to private funds)?

- Should we include a definition of "employee" for the purpose of the proposed partial exemption? If so, how should we define the term? Should we define it to include an adviser's independent contractors that are subject to the adviser's supervision and control? Why or why not? We believe that the Form ADV definition of "employee" would not work for the solicitation rule because many soliciting employees and independent contractors do not provide investment advisory services.[441] Do commenters agree? Do advisers use independent contractors to solicit investors on their behalf? If so, are those independent contractors subject to the adviser's supervision and control, or are those contractors subject to the supervision and control of another regulated entity such as a registered broker-dealer or a commercial bank? Should we provide that the partial exemption for in-house personnel does or does not apply to an adviser's independent contractors? Why or why not? Should we use another term instead of "employee," such as "supervised person"?

[441] *C.f.* Form ADV Glossary (defining "employee," to include an adviser's independent contractors who perform advisory functions on the adviser's behalf).

- Do commenters agree with the proposed requirement for an adviser to document the status of its solicitors as partners, officers, directors, or employees, or affiliated solicitors, as applicable? Do commenters agree that such documentation should be made at the time the adviser enters into the solicitation arrangement, to ensure that advisers do not make a determination as to the solicitor's status after-the-fact? Will such timing be feasible for advisers? Why or why not? Do commenters recommend another point in time, and if so, when, and why?
- Do commenters agree that in-house solicitors should be subject to the proposed rule's disqualification provisions? Why or why not?

### c. *De Minimis Compensation*

The proposed rule contains an exemption for *de minimis* compensation. Specifically, the rule would not apply if the solicitor has performed solicitation activities for the investment adviser during the preceding twelve months and the investment adviser's compensation payable to the solicitor for those solicitation activities is $100 or less (or the equivalent value in non-cash compensation).[442] An adviser must come into compliance with the solicitation rule if it makes any compensation to a solicitor that, together with all compensation provided to that solicitor in the preceding 12 month period, exceeds the *de minimis* amount. Accordingly, if an adviser expects to make payments to a solicitor in excess of the *de minimis* amount, even though it has not yet done so, an adviser may wish to carefully consider whether it wishes to avail itself of the exemption. Although, as discussed above, we believe heightened safeguards would generally be appropriate for an investor solicitation because a solicitor's incentives to defraud an investor

[442] *See* proposed rule 206(4)-3(b)(3).

likely would be greater than a promoter's, the solicitor's incentives are significantly reduced when receiving *de minimis* compensation. We believe the need for heightened safeguards is likewise reduced.

There is no *de minimis* exemption in current rule 206(4)-3; payment of *de minimis* cash referral fees to a solicitor is subject to the provisions of the current rule. We are proposing a *de minimis* exemption because we believe it could be overly burdensome for advisers and solicitors that engage in solicitation for *de minimis* compensation to comply with the rule, in light of the benefits. We have observed that changes in technology, such as the advent of social media, since the current rule was adopted have resulted in an increasing trend toward the use of solicitation and referral programs that involve *de minimis* compensation, such as refer-a-friend programs. Our proposed solicitor disclosure and written agreement requirements are designed to be adaptable to a variety of solicitation arrangements, including refer-a-friend programs and other solicitation arrangements that may involve small amounts of compensation; however, we acknowledge that the proposed solicitor disqualification provisions might present greater compliance challenges for advisers that compensate multiple solicitors for *de minimis* compensation than for other advisers. These advisers may be smaller advisers without the resources to make the necessary inquiry into each person's disciplinary history, as required by the proposed rule.[443] Accordingly, we believe a *de minimis* exemption is now appropriate to ease the burden for these solicitation arrangements. Moreover, to the extent a solicitation is also a testimonial or endorsement of the proposed advertising rule, one of the primary policy goals of the proposed solicitation rule – disclosure of the compensation to the solicitor – would be

[443] *See infra* section II.B.8 (discussing current and proposed solicitor disqualification provisions).

satisfied by applying the testimonials and endorsements provision of the proposed advertising rule.

Drawing from other rules applicable to certain dual registrants and broker-dealers, we chose a $100 threshold (or the equivalent value in non-cash compensation) payable to the solicitor for its solicitation activities for the investment adviser during the preceding twelve months.[444] We believe that proposing an aggregate *de minimis* amount over a trailing year period is more consistent with our goal of providing an exception for small or nominal payments than an exception of a certain amount per referral. A very engaged solicitor who is paid even a small amount per referral could potentially receive a significant amount of compensation from an adviser over time, and in such a case we believe that investors should be informed of the conflict of interest and gain the benefit of the other provisions of the rule. The proposed advertising rule's requirements for testimonials and endorsements would often apply even when an adviser provides *de minimis* compensation to a person for solicitation activity.[445]

We request comment on our proposed treatment of *de minimis* compensation under the solicitation rule.

- Is our belief correct that the fact of compensation would still be disclosed when a solicitor receives $100 or less because such referrals would often be testimonials or endorsements? Are there situations that might qualify for the proposed exemption that would not be subject to the proposed testimonials and

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444 FINRA's "gifts rule" prohibits any member or person associated with a member, directly or indirectly, from giving anything of value in excess of $100 per year to any person where such payment is in relation to the business of the recipient's employer. FINRA Rule 3220 (Influencing or Rewarding Employees of Others) ("FINRA's Gifts Rule"). FINRA's Gifts Rule also requires members to keep separate records regarding gifts and gratuities. *Id*.

445 *See supra* section II.A.4.

endorsements provision of the proposed advertising rule? For example, because an oral statement by a person would not be an advertisement under the rule, would investors who are solicited through oral conversations not be informed of the payment made by the adviser for the referral? Should a *de minimis* exception be available only to the extent the referral is subject to the proposed advertising rule's provisions regarding testimonials and endorsements (notably, disclosure of the fact of compensation)? Should we require the fact of compensation to be disclosed by an adviser availing itself of the *de minimis* exception?

- Should the proposed rule include an exemption for *de minimis* compensation for solicitation? If so, what should the *de minimis* amount be, and how should it be calculated (*e.g.*, per referral, or per aggregated referrals over a certain time period)? Should it be higher or lower than $100? For example should it be $20, $50, $200, or $500? How should a *de minimis* exemption be applied to non-cash compensation?
- Should some of the rule's provisions continue to apply to a solicitation arrangement that qualifies for the *de minimis* exemption? If so, which ones?
- When a promotional communication triggers the application of both the proposed advertising and solicitation rules, as discussed above,[446] should a *de minimis* exemption apply? For example, if an adviser provides $50 per successful referral to its investors for writing a positive review about the adviser on the adviser's social media page, should the advertising rule, but not the solicitation rule, apply? Would an exemption in such a case meaningfully reduce an adviser's compliance

446 *See supra* text accompanying footnotes 351-353.

burden? Would it reduce a solicitor's burden? Would potential investor harm weigh in favor of applying the additional safeguards under the proposed solicitation rule? What kinds of investor harm would that be?

- Basing the exemption on a specified dollar value means that over time inflation may cause such a value to become outdated or lose its utility. Should we consider a more principles-based *de minimis* exception rather than one based on a dollar value? For example, an exemption could alternatively or additionally be made for promotional items of nominal value and commemorative items,[447] or for an occasional meal, a ticket to a sporting event or the theater or comparable entertainment which is neither so frequent nor so extensive as to raise any question of propriety.[448] Should we incorporate such an exemption? If so, should we provide guidance on when such items raise a question of propriety? If so, should we include a recordkeeping requirement in the rule to highlight that advisers must track their use of *de minimis* compensation?

#### d. *Nonprofit programs*

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447 *See* Notice to Members, Guidance: Gifts and Gratuities: NASD Issues Additional Guidance on Rule 3060 (Influencing or Rewarding Employees of Others), December 2006, *available at* http://www.finra.org/sites/default/files/NoticeDocument/p018024.pdf (providing staff guidance that gifts of *de minimis* value (*e.g.*, pens, notepads or modest desk ornaments) or promotional items of nominal value that display the firm's logo (*e.g.*, umbrellas, tote bags or shirts) would not be subject to the restrictions of the Gifts Rule or its recordkeeping requirements). In 2008, the Commission approved the transfer of NASD Rule 3060 into the Consolidated FINRA Rulebook without material change and renumbered the rule as FINRA Rule 3220 (*i.e.*, FINRA's Gifts Rule). FINRA staff did not specify in its 2006 staff guidance at what value it would consider a gift to be of *de minimis* value. *Id*. *See* FINRA's Gifts Rule, which also requires members to keep separate records regarding gifts and gratuities.

448 *See* letter from R. Clark Hooper, Executive Vice President, NASD, to Henry H. Hopkins, Director, and Sarah McCafferty, Vice President, T. Rowe Price Investment Services, Inc., dated June 10, 1999 (NASD staff interpretive letter taking this approach).

Under our proposed rule, certain types of nonprofit programs would be exempt from the substantive requirements of the rule because we believe the potential for the solicitor to demonstrate bias towards one adviser or another is sufficiently minimal to make the protections of the rule unnecessary. Specifically, the rule would not apply to an adviser's participation in a program,

(i) when the adviser has a reasonable basis for believing that

(A) the solicitor is a nonprofit program,

(B) participating advisers compensate the solicitor only for the costs reasonably incurred in operating the program; and

(C) the solicitor provides clients a list of at least two advisers the inclusion of which is based on non-qualitative criteria such as, but not limited to, type of advisory services provided, geographic proximity, and lack of disciplinary history; and

(ii) the solicitor or the investment adviser prominently discloses to the client at the time of any solicitation activities:

(A) the criteria for inclusion on the list of investment advisers, and

(B) that investment advisers reimburse the solicitor for the costs reasonably incurred in operating the program.[449]

The first and second elements of the proposed exemption, taken together, are intended to mitigate the conflict of interest associated with the nonprofit solicitor's receipt of compensation.

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449 Proposed rule 206(4)-3(b)(4). Some solicitors have, from time to time, requested no action relief from the cash solicitation rule from the Commission staff for referral programs with some, or all, of these features. *See* National Football League Players Association, SEC Staff No-Action Letter (Jan. 25, 2002) ("NFLPA Letter"); Excellence in Advertising, Limited, SEC Staff No-Action Letter (Nov. 13, 1986; pub. avail. Dec. 15, 1985) ("EIA Letter"); International Association for Financial Planning, SEC Staff No-Action Letter (Jun. 1, 1998) ("IAFP Letter"). As discussed in section II.D., staff in the Division of Investment Management is reviewing staff no-action and interpretative letters to determine whether any such letters should be withdrawn in connection with any adoption of this proposal.

We believe that the absence of compensation that is related to the program's generation of referrals lessens the need for the protections of the rule. This is because a solicitor would be unlikely to demonstrate bias in referring one adviser over another when neither adviser compensates the solicitor based on the number of referrals made or any other indicator of the potential to earn the adviser profit. The third element of the proposed exemption (requiring the solicitor to provide a list of at least two advisers based on non-qualitative criteria) is intended to mitigate the risk that clients would view the nonprofit program as referring any one adviser. Requiring that the list be based on non-qualitative criteria would also reduce the likelihood of the solicitor appearing to favor or endorse the advisers in the program over other advisers that are not in its program, or any particular advisers in the program over other advisers in the program. Examples of non-qualitative criteria are the type of advisory services provided, geographic proximity, and lack of disciplinary history. Another example that would likely be a non-qualitative criterion is the presence of certain certifications for the firm or its personnel. If the list were to be sorted based on a qualitative assessment, such as adhering to a particular investment philosophy, that would not fall within the scope of the proposed exemption. Once the solicitor has selected a pool of advisers based on non-qualitative criteria, the program could permit a client to then screen for specific types of advisers within the pool based on the client's own selection criteria. Similar to other proposed solicitation rule requirements, we are proposing to require that, in order to rely on the nonprofit exemption, the adviser must have a reasonable belief that the program meets these requirements.

Finally, we are proposing to require, as a condition of the nonprofit exemption, disclosures to be made by the solicitor to the client at the time of any solicitation activities: the criteria for inclusion on the list of investment advisers, and that investment advisers reimburse

the solicitor for the costs reasonably incurred in operating the program. We believe that these disclosures would inform clients of the basis for advisers' participation in the program. Depending on the context and content of the required disclosures, however, there could be circumstances where a solicitor's disclosures do not effectively convey to clients the scope and limitations of the program with respect to the selection of advisers in the program. For example, if it is not clear from the disclosures that the program does not assess the quality of any adviser or its appropriateness for any client, and that that the program does not present a client with all of the investment advisers that may be available to the client, an adviser should consider making such disclosures or requiring them of the solicitor.

We request comment on this aspect of the proposal.

- Should we provide the proposed nonprofit exemption? Should we define what types of programs qualify as "nonprofit," perhaps through reference to IRS guidance? If so what entities should we include and why? Would such a list become outdated? Should there be any limit on the kind of compensation paid to the solicitor to ensure that the nonprofit status of the program does not serve merely as a conduit for circumventing the solicitation rule?
- Should some of the rule's provisions apply to a solicitation arrangement that qualifies for the proposed nonprofit exemption? If so, which ones?
- Should we limit the use of the fees paid to covering "costs reasonably incurred in operating the program," as proposed? If not, what other types of costs should we permit, any why? How would an adviser seeking to rely on the exemption demonstrate that the fees paid to the solicitor only cover such costs? Should we include a recordkeeping requirement that the adviser maintain records of the fees

paid to the solicitor, as we do in our proposed corresponding amendments to the books and records rule?

- Should we provide further guidance on what we mean by "non-qualitative" criteria? For example, should we provide a list of such criteria that a person could use in accepting advisers for the nonprofit program and/or sorting the list? What should that list include?
- Should we require the adviser or the solicitor to disclose to the client, at the time of any solicitation activities or as soon as reasonably practicable thereafter, the criteria for inclusion on the list of investment advisers, and that the advisers reimburse the program for the costs reasonably incurred in operating the program? Why or why not? Should we require disclosure of the amount of reimbursement? Should we also require that the program state that it does not assess or opine on the quality of any adviser or its appropriateness for any client, and/or that the program does not include all investment advisers that may be available to clients? Why or why not?
- As proposed, should we require that a list that includes more than a single adviser be provided clients to qualify for the exemption? Should a solicitor be allowed to provide the name of only a single adviser if such an adviser is the only participating adviser that meets the non-qualitative criteria established?
- Our staff has previously stated that it would not recommend enforcement action against certain persons that operate programs similar to what we are proposing

today under the non-profit exemption.[450] Would such existing programs be able to meet the proposed exemption? If not, should we consider making any other changes to the proposed exemption to allow existing similar programs to continue to operate? What changes and why?

### 8. Disqualification for Persons Who Have Engaged in Misconduct

We are proposing to revise the current rule's disqualification provision, which prohibits persons who have engaged in certain misconduct from acting as solicitors.[451] The current rule generally disqualifies a person from acting as a solicitor if: (i) the person is subject to a Commission order issued under section 203(f) of the Act (*i.e.*, the Commission has barred or suspended that person from association with an investment adviser, or has censured or placed limitations on the activities of a person associated with an investment adviser, under section 203(f) of the Advisers Act);[452] or (ii) the Commission or a court has found that person to have engaged in enumerated misconduct that could subject them to sanctions under section 203(f), or that could subject the firm with which they are associated to disciplinary action by the Commission under section 203(e) of the Act.[453] These provisions reflect the Commission's

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450 *See, e.g.,* NFLPA Letter; EIA Letter; IAFP Letter, *id* .

451 *See* rule 206(4)-3(a)(1)(ii).

452 Section 203(f) of the Act authorizes the Commission to bar persons from association with an investment adviser, or to suspend them from association with an investment adviser. Under section 203(f), we may issue a bar or suspension order if the Commission, a court, or another regulatory authority has found the person to have engaged in categories of misconduct specified in section 203(e) of the Act, discussed below. Section 203(f) also authorizes us to censure or place limitations on the activities of a person associated with an investment adviser instead of barring or suspending them.

453 Section 203(e) of the Act [15 U.S.C. 80b-3(e)] authorizes the Commission to, by order, censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any investment adviser, under certain circumstances described therein. Under section 203(e), we may take these disciplinary actions in connection with our finding that a firm, or a person associated with the firm, has engaged in categories of misconduct specified in section 203(e), such as violating the Federal securities laws or willfully filing a false registration form. Section 203(e) also

concern that persons with a history of misconduct that might affect their prospects for direct employment with an adviser not seek to avoid our scrutiny by working as solicitors instead.[454] Drawing from statutory changes and Commission rules regarding limitations on activities since the rule was promulgated, including the Dodd-Frank Act and the rules disqualifying felons and other "bad actors" from certain securities offerings, our proposal would add to the types of disciplinary events that would disqualify a person from acting as a solicitor, including by adding certain disciplinary actions by other regulators and self-regulatory organizations. It would also provide a conditional carve-out for certain types of Commission actions.

#### a. *Disqualification*

Under our proposal, an investment adviser could not compensate, directly or indirectly, a person for any solicitation activities that it knows, or that it, in the exercise of reasonable care, should have known, is an *ineligible solicitor*.[455] An "ineligible solicitor" would be defined to mean a person who, at the time of the solicitation, is either subject to a disqualifying Commission action or is subject to any disqualifying event.[456] The proposal's inclusion of a reasonable care standard would be a change from the current rule, which contains an absolute bar on paying cash for solicitation activities to a person with any disciplinary history enumerated in the rule.

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authorizes us to commence disciplinary action if a court or certain other regulatory authority find an adviser or an associated person has engaged in categories of misconduct specified in section 203(e), such as committing a crime in connection with the conduct of a securities business or a violating a foreign regulation regarding transactions in securities.

454 *See* 1978 Proposing Release, *supra* footnote 27, at n.1 and accompanying text.

455 Proposed rule 206(4)-3(a)(3)(i). The proposed rule would, however, provide exemptions for referrals for the provision of *de minimis* compensation and for certain nonprofit programs. *See supra* section II.B.7.c.

456 Proposed rule 206(4)-3(a)(3)(ii). *See* proposed rule 206(4)-3(a)(3)(iii) for the defined terms "disqualifying Commission action" and "disqualifying event."

We believe that adding a proposed reasonable care standard would preserve the rule's benefits while reducing the risk that advisers would violate the rule as a result of disqualifying event or actions that they should not have known, in the exercise of reasonable care, existed.[457] Such a standard necessarily includes inquiry by the adviser into the relevant facts; however, we are not proposing to specify what method or level of due diligence or other inquiry would be sufficient to exercise reasonable care. We are also not proposing to prescribe the frequency of such inquiry, but whether the adviser satisfied the reasonable care standard would be determined in light of the circumstances of the solicitor and the solicitation arrangement. For example, as we have stated in other contexts implementing rules for the treatment of "bad actors", where we have included a reasonable care standard and have not prescribed or delineated what steps an issuer would be required to take to show reasonable care[458]:

> "…the steps an issuer should take to exercise reasonable care will vary according to the particular facts and circumstances. For example, we anticipate that issuers will have an in-depth knowledge of their own executive officers and other officers participating in securities offerings gained through the hiring process and in the course of the employment relationship, and in such circumstances, further steps may not be required in connection with a particular offering. Factual inquiry by means of questionnaires or certifications, perhaps accompanied by contractual representations, covenants and undertakings, may be sufficient in some circumstances, particularly if there is no information or other indicators suggesting bad actor involvement."[459]

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457 *Cf.,* Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Release No. 33-9414 (Jul. 10, 2013) [78 Fed. Reg. 44729 (Jul. 24, 2013)] ("Bad Actor Disqualification Adopting Release"). As with the "bad actor" disqualification provisions adopted therein, our proposed reasonable care standard would address the potential difficulty for advisers in establishing whether any solicitors are the subject of disqualifying events, particularly given that there is no central repository that aggregates information from all the Federal and state courts and regulatory authorities that would be relevant in determining whether solicitors have a disqualifying event in their past. *Id*., at text accompanying nn.190-191.

458 *Id*. *See* Rule 506(d)(2)(iii) and instruction thereto (providing an exception to the rule's disqualification provision: "If the issuer establishes that it did not know and, in the exercise of reasonable care, could not have known that a disqualification existed under paragraph (d)(1) of this section").

459 Bad Actor Disqualification Adopting Release, *supra* footnote 457, at nn.201- 202 and accompanying text.

The frequency of inquiry could vary depending upon, for example, the risk of using an ineligible solicitor, the impact of other screening and compliance mechanisms already in place, and the cost and burden of the inquiry.[460] For example, if the adviser has an ongoing relationship with a solicitor that solicits investors over time, the adviser should consider inquiring into the solicitor's status on a periodic basis during the relationship as appropriate based on the applicable facts and circumstances. In this circumstance, an annual inquiry could be sufficient if there is no information or other indicators suggesting changes in circumstance that would be disqualifying under the rule. Conversely, if an adviser compensates a solicitor on a one-time basis at the time of solicitation, an inquiry into the solicitor only once no later than the time of solicitation generally should be sufficient.

Additionally, our proposal would prohibit adviser compensation of a solicitor if the solicitor is subject to a disqualifying Commission action or is subject to any disqualifying event at the time of the solicitation.[461] We believe the time of solicitation – rather than the time the adviser compensates, or engages, the solicitor for solicitation – is the appropriate point in time to tie the disqualifying event or action to the solicitor's status as an ineligible solicitor.[462] The time of solicitation is when investors are most vulnerable to fraud or deceit regarding the solicitation. However, even though our proposed provision is tied to the time of solicitation, as a practical matter advisers generally should conduct due inquiry into the solicitor's eligibility at the time of

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460 Advisers should address such methods in their policies and procedures under the compliance rule. *See* rule 206(4)-7.

461 The proposed disqualification provision would apply to an "ineligible solicitor", which would mean a person who *at the time of the solicitation* is either subject to a disqualifying Commission action or has any disqualifying event. Proposed rule 206(4)-3(a)(3)(ii) (emphasis added).

462 The time of solicitation (or, in the case of mass communications, as soon as reasonably practicable thereafter) is also when the solicitor or the adviser, as applicable, is required under the required written agreement to deliver the solicitor disclosure. Proposed rule 206(4)-3(a)(1)(iii).

engagement, because an adviser that engages a solicitor that is ineligible at the time of engagement runs the risk that the solicitor will remain ineligible and conduct solicitations before the adviser becomes aware of such status. Under our proposed rule, if a solicitor was eligible at the time of solicitation but subsequently became ineligible, an adviser would be permitted to compensate the solicitor for the solicitation activity that occurred prior to the ineligibility.

Our proposed rule would also apply the rule's definition of ineligible solicitor to certain persons associated with a firm that is an ineligible solicitor.[463] For each ineligible solicitor, the following persons would also be ineligible solicitors: (i) any employee, officer or director of an ineligible solicitor and any other individuals with similar status or functions; (ii) if the ineligible solicitor is a partnership, all general partners; (iii) if the ineligible solicitor is a limited liability company managed by elected managers, all elected managers; (iv) any person directly or indirectly controlling or controlled by the ineligible solicitor as well as any person listed in (i)-(iii) with respect to such person.[464] These persons would therefore be ineligible solicitors even if they do not themselves have any of the rule's disqualifying events. However, under our proposal, a *firm* would not necessarily be an ineligible solicitor if one or more of such listed persons are ineligible solicitors under the proposed rule, provided that such persons do not conduct solicitation activities. Because a solicitor that is a firm engages in solicitation activities through its associated individuals, we believe that an individual's conduct should be subject to the rule's disqualification when the firm is disqualified. A firm sets the compliance tone for its personnel, and many types of regulated entities are responsible under their regulatory regimes for the supervision and control of their personnel.

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463 Proposed rule 206(4)-3(a)(3)(ii).

464 *Id*.

We request comment on the proposed disqualification provision; particularly the "reasonable care" standard, the point of time referenced in the ineligible solicitor definition, and the application of the rule's ineligible solicitor definition to certain individuals associated with a firm that is disqualified.

- Should the rule *per se* prohibit advisers from compensating for solicitation activities persons that have certain disqualifying events that meet the rule's definition of ineligible solicitor? Or, should the rule include the reasonable care standard we have proposed? Should we further specify in the rule or in guidance what would constitute reasonable care for knowing that the solicitor is an ineligible solicitor? For example, should we specify a method or level of due diligence that would be sufficient to establish reasonable care? Should we prescribe the frequency of such inquiry? Why or why not? Should we specifically require that the adviser conduct due inquiry as part of exercising reasonable care? Why or why not?
- Should the definition of ineligible solicitor refer to a person's disqualifying events or orders at the time of solicitation, as proposed? Or, should it refer to a different point in time, such as the adviser's engagement of the solicitor or when the adviser compensates the solicitor? Why or why not? For example, under our proposed rule, if a solicitor was eligible at the time of solicitation but subsequently became ineligible, an adviser would be permitted to compensate such person for the solicitation activity that occurred prior to the solicitor becoming ineligible. Do commenters agree with this result? Why or why not?

- Should we apply the rule's definition of ineligible solicitor to any individual associated with a firm that is an ineligible solicitor, even if the individual would not otherwise be an ineligible solicitor absent the particular association with the ineligible solicitor firm? Do commenters agree with the categories of persons as proposed? Why or why not? Should we list in the rule different categories of persons we would presume to be associated with a firm? For example, should the proposed rule specify whether or not an independent contractor would be included as "any employee, officer or director of such ineligible solicitor and any other individuals with similar status or functions"? The Form ADV definition of "employee" includes an adviser's independent contractors who perform advisory functions on the adviser's behalf. Should these persons be included in the rule as associated with a firm? Why or why not?
- Should we specify in the rule that a firm would be an Ineligible Solicitor if an individual who is an ineligible solicitor controls the firm, even if the firm is not otherwise an ineligible solicitor and the individual who is an ineligible solicitor does not engage in solicitation activities on behalf of the adviser? Why or why not? If so, should we define the term "control", and if so, how? For example, should we use the Act's definition of "control," which means "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company"? Should we use the definition of "control" in Form ADV, which includes, but is not limited to, each of the firm's officers, partners, or directors exercising

executive responsibility (or persons having similar status or functions)? Should we use another definition, and if so, what should that definition be, and why?

- If the rule permits an adviser to compensate for solicitation a firm that employs one or more individuals who are ineligible solicitors, should we specify the level of diligence an adviser should conduct in order to establish that none of the firm's ineligible solicitors conducts solicitation activities on the adviser's behalf?

#### b. *Disqualifying Commission Action*

Under our proposal, a person who at the time of solicitation is subject to a disqualifying Commission action would be an ineligible solicitor.[465] A disqualifying Commission action would be a Commission opinion or order barring, suspending, or prohibiting a person from acting in any capacity under the Federal securities laws, or ordering the person to cease and desist from committing or causing a violation or future violation of (1) any scienter-based antifraud provision of the Federal securities laws, including a non-exhaustive list of such laws and the rules and regulations thereunder; or (2) Section 5 of the Securities Act of 1933.[466] Under our proposal, if the Commission prohibits an individual from acting in a specific capacity under the Federal securities laws (e.g., supervisor, compliance officer), the individual would be disqualified as a solicitor under the proposed rule, even if the Commission has not barred or suspended the individual from association with an investment adviser, broker-dealer or other

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465 In addition, as discussed below, a person who at the time of solicitation has any disqualifying event is also an ineligible solicitor. *See infra* footnote 468 and accompanying text.

466 Proposed rule 206(4)-3(iii)(A). The imposition of a bar, suspension, or prohibition may appear in an opinion of the Commission or in an administrative law judge initial decision that has become final pursuant to a Commission order. In both cases, such a bar, suspension, or prohibition would be a disqualifying Commission action. These would include, for example, officer and director bars imposed in Commission cease and desist orders, limitations on activities imposed under section 203(e) or 203(f) of the Advisers Act that prevent persons from acting in certain capacities, penny stock bars imposed under section 15(b) of the Exchange Act, and investment company prohibitions imposed under section 9(b) of the Investment Company Act.

registrant. In addition, if the Commission has ordered a person to cease and desist from committing or causing a violation or future violation of a scienter-based antifraud provision of the Federal securities laws, but has not barred or suspended that person, that person would be disqualified under the proposed rule.[467] We believe that this provision would cover a wide scope of Commission orders concerning misconduct that could call into question the person's trustworthiness or ability to act as a solicitor. We believe that the Commission's cease and desist orders we propose to include as a disqualifying Commission action would call into question that person's trustworthiness or ability to act as a solicitor even if the Commission did not bar, suspend, or prohibit that person from acting in any capacity under the Federal securities laws.

#### c. *Disqualifying Event*

Under our proposal, a person that at the time of the solicitation is subject to any disqualifying event would also be an ineligible solicitor.[468] A disqualifying event would generally include a finding, order or conviction by a United States court or certain regulatory agencies (other than the Commission) that a person has engaged in any act or omission referenced in one or more of the provision's four prongs, as discussed below. Any such finding, order or conviction would generally be a disqualifying event if it occurred within the previous ten years or if the bar or injunction is in effect at the time of solicitation.

We are proposing a ten-year time limit (or "look-back period") on certain of the disqualifying events, as described below, because this look-back period is used in section 203(e),

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467 The reference to a scienter-based anti-fraud provision of the Federal securities laws is based on the bad actor disqualification provisions under Rule 506 of Regulation D. *See* Rule 506(d)(1)(v) (including, in a non-exhaustive list of scienter-based anti-fraud provisions of the Federal securities laws, section 17(a)(1) of the Securities Act, section 10(b) of the Exchange Act and rule 10b-5, section 15(c)(1) of the Exchange Act, section 206(1) of the Advisers Act).

468 Proposed rule 206(4)-3(a)(3)(iii)(B).

which is a basis for Commission action to censure, place limitations on the activities, or revoke the registration of any investment adviser or its associated persons.[469] It is also used for certain disciplinary events in the rules disqualifying felons and other "bad actors" from certain securities offerings.[470] For regulatory and court-ordered bars and injunctions, we are proposing that such bar or injunction be in effect at the time of solicitation in order to be disqualifying. This is consistent with the current rule as well as the bad actor disqualification requirements under rule 506.[471]

Under our proposal, certain solicitors that are not currently disqualified under the rule would be disqualified under the amended rule as "ineligible solicitors" solely as a result of the proposed changes to the rule's disqualification provisions. To the extent that the proposed amendments would expand disqualifying events under the proposed rule (*i.e.*, any disqualifying Commission action or disqualifying event) beyond the scope of disqualifying events listed in the current rule's disqualification provision, the proposed disqualification provision would apply only to any disqualifying Commission action or disqualifying event occurring after the effective date (or the compliance date, as applicable) of the proposed rule amendments. Any disqualifying Commission action or disqualifying event that occurs prior to the effectiveness of the proposed rule (or the compliance date, as applicable) would be subject to the current rule's disqualification

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469 Section 203(e)(2) and (3) (containing a ten-year look-back period for convictions for certain felonies and misdemeanors). *See supra* footnotes 453 and 452 (describing sections 203(e) and 203(f), respectively).

470 *See, e.g.,* paragraph (d)(1)(iii)(B) of Rule 506 of Regulation D (disqualifying a covered person subject to a final order of the U.S. Commodity Futures Trading Commission or another regulatory entity described therein, based on a violation of any law or regulation that prohibits fraudulent, manipulative, or deceptive conduct entered within ten years before the sale described in the rule).

471 *See* rule 206(4)-3(a)(1)(ii)(D) (applying the disqualification provision to a solicitor that "is subject to an order, judgment or decree described in section 203(e)(4) of the Act); *see also* paragraphs (d)(1)(ii), (d)(1)(iii)(A) and (d)(1)(iv) of rule 506 of Regulation D (requiring that the applicable order, judgment or decree be in effect at the time of the sale, and also in some cases that the order, judgment or decree have been entered within a look-back period of five or ten years).

provision. We recognize that some advisers and solicitors rely on letters issued by the Commission staff stating that the staff would not recommend enforcement action to the Commission under section 206(4) and rule 206(4)-3 if an investment adviser paid cash solicitation fees to a solicitor that was subject to particular disciplinary events that fall within the current rule's disqualification provision.[472] We request comment, below, on whether we should "grandfather" such persons into compliance with the proposed rule by permitting advisers to continue to compensate such solicitors after the effective date of the proposed rule, if the solicitors continue to comply with the conditions specified in the letters and, except for the disciplinary events described in the applicable letter, would not otherwise be ineligible solicitors under the proposed rule.

The first prong of the proposed disqualifying event definition describes a conviction by a court of competent jurisdiction within the United States, within the previous ten years, of any felony or misdemeanor involving conduct described in paragraphs (2)(A) through (D) of section 203(e) of the Act.[473] This prong generally follows the provision of the current rule that disqualifies persons convicted within the previous ten years of any felony or misdemeanor involving conduct described in section 203(e)(2)(A) through (D) of the Act, which are bases for Commission action to censure, place limitations on the activities, or revoke the registration of

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472 *See, e.g.,* the "bad actor" letters listed below in Section II.D. While these staff letters generally only apply to the solicitor or adviser to which the letter is addressed, the staff has issued one letter which it stated would apply with respect to any cash solicitation arrangement under which an investment adviser proposes to pay cash solicitation fees to a solicitor subject to a specific type of disqualification event under the circumstances described in the letter. *See* Dougherty & Co., LLC, SEC Staff No-Action Letter (Jul. 3, 2003) ("Dougherty Letter"), discussed *infra* footnote 495.

473 Proposed rule 206(4)-3(a)(3)(iii)(B)(1). Paragraphs (2)(A) through (D) of section 203(e) of the Act include, for example, felonies or misdemeanors involving dishonesty or misappropriation of funds or securities, and any felony or misdemeanor arising out of the conduct of the business of certain types of entities such as a broker, dealer, investment adviser, bank, and insurance company. Section 203(e)(A)-(D).

any investment adviser or its associated persons.[474] We are proposing, however, not to include as a disqualifying event a conviction by a foreign court of competent jurisdiction with respect to the misconduct described in section 203(e)(2)(A) through (D) of the Act because we do not believe advisers should be required to incur the cost and burden, with respect to their solicitors,[475] of inquiry into foreign proceedings or to make a determination of what is a "substantially equivalent crime" to a felony or misdemeanor, as is part of the conditions of section 203(e)(2).[476] A person subject to any such foreign conviction might still be an ineligible solicitor, however, to the extent that the Commission uses its authority to bar, suspend or place limits on that person's association with an investment adviser, or otherwise issues a disqualifying Commission action based on such conduct.[477]

The second prong of the proposed disqualifying event definition describes a conviction by a court of competent jurisdiction within the United States, within the previous ten years, of engaging in any of the conduct specified in paragraphs (1), (5), or (6) of section 203(e) of the Act.[478] This prong is derived from the third prong of the current rule's disqualification provision, which describes persons the Commission finds to have engaged, or that have been convicted of

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474 Rule 206(4)-3(a)(1)(ii)(B).

475 *Compare* Item 11 of Part 1A of Form ADV (requiring advisers to report certain foreign court actions about themselves and their affiliates). We believe that requiring an adviser to gather such information about foreign court actions affecting the solicitors they use (who may or may not be affiliated) may be significantly more difficult than gathering and reporting such data about the adviser *itself* or its affiliates as required under Form ADV.

476 Section 203(e)(2)(A)-(D). *Cf* section 9(b) of the Investment Company Act, pursuant to which foreign court convictions are not automatically disqualifying.

477 *See* section 203(f). Any Commission order issued under this section would be a disqualifying Commission action under the proposed rule.

478 Proposed rule 206(4)-3(a)(3)(iii)(B)(2). Paragraphs (1), (5), or (6) of section 203(e) of the Act generally include, but are not limited to, a person who: (i) has willfully made or caused to be made certain false reports with the Commission; (ii) has willfully violated any provision of the Act or other Federal securities laws; and (iii) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of the of the Act or other Federal securities laws.

engaging, in any of the conduct specified in paragraphs (1), (5) or (6) of section 203(e) of the Act.[479] We believe that these felony and misdemeanor convictions should continue to be disqualifying under the rule, subject to the rule's carve-out as described below. In many cases, conduct underlying a felony or misdemeanor would be picked up by our proposed rule as a disqualifying Commission action (*i.e.*, to the extent the Commission has issued an opinion or order barring, suspending, or prohibiting the person from acting in any capacity under the Federal securities laws or issued certain types of cease and desist orders described in the proposed rule).

We are not proposing to add to the provision's second prong any references to conduct specified in paragraphs (3) and (8) of section 203(e) of the Act (*e.g.*, certain felony convictions not described in paragraph (2) of section 203(e) and certain findings by foreign financial regulatory authorities).[480] Similar to our rationale for not proposing to include in the first prong any "substantially equivalent crime by a foreign court of competent jurisdiction," we do not believe advisers should be required to incur the cost and burden of inquiry into findings by foreign financial regulatory authorities, as is required in section 203(e)(8).[481] In addition, we are not convinced that the rule should prohibit the compensation of solicitors subject to certain felony convictions not described in paragraph 203(e)(2) or substantially equivalent crimes by a

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479 Rule 206(4)-3(a)(1)(ii)(C).

480 Since 1979, section 203 has been amended to expand the types of misconduct for which the Commission has the authority to bar or suspend a person from being associated with an adviser, including by the addition of paragraphs (3) and (8) of section 203(e) of the Act. *See* Securities and Exchange Commission Authorization Act of 1987, Pub. L. No. 100-181 (amending section 203(e) and 203(f) of the Act); Securities Act Amendments of 1990, Pub. L. 101-550 (amending section 203(e) and 203(f) of the Act); National Securities Markets Improvement Act of 1996, Pub. L. 104-290 (amending section 203(e) and 203(f) of the Act); Securities Litigation Uniform Standards Act of 1998, Pub. L. 105-353 (amending section 203(e) of the Act); and Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 (amending section 203(e) of the Act).

481 Section 203(e)(8).

foreign court of competent jurisdiction. We believe that including such felony convictions could overly broaden the scope of the disqualifying provision because such types of convictions are less likely to call into question the credibility of such solicitor's referral. However, a person subject to such felony convictions might still be an ineligible solicitor under our proposed rule, if the Commission has used its authority to bar, suspend or place limits on that person's association with an investment adviser, or otherwise issue a disqualifying Commission action based on such conduct.

The third prong of the proposed disqualifying event definition generally describes the entry of a bar or final order based broadly on the person's fraudulent conduct, by certain regulators and self-regulatory organizations. In particular, this section refers to: the Commodity Futures Trading Commission ("CFTC"), any self-regulatory organization, a State securities commission (or any agency or officer performing like functions), a State authority that supervises or examines banks, savings associations, or credit unions, a State insurance commission (or any agency or office performing like functions), an appropriate Federal banking agency (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813(q))), or the National Credit Union Administration. The proposed provision refers to any final order of any such body that (i) bars a person from association with an entity regulated by such body, or from engaging in the business of securities, insurance, banking, savings association activities, or credit union activities; or (ii) constitutes a final order, entered within the previous ten years, based on violations of any laws, regulations, or rules that prohibit fraudulent, manipulative, or deceptive conduct.[482]

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[482] Proposed rule 206(4)-3(a)(3)(iii)(B)(3).

This proposed third prong is not part of the current rule's statutory disqualification provision.[483] It is derived from section 203(e)(9) of the Act, which is a basis for Commission action to censure, place limitations on the activities, or revoke the registration of any investment adviser or its associated persons.[484] However, our proposal would add self-regulatory organizations and the CFTC to the list of regulators incorporated from section 203(e)(9). Adding these entities would be consistent with the rules disqualifying felons and other "bad actors" from certain securities offerings.[485] Our reference to the definition of self-regulatory organization in section 3 of the Exchange Act in the proposed provision would also be consistent with such rules: it would mean any registered national securities exchange or a registered national or affiliated securities association.[486] As we determined when adopting such rules, the conduct that would typically give rise to CFTC sanctions is similar to the type of conduct that would result in disqualification if it were the subject of sanctions by another financial services industry regulator.[487] In addition, we believe that the type of conduct that would typically give rise to a

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483 The current rule's statutory disqualification provision includes findings of certain misconduct by another regulatory authority only insofar as such findings form a basis of a finding by the Commission (including a Commission order issued under section 203(f) of the Act) or certain convictions by a court of competent jurisdiction, including a foreign court of competent jurisdiction. *See* rule 206(4)-3(a)(1)(ii).

484 *See* sections 203(e)(9) and 203(f).

485 *See, e.g.*, paragraph (d)(iii) of rule 506 of Regulation D; paragraph (d)(vi) of rule 506 of Regulation D (disqualifying a person who is suspended or expelled from membership in, or suspended or barred from association with a member of, a registered national securities exchange or a registered national or affiliated securities association for any act or omission to act constituting conduct inconsistent with just and equitable principles of trade). To the extent that a person is subject to both the disqualification provision of rule 506 and the proposed amendments to the disqualification provision under the solicitation rule, there would be some overlapping categories of disqualifying events (*i.e.*, certain bad acts would disqualify a person under both provisions). For instance, certain types of final orders of certain state and Federal regulators would be disqualifying events under both provisions.

486 Proposed rule 206(4)-3(a)(3)(iii)(B)(3).

487 For example, both registered broker-dealers and investment advisers may be subject to Commission disciplinary action based on their conduct that gave rise to violations of the Commodity Exchange Act. *See, e.g.*, section 15(b)(4)(D) of the Exchange Act (15 U.S.C. 80(b)(4)(C)) and section 203(e)(5) of the Advisers Act (15 U.S.C. 80b-3(e)(5)).

self-regulatory organization's bar or final order based on violations of any laws or regulations that prohibit fraudulent, manipulative, or deceptive conduct is similar to the type of conduct that would result in disqualification if it were the subject of sanctions by another financial services industry regulator. We believe that including applicable bars and orders of such regulators will also make the disqualification provisions more internally consistent with other bad actor disqualification provisions in the Federal securities laws, treating similar types of sanctions similarly for disqualification purposes.

The fourth prong of the proposed disqualifying event definition describes the entry of an order, judgment, or decree described in paragraph (4) of section 203(e) of the Act, of any court of competent jurisdiction within the United States.[488] Paragraph (4) of section 203(e) describes certain orders, judgments or decrees that permanently or temporarily enjoin persons from acting in multiple capacities within the securities industry, and they are bases for Commission action to censure, place limitations on the activities, or revoke the registration of any investment adviser or its associated persons.[489] This prong would generally follow the corresponding provision of the current rule's disqualification provision, except that we are proposing not to include orders, judgments, or decrees by a foreign court, as we discuss below.[490] As when we adopted the cash solicitation rule, we continue to believe that these events should be disqualifying under the rule, subject to our proposed carve-out, because such events call into question the credibility of a solicitor's referral or solicitation.

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488 Proposed rule 206(4)-3(a)(3)(iii)(B)(4).

489 *See* sections 203(e)(4) and 203(f) of the Act.

490 Rule 206(4)-3(a)(1)(ii)(D).

Similar to our rationale for not proposing to include in our first prong convictions by foreign courts, we do not believe advisers should be required to incur the cost and burden of inquiry into foreign proceedings or to make a determination of what is a "foreign person performing a function substantially equivalent to" the functions described in the section, or what is a "foreign entity substantially equivalent" to the entities described in the section, as is required under section 203(e)(4).[491] A person subject to any such order, judgment, or decree by a foreign court might still be an ineligible solicitor, however, to the extent that the Commission uses its authority to bar, suspend, or place limits on that person's association with an investment adviser or otherwise issue a disqualifying Commission action based on such conduct.[492]

### d. *Conditional Carve-Out from Definition of "Ineligible Solicitor"*

We are proposing a conditional carve-out from the determination of whether a person is an ineligible solicitor due to a person's act or omission that is the subject of a disqualifying event and that is also the subject of a "non-disqualifying Commission action" with respect to that person.[493] The term "non-disqualifying Commission action" would mean (i) an order pursuant to section 9(c) of the Investment Company Act (commonly referred to as a "waiver"), or (ii) a Commission opinion or order that is not a disqualifying Commission action.[494] For either such opinion or order to be disregarded in determining whether the person is an ineligible solicitor, (i) the person must have complied with the terms of the opinion or order, including, but not limited

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491 Section 203(e)(2)(A)-(D). *Cf.* section 9(b) of the Investment Company Act, pursuant to which foreign court convictions are not automatically disqualifying (in such instances, in order for its action to be disqualifying, the Commission would have to use its authority to bar, suspend or place limits on that person's activity).

492 *See* section 203(f). Any Commission order issued under this section would be a disqualifying Commission action under the proposed rule.

493 Proposed rule 206(4)-3(a)(3)(iii)(C).

494 *Id*.

to, the payment of disgorgement, prejudgment interest, civil or administrative penalties and fine; and (ii) for a period of ten years following the date of each opinion or order, the person must include in its solicitor disclosure a description of the acts or omissions that are the subject of, and the terms of, the opinion or order.

Our proposed conditional carve-out would permit advisers to compensate for solicitation activities, in certain circumstances, persons with disciplinary events that would otherwise be disqualifying events. Our proposed approach would carve out of the definition of ineligible solicitor a person whose only disqualifying events are those for which the Commission has issued a waiver under the Investment Company Act or the Commission has issued an opinion or order that is not disqualifying Commission action (e.g., an order that does not bar or suspend the person from association with a Commission-registered entity or prohibit the person from acting in any capacity under the Federal securities laws). We are proposing this carve-out because, in those instances where the Commission has acted on the conduct yet not barred or suspended the person or prohibited the person from acting in any such capacity, and has not made a finding of a violation of a scienter-based anti-fraud provision of the Federal securities laws, it would be appropriate to likewise permit such person to engage in solicitation activities. This approach will obviate the need for the Commission to consider how to treat under the solicitation rule a person with disciplinary events for which the Commission has issued one or more opinions or orders but did not bar or suspend the person or prohibit the person from acting in any capacity under the Federal securities laws, and did not order the person to cease and desist from committing or causing a violation or future violation of certain provisions of the Federal securities laws.[495]

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[495] *Cf.* Dougherty Letter. In the Dougherty Letter, Commission staff stated that it would not recommend enforcement action to the Commission under section 206(4) and rule 206(4)-3 if an investment adviser pays cash solicitation fees to a solicitor who is subject to an order issued by the Commission under section

Under our proposal, a solicitor that is subject to a disqualifying event would be an ineligible solicitor unless the Commission has issued a non-disqualifying Commission action covering such event.[496] However, in the event that (i) the Commission has not previously evaluated the disqualifying event and, (ii) neither the solicitor nor any person on its behalf has previously sought a waiver under the Investment Company Act with respect to the disqualifying event, the solicitor could contact the Commission to seek relief.

We believe that the two conditions of the proposed carve-out are important for solicitors with certain disciplinary events to meet in order for the events to be disregarded in determining whether the person is an ineligible solicitor. Our first condition – that the person has complied with the terms of the non-disqualifying Commission action, including, but not limited to, the payment of disgorgement, prejudgment interest, civil or administrative penalties and fines – would demonstrate the person's compliance regarding the Commission opinion or order. We believe that our second condition – that for a period of ten years following the date of each non-disqualifying Commission action, the solicitor disclosure includes a description of the acts or

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203(f) of the Advisers Act, or who is subject to an order issued by the Commission in which the Commission has found that the solicitor: (a) has been convicted of any felony or misdemeanor involving conduct described in section 203(e)(2)(A) through (D) of the Advisers Act; (b) has engaged, or has been convicted of engaging, in any of the conduct specified in paragraphs (1), (5) or (6) of section 203(e) of the Advisers Act; or (c) was subject to an order, judgment or decree described in section 203(e)(4) of the Advisers Act (for purposes of the Dougherty Letter, such Commission orders are collectively referred to as "Rule 206(4)-3 Disqualifying Orders"), provided that certain conditions are met, including that no Rule 206(4)-3 Disqualifying Order bars or suspends the solicitor from acting in any capacity under the Federal securities laws.

[496] Under the current rule, Commission staff has issued several staff no-action letters stating that it would not recommend enforcement action to the Commission under section 206(4) and rule 206(4)-3 if any investment adviser registered or required to be registered with the Commission pays solicitation fees to a solicitor in accordance with the solicitation rule, notwithstanding a final judgment entered by a U.S. court of competent jurisdiction that otherwise would preclude such an investment adviser from paying such a fee to the solicitor, subject to the conditions therein. *See, e.g.*, Stifel, Nicolaus & Company, Inc. (Dec. 6, 2016); Macquarie Capital (USA) Inc., (June 1, 2017); F. Porter Stansberry, (pub. avail. Sept. 30, 2015); and Royal Bank of Canada, (Dec. 19, 2014). Under the proposed rule, however, a solicitor subject to a conviction by U.S. court of competent jurisdiction that meets the second prong of the disqualifying event definition would be an ineligible solicitor unless such person is subject to a non-disqualifying Commission action with respect to the disqualifying event.

omissions that are the subject of, and the terms of, the opinion or order – would provide investors with important information regarding the solicitor's misconduct. Investors should be aware of the solicitor's misconduct and the terms of the Commission opinion or order so that the investor can fully evaluate the integrity of the solicitor. Knowledge of a solicitor's misconduct may affect the degree of trust and confidence an investor would place in the solicitor's referral. We believe that these two conditions should sufficiently address the risks associated with a solicitor who has engaged in the type of misconduct that results in a Commission sanction, but not a bar, suspension, or prohibition, or certain cease and desist orders described in the proposed rule. However, we believe the two conditions described above may not sufficiently address the risks associated with allowing a person to solicit investors who has engaged in such significant misconduct that the person has been barred from acting in the capacities described above or has been subject to certain cease and desist orders described above.

The time period of ten years is consistent with the proposed look-back period for the rule's disqualifying events.[497] We believe that a ten year look back period should provide for a sufficient period of time after the disqualifying event that the past actions of the ineligible solicitor may no longer pose as significant a risk. We believe that a limited look back period is more appropriate than a permanent bar on acting as a solicitor because a limited look back period would allow for the potential of a barred solicitor who has not continued to engage in misconduct to act as a solicitor after a period of time.

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[497] In the Dougherty Letter, discussed *supra* footnote 495, the staff stated that it would not recommend enforcement action under the cash solicitation rule if: (i) the solicitor has complied with the terms of each Rule 206(4)-3 Disqualifying Order, including, but not limited to, the payment of disgorgement, prejudgment interest, civil or administrative penalties and fines; and (ii) for a period of ten years following the date of each Rule 206(4)-3 Disqualifying Order, the solicitor discloses the order to each person whom the solicitor solicits in the separate written disclosure document required to be delivered to such person under rule 206(4)-3(a)(2)(iii)(A) or, if the solicitor is a person specified in rule 206(4)-3(a)(2)(i) or (ii), the solicitor discloses the order to each person whom the solicitor solicits by providing the person at the time of the solicitation with a separate written disclosure document that discusses the terms of the order.

We request comment on our proposed disqualification provision; particularly, the proposed definitions of disqualifying Commission action, disqualifying event, and non-disqualifying Commission action.

- Do commenters agree with the proposed definition of disqualifying Commission action? Why or why not? Should we narrow the proposed definition of disqualifying Commission action, and if so, how? Alternatively, should we expand the proposed definition to capture other types of misconduct? If so, why, and how? For example, should a disqualifying Commission action include, as proposed, officer and director bars imposed in Commission cease and desist orders and penny stock bars under section 15(b) of the Exchange Act? Should a disqualifying Commission action include, as proposed, a Commission opinion or order to cease and desist from committing or causing a violation or future violation of any scienter-based antifraud provision of the Federal securities laws or Section 5 of the Securities Act of 1933, even if that person is not barred, suspended, or prohibited from acting in any capacity under the Federal securities laws?
- Do commenters agree with the proposed definition of disqualifying event, including the types of misconduct and events enumerated in its four prongs? Should we add or subtract any misconduct or events to the proposed definition? If so, why, and how should the proposed definition be changed?
- Should we, as proposed, include as disqualifying events certain final orders by the CFTC, any self-regulatory organization, a State securities commission, State authority that supervises or examines banks, savings associations, or credit

unions, State insurance commission, certain Federal banking agencies, or the National Credit Union Administration? Do commenters agree with the proposed definition of self-regulatory organization, or should the proposed definition be modified, for example, to include any national commodities exchange? Should we modify the scope of these final orders?

- We have not proposed to include in the definition of disqualifying event any convictions and orders, judgments, or decrees by foreign courts and findings by foreign financial regulatory authorities, on the basis that advisers should not be required to incur the cost and burden of inquiry into foreign proceedings and foreign regulatory actions or to make a determination of what is a "substantially equivalent crime" to certain felonies or misdemeanors. Do commenters agree?
- Do commenters agree that the definition of disqualifying event should generally capture enumerated events that occurred within the previous ten years or, in the case of bars and injunctions, that are in effect at the time of solicitation? Why or why not? Should the look-back period be longer (or permanent) or shorter?
    - Do commenters agree with the proposed carve-out to disregard, in determining whether a person with a disqualifying event is an ineligible solicitor, the same act(s) or omission(s) that are also the subject of a non-disqualifying Commission action with respect to that person? Are the conditions for such carve-out appropriate (*i.e.*, to have complied with the terms of the order and making required disclosures for 10 years)? Why or why not? Should we modify the conditions or impose additional conditions?

- Given that the term non-disqualifying Commission action would include a Commission opinion or order that does not bar, suspend, or prohibit the person from acting in any capacity under the Federal securities laws, and certain Commission ceases and desist orders relating to scienter-based antifraud provisions of the Federal securities laws and Section 5 of the Securities Act of 1933, subject to conditions described herein, should we specify whether or not non-disqualifying Commission action" should also include a Commission opinion or order requiring an adviser, broker-dealer or other registrant to hire an independent compliance consultant?

- Are there any other types of misconduct or act(s) or omission(s) that should be disregarded for a person in determining whether that person is an ineligible solicitor?

- Are there additional conditions that we should place on an adviser's ability to compensate for solicitation activity persons whose only disqualifying events are also subject to non-disqualifying Commission actions? For example, should the Commission include a similar mechanism to the one used under Securities Act rule 405 and in the rules disqualifying felons and other "bad actors" from certain securities offerings, which states that the Commission may grant waivers of ineligible issuer status "upon a showing of good cause, that it is not necessary under the circumstances that the issuer be considered an ineligible issuer"?[498] If so, how should the Commission incorporate these or other considerations into the rule?

[498] Securities Act Rule 405. *See* paragraphs (d) and (e) of rule 506 of Regulation D.

- Should we require advisers that compensate for solicitation activity persons whose only disqualifying events are also subject to non-disqualifying Commission actions report such events to the Commission in Form ADV or to disclose such events to investors?
- Are there additional terms that should be defined in the rule, such as "felony," "misdemeanor," "convicted," "found," "bar," "suspend," "sanctions," "final order," "order," "judgment," or "decree"? If so, how should we define those terms?
- As discussed above, under our proposal, certain solicitors that are not currently disqualified under the rule would be disqualified under the amended rule as "ineligible solicitors" solely as a result of the proposed changes to the rule's disqualification provisions. For example, under the current rule, an adviser would not be prohibited from using a solicitor based solely on the entry of a final order of the CFTC or a self-regulatory organization. But under the proposed rule, such a solicitor would be an ineligible solicitor if, for example, the final CFTC or self-regulatory order bars the solicitor from association with an entity regulated by the CFTC or the self-regulatory authority, respectively. While the proposed disqualification provision would apply only to any disqualifying Commission action or disqualifying event occurring after the effectiveness of the proposed rule amendments (or the compliance date, as applicable), we request comment on whether we should provide a longer transition period for any such solicitors that are not currently disqualified under the rule but would be disqualified under the amended rule as "ineligible solicitors" solely as a result of the proposed changes

to the rule's disqualification provisions. If so, how long a transition period for such solicitors should we provide, and why?

- Should we, as discussed above, "grandfather" certain advisers and solicitors that currently rely on letters issued by the Commission staff stating that the staff would not recommend enforcement action to the Commission under section 206(4) and rule 206(4)-3 if an investment adviser paid cash solicitation fees to a solicitor that was subject to particular disciplinary events that fall within the current rule's disqualification provision?[499] Why or why not? Should we permit some, but not all, persons to be grandfathered under the proposed rule, if the solicitors continue to comply with the conditions specified in the Commission staff no-action letters and, except for the disciplinary events described in the applicable letter, would not otherwise be ineligible solicitors under the proposed rule? Why or why not? If so, what standards should we apply in making such determination?

### C. Recordkeeping

We are also proposing to amend Advisers Act rule 204-2, the books and records rule, which sets forth requirements for maintaining, making, and retaining advertisements and books

[499] *See, e.g.,* the "bad actor" letters listed below in section II.D. While these staff letters generally only apply to the solicitor or adviser to which the letter is addressed, the staff has issued one letter that it stated would apply with respect to any cash solicitation arrangement under which an investment adviser proposes to pay cash solicitation fees to a solicitor subject to a specific type of disqualification event under the circumstances described in the letter. *See* Dougherty Letter, discussed *supra* footnote 495.

and records relating to the solicitation of clients.[500] These proposed amendments would help facilitate the Commission's inspection and enforcement capabilities.

First, we are proposing to amend the current rule to require investment advisers to make and keep records of all advertisements they disseminate to one or more persons.[501] The current rule requires investment advisers to keep a record of advertisements sent to 10 or more persons. We are proposing this change to conform the books and records rule to the definition of "advertisement" in the proposed amendments to the advertising rule, which would not be defined in terms of the number of persons to whom it is disseminated.[502] We are not proposing to change the requirement that advisers keep a record of communications other than advertisements (*e.g.*, notices, circulars, newspaper articles, investment letters, and bulletins) that the investment adviser disseminates, directly or indirectly, to 10 or more persons. The proposed books and recordkeeping revision would not apply to live oral communications that are not broadcast, as those communications are excluded from the proposed definition of "advertisement."[503] It would, however, apply to any information provided under proposed rule 206(4)-1(c)(1)(v), which permits hypothetical performance in an advertisement subject to certain conditions, including a requirement that the investment adviser provides (or offers to provide promptly to a recipient that is a Non-Retail Person) sufficient information to enable the person to understand the risks and limitations of using such hypothetical performance in making investment decisions.

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500 Provisions of rule 204-2 that relate to advertising or solicitation under the proposed rules do not apply to registered investment companies.

501 An adviser's live oral communications that are broadcast would be excluded from the recordkeeping requirements. *See* proposed rule 206(4)-1(d)(2).

502 *See* proposed rule 206(4)-1(e)(1).

503 Proposed rule 206(4)-1(e)(1)(i).

We consider any such supplemental information that would be required by proposed rule 206(4)-1 to be a part of the advertisement and therefore subject to the books and records rule.[504]

Second, we are proposing to add a provision to the books and records rule that would explicitly require investment advisers to maintain records related to third-party questionnaires and surveys, as applicable. Specifically, the proposed amendment would require investment advisers that use third-party ratings in an advertisement to make and keep a record of any questionnaire or survey used to create the third-party rating. This requirement would include any questionnaire or survey completed by the adviser for the third party, as well as the form of any questionnaire or survey sent by the third party to the adviser's investors or other participants. This proposal would track the proposed provision of the advertising rule that would permit the use of third-party ratings in advertisements so long as the investment adviser reasonably believes that any questionnaire or survey used in the preparation of the third-party 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.[505] Requiring that such information be retained can provide helpful information to examiners or internal compliance personnel, especially since the persons providing the rating often will not be registered with the Commission and subject to the Commission's books and records requirements.[506]

Third, we are proposing to add a provision to the books and records rule that would require investment advisers to maintain a copy of all written approvals of advertisements by

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504 Among other conditions, the proposed rule also would require the adviser to provide (rather than simply offer to provide) information sufficient to enable Retail Persons to understand the risks and limitations of using such hypothetical performance in making investment decisions. *See* proposed rule 206(4)-1(c)(1)(v)(C); *see also supra* footnote 317 and accompanying text.

505 *See* proposed rule 206(4)-1(b)(2).

506 *See supra* section II.A.4.

designated employees.[507] Requiring that such information be retained can also provide helpful information to examiners or internal compliance personnel.

Fourth, we are proposing to amend the provisions of the books and records rule that require investment advisers to maintain communications containing any performance or rate of return in their advertisements. Specifically, we are proposing to require that investment advisers make and keep originals of written communications received, and copies of written communications sent, relating to the performance or rate of return of any or all portfolios, as defined in the proposed advertising rule.[508] Similarly, we are proposing to require that investment advisers make and keep all supporting records regarding the calculation of the performance or rate of return of any or all portfolios, as defined in the proposed advertising rule, in any advertisement or other communication.[509] The current books and records rule requires investment advisers to make and keep these communications and supporting records with respect to the performance or rate or return of any or all managed accounts or securities recommendations.[510] The proposed amendments seek to impose the same requirements with respect to the performance or rates of return of any or all "portfolios," a defined term that the proposed advertising rule would use to impose specific requirements on the presentation of performance.[511]

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507 Proposed rule 204-2(a)(11)(iii).

508 Proposed rule 204-2(a)(7)(iv).

509 Proposed rule 204-2(a)(16).

510 Rule 204-2(a)(7)(iv) and (a)(16). *See also* Recordkeeping by Investment Advisers, Release No. IA-1135 (Aug. 17, 1988) [53 FR 32033 (Aug. 23, 1988)] (describing as "supporting records" the documents necessary to form the basis for performance information in advertisements that are required under rule 204-2(a)(16)).

511 *See, e.g.,* proposed rule 206(4)-1(c)(2)(ii) (requiring the inclusion of performance results of the same "portfolio" for specific time periods in any Retail Advertisement presenting performance results of such portfolio); proposed rule 206(4)-1(e)(4) (defining "gross performance" by reference to the performance

Fifth, we are proposing two changes to paragraph (a)(16) of the current books and records rule, which requires investment advisers to make and keep all "accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations" appearing in any advertisement.[512] First, as described above, we are proposing to require investment advisers to make and keep all supporting records regarding the calculation of the performance or rate of return of any or all "portfolios," in addition to the managed accounts and securities recommendations already addressed in the provision.[513] Second, we are proposing to amend the provision to clarify that such supporting records must include copies of all information provided or offered pursuant to the hypothetical performance provisions of the proposed advertising rule.[514] Although we believe that this provision of the current books and records rule, which we recently amended,[515] is broad and would apply to the proposed advertising rule's performance provisions, we want to ensure that copies of the information provided to investors in connection with hypothetical performance requirements of the proposed advertising rule are available to our examination staff to better review compliance with that proposed rule and other applicable law. As a result, investment advisers would be required to create and retain records for any performance-related data the proposed rule permits an investment adviser to include in an advertisement.

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results of a specific portfolio); proposed rule 206(4)-1(e)(6) (defining "net performance" by reference to the performance results of a specific portfolio).

512 *See* rule 204-2(a)(16); *see also supra* footnote 512.

513 *See supra* footnote 511 and accompanying text.

514 Proposed rule 206(4)-1(c)(1)(v).

515 *See* Form ADV and Investment Advisers Act Rules, Release No. IA-4509 (Aug. 26, 2016) [81 FR 60417 (Sept. 1, 2016)].

Finally, to correspond to changes we are proposing to make to the solicitation rule 206(4)-3, we are proposing to amend the current books and records rule to require investment advisers to make and keep records of: (i) copies of the solicitor disclosure delivered to investors pursuant to rule 206(4)-3(a)(1)(iii), and, if the adviser participates in any nonprofit program pursuant to rule 206(4)-3(b)(4), copies of all receipts of reimbursements of payments or other compensation the adviser provides relating to its inclusion in the program; (ii) any communication or other document related to the investment adviser's determination that it has a reasonable basis for believing that (a) any solicitor it compensates under rule 206(4)-3 has complied with the written agreement required by rule 206(4)-3(a)(1), and that such solicitor is not an ineligible solicitor, and (b) any nonprofit program it participates in pursuant to rule 206(4)-3(b)(4) meets the requirements of rule 206(4)-3(b)(4); and (iii) a record of the names of all solicitors who are an adviser's partners, officers, directors or employees or other affiliates, pursuant to rule 206(4)-3(b)(2).[516]

The current books and records rule requires investment advisers to keep a record of all written acknowledgments of receipt obtained from clients pursuant to rule 206(4)-3(a)(2)(iii)(B), and copies of the disclosure documents delivered to clients by solicitors pursuant to rule 206(4)-3.[517] Even though our proposed amendments to the solicitation rule would remove the current rule's acknowledgment requirement, an adviser may still choose to receive acknowledgements as a means to inform its belief that the solicitor has satisfied the terms of the written agreement. If the adviser uses investor acknowledgments to evidence its compliance with the proposed

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516 Proposed rule 204-2(a)(15)(i) - (iii).

517 Rule 206(4)-3(a)(2)(iii)(B) requires that, as a condition to paying a cash fee to a solicitor for solicitation activity, the adviser must receive from the client, prior to, or at the time of, entering into any written or oral investment advisory contract with such client, a signed and dated acknowledgment of receipt of the investment adviser's written disclosure statement and the solicitor's written disclosure document.

solicitation rule, then the adviser would be required to maintain the communications or other documents containing those acknowledgments in accordance with this provision.[518] Requiring that such information be retained can also provide helpful information to our examiners or internal compliance personnel.

The current rule also requires investment advisers to keep a record of copies of the disclosure documents delivered to clients by solicitors pursuant to rule 206(4)-3. We are proposing to maintain this requirement with adjustments to correspond to our proposed changes to the solicitation rule, which would permit either the adviser or the solicitor to deliver the solicitor disclosure. We believe that such proposed changes to the solicitation rule and corresponding changes to the recordkeeping rule aid internal compliance personnel by making it easier for advisers to comply with the books and records requirement to keep records of the solicitor disclosure. Further, our proposed amendment to the solicitation rule would remove the current rule's requirement to include the adviser's brochure in the disclosures. Accordingly, the corresponding books and records requirement would be removed as no longer relevant or necessary.

Additionally, our proposal to add to the books and records rule a new requirement that advisers keep a record of the names of all solicitors who are an adviser's partners, officers, directors or employees or other affiliates, would correspond to our proposed changes to the solicitation rule. Our proposed amendments to the solicitation rule would require advisers that employ the solicitation rule's limited exemptions for solicitors that are partners, officers, directors or employees or certain other affiliates, to document such solicitor's status at the time

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[518] Proposed rule 204-2(a)(15)(ii).

the adviser enters into the solicitation arrangement.[519] Amending rule 204-2 as proposed will therefore correspond to the proposed changes to the solicitation rule. Our proposal would also add to the books and records rule new recordkeeping requirements for advisers that participate in nonprofit referral programs pursuant to the nonprofit exemption from the solicitation rule. This recordkeeping requirement would correspond to the solicitation rule's proposed nonprofit exemption by requiring an adviser to maintain communications relating to its determination that it has a reasonable basis for believing the nonprofit program meets the requirements of the proposed solicitation rule exemption for nonprofit programs. In addition, the proposed new books and record requirement would require advisers that use the nonprofit exemption to retain copies of all receipts of reimbursements the adviser provides relating to its inclusion in the program. This information would be critical for an adviser to demonstrate that it compensates the solicitor only to reimburse it for the administrative costs incurred in operating the program, as required under the exemption. Requiring that such information be retained can also provide helpful information to our examiners or internal compliance personnel, especially since we believe that under our proposed solicitation rule, solicitors would often deliver to investors the solicitor disclosure; solicitors (rather than advisers) would operate nonprofit referral programs, and; solicitors would oftentimes not themselves be registered with the Commission and therefore not subject to the Commission's books and records requirements.

We are not proposing amendments to the books and records rule that would specifically reference the adviser's obligation to retain any written agreements with solicitors entered into pursuant to the requirements of the solicitation rule.[520] Such a provision would be duplicative of

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519 *See* proposed rule 206(4)-3(b)(2).

520 *See* proposed rule 206(4)-3(a)(1).

the current books and records rule, which requires advisers to retain "[a]ll written agreements (or copies thereof) entered into by the investment adviser with any client or otherwise relating to the business of such investment adviser as such."[521] We are not proposing to make any changes to this provision of the rule because we believe that this provision currently applies, and would continue to apply, to the solicitation rule written agreement requirement.

We request comment on the proposed books and recordkeeping amendments.

- Do commenters agree that the recordkeeping requirement should be revised to apply to advertisements distributed to one or more persons? If we were to require records only for advertisements disseminated to a minimum number of people, as under the current rule, what is the appropriate minimum? Is it less or more than 10?
- Do advisers have concerns it will be difficult to retain advertisements distributed to one or more persons? Would this place an undue burden on smaller advisers? How many advertisements do advisers disseminate via electronic correspondence, and do advisers already have processes in place to automatically retain all such correspondence?
- Proposed rule 204-2(a)(11), like the current rule, would require advisers to make and keep records of communications other than advertisements (*e.g.*, notices, circulars, newspaper articles, investment letters, and bulletins) distributed to 10 or more person. While we believe many of these communications nonetheless would fall under the proposed definition of "advertisement," should we treat any such communications that are not advertisements differently (*e.g.*, subject them to the recordkeeping rule if distributed to one or more persons)?

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521 *See* rule 204-2(a)(10).

- Is it clear to commenters what supplemental information would be required to be maintained by advisers advertising hypothetical performance?
- Have advisers had difficulty retaining communications that are not advertisements under this provision of the current rule? How many communications do advisers disseminate via electronic correspondence, and do advisers already have processes in place to automatically retain all such correspondence?
- Do commenters believe it will be difficult for any investment advisers to obtain a copy of a survey or questionnaire used to create third-party rating?
- Do commenters agree with the proposed amendments to the performance recordkeeping requirements in 204-2(a)(16)? Why or why not?
- Should we consider amending the rule to address specifically other provisions of the proposed advertising rule? For example, should the books and recordkeeping rule require specific records related to testimonials and endorsements?
- Do commenters agree that the recordkeeping requirement should be revised to correspond to our proposed changes to the solicitation rule? Why or why not?
- Given that our proposed solicitation rule would remove the current requirement that an adviser obtain signed and dated client acknowledgments of the rule's required disclosures, should we require that the adviser maintain any communication with a solicitor or another person related to the investment adviser's determination that it has a reasonable basis for believing that any solicitor it compensates under rule 206(4)-3 has complied with the written agreement required by rule 206(4)-3(1), and that such solicitor is not an ineligible solicitor? Why or why not?

- Proposed rule 204-2(a)(15) does not currently require advisers to make and keep records of their written agreements with solicitors required under the solicitation rule, but advisers are required to make and keep records of such agreements under another provision of the books and records rule that applies more broadly to an adviser's business. Should we clarify, in the books and records provision relating specifically to the solicitation rule, the requirement to keep such records? Why or why not?
- Is it currently difficult for investment advisers to obtain copies of the solicitor disclosure that the solicitor delivers to clients, even though the adviser is also required to obtain signed and dated client acknowledgments of receipt of such disclosure? Why or why not? If so, would the proposed change to the solicitation rule – that would allow advisers to deliver the solicitor disclosure – improve compliance with the books and records rule's requirement to retain copies of the solicitor disclosure? Why or why not?
- Should the books and records rule require that advisers make and keep records of the names of solicitors that are in-house or otherwise affiliated with the adviser? Why or why not?
- Are there other records related to advertisements that we should require investment advisers to keep and maintain? For example, should we require advisers to retain materials substantiating the policies and procedures reasonably designed to ensure that a Non-Retail Advertisement is disseminated solely to Non-Retail Persons, as defined in the proposed rule?
- Investment advisers would be required to maintain the proposed records for the same period of time as required under the current books and recordkeeping rule. Do

commenters believe advisers should be required to maintain these records for a shorter or longer period of time? Why?

- Should we require that investment advisers include a unique identifier, such as the adviser's SEC number or Central Registration Depository (CRD) number, on all advertisements?

### D. Existing Staff No-Action Letters and Other Related Guidance

Staff in the Division of Investment Management is reviewing certain of our staff's no action letters and other guidance addressing the application of the advertising and solicitation rules to determine whether any such letters should be withdrawn in connection with any adoption of this proposal. If the rule is adopted, some of these letters and other guidance would be moot, superseded, or otherwise inconsistent with the amended rules and, therefore, would be withdrawn. We list below the letters that are being reviewed for withdrawal as of the dates the proposed rules, if adopted, would be effective after a transition period.[522] If interested parties believe that additional letters should be withdrawn, they should identify the letter, state why it is relevant to the proposed rule, and how it should be treated and the reason therefor. To the extent that a letter listed relates both to a topic identified in the list below and another topic, the portion unrelated to the topic listed is not being reviewed in connection with the adoption of this proposal.

#### 1. Letters to be reviewed concerning rule 206(4)-1

| Letter and date | Topic subject to withdrawal |
|---|---|
| A.R. Schmeidler & Co. Inc. (pub. avail. June 1, 1976) | Hypothetical performance |
| Alphadex Corp. (pub. avail. Feb. 21, 1971) | Graphs, charts, and formulas. hypothetical performance, past specific |

[522] *See infra* Section II.E, discussing the proposed transition periods.

| Letter and date | Topic subject to withdrawal |
|---|---|
| | recommendations |
| Amherst Financial Services Inc. (pub. avail. May 23, 1995) | Prohibition and scope of testimonials, generally, including audio files |
| Analytic Investment Management Incorporated (pub. avail. March 22, 1971) | Prohibition and scope of testimonials, such as client reference letters |
| Anametrics Investment Mgmt. (pub. avail. May 5, 1977) | Misleading performance |
| Andrew M. Rich (pub. avail. Feb. 22, 1989) | False or misleading advertisements |
| Association for Investment Management and Research (pub. avail. Dec. 18, 1997) | Performance advertisements |
| Bache & Company (pub. avail. Feb 5, 1976) | Graphs, charts, and formulas, false or misleading advertisements, hypothetical performance |
| Bradford Hall (pub. avail. Jul. 19, 1991) | Performance advertisements, gross performance |
| BullBear Indicator, Inc. (pub. avail. Apr. 14, 1976) | Past specific recommendations |
| Bypass Wall Street, Inc. (pub. avail. Jan. 17, 1992) | Performance advertisements, gross performance |
| Cambiar Investors, Inc., (pub. avail. Aug. 28, 1997) | Prohibition and scope of testimonials, generally, including partial client lists |
| CIGNA Securities, Inc. (pub. avail. May 8, 1991) | Prohibition and scope of testimonials, generally |
| Clover Capital Management (pub. avail. July 19, 1991) | Performance advertisements, gross performance |
| Clover Capital Management (pub. avail. Oct. 28, 1986) | Performance advertisements, model or actual results |
| Covato/Lipsitz, Inc. (pub. avail. Oct. 23, 1981) | Past specific recommendations |
| Cubitt-Nichols Associates (pub. avail. Dec. 22, 1971) | Past specific recommendations, hypothetical performance |
| DALBAR, Inc., (pub. avail. March 24, 1998) | Prohibition and scope of testimonials, generally, including third-party ratings |
| Denver Investment Advisors, Inc. (pub. avail. July 30, 1993) | Prohibition and scope of testimonials, generally, including partial client lists |
| Donaldson, Lufkin & Jenrette Securities Corp. (pub. avail. Mar. 2, 1977) | Misleading advertisements, past specific recommendations |
| Dow Theory Forecasts, Inc. (pub. avail. May 21, 1986) | Report, analysis or service provided “free of charge” |
| Dow Theory Forecasts, Inc. (pub. avail. Nov. 7, 1985) | Past specific recommendations |
| Edward F. O’Keefe (pub. avail. Apr. 13, 1978) | False or misleading advertisements, past specific recommendations |
| Executive Analysts, Inc. (pub. avail. Aug. 6, 2972) | False or misleading advertisements |
| F. Eberstadt & Co., Inc. (pub. avail. Jul. 2, 1978) | False or misleading advertisements |

| Letter and date | Topic subject to withdrawal |
|---|---|
| Ferris & Company, Inc. (pub. avail. May 23, 1972) | Performance advertisements, model or actual results |
| Foster & Marshall, Inc. (pub. avail. Feb, 18, 1977) | Past specific recommendations |
| Franklin Management, Inc. (pub. avail. Dec. 10, 1998) | Past specific recommendations |
| Gallagher and Associates, Ltd. (pub. avail. July 10, 1995) | Prohibition and scope of testimonials, generally, including non-investment related commentary (e.g., religious affiliation or moral character) *<br><br>* Note that staff has previously partially rescinded its Gallagher position. See IM Guidance Update No. 2014-04, at note 12 and accompanying text. |
| Investment Adviser Association (pub. avail. Dec. 2, 2005) | Prohibition and scope of testimonials, generally, including third-party ratings |
| Investment Company Institute (pub. avail. Aug. 24, 1987) | Performance advertisements, gross performance |
| Investment Company Institute (pub. avail. Sept. 23, 1988) | Performance advertisements, gross performance |
| Investment Counsel Association of America (pub. avail. Mar. 1, 2004) | Past specific recommendations |
| Investor Intelligence (John Anthony) (pub. avail. April 18, 1975) | False or misleading advertisements |
| J.D. Minnick & Co. (pub. avail. Apr. 30, 1975) | Past specific recommendations |
| J.P. Morgan Investment Mgmt., Inc. (pub. avail. May 7, 1996) | Performance advertisements, gross performance, model fees |
| J.Y. Barry Arbitrage Management, Inc. (pub. avail. October 18, 1989) | Prohibition and scope of testimonials, generally |
| James B. Peeke & Co., Inc. (pub. avail. Sept. 13, 1982) | Past specific recommendations |
| James Maratta (pub. avail. June 3, 1977) | Graphs, charts, and formulas, false or misleading advertisements |
| Kurtz Capital Management (pub. avail. Jan. 18, 1988) | Prohibition and scope of testimonials, generally, and third-party reports |
| Mark Eaton (pub. avail. June 9, 1977) | Past specific recommendations |
| Multi-Financial Securities Corp. (pub. avail. November 9, 1995) | Prohibition and scope of testimonials, generally, including audio files |
| New York Investors Group, Inc. (pub. avail. Sept. 7, 1982) | Prohibition and scope of past specific recommendations and testimonials, generally, and reprints of articles; false or |

| Letter and date | Topic subject to withdrawal |
|---|---|
| | misleading advertisements |
| Norman L. Yu (pub. avail. Apr. 12, 1971) | Past specific recommendations |
| Oberweis Securities, Inc. (pub. avail. July 25, 1983) | Past specific recommendations |
| Richard Silverman (pub. avail. March 27, 1985) | Prohibition and scope of testimonials, generally |
| S. H. Dike & Co., Inc. (pub. avail. Apr. 20, 1975)[523] | Past specific recommendations, hypothetical performance, graphs, charts, and formulas |
| Schield Stock Services, Inc. (pub. avail. Feb. 26, 1972) | False or misleading advertisements |
| Scientific Market Analysis (pub. avail. Mar. 24, 1976) | Hypothetical performance, past specific recommendations |
| Securities Industry Association (pub. avail. Nov. 27, 1989) | Performance advertisements, gross performance |
| Stalker Advisory Services (pub. avail. Jan. 18, 1994) | Prohibition and scope of testimonials, generally, and reprints of articles |
| Starr & Kuehl, Inc. (pub. avail. Apr. 17, 1976) | Past specific recommendations |
| Taurus Advisory Group, Inc. (pub. avail. July 15, 1993) | Performance advertisements, past performance |
| The Mottin Forecast (pub. avail. Nov. 29, 1975) | Graphs, charts, and formulas, false or misleading advertisements |
| The TCW Group (pub. avail. Nov. 7, 2008) | Performance advertisements, past specific recommendations |
| Triad Asset Management (pub. avail. Apr. 22, 1993) | Past specific recommendations |

### 2. Letters to be reviewed concerning rule 206(4)-3

| Letter and date | Topic subject to withdrawal |
|---|---|
| Allen Isaacson (pub. avail. Dec. 17, 1979) | Scope of the rule's exemption for certain affiliates |
| AMA Investment Advisers, Inc. (pub. avail. Oct. 28, 1993) | Delivery of solicitor brochure (timing and the requirement for the solicitor to deliver it) |

[523] The portion of this letter pertaining to rule 206(4)-1 would be withdrawn, but the portions pertaining to the adviser's investment management arrangements potentially involving the creation of investment companies under section 3(a) of the Investment Company Act, as well as the participations in those investment companies as securities as defined in section 2(1) of the Securities Act, would not be withdrawn.

| Letter and date | Topic subject to withdrawal |
|---|---|
| Ameriprise Financial Services, Inc. (pub. avail. Apr. 5, 2006) | Timing of delivery of required disclosures (solicitor disclosure and/or adviser brochure) |
| Bond Timing Securities Corporation (pub. avail. Nov. 29, 1984) | Solicitation for impersonal investment advice |
| Charles Schwab & Co. (pub. avail. Dec. 17, 1980) | Discussion of "person associated with an investment adviser" |
| Charles Schwab & Co. Inc. (pub. avail. Apr. 29, 1998) | Timing of delivery of required brochure |
| Cunningham Advisory Services, Inc. (pub. avail. Apr. 27, 1987) | "Person associated with an investment adviser" |
| Dana Investment Advisors, Inc. (pub. avail. Oct. 12, 1994)*<br><br>* Staff has previously partially retracted statements it made in this letter about the application of the rule to solicitation of investors in investment pool managed by the adviser (see e.g., Mayer Brown, below). | Application of rule to solicitation of investors in investment pool managed by the adviser |
| Dechert Price and Rhoads (pub. avail. Dec. 4, 1990)*<br><br>* Staff has previously retracted statements it made in this letter about the application of the rule to solicitation of investors in investment pool managed by the adviser (see e.g., Mayer Brown, below). | Application of rule to solicitation of investors in investment pool managed by the adviser |
| Denver Credit Union (pub. avail. Sept. 15, 1988) | General applicability of the rule |
| E. Magnus Oppenheim & Co. (pub. avail. Mar. 25, 1985) | Written agreement requirement for an adviser's in-house (employee) solicitors, including solicitor disclosure |
| E.F. Hutton and Co. Inc. (pub. avail. Sept. 21, 1987) | Delivery of solicitor brochure (timing and the requirement for the solicitor to deliver it) |
| Excellence in Advertising, Ltd. (pub. avail. Dec. 15, 1986) | Scope of rule |
| Fried, Frank, Harris, Shriver & Jacobson (pub. avail. Dec. 17, 1979) | Scope of the rule's exemption for certain affiliates |
| Heys, Robert J. (pub. avail. May 12, 1986) | Scope of rule |
| International Association for Financial Planning (pub. avail. June 1, 1998) | Scope of rule |
| JMB Financial Managers, Inc. (pub. avail. Jun. 23, 1993) | General application of the rule |
| Koyen, Clarke and Assoc. Inc. (pub. avail. Nov. 10, 1986) | Discussion of "person associated with an investment adviser" |

| Letter and date | Topic subject to withdrawal |
|---|---|
| Lincoln National Investment Management Co. (pub. avail. Mar. 26, 1992) | Timing of delivery of required disclosures |
| Mayer Brown LLP (pub. avail. July 15, 2008, superseded by letter with minor, non-substantive changes, pub. avail. Jul. 28, 2008) | Application of rule to cash payments by registered advisers to persons who solicit investors to invest in investment pool managed by the adviser |
| Merchants Capitol Management, Inc. (pub. avail. Oct. 4, 1991) | Written agreement requirement for an adviser's in-house (employee) solicitors, including solicitor disclosure |
| Mid-States Capital Planning (pub. avail. Apr. 11, 1983) | Setting the amount of the solicitation fee |
| Moneta Group Investment Advisors, Inc. (pub. avail. Oct. 12, 1993). | Delivery of solicitor brochure (timing and the requirement for the solicitor to deliver it) |
| National Football League Players Ass'n (pub. avail. Jan. 25, 2002) | Scope of rule |
| Redmond Associates, Inc. (pub. avail. Jan, 12, 1985) | General requirements of the rule |
| Roy Heybrock (pub. avail. Apr. 5, 1982) | General applicability of the rule |
| Securities International, Ltd., dba ITZ, Ltd. (pub. avail. Mar. 14, 1989) | General applicability of the rule |
| Shareholder Service Corporation (pub. avail. Feb. 3, 1989) | Setting the amount of the solicitation fee |
| Stein, Roe and Farnham Inc. (pub. avail. May 26, 1987) | Scope of the rule's exemption for certain affiliates |
| Stein, Roe and Farnham, Inc. (pub. avail. June 29, 1990)*<br><br>* Staff has previously partially retracted statements it made in this letter about the application of the rule to solicitation of investors in investment pool managed by the adviser (see e.g., Mayer Brown, above). | Application of rule to solicitation of investors in investment pool managed by the adviser; satisfaction of the rule's disclosure provisions |
| Stonebridge Capital Management (pub. avail. Dec. 12, 1979) | General applicability of the rule |
| The Lowry Management Corp. (pub. avail. Sept. 7, 1982) | Definition of solicitor (specifically, the term "person" as used in the definition of solicitor) |
| Trident Investment Management, Inc. (pub. avail. Dec. 18, 1981) | Content of solicitor disclosure |
| Trinity Investment Management Corp. (pub. avail. Mar. 7, 1980) | General application of the rule |
| Van Eerden Investment Advisory Services, Inc. (pub. avail. May 21, 1984) | Requirements for the written agreement |
| All rule 206(4)-3 "bad actor" letters (see list | Solicitor disqualification |

| Letter and date | Topic subject to withdrawal |
|---|---|
| below). But see requests for comment on grandfathering some disqualification letters, *infra* section II.E. | |

Solicitor disqualification letters that are being reviewed in full:

1. Aeltus Investment Management, Inc. (pub. avail. Jul. 17, 2000)
2. American International Group, Inc. (pub. avail. Dec. 8, 2004)
3. American International Group, Inc. (pub. avail. Feb. 21, 2006)
4. Automated Trading Desk Specialists, LLC (pub. avail. Mar. 13, 2009)
5. BAC Home Loans Servicing, LP (formerly Countrywide Home Loans Servicing LP) (pub. avail. June 2, 2011)
6. Banc of America Securities LLC (pub. avail. June 10, 2009)
7. Bank of America, N.A. (pub. avail. Nov. 25, 2014)
8. Barclays Bank, PLC (pub. avail. Jun. 6, 2007)
9. Bear Sterns & Co., Inc., and several settling firms (pub. avail. Jan. 1, 1999).
10. Bear, Stearns & Company Inc. (pub. avail. Oct. 31, 2003)
11. Bear, Stearns Securities Corp. (pub. avail. Aug. 5, 1999)
12. BT Alex. Brown Inc. (pub. avail. Nov. 17, 1999)
13. BT Securities Corp. (pub. avail. Mar. 30, 1992)
14. Carnegie Asset Management, Inc. (pub. avail. July 11, 1994)
15. CIBC Mellon Trust Company (pub. avail. Feb. 24, 2005)
16. Citigroup Global Markets Inc. (pub. avail. Oct. 31, 2003)
17. Citigroup Inc. (pub. avail. Oct. 22, 2010)
18. Credit Suisse First Boston Corp. (pub. avail. Aug. 24, 2000)
19. Credit Suisse First Boston LLC (pub. avail. Oct. 31, 2003)
20. Credit Suisse (pub. avail. May 20, 2014)
21. Deutsche Bank Securities Inc. (pub. avail. Sept. 24, 2004)
22. Deutsche Bank Securities Inc. (pub. avail. June 9, 2009)
23. Dougherty & Company LLC (pub. avail. July 3, 2003)
24. Dougherty & Company LLC (pub. avail. Mar. 21, 2003)
25. E*Trade Capital Markets LLC (pub. avail. Mar. 12, 2009)
26. E-Invest, Inc. (pub. avail. Sept. 22, 2000)
27. F. Porter Stansberry (pub. avail. Sept. 30, 2015)
28. Fahnestock & Company Inc. (pub. avail. Apr. 21, 2003)
29. First City Capital Corp. (pub. avail. Feb. 9, 1990)
30. Founders Asset Management LLC (pub. avail. Nov. 8, 2000)
31. GE Funding Capital Market Services, Inc. (pub. avail. Jan. 25, 2012)
32. General Electric Company (pub. avail. Aug. 12, 2009)
33. General Electric Company (pub. avail. Aug. 2, 2010)
34. Goldman, Sachs & Co. (pub. avail. Feb. 23, 2005)
35. Goldman, Sachs & Co. (pub. avail. July 22, 2010)
36. Goldman, Sachs & Co. (pub. avail. Oct. 31, 2003)
37. Gruntal & Co. (pub. avail. July 17, 1996)

38. Hickory Capital Management (pub. avail. February 11, 1993)
39. In re William R. Hough & Co./In the Matter of Certain Municipal Bond Refundings (pub. avail. Apr. 13, 2000)
40. In the Matter of Market Making Activities on Nasdaq (pub. avail. Jan. 11, 1999)
41. ING Bank N.V. (pub. avail. Aug. 31, 2005)
42. Interstate/Johnson Lane Corp. (pub. avail. Apr. 21, 1997)
43. J.B. Hanauer (pub. avail. Apr. 27, 1999)
44. J.B. Hanauer (pub. avail. Dec. 12, 2000)
45. J.P. Morgan Securities Inc. (pub. avail. Oct. 8, 2003)
46. J.P. Morgan Securities LLC (pub. avail. Jan. 9, 2013)
47. J.P. Morgan Securities LLC (pub. avail. July 11, 2011)
48. J.P. Morgan Securities LLC (pub. avail. June 29, 2011)
49. J.P. Morgan Securities Inc. (pub. avail. Oct. 31, 2003)
50. J.P. Turner & Company, L.L.C., et al. (pub. avail. Sept. 10, 2012)
51. James DeYoung (pub. avail. Oct. 24, 2003)
52. Janney Montgomery Scott LLC and Norman T. Wilde, Jr. (pub. avail. July 18, 2000)
53. JPMorgan Chase & Co. (pub. avail. May 20, 2015)
54. Kidder Peabody & Co. (pub. avail. Mar. 30, 1992)
55. Kidder Peabody & Co., Inc. (pub. avail. Oct. 11, 1990)
56. Legg Mason Wood Walker, Inc. (pub. avail. June 11, 2001)
57. Lehman Brothers (pub. avail. Oct. 31, 2003)
58. Macquarie Capital (USA) Inc. (pub. avail. June 1, 2017)
59. McDonald Investments Inc. (pub. avail. Apr. 2, 1999)
60. Merrill Lynch, Pierce, Fenner & Smith Inc. (pub. avail. Sept. 15, 1999)
61. Merrill Lynch, Pierce, Fenner & Smith Inc. (pub. avail. Aug. 7, 1997)
62. Merrill Lynch, Pierce, Fenner & Smith Inc. (pub. avail. Oct. 31, 2003)
63. Millennium Partners, L.P. (pub. avail. Mar. 9, 2006)
64. Mitchell Hutchins Asset Management, Inc. (pub. avail. Jan. 2, 1998)
65. Morgan Keegan & Co., Inc. (pub. avail. Jan. 9, 1998)
66. Morgan Stanley & Co., Inc. (pub. avail. Feb. 4, 2005)
67. Morgan Stanley & Co. (pub. avail. Oct. 31, 2003)
68. Nationsbanc Investments, Inc. (pub. avail. May 6, 1998)
69. Norman Zadeh and Prime Advisors, Inc. (pub. avail. Nov. 8, 2001)
70. Oppenheimer & Co., Inc. (pub. avail. June 5, 1992)
71. PaineWebber Inc. (pub. avail. Dec. 22, 1998)
72. Paul Laude, CFP (pub. avail. June 22, 2000)
73. Prudential Financial, Inc. (pub. avail. Sept. 5, 2008)
74. Prudential Securities Inc. (pub. avail. Feb. 7, 2001)
75. Ramius Capital Management (pub. avail. Apr. 5, 1996)
76. RBC Capital Markets Corp. (pub. avail. June 10, 2009)
77. RBS Securities, Inc. (pub. avail. Nov. 26, 2013)
78. RNC Capital Management Inc. (pub. avail. Feb. 7, 1989)
79. Royal Bank of Canada (pub. avail. Dec. 19, 2014)
80. Salomon Brothers, Inc. (pub. avail. Jan. 26, 1994)
81. Stein Roe & Farnham Inc. (pub. avail. Aug. 25, 1988)
82. Stein Roe Farnham - Touche Remnant Holdings Ltd. (pub. avail. Jan. 20, 1990)

83. Stephanie Hibler (pub. avail. Jan. 24, 2014)
84. Stephens Inc. (pub. avail. Dec. 27, 2001)
85. Stifel, Nicolaus & Company, Inc. (pub. avail. Dec. 6, 2016)
86. The Dreyfus Corp. (pub. avail. Mar. 9, 2001)
87. Thomas Weisel Partners LLC (pub. avail. Sept. 24, 2004)
88. Tucker Anthony Inc. (pub. avail. Dec. 21, 2000)
89. U.S. Bancorp Piper Jaffray Inc. (pub. avail. Oct. 31, 2003)
90. UBS AG (pub. avail. Mar. 20, 2009)
91. UBS AG (pub. avail. May 20, 2015)
92. UBS Financial Services Inc. (pub. avail. May 9, 2011)
93. UBS Securities LLC (pub. avail. Oct. 31, 2003)
94. UBS Securities LLC (pub. avail. Dec. 23, 2008)
95. Wachovia Securities LLC (pub. avail. Feb. 18, 2009)
96. Wells Fargo Bank, N.A. (pub. avail. July 15, 2013)
97. Wells Fargo Bank, N.A. (pub. avail. Sept. 21, 2012)
98. Wells Fargo Bank, N.A. (pub. avail. Dec. 12, 2011)

### E. Transition Period and Compliance Date

We are proposing that advisers registered or required to be registered with the Commission would be permitted to rely on each amended rule after its effective date as soon as the adviser could comply with the rule's conditions, and would be required to comply with each amended rule applicable to it starting one year from the rule's effective date (the "compliance date"). This would provide a one-year transition period during which we would permit registered investment advisers to continue to rely on the current rules. If any final rule is adopted, the proposed transition period would permit firms to develop and adopt appropriate procedures to comply with the proposed new advertising rule and the proposed changes to the solicitation rule.

Pursuant to our proposal, any advertisements and solicitations made on or after the compliance date by advisers registered or required to be registered with the Commission would be subject to the new and amended rules, respectively. Our proposed transition period would also address solicitation arrangements where an adviser continues to compensate a solicitor for soliciting an investor for a period of time (*i.e.*, trailing payments). Under our proposal, an

adviser would not be subject to the proposed amendments to the solicitation rule with respect to trailing payments for any solicitations made prior to the compliance date. However, any solicitation arrangement structured to avoid the solicitation rule's restrictions, depending on the facts and circumstances, would violate section 208(d) of the Act's general prohibitions against doing anything indirectly which would be prohibited if done directly.[524]

We request comment on the following:

- Do commenters agree that a one-year transition period following each rule's effective date is appropriate? If not, how long of a transition period following each rule's adoption would be appropriate? For example, would 90 days be an appropriate amount of time? Would longer be necessary, *e.g.,* eighteen months, and if so, why? Should we have different compliances dates for each rule? Why or why not? Should we have different compliances dates for larger or smaller entities? Why or why not?
- Under our proposal, certain solicitors that are not currently disqualified under the rule would be disqualified under the amended rule as "ineligible solicitors" solely as a result of the proposed changes to the rule's disqualification provisions. For example, under the current rule, an adviser would not be prohibited from using a solicitor based solely on the entry of a final order of the CFTC or a self-regulatory organization. But under the proposed rule, such solicitor would be an Ineligible Person if, for example, the final CFTC or self-regulatory order bars the solicitor from association with an entity regulated by the CFTC or the self-regulatory authority, respectively. We request comment on whether the rule should include a

[524] Section 208(d) of the Act.

provision that grandfathers an adviser's arrangement with a solicitor when the solicitor was engaged immediately prior to the proposed rule's effective date and was not subject to disqualification under the current rule, but would be an ineligible solicitor under the proposed rule because of the changes to the rule's disqualification provision. We would not apply such a grandfathering provision where a solicitor becomes subject to disqualification during the rule's transition period. Should we? We would not apply such grandfathering provision to solicitation arrangements established after the rule's effective date. Do commenters agree? Would a different grandfathering provision be appropriate? Why or why not?

## III. ECONOMIC ANALYSIS

### A. Introduction

The Commission is proposing amendments to rule 206(4)-1 related to investment adviser advertising. The proposed amendments expand the scope of the definition of "advertisement." The proposed amendments also include general prohibitions of certain advertising practices, and the proposed approach (i) would impose requirements on investment adviser performance in advertisements, and (ii) would require investment advisers that use certain features in an advertisement, such as testimonials and endorsements, to disclose information that would help investors evaluate the advertisement. The proposal would also amend rule 206(4)-3 to, among other things, broaden its application to all forms of compensation while also removing requirements that are duplicative of more recent rules adopted under the Act, and extend the solicitation rule requirements to solicitors of investors in private funds. The Commission is also proposing amendments to Form ADV that are designed to provide additional information

regarding advisers' advertising practices, and amendments to the Advisers Act books and records rule to correspond to the proposed changes to the advertising and solicitation rules. Some portion of these provisions would create a collection of information burden under rule 206(4)-1 and would have an impact on the current collection of information burdens of rules 206(4)-3 and 204-2 under the Investment Advisers Act ("the Act") and Form ADV, which we discuss in the next section. The proposed rules reflect market developments since 1961 and 1979, when rules 206(4)-1 and 206(4)-3 respectively were adopted, as well as practices consistent with conditions in staff no-action letters and guidance. These market developments include advances in communication technology and advertising practices that did not exist at the time the rule was adopted and may fall outside of the scope of the current rules.

We are mindful of the costs imposed by, and the benefits obtained from, our rules. Whenever we engage in rulemaking and are required to consider or determine whether an action is necessary or appropriate in the public interest, section 202(c) of the Investment Advisers Act requires the Commission to consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and capital formation. The following analysis considers, in detail, the potential economic effects that may result from the proposed rule, including the benefits and costs to market participants as well as the broader implications of the proposal for efficiency, competition, and capital formation. Where possible, the Commission quantifies the likely economic effects of the proposal; however, the Commission is unable to quantify certain economic effects because it lacks the information necessary to provide estimates or ranges. In some cases, quantification is particularly challenging due to the number of assumptions that it would need to make to forecast how investment advisers would respond to the new conditions of the proposed rules, and how those responses would in turn affect the

broader market for investment advice and the investors' participation in this market. Nevertheless, as described more fully below, the Commission is providing both a qualitative assessment and quantified estimate of the economic effects, where feasible. The Commission invites commenters to include estimates and data that could help it form useful estimates of the economic effects of the proposed amendments.

### B. Broad Economic Considerations

The proposed rule and form amendments would affect many different methods and practices that investment advisers use to advertise their services. While we discuss each of these methods and practices in detail later, in this section we discuss the broad economic considerations that frame our economic analysis of the proposed amendments and describe the relevant structural features of the market for investment advice and its relationship to marketing of advisory services and pooled investment vehicles. Key to this framework is the concept of "information asymmetry" – in this case, the lack of information that investors have about the ability and potential fit of investment advisers available to them – and the difficulties certain investors may face in verifying the ability and potential fit of investment advisers. By setting up this economic framework, we can see how the characteristics of the market for investment advice and its participants can influence the costs and benefits of elements of the proposed amendments, as well as their impact on efficiency, competition, and capital formation. This economic framework demonstrates how the features of the market for investment advice and its participants can influence whether certain investment adviser advertising practices promote or hinder economic efficiency.

The accuracy of investment adviser advertisements is an important factor in determining how investors decide which investment advisers to engage with. If investment advisers faced

fewer consequences for making untruthful statements about their performance in advertisements, investors would have more difficulty choosing an investment adviser. For the purposes of the proposed advertising rule, we use the term "ability" to refer to the usefulness and accuracy of advice an investment adviser is willing to provide for a given fee. The "potential fit" of an investment adviser refers to attributes that investors may have specific preferences for, such as communication style, investment style, or risk preference. For example, some investors would prefer an investment adviser that does not proactively provide advice or suggest investments, while others might prefer a more active communication style.

While the effectiveness and accuracy of an investment adviser's advertisements can have direct effects on the quality of the matches that investors make with investment advisers – in terms of both fit and better returns from the investment, there may be important indirect effects as well. If the proposed rules provide additional methods for investment advisers to credibly and truthfully advertise the quality of their services, investment advisers may have a greater incentive to invest more in the quality of their services, because advisers would be able to communicate the quality of these services more easily through advertisements. Additionally, because investors might be able to better observe the relative qualities of competing investment advisers, the proposed rules may also enhance competition between investment advisers. To the extent that the proposed rules improve the effectiveness and accuracy of investment adviser advertisements, the proposed rules could also have a secondary effect of increasing competition among investment advisers, and encourage investment in the quality of services.

Investors generally have access to a variety of sources of information on the ability and potential fit of an investment adviser. Advertisements, word of mouth referrals, and independent research are all ways in which investors acquire information about investment advisers as they

search for them. During this search, investors trade off the benefits of finding a better investment adviser against the costs of searching for one, or for more information about one. If the costs of search are too high, investors will contract with lower quality investment advisers on average, because they either do not know a higher quality alternative exists with the available information or are unable to evaluate the quality of the investment adviser they have found. Thus, higher search costs can result in inefficiencies because the same expected quality of match requires an investor to incur higher search costs. Similarly, for a fixed amount of spending on a search, an investor is less able to find information about investment advisers, and finds a lower expected quality of match.

Advertising and investor solicitation can potentially mitigate inefficiencies associated with the costs of searching for good products or suitable services. To the extent that advertising and investor solicitation provide accurate and useful information to investors about investment advisers at little or no cost to investors, advertising and investor solicitation can reduce the search costs that investors bear to acquire information and improve the ability of investors to identify high quality investment advisers. Investors have a variety of preferences over investment adviser characteristics such as investment strategies or communication styles. Investment adviser advertisements and use of solicitors can help communicate information about an investment adviser that may aid an investor in selecting an investment adviser who is a good "fit" for the investor's preferences.

While advertisements and communications by investment advisers and solicitors may reduce search costs, their incentives are not necessarily aligned with those of their potential investors, which may undercut the potential gains to efficiency. For example, investment advisers and solicitors have incentives to structure their advertisements to gain potential

investors, regardless of whether their advertisements correspond to their ability and potential fit with an investor. In addition, advertisements might make claims that are costly for investors to verify or are inherently unverifiable. For example, evaluating a claim that an investment adviser's strategy generates "alpha" or returns in excess of priced risk factors generally requires information about the strategy's returns and permitted holdings, as well as a model that attributes returns to risk factors. While some investors may have ready access to these resources or information, other investors may not. In some cases, an investor may be unable to assess the plausibility of an investment adviser's claims. An investment adviser or solicitor might also state facts but omit the contextual details that an investor would need to properly evaluate these facts.

Notably, there are considerable differences among investors and potential investors of investment advisers in their ability to process and evaluate information communicated by investment advisers. Many investors and prospective investors may lack the financial knowledge needed to evaluate and interpret the types of financial information contained in investment adviser advertisements. In 2010, the Dodd-Frank Act required the Commission to conduct a study to identify the existing level of financial literacy among retail investors as well as methods and efforts to increase the financial literacy of investors.[525] The Commission then contracted with the Federal Research Division at the Library of Congress to conduct a review of the quantitative studies on the financial literacy of retail investors in the United States.[526]

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525 U.S. Securities and Exchange Commission, *Study Regarding Financial Literacy Among Investors As Required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Aug. 2012), *available at* https://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf. ("Financial Literacy Study")

526 *See id.* Although the report does not link American investors specifically to those who would become clients of SEC registered investment advisers or investors in private pooled investment vehicles, we believe that the study may be indicative of the level of financial literacy for prospective investors.

According to the Library of Congress Report, studies show consistently that American retail investors[527] lack basic financial literacy. For example, studies have found that investors do not understand many elementary financial concepts, such as compound interest and inflation. Studies have also found that many investors do not understand other key financial concepts, such as diversification or the differences between stocks and bonds, and are not fully aware of investment costs and their impact on investment returns. [528] A 2016 FINRA survey found that 56 percent of respondents correctly answered less than half of a set of basic financial literacy questions, and yet 65 percent of respondents assessed their own knowledge about investing as high (between five and seven on a seven-point scale).[529]

The general lack of financial literacy among some investors makes it difficult for those investors to evaluate claims about financial services made in advertisements, which increases the risk that such investors are unable to effectively use the information in advertisements to find an investment adviser that has high ability and is a good fit.[530] Moreover, evidence presented in recent research suggests that market forces alone may not be sufficient to discipline financial professionals. Egan, Matvos and Seru (2019) observe that 44 percent of associated persons of broker-dealers with a history of misconduct are re-employed in the financial services industry

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527 The financial literacy studies in the Library of Congress Report (2011) fall into three categories, depending on the population or special topic under investigation. Most studies survey the general population. For example, the FINRA Investor Education Foundation's 2009 National Financial Capability study, which was included in the Library of Congress Report, consisted of a national sample of 1488 respondents. Other research included in the report focus on particular subgroups, such as women, or specific age groups or minority groups. A third type of study deals specifically with investment fraud. These studies do not differentiate between qualified purchasers, knowledgeable employees, and other investors. Results from studies conducted on general populations may not apply to private fund investors.

528 *See* Financial Literacy Study *supra* footnote 524.

529 "Investors in the United States." FINRA Investor Education Foundation, 2016.

530 Annamaria Lusardi and Olivia S. Mitchell, *The Economic Importance of Financial Literacy: Theory and Evidence*, 52 J. ECON. LITERATURE 5 (2014).

within a year.[531] Furthermore, prior offenders are found to be five times as likely to engage in new misconduct as the average registered representative.[532] Approximately 84 percent of active registered investment adviser representatives are dually registered with FINRA as broker-dealer representatives, who are the subjects studied in the paper.[533] To the extent that these results carry over to investment adviser advertisements, they potentially highlight the risk that false or exaggerated advertising exacerbates information asymmetries by providing investors, especially investors that lack financial literacy, an incorrect impression of an investment adviser's ability or quality of fit.

## C. Baseline

### 1. Market for Investment Advisers

#### a. *Current Rule*

As mentioned in adopting current rule 206(4)-1, the Commission targeted advertising practices that it believed were likely to be misleading by imposing four per se prohibitions. In addition to these prohibitions, the current rule prohibits any advertisement that contains any untrue statement of a material fact, or which is otherwise false or misleading. This prohibition operates more generally than the specific prohibitions to address advertisements that do not violate any per se prohibition but still may be fraudulent, deceptive, or manipulative and, accordingly, risk misleading investors.

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531 Mark Egan, Gregor Matvos and Amit Seru, *The Market for Financial Adviser Misconduct*, 127 J. POL. ECON. 233 (2019). The dataset used in the paper covers all financial services employees registered with FINRA from 2005 to 2015. The paper's results apply to the population represented by the dataset used in the study, some of which are investment adviser representatives. Roughly 84 percent of active registered investment adviser representatives were also dually registered with FINRA as broker-dealer representatives in 2017. (There were 286,799 dual broker-dealer –IA representatives, and 56,472 non-broker-dealer RIA representatives in 2017.) See, 2018 FINRA Industry Snapshot report, https://www.finra.org/sites/default/files/2018_finra_industry_snapshot.pdf).

532 *Id.*

533 *Id.*

### b. *Market Practice*

In addition to rule 206(4)-1, investment adviser advertising practices have been shaped by staff no-action letters and other staff guidance. For example, staff have issued no-action letters stating that the staff would not recommend enforcement actions under rule 206(4)-1(b) based on certain questions related to the definition of "advertisement," taking the position that, in general, a written communication by an adviser to an existing client or investor about the performance of the securities in the investor's account is not an "offer" of investment advisory services but is part of the adviser's advisory services (unless the context in which the performance or past specific recommendations are provided suggests otherwise), and that communications by an adviser in response to an unsolicited request by an investor, prospective client, or consultant for specified information is not an advertisement.[534]

The staff has also stated that it would not recommend enforcement action under section 206(4) on issues relating to third-party ratings and testimonials. The staff has stated that it would not recommend enforcement action if certain conditions were met regarding the use of ratings or testimonials, such as: (i) references to independent third-party ratings that are developed by relying significantly on client surveys or clients' experiences more generally;[535] (ii) the use of "social plug-ins" such as the "like" feature on an investment adviser's social media site;[536] and

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534 *See supra* footnote 59.

535 *See* Investment Adviser Association, SEC Staff No-Action Letter (Dec. 2, 2005) (not recommending enforcement action if in determining whether a third-party rating is a testimonial, the adviser considers the criteria used by the third party when formulating the rating and the significance to the ratings formulation of criteria related to client evaluations of the adviser); DALBAR, Inc., SEC Staff No-Action Letter (Mar. 24, 1998) (not recommending enforcement action if an adviser used references to third-party ratings that reflect client experiences, provided certain conditions were met and certain disclosures made, both of which designed to ensure the that rating is developed in a fair and unbiased manner and that disclosures provide investors with sufficient context to make informed decisions).

536 *See, e.g.,* National Examination Risk Alert, Office of Compliance, Inspections and Examinations (Jan. 4, 2012).

(iii) references regarding, for example, an adviser's religious affiliation or moral character, trustworthiness, diligence or judgement, in addition to more typical testimonials that reference an adviser's technical competence or performance track record.[537] The Commission has also stated that an adviser should consider the application of rule 206(4)-1, including the prohibition on testimonials, before including hyperlinks to third-party websites on its website or in its electronic communications.[538] For example, staff has stated that it would not recommend enforcement action, under certain conditions, when an adviser provided: (i) full and partial client lists[539]; and (ii) references to unbiased third-party articles concerning the investment adviser's performance.[540]

Staff no-action letters have stated that the staff would not recommend enforcement action under rule 206(4)-1 for references to specific investment advice in an advertisement, notwithstanding the rule's general prohibition of the use of past specific recommendations. An adviser that is able to rely on a staff no-action letter may include past specific recommendations in an advertisement provided the recommendations were selected using performance-based or

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537 *See* Gallagher and Associates, Ltd., SEC Staff No-Action Letter (July 10, 1995) (where the staff reiterated its view that rule 206(4)-1 prohibits testimonials of any kind concerning the investment adviser); *see also* IM Guidance Update No. 2014-04, at note 12 and accompanying text, in which staff partially withdrew its Gallagher position.

538 *See* Interpretive Guidance on the Use of Company Web Sites, Release No. IC-28351 (Aug. 1, 2008); *see also* Guidance on the Testimonial Rule and Social Media, IM Guidance Update No. 2014-04, at n.19 and accompanying text.

539 *See, e.g.,* Cambiar Investors, Inc., SEC Staff No-Action Letter (Aug. 28, 1997) (stating it would not recommend enforcement action when the adviser proposed to use partial client lists that do no more than identify certain clients of the adviser, the Commission staff stated its view that partial client lists would not be testimonials because they do not include statements of a client's experience with, or endorsement of, an investment adviser); *see also* Denver Investment Advisors, Inc., SEC Staff No-Action Letter (July 30, 1993) (providing that partial client lists can be, but are not necessarily, considered false and misleading under 206(4)-1(a)(5)).

540 *See* New York Investors Group, Inc., SEC Staff No-Action Letter (Sept. 7, 1982) (stating that an unbiased third-party article concerning an adviser's performance is not a testimonial unless the content includes a statement of a customer's experience with or endorsement of the adviser).

objective, non-performance-based criteria, and in either case, the adviser practices are consistent with a number of specific conditions articulated in the no action letters.[541] For example, the staff stated that it would not recommend enforcement action if an adviser included in an advertisement a partial list of recommendations provided that, in general, the list: (i) includes an equal number (at least five) of best and worst-performing holdings; (ii) takes into account consistently the weighting of each holding within the portfolio (or representative account) that contributed to the performance during the measurement period; (iii) is presented consistently from measurement period to measurement period; and (iv) discloses how to obtain the calculation methodology and an analysis showing every included holding's contribution to the portfolio's (or representative account's) overall performance.[542]

The staff has also stated that it would not recommend enforcement action if an adviser includes in an advertisement a partial list of recommendations selected using objective, non-performance-based criteria, provided that, in general: (i) the same selection criteria are used consistently from measurement period to measurement period (ii) there is no discussion of the profits or losses (realized or unrealized) of any specific securities; and (iii) the adviser maintains certain records, including, for example, records that evidence a complete list of securities recommended by the adviser in the preceding year for the specific investment category covered

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541 *See, e.g.,* Scientific Market Analysis, SEC Staff No-Action Letter (Mar. 24, 1976) (the staff would not recommend enforcement action when an investment adviser offers a list of past specific recommendations, provided that the adviser offers to provide the list free of charge); and Kurtz Capital Management, SEC Staff No-Action Letter (Jan. 18, 1988) (the staff would not recommend enforcement action relating to an adviser's distribution of past specific recommendations contained in third-party reports, provided that the adviser sends only bona-fide unbiased articles).

542 *See* The TCW Group, SEC Staff No-Action Letter (Nov. 7, 2008) (not recommending enforcement action provided that the adviser met certain other conditions such as presenting best and worst-performing holdings on the same page with equal prominence; disclosing that the holdings identified do not represent all of the securities purchased, sold or recommended for the adviser's clients and that past performance does not guarantee future results; and maintaining certain records, including, for example, evidence supporting the selection criteria used and supporting data necessary to demonstrate the calculation of the chart or list's contribution analysis).

by the advertisement and the criteria used to select the specific securities listed in the advertisement.[543]

Finally, the Commission has brought enforcement actions related to the presentation of performance results in advertisements. For example, we have alleged in settled enforcement actions that the performance information that certain advisers included in their advertisements failed to disclose all material facts, and thus created unwarranted implications or inferences.[544] Our staff has also expressed its views as to the types of disclosures that would be necessary in order to make the presentation of certain performance information in advertisements not misleading.[545] Our staff has taken the position that the failure to disclose how material market conditions, advisory fee expenses, brokerage commissions, and the reinvestment of dividends affect the performance results would be misleading.[546] Our staff has also considered materially misleading the suggestion of potential profits without disclosure of the possibility of losses.[547]

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543 *See* Franklin Management, Inc., SEC Staff No-Action Letter (Dec. 10, 1998) (not recommending enforcement action provided that the adviser met certain other conditions such as requiring that the adviser disclose in the advertisement that the specific securities identified and described do not represent all of the securities purchased, sold, or recommended for advisory clients, and that the investor not assume that investments in the securities identified and discussed were or will be profitable).

544 *See, e.g.,* In re Van Kampen Investment Advisory Corp., Release No. IA-1819 (Sept. 8, 1999)(settled order); In re Seaboard Investment Advisers, Inc., Release No. IA-1431 (Aug. 3, 1994)(settled order).

545 *See, e.g.,* Clover Capital Mgmt., Inc., SEC Staff No-Action Letter (Oct. 28, 1986) (not recommending enforcement action provided that certain disclosures about included performance results are made). Regarding mutual funds, our staff has stated that it would not recommend enforcement action if an advertisement included performance data from private accounts that are substantially similar in size and investment strategy to the fund in the fund's prospectus or sales literature provided that the prospectuses or advertisements: (i) disclose that the performance results are not those of the fund and should be considered a substitute for such performance; (ii) include the fund's performance results if such results exist and; (iii) disclose all material differences between the institutional accounts and the fund. *See* Nicholas-Applegate Mutual Funds, SEC Staff No-Action Letter (Aug. 6, 1996); GE Funds, SEC Staff No-Action Letter (Feb. 7, 1997); ITT Hartford Mutual Funds, SEC Staff No-Action Letter (Feb. 7, 1997).

546 *See* Clover Capital Management., Inc., SEC Staff No-Action Letter (Oct. 28, 1986) (not recommending enforcement action provided that that if an adviser compares performance to that of an index, they must disclose all material factors affecting the comparison) *See also* Investment Company Institute, SEC Staff No-Action Letter (May 5, 1988); Association for Investment Management and Research, SEC Staff No-Action Letter (Dec. 18, 1996) (not recommending enforcement action provided that gross performance results may be provided to clients so long as this information is presented on a one-on-one basis or

Our staff has taken the position that prior performance results of accounts managed by a predecessor entity may be used so long as: (i) the person responsible for such results is still the adviser; (ii) the prior account and the present account are similar enough that the performance results would provide relevant information; (iii) all prior accounts that are being managed in a substantially similar fashion to the present account are being factored into the calculation; and (iv) the advertisement includes all relevant disclosures.[548] More recently, our staff has taken the position that, subject to certain conditions, a surviving investment adviser following an internal restructuring may continue to use the performance track record of a predecessor advisory affiliate to the same extent as if the restructuring had not occurred.[549]

Regarding the use of model performance results, our staff has indicated it would consider such results misleading under rule 206(4)-1(a)(5) if the investment adviser fails to make certain disclosures.[550] Our staff has also indicated it would find the use of backtested performance data to be misleading unless accompanied by disclosure detailing the inherent limitations of data

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alongside net performance with appropriate disclosure.) *See Also* Securities Industry Association, SEC Staff No-Action Letter (Nov. 27, 1989) (not recommending enforcement action provided that an adviser that advertises historical net performance using a model fee makes certain disclosures.)

547 *Id.*

548 *See* Horizon Asset Management, LLC, SEC Staff No-Action Letter (Sept. 13, 1996); *see also* Great Lakes Advisers, Inc., SEC Staff No-Action Letter (Apr. 3, 1992) (not recommending enforcement action if a successor adviser, composed of less than 100 percent of the predecessor's committee, used the preceding performance information in their calculation so long as there is a substantial identification of personnel, and noting that without substantial identification of personnel in such a committee, use of the data would be misleading even with appropriate disclosure.)

549 *See* South State Bank SEC Staff No-Action Letter (May 8, 2018) (conditioning the staff's position not to recommend enforcement action on representations including, for example, that the successor adviser would operate in the same manner and under the same brand name as the predecessor adviser).

550 *Id. See also In re LBS Capital Mgmt., Inc.*, Release No. IA-1644 (July 18, 1997) (not recommending enforcement action provided that the Commission will look into the identity of the intended recipient of advertisement when determining if the results were misleading.)

derived from the retroactive application of a model developed with the benefit of hindsight.[551] Moreover, staff have taken the position that the rule 204-2(a)(16) requirement to keep records of documents necessary to form the basis for performance data provided in advertisements also applies to a successor's use of a predecessor's performance data.[552]

### c. *Data on Investment Advisers*

Based on Form ADV filings, as of Sep 30, 2019, 13,463 investment advisers were registered with the Commission. Of these registered investment advisers ("RIAs"), 11,289 reported that they were "large advisory firms," with regulatory assets under management ("RAUM") of at least $90 million. 538 reported that they were "mid-sized advisory firms," with RAUM of between $25 million and $100 million, and 1,639 did not report as either, which implies that they have regulatory assets under management of under $25 million.[553]

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551 *See re Market Timing Systems, Inc., et al.,* Release No. IA-2047 (Aug. 28, 2002) (settled order) (the Commission brought an enforcement action against, among others, a registered investment adviser, asserting that its advertising was misleading because it failed to disclose that performance results advertised were hypothetical and generated by the retroactive application of a model, and in other cases failed to disclose the relevant limitations inherent in hypothetical results and the reasons why actual results would differ); *see also In re Leeb Investment Advisers, et al.,* Release No. IA-1545 (Jan. 16, 1996) (settled order) (the Commission brought an enforcement action against, among others, a registered investment adviser, asserting that advertising mutual fund performance using a market-timing program based on backtested performance was misleading because the program changed during the measurement period and certain trading strategies were not available at the beginning of the measurement period). *See also In re Schield Mgmt. Co., et al.,* Release No. IA-1872 (May 31, 2000) (settled order) (The Commission brought an enforcement action against, among others, a registered investment adviser, asserting that advertisements presenting backtested results were misleading in violation of section 206(2) and rule 206(4)-1 because, among other things, they failed to disclose or inadequately disclosed that the performance was backtested, and stating that labeling backtested returns "hypothetical" did not fully convey the limitations of the performance).

552 Rule 204-2(a)(16); *See* Great Lakes Advisors, Inc., SEC Staff No-Action Letter (Apr. 3, 1992) (not recommending enforcement action and stating the staff's view that the requirement in rule 204-2(a)(16) applies to a successor's use of a predecessor's performance data.)

553 From Form ADV: a "Large advisory firm" either: (a) has regulatory assets under management of $100 million or more or (b) has regulatory assets under management of $90 million or more at the time of filing its most recent annual updating amendment and is registered with the SEC; a "mid-sized advisory firm" has regulatory assets under management of $25 million or more but less than $100 million and either: (a) not required to be registered as an adviser with the state securities authority of the state where they maintain

Form ADV disclosures show $83.9 trillion RAUM for all registered investment advisers, with an average of $6.23 billion RAUM and a median of $318 million. These values show that the distribution of RAUM is skewed, with more RIAs managing assets below the average, than above.

The majority of Commission-registered investment advisers report that they provide portfolio management services for individuals and small businesses.[554] In aggregate, investment advisers have over $83 trillion in assets under management ("AUM"). A substantial percentage of AUM at investment advisers is held by institutional investors, such as investment companies, pooled investment vehicles, and pension or profit-sharing plans.[555] Based on staff analysis of Form ADV data, 8,396 (62 percent) have some portion of their business dedicated to individual clients, including both high net worth and non-high net worth individual clients.[556] However, using the number of high-net worth clients as a basis for estimating the number of non-retail clients likely significantly overstates the number of non-retail clients. In total, these firms have approximately $41.2 trillion of AUM,[557] of which $11 trillion is attributable to clients, including both non-high net worth and high net worth clients. Approximately 7,330 registered investment

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their principal office and place of business or (b) not subject to examination by the state securities authority of the state where they maintain their principal office and place of business.

554 Of the 13,463 SEC-registered investment advisers, 8,569 (64 percent) report in Item 5.G.(2) of Form ADV that they provide portfolio management services for individuals and/or small businesses. In addition, there are approximately 17,933 state-registered investment advisers. Approximately 14,360 state-registered investment advisers are retail facing (see Item 5.D. of Form ADV).

555 See Table 1. High-net worth clients are not necessarily qualified purchasers for purposes of the rule's distinction between retail and non-retail advertisements.

556 We use the responses to Items 5(D)(a)(1), 5(D)(a)(3), 5(D)(b)(1), and 5(D)(b)(3) of Part 1A of Form ADV. If at least one of these responses was filled out as greater than 0, the firm is considered as providing business to retail investors. Form ADV Part 1A. Of the 8,396 investment advisers serving individual clients, 311 are also registered as broker-dealers.

557 The aggregate AUM reported for these investment advisers that have retail investors includes both retail AUM as well as any institutional AUM also held at these advisers.

advisers (54 percent) serve 31.4 million non-high net worth individual[558] clients and have approximately $4.8 trillion in AUM attributable to the non-high net worth clients, while nearly 8,143 registered investment advisers (60 percent) serve approximately 4.6 million high net worth clients with $6.1 trillion in AUM attributable to the high-net worth clients. The Commission preliminarily believes that many advisers currently prepare and present Global Investment Performance Standards ("GIPS")-compliant performance information, and also that many advisers, particularly private fund advisers, currently prepare annual performance for investors.

### 2. Market for Solicitors

#### a. *Current Rules*

The current rule makes paying a cash fee for referrals of advisory clients unlawful unless the solicitor and the adviser enter into a written agreement that, among other provisions, requires the solicitor to provide the client with a current copy of the investment adviser's Form ADV brochure and a separate written solicitor disclosure document at the time of solicitation.[559] The solicitor disclosure must contain information highlighting the solicitor's financial interest in the investor's choice of an investment adviser.[560] In addition, the rule prescribes certain methods of compliance, such as requiring an adviser to receive a signed and dated acknowledgment of receipt of the required disclosures.[561] The current rule also prohibits advisers who have engaged in certain misconduct from acting as solicitors.[562]

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558 A high net worth (HNW) individual is an individual who is a "qualified client". Generally, this means a natural person with at least $1,000,000 assets under the management of an adviser, or whose net worth exceeds $2,100,000 (excluding the value of his or her primary residence).

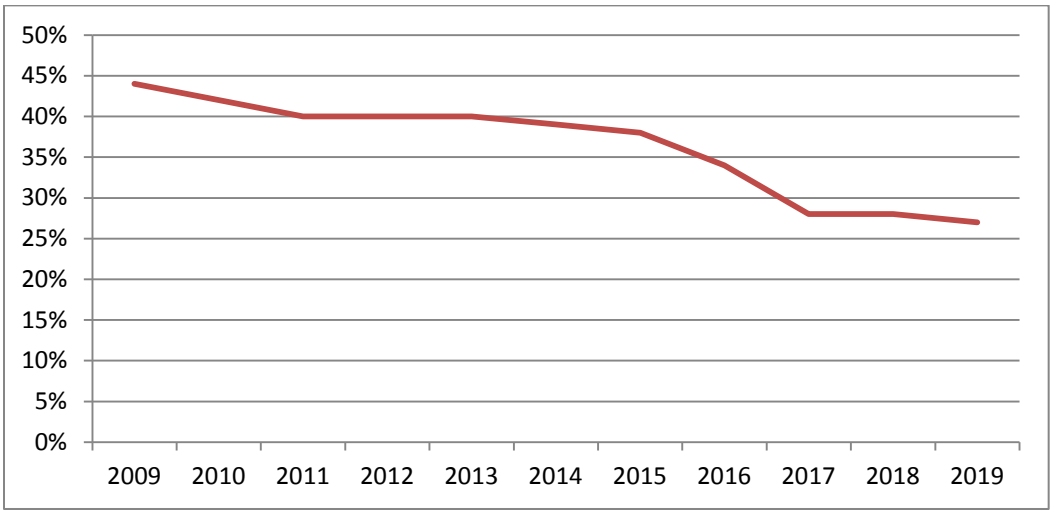
559 *See supra* footnote 28.

560 *See supra* footnote 29.

561 *See supra* footnote 30.

562 *See* rule 206(4)-3(a)(1)(ii).

Figure [1] Percent of RIA that Compensate Persons besides Employees for Client Referrals




Given that there is no registration requirement for solicitors of investment advisers, our only view on solicitation practices is through the disclosures made by registered investment advisers in Form ADV. As of August 2019, 27 percent of registered investment advisers reported compensating any person besides an employee for client referrals.[563] Based on Figure [1], the share of registered investment advisers that reported this type of arrangement has declined since 2009. However, this figure does not capture employees of an investment adviser that are compensated for client referrals, who are solicitors under the current rule. The downward trend of Figure [1] may suggest that the use of solicitors is declining through an overall decline in client referral activity. Or, the chart may suggest that employers are shifting their solicitation activities in-house.

### b. *RIAs to Private Funds*

Based on Form ADV data from Sep 30 2019, 4865 RIAs report that they are advisers to private funds, and 44 of them report that they are a small entity.[564] Of the RIAs that advise

563 Response to Item 8(h)(1) of Part 1A of Form ADV.

564 Form ADV Item 5.F. and Item 12.

private funds, 1590 RIAs report to use the services of solicitors ("marketers" in Form ADV) that are not their employees or themselves ("related marketers" in Form ADV). Among the RIAs that hire solicitors, each RIA uses 3 solicitors on average, while the median number of solicitors reported is 1, and the maximum is 79. There are 340 RIAs indicate that they have at least one related marketer, and 210 of them indicate that they only hire related marketers. Among RIAs that report using a related marketer, the average number of related marketers reported is 1.7, while the median reported is 1 and the maximum is 21. 1315 RIAs indicate that they have at least one marketer which is registered with the SEC: the average number of SEC registered marketers employed by these RIAs is 2.1, while the median number reported is 1 and the maximum is 49. Finally, 556 RIAs indicate that they have at least one non-US marketer: the average number of non-US marketers reported among these RIAs is 2.9, while the median is 1 and the maximum is 71. [565]

### 3. RIA Clients

SEC-registered advisers are required to report their specific number of clients in 13 different categories and a catch-all "Other" category.[566] Based on Form ADV data collected as of September, 2019, SEC-registered advisers report having a total of approximately 38 million clients, and 84 trillion RAUM. Individual investors constitute the majority (92 percent) of the RIA client base. Columns 2 and 3 of Table 1 present the breakdown of the RIA client base, and column 4 shows the total RAUM from each investor category as of October 2018.

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565 Data on solicitors (marketers) hired by RIAs to private funds are collected from Form ADV Section 7.B(1)(28).

566 Form ADV Item 5.D. of Part 1A.

Non-high net worth (HNW) individuals comprise the largest group of advisory clients by client number – 78 percent of total clients. The number of HNW individuals is only 13 percent of advisory clients, but RAUM from HNW individuals makes up almost 7 percent of the industry-wide RAUM ($82.5 trillion) in 2018, while RAUM from non-HNW individuals accounts for about 5.5 percent. Investment companies and other pooled investment vehicles and pension plans represent the largest portion of RAUM among all non-retail investors.

Table [1]

| Investor Categories | Clients | Clients (%) | RAUM (Billions) | RAUM (%) | Advisers |
|---|---|---|---|---|---|
| **Non-HNW individuals** | 27,996,201 | 78.288% | $ 4,842.93 | 5.429% | 7,068 |
| **HNW individuals** | 4,763,963 | 13.322% | $ 6,119.78 | 6.860% | 7,854 |
| **Other investment advisers** | 824,986 | 2.307% | $ 1,784.57 | 2.000% | 1,045 |
| **Corporations or other businesses** | 434,859 | 1.216% | $ 2,975.73 | 3.336% | 5,050 |
| **Pension and profit sharing plans** | 426,570 | 1.193% | $ 6,233.17 | 6.987% | 5,626 |
| **Other** | 338,150 | 0.946% | $ 2,365.03 | 2.651% | 1,484 |
| **Pooled Investment Vehicles (PIVs)- Other** | 221,594 | 0.620% | $ 21,856.89 | 24.500% | 5,384 |
| **State/municipal entities** | 219,058 | 0.613% | $ 3,805.27 | 4.265% | 1,399 |
| **Charities** | 200,256 | 0.560% | $ 1,261.84 | 1.414% | 4,832 |
| **Banking or thrift institutions** | 183,886 | 0.514% | $ 1,078.13 | 1.209% | 633 |
| **Insurance companies** | 101,171 | 0.283% | $ 5,374.18 | 6.024% | 1,079 |
| **PIVs – Investment companies** | 47,188 | 0.132% | $ 29,673.14 | 33.262% | 1,831 |
| **Sovereign Wealth Funds and Foreign official institutions** | 1,412 | 0.004% | $ 1,691.79 | 1.896% | 193 |
| **PIVs – Business development companies** | 1,175 | 0.003% | $ 148.61 | 0.167% | 109 |

A number of surveys show that individuals[567] predominantly find their current financial firm or financial professional from personal referrals by family, friends, or colleagues, rather than through advertisements.[568] For instance, a 2008 study conducted by RAND reported that 46

567 The surveys generally use "retail investors" to refer to individuals that invest for their own personal accounts.

568 *See* Angela A. Hung, et al., *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers,* RAND Institute for Civil Justice Technical Report (2008), *available at* https://www.rand.org/content/dam/rand/pubs/technical_reports/2008/RAND_TR556.pdf ("RAND 2008"),

percent of survey respondents indicated that they located a financial professional from personal referral, although this percentage varied depending on the type of service provided (*e.g.*, only 35 percent of survey participants used personal referrals for brokerage services). After personal referrals, RAND 2008 survey participants ranked professional referrals (31 percent), print advertisements (4 percent), direct mailings (3 percent), online advertisements (2 percent), and television advertisements (1 percent), as their source of locating individual professionals. The RAND 2008 study separately inquired about locating a financial firm,[569] in which respondents reported selecting a financial firm (of any type) based on: referral from family or friends (29 percent), professional referral (18 percent), print advertisement (11 percent), online advertisements (8 percent), television advertisements (6 percent), direct mailings (2 percent), with a general "other" category (36 percent).

The Commission's 2012 Financial Literacy Study provides similar responses, although it allowed survey respondents to identify multiple sources from which they obtained information that facilitated the selection of the current financial firm or financial professional.[570] In the 2012 Financial Literacy Study,[571] 51 percent of survey participants received a referral from family, friends, or colleagues. Other sources of information or referrals came from: referral from another financial professional (23 percent), online search (14 percent), attendance at a financial professional-hosted investment seminar (13 percent), advertisement (*e.g.*, television or

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which discusses a shift from transaction-based to fee-based brokerage accounts prior to recent regulatory changes; *see also* Financial Literacy Study, *supra* footnote 524.

569 The Commission notes that only one-third of the survey respondents that responded to "method to locate individual professionals" also provided information regarding locating the financial firm.

570 *See* Financial Literacy Study, *supra* footnote 524.

571 The data used in the 917 Financial Literacy Study comes from the Siegel & Gale, Investor Research Report (Jul. 26, 2012), *available at* https://www.sec.gov/news/studies/2012/917-financial-literacy-study-part3.pdf.

newspaper) (11.5 percent), other (8 percent), while approximately 4 percent did not know or could not remember how they selected their financial firm or financial professional. Twenty-five percent of survey respondents indicated that the "name or reputation of the financial firm or financial professional" affected the selection decision.

### D. Costs and Benefits of the Proposed Rule and Form Amendments

In this section, we first outline the overall costs and benefits of the general structure and prohibitions of the proposed rule and form amendments, and later discuss the costs and benefits of specific provisions of the proposed amendments. We have considered the potential costs and benefits of the amendments, but these economic effects are generally difficult to quantify. Several factors make quantification of the potential effects of the proposed rule difficult. First, there is little to no direct data suggesting how investment advisers might alter their advertising practices as a result of the proposed rule or mitigate the compliance burdens related to the proposed rule. Second, it is difficult to quantify the impact that the specific disclosures required in the proposed rule would have on investor behavior because we cannot meaningfully predict the impact on investor behavior that the proposed rule might have. In addition, the specific provisions of the proposed rule sometimes contain multiple effects that could potentially affect investor behavior in opposing directions. Without knowing the magnitude of these opposing effects, it is not possible to quantify the net effect of specific provisions of the proposed rule. Finally, it is difficult to quantify the extent to which certain changes in adviser and investor behavior enhance or diminish the welfare of specific market participants. For example, if investors increased the amount of regulatory assets under management as a result of the proposed rule, it is not clear that investor welfare would have improved, without knowing the extent to which the proposed rule also affected the quality of investment advisers that investors chose.

Some advisers might have to advertise at a (net) cost due to competitive pressure; or they might seek to increase their fees due to marketing, and the burden could be partially transferred to investors. In addition, the total welfare effects of the rule are distinct from the welfare effects on a specific type of market participant.

Instead of directly quantifying the effect brought by the proposed rule in the market of investment advice, a close alternative is to learn from a comparable market that is also advised by registered investment advisers, *i.e.*, the mutual fund market. The study mentioned in section D.1 quantifies the effect of advertising on investor welfare in the mutual fund market, which serves as a reference, though the finalized effect of the proposed rule still will not be exactly the same. We encourage commenters to provide data and information to help quantify the benefits, costs, and the potential impacts of the proposed rule on efficiency, competition, and capital formation. In those circumstances in which we do not currently have the requisite data to assess the impact of the proposal quantitatively, we have qualitatively analyzed the economic impact of the proposed rule.

### 1. General Costs and Benefits of the Advertising Rule

Broadly speaking, the proposed advertising rule expands the definition of "advertisement," and expands the set of permissible elements in advertisements that an investment adviser can disseminate relative to the baseline. This expanded set of permissible elements are subject to additional required disclosures.

The proposed rule would change the definition of "advertisement" to 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. This would expand the set of communications subject to the advertisement prohibitions, including both the general anti-fraud prohibitions, as well as the specific prohibitions of the proposed rule.

In addition, the proposed general anti-fraud prohibitions would prohibit certain advertising practices, and would include disclosure requirements designed to prevent other misleading statements. By reducing the potential for misleading or fraudulent statements in these additional communications, the prohibitions of the proposed rule would provide investors with protections. While expanding the set of communications covered by the definition of "advertisement" and subject to prohibitions applicable to all advertisements, the proposed advertising rule permits some new elements in advertisements, and provides advisers with additional flexibility in the creation and dissemination of advertisements and communications, conditional on meeting disclosure requirements designed to support investor protection. At the same time, this additional flexibility for advisers could impose costs on investors, particularly individuals with less access to financial knowledge and resources, if new advertisements are unrelated to the underlying performance of an investment adviser, or if the disclosures cannot be properly digested by the recipients of the advertisements – especially those without relevant financial knowledge or resources. However, we anticipate that these costs would be limited by the additional requirements for fair and balanced references to specific investment advice and portrayals of advisers' performance in advertisements. These new elements and the additional flexibility could also lead to more spending on advertising, and these additional costs could be passed through to investors.

The proposed amendments would provide additional flexibility to investment advisers in certain respects, but also impose additional restrictions on certain types of advertisements that

investment advisers currently use. In evaluating whether to take advantage of the flexibility provided by new amendments, investment advisers must weigh the potential benefits of newly permitted forms of communication against the compliance burdens of additional disclosure requirements associated with those forms of communication. Thus, an investment adviser that modifies its advertisements as a result of the proposed rule has likely determined the benefits of the modifications justify the costs. However, we acknowledge that this does not necessarily mean that investment advisers would experience a net benefit as a result of those provisions of the proposed rules that provide additional flexibility. As we discuss further below, there is a possibility that investment advisers may also enter a costly "arms race" in advertising spending. Investment advisers that modify their advertising might expend resources on more expensive advertisements to compete against other investment advisers that are also producing expensive advertisements, without necessarily experiencing increases in revenues.

Investment adviser advertising under the proposed rule will likely include more information given the changes in information permitted by the rule, with additional disclosures provided to protect investors.[572] On its face, an increase in information could improve investor outcomes in several ways. The additional information in advertisements could aid investors by increasing investor awareness of different service providers' offerings, thus reducing search costs. Reducing the cost of search may not only aid investors as they search for investment advisers, but might also promote competition among investment advisers if expanded options for advertising permits investment advisers with higher ability to more credibly signal that ability to potential investors and clients under the proposed rule. For example, to the extent that third

[572] While we preliminarily believe that the advertising rule will improve the information available to investors, there is a possibility that investment advisers would not alter their advertisements as a result of the rule.

party ratings are correlated with investment adviser ability, investment advisers would be able to present these ratings to potential clients under the proposed rule, who could, in turn use these ratings as part of their overall assessment of the investment adviser as they consider entering into an advisory relationship.

The proposed rule generally would require investment advisers to include disclosures to provide investors with additional context that would help them evaluate an investment adviser's claims. While information contained in required disclosures might be useful to investors, it is not clear to what extent investors, especially retail investors, would have the financial knowledge, experience or access to resources to i) fully process these disclosures to assess an investment adviser's claims, and ii) fully account for an investment adviser or solicitor's conflicts of interest when choosing among investment advisers. Disclosures may reduce or eliminate information awareness and acquisition costs, but individuals may still face difficulties utilizing this information in their decision-making process, which may also vary depending on the investor's level of financial sophistication and access to expertise.

In order to gauge the general effect of the proposed advertising rule on the market for investment advice, the practices in a neighboring market could lend some insight. Mutual funds, which are managed by registered investment advisers, advertise to reach more investors. Although mutual funds, private pooled investment vehicles, and investment adviser separate account advisory services are not subject to identical regulatory requirements, similarities among their economic features lend themselves to comparison: specifically, they all may target

similar types of clients and investors and all have an information asymmetry problem between investors and financial service providers.[573]

Academic literature on marketing for mutual funds has examined: (i) how advertising affects investors--both in terms of flows (cash to be managed by financial service providers) and returns (return net of fees back to investors); (ii) how marketing may help imperfectly informed investors find better service providers, *i.e.*, reduce search cost; and (iii) the extent to which competition among financial service providers generates wasteful spending on advertising. To the extent that the market for mutual funds shares common features with the market for private funds and for other types of investment adviser services, evidence from the mutual fund industry may help us understand the potential impact of the proposed advertising rule on the market for investment advisory services and private funds.

A positive relation between funds' marketing efforts and investor flows (cash investment from investors) is well-documented among mutual funds.[574] Because marketing brings in more business and revenues for asset managers, it is important to understand the expenditure associated with marketing, especially its significance to investors. In the context of mutual

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573 Note that while mutual funds are often marketed to retail investors, private funds are marketed to at least accredited investors and often to qualified purchasers.

574 *See* Prem Jain and Joanna Wu, *Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows*, 2 J. FIN 937 (2000) finding that advertising in funds increases flows (comparing advertised funds with non-advertised funds closest in returns and with the same investment objective). Reuter and Zitzewitz (2006) find indirect evidence that advertising can increase fund flows. Controlling for past media mentions and a variety of fund characteristics, a single additional positive media mention for a fund is associated with inflows ranging from 7 to 15 percent of its assets over the following 12 months. Jonathan Reuter and Eric Zitzewitz, *Do Ads Influence Editors? Advertising and Bias in the Financial Media*, 121 Q. JOURNAL ECON. 197 (2006). While positive mentions significantly increase fund inflows, they do not successfully predict returns to investors. Other papers, including Gallaher, Kaniel and Starks (2006) and Kaniel and Parham (2016), also find a significant and positive impact of advertising expenditures and the resulting media prominence of the funds on fund inflows. Steven Gallaher, Ron Kaniel and Laura T. Starks, *Madison Avenue Meets Wall Street: Mutual Fund Families, Competition and Advertising* (SSRN, Jan. 2006); Ron Kaniel and Robert Parham, *WSJ Category Kings – The Impact of Media Attention on Consumer and Mutual Fund Investment Decisions*, 123 J. FIN. ECON. 1 (2016).

funds, marketing expenses[575] contribute to an advisory firm's total operational cost, and fund shareholders will bear at least part of the cost in the form of fund expense, unless shareholders switch to a similar fund with lower expenses. One study observes that firms also choose to charge more fees to cover the marketing cost as they engage in an "arms race" for a similar pool of investors.[576] While some portion of the costs associated with this costly competitive advertising spending would be absorbed by mutual fund advisers, other portions would be passed on to investors. The authors argue that as fees increase, investors with a high– search cost - usually those with lower financial literacy - are more likely to suffer a (net) loss because they are more likely to match with an asset manager with poor ability, and because higher fees further reduce returns. Investors equipped with financial knowledge or access to resources to fully process the additional information conveyed in advertisements and disclosures may perceive

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575 12b-1 fees. A 12b-1 fee is an annual marketing or distribution fee paid by a mutual fund. It is paid by the fund out of fund assets to cover distribution expenses and sometimes shareholder service expenses (see rule 17 CFR 270.12b-1). It is considered to be an operational expense and, as such, is included in a fund's expense ratio. The rule permits a fund to pay distribution fees out of fund assets only if the fund has adopted a plan (12b-1 plan) authorizing their payment. "Distribution fees" include fees paid for marketing and selling fund shares, such as compensating brokers and others who sell fund shares, and paying for advertising, the printing and mailing of prospectuses to new investors, and the printing and mailing of sales literature. The SEC does not limit the size of 12b-1 fees that funds may pay, although FINRA rules limit the amount that may be charged by a fund sold by FINRA member broker-dealers. Although some mutual fund managers also pay marketing/service costs out of their own resources, the 12b-1 fee is used as a close approximation for marketing expenses in the finance literature, because both marketing and distribution costs are costs incurred to promote the asset management service. In addition, various shareholder services fees and administrative fees may be paid outside 12b-1 plans (such as revenue sharing) may provide additional compensation to distribution intermediaries. As a consequence, the use of 12b-1 fees as a proxy for marketing costs may understate the total payments made for marketing by funds and their advisers.

576 Roussanov, Ruan and Wei (2018) study the social welfare (net investor welfare plus asset manager welfare) implications of advertising. They find that marketing expenses are nearly as important as price (i.e., expense ratio) or performance for explaining fund size (AUM). Marketing increases funds' size (asset under management) and brings in more revenue for all funds, regardless of their performance. One extra basis point in marketing fees prompted a 1.15 percent increase in AUM for funds with the best returns, but even for those with the lowest returns it boosted a fund's size by 0.97 percent. Nikolai Roussanov, Hongxun Ruan, and Yanhao Wei, *Marketing Mutual Funds* (NBER Working Paper 25056, Sept. 2018).

potential benefits of improved information and match efficiency that justify higher fees.[577] These results point to potential inefficiencies that could result from the proposed rule if the antecedents of the "arms race" result described in the academic literature that are present between mutual funds and investors are also present between investment advisers and their clients. However, differences between these markets may limit the generalizability of results from studies of mutual fund marketing to the potential impacts of the proposed rule.

The proposed rule defines a "Non-Retail Advertisement" as an advertisement for which an investment adviser has adopted and implemented policies and procedures reasonably designed to ensure that the advertisement is disseminated solely to a "qualified purchaser" or a "knowledgeable employee." As with the proposed definition of "advertisement" (see section 2.a), we expect the proposed definition of "Non-Retail Advertisement" will alter the economic effects of the proposed rule because the obligations of investment advisers differ for Non-Retail Advertisements under certain circumstances. Thus, the programmatic costs and benefits of certain elements of the proposed rule will not only be determined by the scope of entities that are considered non-retail investors, but will also be determined by the extent to which the definition of non-retail investors is calibrated appropriately relative to the proposal's substantive requirements.

Although the staff is not aware of any direct research on the Qualified Purchaser standard and its relationship with financial literacy, multiple studies have found a strong positive correlation between wealth and financial literacy.[578] This evidence suggests that the division of

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577 Some institutional investors will expend resources as part of their own search costs. For example, some institutional investors pay consultants to conduct RFPs for money managers or private funds.

578 *See e.g.,* Annamaria Lusardi, Pierre-Carl Michaud, and Olivia S. Mitchell, *Optimal Financial Knowledge and Wealth Inequality,* 125 J. POL. ECON. 431 (2017); Jere R. Behrman et al., *How Financial Literacy*

certain programmatic requirements may yield benefits by tailoring the provisions of the proposed rule to the financial literacy of the investors that would receive a respective advertisement. In addition, Qualified Purchasers would likely have access to the resources necessary to gain access to expertise and information.[579] Similarly, the requirements for an employee to be a Knowledgeable Employee strongly suggest that the employee has the experience with investment management necessary to properly interpret the same advertisements that a Qualified Purchaser would; and would furthermore be able to obtain additional information the employee deems necessary to interpret Non-Retail Advertisements.

### 2. Specific Costs and Benefits of the Advertising Rule

#### a. *Definition of Advertisements*

The proposed rule redefines an advertisement, and lists three items that would not be considered an advertisement under the definition. Two significant differences between the new definition and the current rule's definition are (i) the inclusion of "all communications"; and (ii) the two purpose tests for determining whether a communication is an advertisement – to "offer or promote" an investment advisory service for "the purpose of obtaining or retaining" one or more clients or investors in pooled investment vehicles.

By determining the scope of communications that would be affected by the proposed rule, the proposed definition of "advertisement" determines, in part, the costs and benefits of the regulatory program set forth by the other components of the proposed rule (the programmatic effects). For example if the definition of "advertisement" is not sufficiently broad, and excludes communications that could serve as a substitute for advertisements while also raising similar

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*Affects Household Wealth Accumulation*, 102 AM ECON REV. 300 (2012). These papers found that financial literacy and knowledge were related across the entire range of wealth, not just at higher levels.

[579] See Section I.A *supra*.

investor protection concerns, investment advisers might use these alternative methods of communication to avoid the costs associated with complying with the proposed rule. This would mitigate the programmatic impact of the proposed substantive provisions that would regulate advertisements. Conversely, if the scope of communications that is captured by the proposed rule is too broad, and captures communications not relevant for an investment adviser's advertisements, the amendments may impose costs on investment advisers while yielding insubstantial benefits.

i. Specific Provisions

The proposed definition of "advertisement" would expand the scope of communications subject to the requirements of rule 206(4)-1. In some cases, we anticipate that the proposed rule would broaden the scope of these communications. The proposed rule would cover all communications disseminated by, or on behalf of, an investment adviser to offer or promote the investment adviser's services.

The "all communications" provision would bolster investor protections by explicitly applying the substantive provisions of rule 206(4)-1 to communications not within the scope of the current rule. Application of the proposed substantive requirements for advertisements to these communications would yield programmatic costs and benefits that would not accrue under the current definition of "advertisement" because the current definition of "advertisement" focuses solely on written communications to more than one recipient.

The proposed definition would include communications of any form, with certain exceptions noted below. Broadening the definition of "advertisement" could bolster investor protections currently afforded by the Advertising Rule, by updating the definition of "advertisement" to reflect the evolving forms of communication used by investment advisers.

The benefits that accrue to investors through investor protections would vary depending on the type of communication covered by the proposed rule.

The additional burdens include mandated review and approval of communications to investors to determine whether the communications meet the rest of the definition of "advertisement." Investment advisers may modify their communication strategies in an effort to reduce the amount of communication that could be deemed to fall within the proposed definition of "advertisement," or that would be subject to the rule's review and approval requirement. These strategic responses could, in turn, impose costs on some investors, to the extent that these investors currently rely on communications by investment advisers other than live oral communications to inform their decisions. If investment advisers respond by reducing the amount of such communications, both prospective and existing investors may need to search more intensively for information about investment advisers than they currently do, or alternatively, base their choice of financial professional on less information. This could result, for example, in inefficiencies if an existing client of an investment adviser is unaware of the breadth of services the investment adviser provided and incurs costs to open a new account with another investment adviser to obtain certain services. Similarly, prospective clients with less information from investment advisers might choose an investment adviser that is a poorer quality match for the investor, or may be discouraged from seeking investment advice. To the extent that some investment advisers who already restrict the use of communications newly regulated by the proposed rule due to risk concerns over inability to monitor or document such communications under the current rule, the change in the cost would be diminished.

The proposed definition of "advertisement" would also include advertisements made "by or on behalf of" of an investment adviser. This provision would expand the set of

communications that would be considered advertisements and subject those communications to the provisions of the proposed rule. Including communications made "on behalf of" an investment adviser into the set of regulated advertisements would make it more costly for investment advisers to avoid the provisions of the advertising rule by delegating or outsourcing advertising communications to third-parties. In addition, the extension of the rule to communications "on behalf of" investment advisers could also create more costs and delays from reviewing and ensuring the compliance of disclosures in such third-party communications, which would likely provide a disincentive to use such third-party communications. Including advertisements that are considered "on behalf of" an investment adviser in the proposed rule will help reduce the potential occurrence of misleading information disseminated by a third party in certain circumstances. In addition, applying the provisions of the proposed rule to these additional communications could also yield programmatic costs and benefits, such as potential improvement of the efficiency of the market for investment advisers, among other effects.[580]

Under the proposed rule, content created by or attributed to third parties could be considered by or on behalf of an investment adviser, depending on the investment adviser's involvement. Some examples of communications that would be included are: positive reviews from clients selectively picked by an adviser to be posted or attributed, materials an adviser helps draft to be disseminated by solicitors or other third-party promoters, endorsements organized by an adviser on social media and etc. This proposed inclusion of communications protects investors from being misled or deceived by third-party promotional information from a source that may have conflicts of interest. In addition, because communications "on behalf of" an adviser are intended to reflect the application of the current rule to communications provided by

[580] For more, see *supra* Section III.D.1.

advisers through intermediaries, investment advisers will comply with this element of the proposed rule through policies and procedures they currently use in communicating with prospective clients through intermediaries. Therefore, the additional burden on investment advisers, if any, should be marginal. While we do not anticipate that investors will bear any direct costs as a result of this provision, investors may be directly affected if investment advisers alter their advertising practices in a way that reduces the information available to investors. For example, investment advisers may reduce promotion of third-party reviews to avoid having to bear the associated costs of disclosure and compliance. If this results in a reduction in the amount of information available to investors, then investors may be directly affected by this provision of the rule.

The proposed definition of "advertisement" also includes communications that "offer or promote the investment adviser's investment advisory services," which would help apply the proposed rule not only to communications offering the services of the investment adviser, but also to those promoting its services. Unlike the "offer" clause, the "promote" clause is not included in the current rule. Under the proposed rule, promotional materials are advertisements, even if the content does not explicitly "offer" investment advisory services or participation in a pooled investment vehicle. Promotional materials implicate many of the same investor protection concerns as explicit offers of advice or offers of shares of pooled investment vehicles to the extent that these materials are designed to persuade potential clients to engage an investment adviser or invest in a pooled investment vehicle. This change broadens the scope of advertisements and extends the investor protection benefits of the advertising rule to a larger volume of communications.

However, because of this change, investment advisers would likely incur costs to review and approve their communications with potential and existing clients and investors, in an effort to determine which constitute promotional materials. Depending on the outcome of this assessment, an investment adviser may respond by reducing the amount of information it disseminates to potential and existing clients and investors, in turn reducing the amount of information available to potential and existing clients and investors.

Similarly, the provision "for the purpose of obtaining or retaining clients" would help apply the proposed rule not only to communications aimed at obtaining clients, but also to those aimed at retaining existing clients. This revision is consistent with the Commission's concerns under the current rule that communications to existing clients may be used to mislead or deceive in the same manner as communications to prospective clients. Given that this particular provision mainly adds to the clarity of the regulation, we expect the additional cost or benefit to be marginal. More generally, the provision benefits investors to a different degree depending on whether an investor is a new client or an existing client. An existing client has the chance to observe the skills of an investment adviser directly through their existing relationship. An existing client would thus have more access to information about the investment adviser than a new client, and hence may receive fewer benefits from the investor protections provided by the proposed rule.

ii. Specific Exclusions

Certain elements of the proposed definition of "advertisement" potentially narrow its scope and are designed to reduce the likelihood that the proposed rule imposes costs or burdens on communications unrelated to advertising or adds costs or burdens for communications already regulated by the Commission as advertisements. In particular, the rule permits four exceptions to

the definition of "advertisement." These exclusions include: (1) non-broadcast live oral communications; (2) responses to certain unsolicited requests; (3) advertisements, other sales materials, and sales literature that is already regulated under rules specifically applicable to RICs and BDCs; and (4) any statutorily or regulatory required notice, filing, or other communication. The first exclusion eliminates the current rule's "more than one person" element and narrows the scope of the rule by excluding all non-broadcast live oral communications, to one or more persons; the second exclusion of responses to unsolicited requests (other than those relating to hypothetical performance or relating to any performance results presented to Retail Persons) is partly consistent with our staff's historical approach when considering whether or not to recommend enforcement action;[581] the third exclusion, for RICs and BDCs, is intended to acknowledge that advertisements, other sales materials, and sales literature that are about RICs and BDCs are regulated under the Securities Act and the Investment Company Act and subject to the specific prescriptions of the rules adopted thereunder; finally, the rule carves out several types of communications that are required to be produced by existing regulatory requirements. These four exclusions narrow the scope of communications that would otherwise be subject to the programmatic costs associated with the proposed rule, and thus avoid imposing costs and burdens on investment advisers.

One exclusion prevents the proposed rule from duplicating rules already in place for RIC and BDC marketing, designed to ameliorate investor protection concerns related to RIC and BDC marketing practices. Therefore, the expected change in costs and benefits from this exclusion under the proposed rule should be minimal, for both investment advisers and investors.

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581 We note that the exclusion for hypothetical performance or for any performance results presented to Retail Persons is a substantive change from current practice in reliance on staff positions.

The proposed exclusion of all non-broadcast live oral communications does not retain the current rule's "more than one person" element. To the extent that live oral communications are addressed to a small audience, the proposed amendment is consistent with the current rule.

To the extent that broadcasting reaches potential clients at a lower cost than direct conversations, the proposed exclusion would probably not cause investment advisers to substitute direct conversations for broadcast advertisements, and hence, there would be no significant change in terms of investor protection either. However, current technologies, such as software that supports live group video and voice chats, may enable investment advisers to reach clients without broadcasting. In addition, investment advisers that choose to avail themselves of the exclusion for responses to unsolicited requests would incur compliance costs associated with determining whether requests for information are unsolicited. However, we note that the proposed exclusion may benefit investors to the extent that investment advisers' responses to unsolicited requests for performance results would have still have to meet the specific performance advertising requirements of the advertising rule, along with its associated costs and benefits.[582]

### b. *General Prohibitions*

The proposed rule prohibits advertisements that contain any untrue statements of a material fact, or that omit a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading.[583] We believe that the scope of this aspect of the proposed rule is substantially the same as its counterpart in the current rule, and thus we do not expect to see any costs or benefits relative to the baseline. Notably, the

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582 *See* Section III.D.2.d *infra*.

583 Proposed rule 206(4)-1(a).

current rule contains an explicit prohibition on advertisements that contain statements to the effect that a report, analysis, or other service will be furnished free of charge, unless the analysis or service is actually free and without condition, but the proposed rule removes this explicit prohibition.[584] As discussed above, we believe that this practice would be captured by the proposed rule prohibition on untrue statements. Given that the removal of this provision entails no substantive change in prohibitions, we believe that the removal of this provision will likewise generate no new costs or benefits.

In addition, the proposed rule also contains several specific prohibitions for advertisements that are not present in the current rule. The prohibitions would apply to statements or communications that, depending on the facts and circumstances, may already be prohibited under the existing general prohibition in the rule of false or misleading statements as well as other anti-fraud provisions of the Federal securities laws. We anticipate that these changes will generate new questions about the rule's application, which will impose costs on investment advisers for legal advice. Similarly, the proposed rule removes the current rule's prohibition of charts and graphs absent certain disclosures, but the use of charts and graphs is still subject to the general anti-fraud prohibition. While the revised rules may allow certain additional advertising, changes to the rule may subject investment advisers to legal and compliance costs when they comply with the new standard.

The proposed rule also prohibits including or excluding favorable or unfavorable performance results, present performance time periods, or referencing specific investment advice in a manner that is not "fair and balanced." To the extent that investment advisers include

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[584] *See* current rule 206(4)-1(a)(4); *see also* Dow Theory Forecasts, Inc., SEC Staff No-Action Letter (May 21, 1986) (staff declined to provide no-action recommendation where an offer for "free" subscription was subject to conditions).

additional information to provide context for the performance results in their advertisements because of the selective inclusion of performance results and "fair and balanced" provisions, investors may benefit from the additional information, as they may be better able to evaluate the performance of investment advisers. While the additional disclosures and statements necessary to ensure performance results do not unfairly include or exclude performance results, and are fair and balanced may impose costs on investment advisers and may cause them to reduce the amount of information they provide, a "fair and balanced" presentation of performance might benefit both investors and investment advisers with higher abilities. Investors will be better able to evaluate investment advisers, and investment advisers who have higher abilities but who could not reveal those abilities to the same extent under the current rule would be better able to advertise their services and performance relative to other investment advisers.

#### c. *Testimonials, Endorsements, and Third-Party Ratings*

The proposed rule defines a testimonial as "any statement of a person's experience, as a client or investor, with the investment adviser," and endorsements as "any statement by a person other than a client or investor indicating approval, support, or recommendation of the investment adviser." Because of the similarity between testimonials and endorsements, we will first discuss the costs and benefits of these testimonials and endorsements together, and then later discuss third-party ratings.

Under the baseline, the current rule prohibits, but does not define, the use of testimonials, and does not address endorsements specifically. However, the staff through no-action letters has indicated it would not recommend enforcement action to the Commission when statements by non-clients (defined as endorsements in the proposed rule) were treated as testimonials as defined by the current rule. The proposed rule thus clarifies the distinction between statements

made by clients and non-clients, and permits the use of testimonials and endorsements, provided that two disclosures are included with the advertisement.

Advertisements containing testimonials or endorsements must disclose whether the person giving the testimonial or endorsement is a client or a non-client, and whether he or she was compensated for his or her testimonial or endorsement. Testimonials and endorsements can play an important role in investor decisions by giving investors information about an investment adviser's interactions with investors, or the opinions of individuals who are not clients of the investment adviser, but might nevertheless be persuasive to prospective investors. To the extent that the quality of the testimonials and endorsements in investment adviser advertisements is correlated with the ability or potential fit of an investment adviser, investment advisers could benefit more from the proposed rule.

The ability to provide testimonials in advertisements may benefit investment advisers by allowing investment advisers to show satisfied clients or other individuals willing to endorse the investment adviser. Investment advisers with higher ability will likely receive more benefit from this provision, either because they will have to pay less for a testimonial, or will have access to more positive testimonials. However, given that the quality of a testimonial may be uncorrelated with the ability or potential fit of an investment adviser's services, the proposed rule may also create an "arms race" of testimonials in advertisements, where investment advisers, regardless of ability, increase spending on testimonials in advertisements to attract and retain clients. In this case, permitting paid testimonials and endorsements could leave both investment advisers and investors worse off.

Although including testimonials or endorsements in an advertisement will entail costs for investment advisers to either identify or compensate clients and non-clients, the Commission

believes that investment advisers will only choose to include testimonials and endorsements in their advertisements if the expected benefits to their revenue exceed the expected costs of doing so. However, as noted above, competitive pressures may result in an inefficient level of advertising expenditures.

The proposed rule also includes provisions that require investment advisers to disclose whether the person giving a testimonial or endorsement is a client or former client. This disclosure could provide investors with information about the potential bias of the person offering a testimonial or endorsement, but also information about the knowledge and experience a person might have to form a basis for his statements. Research suggests that when investors receive disclosures about the conflict of interest and the informational basis associated with advisers, they are able to filter out some, but not all, of the bias associated with these disclosures.[585]

Testimonials and endorsements bear similarity in the appearance, but differ in the source, of the promotional information. A testimonial is from a client who has first-hand asset management experiences with the investment adviser. Testimonials may be appealing to the prospective clients since they appear to convey more reliable information. However, an existing client might be incentivized to give a positive review in exchange for better or additional service from the adviser, even without any explicit compensation, which could compromise the credibility of his testimonials, while keeping the conflict of interest hidden. Meanwhile, endorsements are from non-clients, who may not rely as much on the adviser's services as an

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[585] *See* Daylian M.Cain et al., *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. L. STUD. 1 (2005); George Loewenstein et al., *The Limits of Transparency: Pitfalls and Potential of Disclosing Conflicts of Interest*, 101 AM. ECON. REV. 423 (2011).These papers observed that when disclosure of conflicts of interest was required, an adviser exaggerated the bias in their advice to counteract the fact that their clients would account for their conflict of interest.

existing client does. The endorsements are, therefore, more likely to be arranged with certain compensation. The disclosure of such compensation can highlight the conflict of interests for prospective clients.

The Commission estimates that the aggregate internal cost of providing the disclosures associated with testimonials and endorsements will be $337 per adviser per year, assuming each investment adviser would use approximately 5 testimonials or endorsements per year.[586] However, these estimates do not account for potential changes in investment adviser behavior and advertising practices as a result of the proposed rule, which are difficult to quantify. If 50 percent of current registered investment advisers would use testimonials or endorsements in advertisements, the aggregate internal cost of preparing the disclosures is estimated to be $2,268,684 per year.[587] If the proposed approach to testimonials and endorsements induces a marketing "arms race" and close to 100 percent of current RIAs invest in advertisements with 5 testimonials and endorsements per year, the estimated cost of preparing the disclosures is nearly $4,537,368 in aggregate. However, if the investment adviser believes that revenue brought in by new testimonials and endorsements under the proposed rule does not justify the cost of compliance with the rule, as related to using these testimonials and endorsements, the increase in cost would be minimal, as there would be no change in advertising practices regarding testimonials and endorsements.

The proposed rule would also permit the use of third-party ratings in advertisements, which are defined as ratings or rankings of an investment adviser provided by a person who is not an affiliated person of the adviser and provides such ratings or rankings in the ordinary

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586 *See* section III.F.1 for more details.

587 *See footnote 625*.

course of its business. To the extent that third-party ratings are produced using methodologies that yield useful information for investors, the proposed rules may improve the information available to investors about investment advisers. The proposed rule would also require that advertisements that include third-party ratings disclose: (i) the date on which the rating was given and the period of time upon which the rating was based; (ii) the identity of the third party that created and tabulated the rating; and (iii) if applicable, any compensation or anything of value that has been provided in connection with obtaining or using the third-party rating.

Economic models suggest that selective control of or the ability to influence an investor's access to information can hamper the investor's ability to process information in an unbiased manner, even if the specific facts or information communicated to an investor are not false.[588] For example, this type of control or influence on information can be as explicit as deletion or removal of unfavorable testimonials,[589] or as implicit as a reordering of the testimonials or a suggestion of which testimonials to read.[590] The additional disclosures in the proposed rule might have two effects on investment adviser advertisements. First, the disclosures might mitigate the likelihood that retail investors will be misled by an investment adviser's ratings. Providing the additional disclosures would provide investors additional information to judge the context of a third-party rating. Second, the fact that advertisements must also include such disclosures may reduce the incentives of investment advisers to include third-party ratings that might be stale or otherwise misleading. Because third-party ratings included in an advertisement

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588 Luis Rayo and Ilya Segal, *Optimal Information Disclosure*, 118 J. POL. ECON. 949 (2010); Emir Kamencia and Matthew Gentzkow, *Bayesian Persuasion*, 101 AM. ECON. REV. 2590 (2011); Pak Hung Au and King King Li, *Bayesian Persuasion and Reciprocity: Theory and Experiment* (SSRN, June 5, 2018), *available at* https://ssrn.com/abstract=3191203; Jacob Glazer and Ariel Rubinstein, *On Optimal Rules of Persuasion*, 72 ECONOMETRICA 1715 (2004).

589 *See Id.* for Segal and Rayo 2010, Kamenica and Gentzkow 2011, Au li 2018.

590 *See* Glazer *supra* footnote 590.

would be required to have additional disclosures, investors are less likely to be misled by the ratings, which reduces the incentive for investment advisers to include misleading third-party ratings.

For the purposes of estimating burdens in connection with the Paperwork Reduction Act, we estimate that advisers would incur an initial cost of $505.50 to draft and finalize the required disclosure for each third-party rating they advertise. In addition, as many of these ratings or rankings are done annually, an adviser would incur ongoing, annual costs associated with this burden, which we estimate to be 25 percent of the initial costs. In aggregate, because it is uncertain how many investment advisers would find the benefit of using third-party ratings in their advertisements justify the associated compliance costs, the total cost of these disclosures across all advisers is difficult to quantify.

#### d. *Performance Advertising*

The proposed rule permits the inclusion of performance advertising, but includes general requirements for its inclusion in advertisements, and specific disclosures that must be made to investors. The rule also includes specific restrictions that may apply, depending on whether an advertisement is intended for retail or non-retail investors. First, we discuss the several requirements for all advertisements with performance advertising. Then, we discuss the specific restrictions and requirements for Retail Advertisements.

As part of the general prohibitions, the proposed rule would prohibit any investment adviser from including favorable performance results or excluding unfavorable performance results, or presenting time periods for performance, if such selection results in a portrayal of performance that is not fair and balanced, for all advertisements. Although the inclusion of performance advertising may provide valuable information to investors about an investment adviser's ability, absent the current or proposed rule, investment advisers have the ability to

disclose positive information about their past performance in a potentially misleading way. The proposed rule's prohibition on including or excluding performance results in a manner that is not fair and balanced, however, does not significantly differ from the baseline prohibition on any untrue statement of a material fact, or which is otherwise false or misleading, and thus will likely not have significant costs or benefits associated with them.

The proposed rule prohibits the use of gross performance in Non-Retail Advertisements unless the advertisement also provides or offers to provide promptly a schedule of fees or expenses to the investor. Although the use of gross performance in advertising is not fraudulent, it may be misleading to investors who are unaware that they should also consider an investment adviser's net performance results when choosing an investment adviser. By offering to provide the necessary schedule of fees and expenses to investors, the provision would: (i) remind investors that fees and expenses are another important piece of information to consider when choosing an investment adviser; and (ii) give investors access to the fee and expense data to make a direct calculation of the net performance. While we do not expect investors to bear any direct costs from the use of gross performance, we note that investors may bear costs associated with processing the information that is included on the schedule that investment advisers must provide or offer to provide promptly in order to allow the calculation of net performance.

The rule also prohibits the use of hypothetical performance in all advertisements, unless the investment adviser adopts and implements policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the financial situation and investment objectives of the person to whom the advertisement is disseminated; provides sufficient information to enable such person to understand the criteria used and assumptions made in calculating such hypothetical performance; and provides (or, in the case of Non-Retail Persons,

provides or offers to provide promptly) sufficient information to enable such person to understand the risks and limitations of using such hypothetical performance in making investment decisions. To the extent that advisers are required to revise their advertisements as a result of the hypothetical performance requirements in rule 206(4)-1, they may incur additional costs. These types of hypothetical performance include representative performance, derived from representative model portfolios that are managed contemporaneously alongside portfolios managed for actual clients; backtested performance, performance that is backtested by the application of a strategy to market data from prior periods when the strategy was not actually used during those periods; and targeted or projected returns with respect to any portfolio or to the investment services offered or promoted in the advertisement. As discussed above, the Commission preliminarily believes that advertisements that contain hypothetical performance are likely to be misleading to investors. However, the Commission also recognizes that some persons may wish to know specific details about an investment adviser's hypothetical performance, and the required policies and procedures are designed to ensure that investment advisers provide enough information for investors to understand and use hypothetical performance in advertisements. Additionally, while investment advisers must provide sufficient information for Retail Person recipients to understand the risks and limitations of using such hypothetical performance in making investment decisions, investment advisers need only offer to provide promptly such information if the recipient is a Non-Retail Person. This difference in requirements reflects the different of access to resources and expertise between Retail and Non-Retail Persons, which may better equip Non-Retail persons to make appropriate use of potentially confusing or misleading information.

Investors may benefit from the additional information provided by hypothetical performance advertising, if investment advisers provide the required information and context to properly understand it and the investor has the ability to analyze it and its limitations and assumptions. We note that although investors would not any face direct costs from the inclusion of hypothetical performance, they may face indirect costs associated with processing and interpreting this new information. Even if investors are provided with the necessary information to contextualize hypothetical performance, investors would need time and expertise to properly interpret hypothetical performance. Moreover, investors that are unable to interpret the information provided may be misled by hypothetical performance because of a lack of resources or financial expertise. In this case, investors may incur additional costs from the use of hypothetical performance in advertising, associated with poorer matches with investment advisers. Investment advisers may bear costs associated with screening potential investors to determine whether an advertisement with hypothetical performance is appropriate for them. However, we note that investment advisers are unlikely to incur the costs of screening their potential investors if they do not expect the benefits of hypothetical performance advertising to exceed the costs associated with screening.

The proposed rule would condition the presentation of "related performance" in all advertisements on the inclusion of all related portfolios. However, the proposed rule would allow related performance to exclude related portfolios as long as the advertised performance results are no higher than if all related portfolios had been included. This allowed exclusion would be subject to the proposed rule's requirement applicable to Retail Advertisements that the presentation of performance results of any portfolio is conditioned on the inclusion of results for 1-, 5-, and 10-year periods. The proposed rule would allow related performance to be presented

either on a portfolio-by-portfolio basis or as one or more composites of all related portfolios. Similarly, the proposed rule would condition the presentation of extracted performance in all advertisements on the advertisement's providing or offering to provide the performance results of all investments in the portfolio from which the performance was extracted. This prohibition is designed to prevent investment advisers from "cherry-picking" portfolios to provide a selective representation of the investment adviser's performance. Such representations would also be subject to the provisions of proposed rule 206(4)-1(a), including the prohibition on including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced.

The proposed rule contains several provisions specific to Retail Advertisements. These additional provisions generally reflect the lack of access to resources that Retail Persons face, and are designed to mitigate the potential costs that these provisions might impose on Non-Retail persons. The proposed rule would condition the presentation of gross performance results in Retail Advertisements on the advertisement also presenting net performance results, requiring that they be displayed with equal prominence as gross performance, and be calculated over the same time periods. This requirement does not significantly differ from current market practices as shaped by no-action letters, and we preliminarily believe will not generate significant costs and benefits to investment advisers or investors relative to the baseline.

The proposed rule prohibits the presentation of performance results of any portfolio in Retail Advertisements unless the results for one, five, and ten year periods are presented as well. Each of the required time periods must be presented with equal prominence and end on the most recent practicable date. If the portfolio was not in existence in any of these three periods, the lifetime of the portfolio can be substituted. Under the baseline, there is no such requirement

relating to performance advertising. Requiring Retail Advertisements to include this information would benefit investors by giving them more standardized information about the performance and limiting the potential that an investor could be unintentionally misled about an investment adviser's performance through the investment adviser's selection of performance periods. This requirement also does not significantly differ from current market practices as shaped by no-action letters, and we preliminarily believe will not generate significant costs and benefits relative to the baseline.

i. Quantitative Estimates of Performance Advertising Costs

In this section, we describe the quantitative estimates of the provisions of the proposed rule associated with performance advertising, and their relation to the economic costs and benefits of the rule described above.

For the purposes of our Paperwork Reduction Act analysis, we estimate that investment advisers would incur an initial burden of 5 hours to comply with the proposed rules associated with gross performance, for three portfolios each, resulting in a total cost of $4,692 per adviser. We also estimate that investment advisers would incur an ongoing internal cost burden of $3454 per adviser per year to update their fee schedules, based on an estimate of an ongoing cost burden of 10.25 hours per year, and an annual external cost of $500 per year for printed materials. However, we note that many investment advisers already make net performance calculations for their clients under the baseline, and so the actual cost burden might be lower.

In addition, the Paperwork Reduction Act analysis estimates that investment advisers that choose to advertise related portfolio performance will bear an initial cost of $8,425 per adviser. These costs are based on an estimate of 25 hours to review portfolios to determine which ones meet the definition of "related portfolio." These advisers would also face an ongoing cost of

$5,897 per adviser per year, which reflects an estimated 5 hours of labor to update presentations 3.5 times per year.

Similarly, the Paperwork Reduction Act analysis estimates that investment advisers that choose to advertise extracted performance will bear an initial cost of $3,370 per adviser. These costs are based on an estimate of 10 hours to review portfolios and calculate the performance of the entire portfolio from which an extracted performance is taken. In addition, the Paperwork Reduction Act analysis estimates these advisers would incur an ongoing cost of $2359 per adviser per year, which is based on an estimate of a 2 hour review conducted 3.5 times annually.

The Paperwork Reduction Act analysis estimates that investment advisers that choose to advertise hypothetical performance will bear an initial cost of $2,650 per adviser to develop policies and procedures reasonably designed to ensure that hypothetical performance is relevant to the financial situation and investment objectives of the person to whom the advertisement is disseminated. We estimated these policies and procedures would require 5 hours per adviser to implement. In addition, each adviser that chooses to advertise hypothetical performance would face an ongoing annual cost of $2,650 per year to evaluate the relevance of hypothetical performance to an investor, based on an estimated 20 instances of hypothetical performance advertising per year, with each instance taking .25 hours to evaluate. The Paperwork Reduction Act analysis also estimates that an adviser would also incur an initial cost of $5,392 to preparing the information sufficient to understand the criteria used and assumptions made in calculating, as well as risks and limitations in using, hypothetical performance, based on an initial hour burden of 16 hours. Finally, the Paperwork Reduction Act analysis estimates that an adviser that advertises using hypothetical performance will face an ongoing cost burden of $3,538 per adviser per year to update its hypothetical performance information. This estimate is based on an

estimate of 3 hours per update and 3.5 updates annually. Overall, the internal cost burden is estimated to be $8,042 per adviser, initially, and $6188 per adviser per year on an ongoing basis. These costs are estimated on a per adviser basis, and the aggregate costs to investment advisers will be highly dependent on whether they choose to advertise hypothetical performance. However, investment advisers are likely to only incur the costs associated with hypothetical performance if the gains in their expected revenue exceed their expected costs.

### e. *Compliance and Recordkeeping*

The proposed rules expand the set of communications for which records must be kept and require that investment advisers retain the records for advertisements disseminated to one or more individuals. In contrast, current rules require investment advisers to keep records of communications disseminated to more than ten individuals. In addition, the proposed rules require that a designated employee approve in writing each advertisement, and that the investment adviser retain records of these written approvals. These requirements are intended to ensure sufficient oversight of advertising activities by investment advisers.

Requiring a written record of the review and approval of all advertisements, regardless of the size of the intended audience, allows our examination staff to better review adviser compliance with the rule and reduces the likelihood of misleading or otherwise deficient advertisements. We also expect these provisions will impose costs on investment advisers, who will need to expend labor and other resources to create processes for compliance with the written approval requirement and amend processes for retaining records for advertisements distributed to between one and ten individuals. In our Paperwork Reduction Act analysis below, we estimate the hourly cost associated with the review and approval of new advertisements to be about

$671.25 and the cost to update an existing advertisement to be about $223.75.[591] For the proposed recordkeeping amendments that correspond to proposed changes to the advertising rule, we estimate that the incremental cost aggregated across all advisers would be approximately $8,530,157.[592]. However, the proposed rules could also result in reduced communications and advertisements to investors if investment advisers decide to restrict written and recorded communications to reduce the costs associated with creating processes for review and approval. Restricting the amount of communication could, in turn, impose costs on existing clients and investors to the extent that existing clients would not receive valuable information about investment advisers' services. Similarly, prospective investors might receive less information that would be useful in searching for an investment adviser, which could lead to lower quality matches with investment advisers, or which could discourage investors from seeking investment advice altogether. This effect is impossible to quantify, as it depends on the reactions of market participants to the proposed rule, and there are no similar rules to compare how investment advisers adjusted their behavior. The requirement to retain a written record and approval of advertisements may impose additional costs on investment advisers who use third parties for advertisements, given the costs of ensuring that third parties' communications comply with the rule, and the potential liability to the investment adviser. Alternatively, investment advisers may

591 *See* section IV.B.5. for details.

592 In PRA we estimate a 10-hour per advertisement incremental burden for investment advisers associated to recordkeeping amendments that correspond to proposed changes to the advertising rule, including the expanded definition of "advertisement". Further we assume that 100 percent of 13,643 investment advisers would be subject to the proposed amendments, and each of them would disseminate 1 new advertisement per year. 17 percent of the compliance to the proposed rule is assumed to be performed by compliance clerks, whose hourly cost is $70, and 83 percent by general clerks, whose hourly cost is $62 (data is from the Securities Industry and Financial Markets Association's Office Salaries Data 2013 Report, modified to account for an 1,800-hour work-year, inflation, bonuses, firm size, employee benefits and overhead). The annual incremental cost is therefore (17%×$70+83%×$62)*10*13,643 = $8,530,157.

reduce their use of third parties for advertisements and communications, to reduce the cost and risk associated with the recordkeeping and compliance provisions of the proposed rule.

Additionally, we note that dual registrants, with dually licensed personnel, will have to bear costs associated with determining which communications were made in a broker-dealer or investment adviser capacity. Not only do these processes impose costs on investment advisers, these processes also delay communication between investment advisers and their investors, which can impose additional costs on each of them. Alternatively, dual registrants with dually licensed personnel may instead implement a single review and approval process for all communications of dually licensed personnel, to avoid the burden of determining which communications are made in a broker-dealer or investment adviser capacity. This alternative review and approval might incur lower costs than the proposed rules to the extent that dual registrants have already implemented elements of the review and approval process.

### 3. Costs and Benefits of the Proposed Amendments to the Solicitation Rule

The proposed rule expands the current rule to cover solicitation arrangements involving all forms of compensation as well as to solicitors for private funds; eliminates certain duplicative disclosure requirements for solicitors and broadens the scope of the rule's disqualification of certain persons as solicitors while adding a conditional carve-out. In this section, we discuss the costs and benefits of each provision of the proposed amendments to the solicitation rule.

#### a. *Scope of Covered Compensation*

Rule 206(4)-3 currently prohibits an adviser from paying a cash fee, directly or indirectly, to a solicitor with respect to solicitation activities unless the adviser complies with the terms of the rule. The proposed rule's more expansive scope would include the many forms of non-cash compensation that solicitors might receive from advisers or their funds for solicitation, which

generate nearly identical conflicts of interest as cash compensation. For example, advisers use brokerage - a form of non-cash compensation - to reward brokers that refer them to investors. This presents advisers with conflicts of interest as the brokers' interest may not be aligned with investors' interest.

Under the proposed rule, the programmatic costs and benefits of the proposed solicitation rule amendments – the disclosure requirements, the requirements to enter into a written agreement, the adviser's supervision requirement, and the statutory disqualification of certain persons – would apply to solicitors that receive non-cash compensation. Also, the programmatic costs and benefits of these rules would flow to investors that these non-cash compensated solicitors refer. The solicitation rule's extension to non-cash compensated solicitors would extend the benefits of investor protection through the disclosure requirements, the written agreement requirements, the adviser supervision requirement, and the statutory disqualification to investors that are solicited by noncash compensated solicitors. In addition, to the extent that the rule improves investor confidence in the recommendations of non-cash compensated solicitors, another programmatic benefit of the rule is that it may improve the efficiency of matches between investment advisers and investors.

The expansion of the solicitation rule to non-cash compensated solicitors would also impose programmatic costs on additional solicitors, investment advisers, and investors. The expanded scope of the solicitation rule would impose the disclosure requirements and its associated costs onto non-cash compensated solicitors, as well as investment advisers who hire them. Investment advisers and solicitors may pass of some portion of the cost to investors.

**b. *Private Funds***

The proposed rule would also broaden the scope of the current solicitation rule to cover solicitors who solicit on behalf of private funds. Under the baseline, solicitors that solicit on behalf of private funds are primarily subject to the anti-fraud provisions of the Federal securities laws and rules applicable to private fund offerings made in reliance on Regulation D. However, private funds also make offerings under section 4(a)(2) of the Securities Act, which does not have Federal disqualification provisions, and solicitors for such funds would only be subject to state disqualification provisions. While we currently do not have data to directly observe the number and size of private funds that rely on section 4(a)(2), the Commission's recently published Concept Release on the Harmonization of Exempt Offerings and a recent white paper by Commission staff suggest that the overall amount of capital raised outside of Regulation D, including by private funds, is relatively small.[593] We request additional data or other information from commenters that would help estimate the number and size of private funds that could be affected by the proposed amendment to the solicitation rule.

Extending the scope of the current solicitor rule to solicitors that target investors or prospective investors in private funds that are not otherwise covered by the disqualification requirements in Regulation D would extend both the benefits of the disclosure and disqualification requirements of the solicitation rule, to the extent such requirements differ from state requirements, to private fund investors. Specifically, these requirements could enhance investor protection for private fund investors by providing them with the solicitor's

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[593] Concept Release on the Harmonization of Exempt Offerings (Table 2) shows the total number of other exempt offerings, which includes the amount raised under section 4(a)(2), Rule 144A and Regulation S, *available at* https://www.sec.gov/rules/concept/2019/33-10649.pdf; Vladimir Ivanov and Scott Bauguess, Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009-2012 (August 2018) (Figure 1) shows the total amount raised under Regulation S, section 4(a)(2), regulation crowdfunding offerings and Regulation A offerings, *available at* https://www.sec.gov/files/DERA%20white%20paper_Regulation%20D_082018.pdf.

compensation and conflict of interest disclosures, which would provide private fund investors additional information when considering a solicitor's recommendation. In addition, the disqualification requirements would protect private fund investors from disqualified solicitors, to the extent that the proposed rule's disqualification requirements differ from "bad actor" disqualification and applicable state requirements. Likewise, extending this scope would extend the costs of such disclosure and disqualification requirements to advisers, solicitors, and affected private fund investors. The costs of disclosure would stem from compliance and recordkeeping procedures, and advisers would need policies and procedures to establish a reasonable basis to believe that solicitors are not disqualified. While we believe that advisers and solicitors will directly bear the costs of these provisions, we expect that some portion of these costs will be passed along to investors in private funds.

#### c. *Disclosure*

In addition to changing the scope of application of the solicitation rule, the proposed amendments would change elements of the Commission's program for regulation of solicitation arrangements. The proposed rule would eliminate the current rule's written agreement requirement that the solicitor deliver the adviser's Form ADV brochure to a prospective client, as this represents a duplicative requirement because the adviser is also required to deliver its brochure to clients under rule 204-3. As noted above, however, the Commission stated in the solicitation rule's 1979 adopting release that the solicitor's delivery of the adviser's brochure could satisfy the investment adviser's obligation to deliver it under rule 204-3. To the extent that both advisers and solicitors currently deliver the adviser's Form ADV brochure, this proposed rule's elimination of the requirement that the solicitor deliver the adviser's Form ADV brochure would reduce the compliance burden for advisers and solicitors. Currently, rule 204-3 does not

require delivery of Form ADV by investment advisers for private funds, although some choose to do so. Additionally, we note that by eliminating the obligation to deliver the adviser's Form ADV brochure, the information contained in the delivery may not have as much of an impact on an investor's decision to begin a relationship with an investment adviser.

The proposed rule would permit the solicitor or the adviser to deliver the solicitor's disclosure at the time of any solicitation activities (or in the case of a mass communication, as soon as reasonably practicable thereafter). Permitting additional flexibility in the timing of the solicitor's disclosure might reduce the costs associated with these disclosures, and improve the quality of communications that solicitors have with potential investors. However, allowing the adviser rather than the solicitor to deliver the solicitor disclosure might reduce the effectiveness of the disclosure if simultaneously paired with other disclosures provided by the adviser.

The proposed rule would generally maintain the current rule's solicitor disclosure requirement, with some modifications to clarify the requirement and to accommodate disclosure of non-cash compensation, which can be difficult to quantify. The proposed rule would also remove the requirement that the solicitor's disclosure be written, permitting the use of electronic and recorded media to disclose details of the solicitation arrangements. To the extent that presentation of these disclosures in different formats changes their salience to investors, they might support or erode the benefits of the solicitor disclosure requirement. The ability to permit the use of electronic and recorded media may lower the cost of delivery of solicitation arrangements, and may improve the ability of investors to read and understand these disclosures. However, if these disclosures are bundled with a variety of other disclosures and information provided through the same medium, it may reduce the salience of this particular disclosure, and thus might reduce the benefits associated with the disclosure.

The proposed rule would require the solicitor to provide, contemporaneously with the solicitation, separate disclosures related to the terms of compensation and any material conflicts of interest, as well as the amount of any additional cost to the investor as a result of solicitation. This disclosure would draw the client's attention to the solicitor's inherent bias in recommending an adviser that is compensating it for the referral. However, conflict of interest disclosures may not necessarily lead to optimal decisions by investors. The Commission's Financial Literacy Study surveyed investors and found "many of the online survey respondents indicated that they understand existing fee and compensation information, for example, as disclosed in a typical Brochure, but the quantitative research data suggest otherwise. Many of the online survey respondents on the Brochure panel who claimed to understand fee and compensation disclosure in the Brochure, in fact, did not."[594]

In addition, the Financial Literacy Study also found that respondents had difficulty interpreting disclosures related to conflicts of interest.[595] These findings are consistent with academic literature that describes the difficulties of financial disclosure. For example, one study shows that, in an experimental setting, even when subjects were told of the bias of their advisers, they did not fully discount their advice.[596] In addition, these papers and others[597] find that

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[594] *See* Financial Literacy Study, *supra* footnote 524.

[595] "For instance, they had difficulty calculating hourly fees and fees based on the value of their assets under management. They also had difficulty answering comprehension questions about investment adviser compensation involving the purchase of a mutual fund and identifying and computing different layers of fees based on the amount of assets under management. Moreover, many of the online survey respondents on the point-of-sale panel had similar difficulties identifying and understanding fee and compensation information described in a hypothetical point-of-sale disclosure and account statement that would be provided to them by broker-dealers." *See* Financial Literacy Study, *supra* footnote 524.

[596] *See* Daylian M.Cain et al., *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. L. STUD. 1 (2005); George Loewenstein et al., *The Limits of Transparency: Pitfalls and Potential of Disclosing Conflicts of Interest*, 101 AM. ECON. REV. 423 (2011).

[597] *See e.g.,* Steven Pearson et al., *A Trial of Disclosing Physicians' Financial Incentives to Patients*, 166 ARCHIVES OF INTERNAL MEDICINE 623 (2006); Sunita Sah, George Loewenstein & Daylian M.

mandating disclosure from biased advisers may have the unintended consequence of making the biased adviser appear honest and increasing an investor's trust in them.

The proposed rule also increases the flexibility of the delivery of solicitor disclosures. The proposed rule would permit a solicitor's disclosures to be delivered by either the investment adviser or the solicitor, and would eliminate the requirement that investors acknowledge receipt of the solicitor's disclosures. Allowing solicitor disclosures to be delivered by either the investment adviser or the solicitor would give the investment adviser additional flexibility in determining the best method for delivery of the disclosure. In addition, eliminating the requirement to acknowledge the receipt of a disclosure would reduce the costs imposed on investors and solicitors by those disclosures, especially if the solicitor's disclosures are delivered by the investment adviser itself. However, these acknowledgements can be a useful tool for an investment adviser to monitor solicitors' compliance with disclosure requirements. Specifically, acknowledgements help to ensure that a solicitor that is soliciting clients on and adviser's behalf is making the correct disclosures. Therefore, an investment adviser might still require investors to acknowledge receipt of a solicitor's disclosure, even if not required by the proposed rule to do so.

#### d. *Exemptions*

The proposed solicitation rule includes exemptions from the written agreement and adviser oversight and compliance requirements when a solicitor is one of the investment adviser's partners, officers, directors, or employees, or is a person that controls, is controlled by, or is under common control with the investment adviser, or is a partner, officer, director or

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Cain, *The Burden of Disclosure: Increased Compliance With Distrusted Advice*, 104 J. PERSONALITY & SOC. PSYCHOL. 289 (2013).

employee of such a person, so long as the affiliation between the solicitor and the adviser is readily apparent or disclosed to the client or private fund investor at the time of solicitation and the adviser documents the solicitor's status at the time that both parties enter into a solicitation arrangement. This proposed approach to in-house solicitors may reduce compliance costs associated with the use of in-house solicitors. At the same time, we do not expect this approach to erode investor protections to the extent that advisers already have a responsibility to oversee in-house personnel. Moreover, the proposed rule would remove the written agreement requirement for solicitation of impersonal investment advice. This change is unlikely to reduce the benefits of the solicitation rule because even under the current rule, the adviser and solicitor are exempt from the rule's disclosure requirements, the specific requirements of the written agreements and the supervision provisions.[598]

The proposed rule also includes a *de minimis* compensation exemption if the investment adviser's compensation payable to the solicitor is $100 or less during the preceding twelve months. This would streamline compliance for certain solicitation arrangements, and could particularly ease compliance burdens for smaller advisers that provide *de minimis* compensation to multiple solicitors. Although this exemption could result in a higher likelihood that investors are solicited by persons who would be ineligible solicitors, we do not anticipate substantial erosion of investor protection benefits, because we believe that *de minimis* compensation likely implies little incentive to defraud potential clients or private fund investors. The proposed approach would also exempt certain types of nonprofit programs from the substantive requirements of the solicitation rule. To the extent that the conditions of the nonprofit exemption mitigate compensation-related conflicts and the incentive of a solicitor to favor one adviser over

[598] *See supra* footnote 425.

another, we do not anticipate the exemption to erode investor protection benefits of the solicitation rule.

**e. *Ineligible Solicitors***

The proposed amendments define "ineligible solicitor" to mean a person, who at the time of the solicitation, is subject to a disqualifying Commission action or has any disqualifying event, both terms defined by the proposal. The definition further encompasses employees, officers, or directors of an ineligible solicitor, any person directly or indirectly controlling or controlled by an ineligible solicitor, and, as appropriate, all general partners or all elected managers of an ineligible solicitor. That ineligibility under the proposed amendments, which attaches at the time of solicitation should support investor protection because the time of the solicitation is likely when investors are most vulnerable to fraud. The breadth of the definition of ineligible solicitor may protect investors from solicitation by persons that share economic incentives to defraud investors with solicitors that are subject to a disqualifying Commission action or has any disqualifying event. The definition of ineligible solicitor could impose compliance costs on investment advisers to the extent that they must inquire potential solicitor's history to form a reasonable belief that the potential solicitor does not have any disqualifying Commission actions, disqualifying events, and affiliations in their history.

The provisions of the carve-out from disqualification are similar to conditions in staff no-action letters in which the staff stated that it would not recommend enforcement action to the Commission under section 206(4) and rule 206(4)-3 if the solicitor's practices were consistent with those conditions. While broadening the scope of solicitors subject to disqualification would reduce the number of personnel available to advisers to serve as solicitors, and potentially the cost of obtaining referrals, these disqualified persons are arguably the most likely to engage in

fraudulent or misleading behavior.[599] This change in scope might reduce the likelihood of investors being harmed by disqualified persons serving as solicitors.

The proposed rule also contains provisions that would change the definition of ineligible solicitors, and add a limited conditional carve-out from disqualification. Currently, the rule flatly bars advisers from making payments to certain disqualified solicitors. The proposal would change this flat bar to a requirement that the adviser cannot compensate a solicitor, directly or indirectly, for any solicitation activity if the adviser knows, or, in the exercise of reasonable care, should have known, that the solicitor is an ineligible solicitor. This change likely would have the effect of reducing burdens on advisers in making this disqualification determination to the extent that they reduce their efforts to not make payments to ineligible solicitors, but instead can rely on exercising reasonable care to conclude that they are not doing so. Nonetheless, we believe that advisers will generally use many of the same mechanisms that they use today to determine whether disqualified person is an ineligible solicitor under the proposed rule, and thus do not expect that they would incur significant additional costs or realize significant savings in complying with this proposed requirement.

### f. *Compliance and Oversight*

As a result of changes to both the advertising and solicitation rules, an investment adviser may face additional costs associated with compliance and oversight when determining the extent to which a person's activities constitute solicitation rather than a compensated testimonial or endorsement (or both). As a result of the proposed solicitation rule's expansion to cover non-

[599] Egan, M., G. Matvos and A. Seru, study the misconduct among broker-dealer representatives in their paper "The Market for Financial Adviser Misconduct" and find that representatives with misconduct are more likely to be reemployed by the firms that have higher rates of misconduct in general. The Commission is not aware of any data on misconduct in the solicitation market. *See supra* footnote 532.

cash compensation, and the proposed advertising rule's changes to permit endorsements and testimonials in advertisements with certain disclosures, an investment adviser might incur costs associated with determining whether persons that are compensated for testimonials or endorsements do or do not engage in activities that would fall within the scope of the solicitation rule, and vice versa.

Currently, it is reported that about 27 percent of investment advisers registered with the Commission (3,655 RIAs) compensate persons other than employees to obtain one or more clients.[600] This number includes advisers that use cash as well as non-cash compensation. In addition, of the 976 RIAs that report that they only compensate their employees to obtain clients, some might still be subject to the requirement to disclose the affiliation at the time of solicitation if the affiliation is not readily apparent. Moreover, currently some advisers might not consider directed brokerage as a type of non-cash compensation, which would further increase the number of investment advisers and solicitors affected by the proposed rule. In addition to the investment advisers that comply with the current rule, approximately 1,590 registered investment advisers to private funds would likely be newly subject to the proposed rule (about 210 of such advisers report that they solely use solicitors that are "related persons" of the firm, and would be eligible to use the proposed rule's partial exemption for affiliated solicitors if the affiliation is readily apparent). Finally, advisers that use nonprofit programs for solicitation would be exempt from the rule, but would be subject to collection of information only with respect to limited disclosures. Overall, we estimate that 6,432 registered investment adviser would be subject to the proposed collection of information for the purposes of the Paperwork Reduction Act; [601]

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600 *See* details in footnote 696.

601 *See* details in section IV.C, and footnote 703.

5,704 investment advisers and their solicitors would experience the full programmatic costs of the proposed rule, and 728 RIAs and their solicitors would bear a partial programmatic cost due to the partial exemptions.

The proposed amendments to rule 206(4)-3 would apply to the solicitation of current and prospective investors in any private fund, rather than only to "clients" of the investment adviser. We do not have the data on the number of solicitors an average investment adviser currently use, but advisers to private funds report using 2.9 "marketers" on average, with a median of one and a maximum of 79.[602] Therefore, we estimate that the number of solicitors affected by the proposed rule would be in the range of 17,517[603] to 21,075[604] per year, assuming that each adviser would use three solicitors, on average, five percent of all RIAs would use directed brokerage as a type of non-cash compensation, and one percent of RIAs would use nonprofit programs for solicitation. The number of clients or investors each solicitor approaches per year varies, therefore the total cost to investment advisers and solicitors would be hard to quantify. In section IV.C, assuming that each solicitor would have ten referrals subject to the proposed rule, we estimate the total ongoing burden to be approximately $22,654,596.[605] However, according to the data from investment advisers to private funds, investment advisers do not necessarily engage new solicitors every year, and many solicitors work for multiple advisers at the same

602 The numbers are based on responses to Section 7.B.(1) 28(a) as of December 31, 2018.

603 The number is calculated as: 3 × [3,655 (number of advisers that compensate non-employees) + 673(5 percent of RIAs that would use directed brokerage as a type of compensation)-4(advisers provide only impersonal investment advisory services) + 1590(advisers to private funds)-210(advisers to private funds that only use solicitors that are "related persons") + 135(1 percent of RIAs that use nonprofit programs for solicitation)].

604 The number is calculated as: 3 × [3,655 (number of advisers that compensate non-employees) + 976(number of advisers that compensate only employees to obtain more clients, but might be subject to disclosures) + 673(5 percent of RIAs that would use directed brokerage as a type of compensation) - 4(advisers provide only impersonal investment advisory services) + 1590(advisers to private funds) + 135(1 percent of RIAs that use nonprofit programs for solicitation)].

605 *See* table in section IV. C. for details.

time. Therefore, the total ongoing cost could be more or less than the number estimated. For the proposed recordkeeping amendments that correspond to proposed changes to the solicitation rule, we estimate that the proposed amendments would increase the burden of each investment adviser that would be subject to the solicitation rule by $95.[606] As discussed above, approximately 6,432 investment advisers would be subject to the proposed rule, and therefore we estimate a total annual cost of $611,297 across the market to comply with the recordkeeping requirements of the proposed solicitation rule.

## E. Efficiency, Competition, Capital Formation

### 1. Advertising

#### a. *Efficiency*

By generally altering and updating the set of permissible advertisement types, the proposed rules have the potential to improve the information in investment adviser advertisements. Improving the information available in investment adviser advertisements could improve the efficiency of the market for investment advice in two ways. First, the proposed rule could increase the overall amount of information in investment adviser advertisements. This could either be directly through the provisions of the proposed rule, or indirectly, through competition between investment advisers through advertisements. Second, the proposed rule could increase the overall quality of information about investment advisers. To the extent that the proposed rules mitigate misleading or fraudulent advertising practices, investors may be more

606 17 percent of the compliance to the proposed rule is assumed to be performed by compliance clerks, whose hourly cost is $70, and 83 percent by general clerks, whose hourly cost is $62 (data is from the Securities Industry and Financial Markets Association's Office Salaries Data 2013 Report, modified to account for an 1,800-hour work-year, inflation, bonuses, firm size, employee benefits and overhead). In PRA, it is also estimated that all advisers that would use the proposed solicitation rule would incur an estimated 1.5 hour in complying with the recordkeeping requirements related to the solicitation rule. The total incremental cost is calculated as 1.5 × ($70 × 17% + $62 × 83%) = $95.04, per adviser.

likely to believe the claims of investment adviser advertisements. Investment advisers, as a result, may include more relevant or useful information in their advertisements, in lieu of misleading or irrelevant statements.

The information from testimonials, performance data, and third-party ratings can potentially provide valuable information for investors. Better informed investors could improve the efficiency of the market for investment advice, as they may be better able to evaluate investment advisers based on the information in their advertisements.[607]

Although the proposed rule requires additional disclosures when investment advisers include certain elements in their advertisements, the value of these disclosures to investors depends critically on whether they are able to utilize the disclosures to fully understand the proper context of an adviser's claims. By providing enough information to investors in the required disclosures to enable them to evaluate an adviser's advertisements, these disclosures would effectively mitigate the potential that advertisements mislead investors, and improve their ability to find the right investment adviser for their needs. But, to the extent that the proposed rule does not provide investors with the context necessary to make sound financial decisions, then the proposed rule might lead to a reduction in the efficiency of advertisements.

In addition to considering the role that advertisements may play in reducing information asymmetries and the role that information asymmetries play in the risks associated with advertising, we also consider the efficiency of advertisements in reducing these information asymmetries. In particular, one potential consequence of the proposed rule is that investment advisers increase the amount of resources they allocate to advertising their services. While additional spending on advertisements may facilitate matching between investment advisers and

[607] For more, *see* Section III.B.

investors, under some circumstances, this additional spending may be inefficient if the benefits of better matches fall short of the resources required to facilitate better matches. Although there is not much data on the efficiency of investment adviser advertising practices, academic literature provides us with evidence of potential inefficiencies related to advertising in a neighboring market: mutual funds. We recognize that investment advisers to mutual funds are subject to some legal requirements and may operate in distribution channels that are different from those applicable to investment advisers offering direct advisory services and pooled investment vehicles such as those covered by the proposed rule, but we think it is nevertheless useful to understand how advertising by mutual funds affects mutual fund investors, while keeping in mind how similarities and differences between these settings impact the generalizability of results drawn from mutual fund advertising.

The literature on marketing for mutual funds documents a positive correlation between funds' marketing efforts and investor flows (cash investment from investors). Researchers find that marketing expenses are nearly as important as price (*i.e.*, expense ratio) or performance for explaining fund size (AUM), and the effect is larger among top performers than funds with lower returns. However, mutual funds also charge more fees to cover marketing costs as they engage in an "arms race" to attract assets from the same pool of investors.[608] As fees increase, investors with a higher search cost who are less likely to search for lower-fee funds—usually investors with lower financial literacy – are more likely to end up paying higher fees for funds. Further, less sophisticated investors might be matched with a lower quality asset manager to begin with, and a higher fee further reduces their realized returns. While some portion of the costs

[608] *See* Roussanov, Ruan and Wei (2018), *supra* footnote 576.

associated with this costly competitive advertising spending would be absorbed by mutual fund management or advisers, other portions would be passed on to investors.[609]

Although the study's authors examine mutual funds and not investment advisers, both mutual funds and investment advisers target similar groups of clients, have similar fee structures, and exhibit similar information asymmetry problems between investors and financial service or product providers. However, mutual funds differ from investment adviser services in ways that might limit the conclusions we could make about investment adviser advertisements. First, mutual funds operate under specific advertising rules that do not apply to investment advisers marketing direct advisory services or to the marketing of pooled investment vehicles, and the content of mutual fund advertisements may substantively differ from those of investment advisers and pooled investment vehicles. Second, mutual funds sell both financial products and services, while investment advisers primarily sell services, and investors may have different considerations and objectives when evaluating mutual funds compared to investment advisers, or their respective advertisements. Finally, advertising may be a less important determinant of client AUM for investment advisers in the context of the proposed rules, because investors that work with investment advisers may have different financial knowledge and resources, making an "arms race" less likely.

#### b. *Competition*

As discussed earlier, the proposed rule might result in an increase in the efficiency of investment adviser advertisements, providing more useful information to investors about the abilities of an investment adviser than advertisements under the baseline, which would allow

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609 *Id.* The authors observe that in aggregate, although the additional flexibility in advertisement improved information and match efficiency, the costs associated with this advertising "arms race" exceeded those benefits.

them to make better decisions about which investment advisers to choose. In this case, investment advisers might have a stronger incentive to invest in the quality of their services, as the proposed rule would permit them more flexibility to communicate the higher quality of their services by providing additional information about their services. This would promote competition among investment advisers based on the quality of their services, and result in a benefit for investors.

However, the proposed rule might instead provide investment advisers with a stronger incentive to invest in the quality of their advertisements rather than the quality of their services. This would promote inefficient competition among investment advisers based on the quality of their advertisements rather than the quality of their services, which would waste the resources of investment advisers. In addition, to the extent that higher quality advertisements generated by this "arms race" are uncorrelated with the services of an investment adviser's services, investors may be harmed if they enter relationships with investment advisers based on the quality of their advertisements, rather than their services. Although the direct costs of advertisements would be borne by the investment adviser, it is possible that some portion of the costs of advertisement will be borne by investors.[610]

### c. *Capital Formation*

To the extent that the proposed rules result in improved matches in the market for investment advice, potential investors may be drawn to invest additional capital, which would promote capital formation. However, if as a result of the proposed rule, investment advisers may

[610] Firms that face a change in costs will bear some portion of these costs directly, but will also pass a portion of the cost to their consumers through the price. In a competitive market, the portion of these costs that firms are able to pass on to consumers depends on the relative elasticities of supply and demand. For example, if demand for investment adviser services is elastic relative to supply of investment adviser services, investment advisers will be limited in their ability to pass through costs. For more, see [econ textbook ref].

compete with each other based on their advertisements, rather than the quality of their services, advertisements overall would become less efficient in their ability to allow investment advisers to effectively advertise their ability. If the service matches between investors and investment advisers decline as a result of the proposed rule, investors may divert capital from investment to other uses, thus hindering capital formation.

**2. Solicitation**

**a. *Efficiency***

The proposed solicitation rule expands the scope of provisions for solicitors, by covering all forms of compensation. The rule also scopes in solicitors for private funds, applying the disclosure and disqualification requirements of the solicitation rule to broker-dealers that currently are only subject to bad actor provisions from Regulation D. In addition, the rule would continue to require disclosures to make salient the nature of the relationship between a solicitor and the investment advisers. These provisions could improve the efficiency of the market for investment advisers by ensuring that the provisions of the solicitation rule apply to all forms of conflicts of interest for solicitors. If investors are aware of these conflicts of interest through disclosures, they may be better able to interpret their interactions with solicitors and choose an investment adviser that is of higher quality, or a better match. The proposed rule also removes the acknowledgement requirement for solicitor disclosures, and permits either investment advisers or solicitors to deliver the solicitor disclosure, as well as the timing of that delivery. These provisions will lower the cost of making these disclosures for solicitors and investors, and improve the efficiency of the solicitation process.

**b. *Competition***

The proposed solicitation rule expands the scope of solicitor relationships that are covered by the provisions of the rule. By scoping non-cash compensation into the scope of the rule, the proposed rule could improve competition among investment advisers and solicitors by ensuring that all forms of compensation for solicitors are subject to the same requirements. Under the proposed rule, solicitors that prefer cash compensation for their activities would not be unfairly burdened with the requirements of the rule relative to solicitors that prefer or accept non-cash compensation.

### c. *Capital Formation*

Although there are no provisions in the proposed solicitation rule that directly affect capital formation, the proposed rule could still indirectly affect capital formation through its effect on the efficiency of investors' choice of investment advisers, and investor confidence in the quality of solicitors. The proposed rule's expansion of the scope of compensation might improve the efficiency of the ultimate choice of investment adviser that investors make. In addition, the proposed rule expands the set of disqualifying events that would bar an individual from becoming a solicitor, which may improve an investor's confidence in a solicitor's recommendation of an investment adviser. In addition, the proposed rule also specifies a set of events that are not disqualifying, such as orders that impose sanctions with respect to acts or omissions but do not bar, suspend, or prohibit the person from acting in any capacity under the Federal securities laws. These effects could improve investor confidence in the quality of solicitors, and lead investors to allocate more of their resources towards investment, thus promoting capital formation.

## F. Reasonable Alternatives Considered

### 1. Reduce Specific Limitations on Investment Adviser Advertisements

One alternative to the proposed advertising rule would be to reduce the specific limitations on investment adviser advertising, and rely on the general prohibitions to achieve the programmatic costs and benefits of the rule. For example, this might include reducing the specific limitations on the different types of hypothetical performance or testimonials and endorsements. We note that the specific prohibitions of the proposed rule are prophylactic in nature, and that many of the advertising practices described in the specific prohibitions would also be prohibited under the general prohibitions on fraud and deceit. However, we note that the removal of the specific prohibitions may create uncertainty about what types of advertisements would fall under the general prohibition of false or misleading advertisements.

### 2. Not Have an Advertising Rule and Rely on Section 206

Under our proposed approach, as a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts, practices, and courses of business, we would amend rule 206(4)-1 generally to prohibit certain conduct and restrict certain specific identified advertising practices. Alternatively, we could not restrict any specific practices, and instead rely solely on the general prohibitions against fraud or deceit in section 206 of the Advisers Act and certain rules thereunder. Under such an approach, a rule specifically targeting adviser advertising practices might be unnecessary. In the absence of an advertising rule, however, an adviser might have not sufficient clarity and guidance on whether certain advertising practices would likely be fraudulent and deceptive. As a consequence, advisers may bear costs in obtaining such guidance or may otherwise restrict their advertising activities unnecessarily in the absence of such clarity and guidance that would be provided through a rule, and may reduce their advertising as a result.

In addition, under such an approach, investors may also not obtain some of the benefits associated with the proposed rule. For example, in the absence of a specific advertising rule, investors would not obtain the benefits associated with the comparability of performance presentations provided in the proposed rule, or the requirement to provide performance over a variety of periods so that a client or investor may sufficiently evaluate the adviser's performance. Investors and clients would also not benefit from the specific protections against the potential for misleading hypothetical performance contained in the proposed rule, such as the requirement to have policies and procedures designed to ensure that such performance is relevant to the financial situation and investment objectives of the client or investor and includes sufficient disclosures to enable persons receiving it to understand how it is calculated and the risks and limitations of relying on it. Though some advisers might provide such information even in the absence of the proposed specific requirements to help ensure that they do not violate section 206 of the Act, others may not. As a consequence, this approach may benefit certain advisers by allowing them to avoid the costs of the specific requirements of the proposed rule, but may come at the cost of ensuring adequate disclosure to some investors, and may result in them not gaining the benefit of the other protections of the rule.

### 3. Define Non-Retail Investors as Accredited Investors or Qualified Clients

Another alternative to the proposed rule would be to include in the definition of Non-Retail Persons "accredited investors," as defined in rule 501(a) of Regulation D under the Securities Act of 1933 ("Securities Act"), or "qualified clients.". Both of these alternative standards would expand the set of investors that would be considered non-retail investors, and would expand the set of investors subject to the programmatic costs and benefits of the rule that affect non-retail advertisements, while reducing the set of investors subject to the programmatic

costs and benefits of the rule that affect retail advertisements. Although these alternatives would expand the set of advertisements and information available to investors who are accredited investors (or qualified clients) but are not qualified purchasers or knowledgeable employees, these alternatives would also deny investors the protections associated with the additional limitations for performance advertisements for retail investors. As we described earlier, we believe that the qualified purchaser and knowledgeable employee standards provide a more appropriate standard for determining whether an investor has sufficient access to analytical and other resources, and bargaining power to receive different treatment under the proposed rule. [611]

#### 4. Further Bifurcate Additional Requirements

Some of the proposed rule's substantive provisions vary depending on the type of investor that the investment adviser reasonably expects to receive the advertisement.[612] One alternative to the proposed rule would be to further bifurcate requirements of the proposed rule that currently apply to all advertisements. For example, one alternative considered prohibiting hypothetical performance in Retail Advertisements, but not in Non-Retail Advertisements, provided that certain disclosures were made.

Evidence from academic research suggests that that the investors in the market for broker-dealer services are highly segmented in their financial literacy and access to resources. One paper finds that less sophisticated investors are served by broker-dealers that are likely to engage in misconduct, while more sophisticated investors have the financial knowledge and

611 *See supra* Section III.D.

612 *See supra* footnote 3.

resources to avoid such firms.[613] Although misconduct by investment advisers is not directly addressed by the proposed rule, the fact that certain market segments are susceptible to misconduct suggests that the lack of financial knowledge or access to resources may also leave them susceptible to false or misleading statements in advertisements or solicitations.

Tailoring additional requirements to suit the segmented nature of the market for financial advice may yield benefits to investor protection for investors with lower financial literacy or access to resources, as advertisements directed towards these specific market segments vulnerable to misleading statements would face additional requirements. Similarly, advertisements not directed towards those segments would benefit from additional flexibility and information contained in these advertisements. However, increasing the bifurcation of requirements in the proposed rule might also impose additional costs on investment advisers, who may need to expend additional resources to create advertisements that complied with two increasingly different sets of requirements.

### 5. No Bifurcation

Another alternative to the proposed rule would be to have no bifurcation in the requirements for Retail Advertisements and Non-Retail Advertisements. In this alternative, all advertisements would be subject to a single set of requirements, regardless of the intended audience. A lack of bifurcation in requirements for advertisements may mean that a single set of

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613 *See* The Market for Financial Adviser Misconduct, *supra* footnote 532. The paper uses the term "financial advisors," to refer to broker-dealer representatives. The authors argue that broker-dealer representatives target different groups of investors and that this segmentation permits firms with high tolerance for misconduct on the part of their associated persons to coexist with firms maintaining clean records in the current market. They find that misconduct is more common among firms that advise retail investors, and in counties with low education, elderly populations and high incomes (when controlling for other characteristics). Although the paper does not divide the studied population by the Qualified Purchaser or Knowledgeable Employee standards, the relationship between client base and adviser misconduct nonetheless provides relevant information about the potential effects of the rule.

requirements for investment adviser advertisements may be unable to meet the needs of investors with high and low levels of financial sophistication simultaneously. Investors with high levels of financial sophistication might face unnecessarily strict requirements for advertisements, or investors with low levels of financial sophistication might not be sufficiently protected from fraudulent or misleading advertisements. To the extent that a bifurcated set of requirements in the proposed rule is able to correctly distinguish the financial sophistication of investors, each set of advertisement requirements in the proposed rule will be more appropriately tailored to their respective type of investor.

### 6. Hypothetical Performance Alternatives

One alternative to the proposed rule's treatment of hypothetical performance would be to prohibit all forms of hypothetical performance in all advertisements. This alternative would eliminate the possibility that investors are misled by hypothetical performance, but also eliminates the possibility that investors might gain useful information from some types of hypothetical information. While a prohibition on hypothetical performance might improve the efficiency of investment adviser advertising by reducing the chance that investors are misled by advertisements, efficiency can also be reduced if investors are unable to receive relevant information about the investment adviser.

Conversely, another alternative would be to permit all hypothetical performance in all advertisements, without any conditions or requirements. This may permit relevant hypothetical performance to reach investors, and although hypothetical performance poses a high risk of misleading investors, such statements would still be subject to the general prohibitions.

### 7. Alternatives to Proposed Amendments to Rule 206(4)-3

We are proposing an exemption wherein the amended solicitation rule would not apply if the solicitor has performed solicitation activities for the investment adviser during the preceding twelve months and the investment adviser's compensation payable to the solicitor for those solicitation activities is $100 or less (or the equivalent value in non-cash compensation). We considered the alternative of not having any *de minimis* exemption. Although this alternative would expand the scope of compensation covered by the solicitation rule, potentially extending the costs and benefits of the proposed solicitation rule to these solicitation activities, we believe the solicitor's incentives to defraud an investor are significantly reduced when receiving *de minimis* compensation, and that the need for heightened safeguards is likewise reduced.

Conversely, we considered the alternative of proposing a higher threshold for a *de minimis* exemption. However, we drew from other rules applicable to certain dual registrants and broker-dealers, and chose a $100 threshold (or the equivalent value in non-cash compensation) over a trailing one-year period. We believe that proposing an aggregate $100 *de minimis* amount over a trailing year period is consistent with our goal of providing an exception for small or nominal payments. Regarding the trailing period, we understand that a very engaged solicitor who is paid even a small amount per referral could potentially receive a significant amount of compensation from an adviser over time even if the solicitor receives less than $100 per each individual referral. In such a case we believe that investors should be informed of the conflict of interest and gain the benefit of the other provisions of the rule.

We also considered the alternative of not applying the proposed amended solicitation rule to the solicitation of existing and prospective private fund investors. Under this alternative, the rule would apply only to the adviser's clients (including prospective clients), which are generally

the private funds themselves, and would not apply to investors in private funds. However, while investors in private funds may often be financially sophisticated, they may not be aware that the person engaging in the solicitation activity may be compensated by the adviser, and we believe investors in such funds should be informed of that fact and the related conflicts. In addition, we believe that our proposal to apply the solicitation rule to investors in private funds would be consistent with the proposed advertising rule. We believe that harmonizing the scope of the solicitation rule with the advertising rule to the extent possible should ease compliance burdens.

## IV. PAPERWORK REDUCTION ACT ANALYSIS

### A. Introduction

Certain provisions of our proposal would result in new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[614] The proposed amendments would have an impact on the current collection of information burdens of rules 206(4)-3 and 204-2 under the Investment Advisers Act ("the Act") and Form ADV. The title of the new collection of information we are proposing is "Rule 206(4)-1 under the Investment Advisers Act." OMB has not yet assigned a control number for "Rule 206(4)-1 under the Investment Advisers Act." The titles for the existing collections of information that we are proposing to amend are: (i) "Rule 206(4)-3 under the Investment Advisers Act of 1940 (17 CFR 275.206(4)-3)" (OMB number 3235-0242); (ii) "Rule 204-2 under the Investment Advisers Act of 1940" (OMB control number 3235-0278); and (iii) "Form ADV" (OMB control number 3235-0049). The Commission is submitting these collections of information to the Office of Management and Budget ("OMB") for review and approval in accordance with 44 U.S.C.

614 44 U.S.C. 3501 et seq.

3507(d) and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

We discuss below the new collection of information burdens associated with the proposed amendments to rule 206(4)-1, as well as the revised existing collection of information burdens associated with the proposed amendments to rules 206(4)-3 and 204-2, and Form ADV. Responses provided to the Commission in the context of its examination and oversight program concerning the proposed amendments to rule 206(4)-1, rule 206(4)-3, and rule 204-2 would be kept confidential subject to the provisions of applicable law. Responses to the disclosure requirements of the proposed amendments to Form ADV, which are filed with the Commission, are not kept confidential. In addition, because the information collected pursuant to rule 206(4)-3 requires solicitor disclosures to investors, these disclosures would not be kept confidential. The Commission also intends to use a Feedback Flier to obtain information from investors about the proposed rule.[615] The Feedback Flier is included in this proposal as Appendix B hereto.

### B. Rule 206(4)-1

Proposed rule 206(4)-1 states that, as a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts, practices, or courses of business within the meaning of section 206(4) of the Act, it is unlawful for any investment adviser registered or required to be registered under section 203 of the of the Act, directly or indirectly, to disseminate any advertisement that violates any of paragraphs (a) through (d) of the proposed rule, which include the proposed rule's

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615 The Commission has determined that this usage is in the public interest and will protect investors, and therefore is not subject to the requirements of the Paperwork Reduction Act of 1995. *See* section 19(e) and (f) of the Securities Act. Additionally, for the purpose of developing and considering any potential rules relating to this rulemaking, the agency may gather from and communicate with investors or other members from the public. *See* section 19(e)(1) and (f) of the Securities Act.

general prohibitions. For example, an adviser could not refer in an advertisement to its specific investment advice if the presentation is not "fair and balanced,"[616] and an adviser cannot make a material claim or statement that is unsubstantiated.[617] The proposed rule also contains conditions on testimonials, endorsements and third-party ratings.[618] Those conditions would require that advertisements containing testimonials, endorsements, or third-party ratings contain certain disclosures and, for third-party ratings, comply with other conditions. Our proposal would recognize that while consumers and businesses often look to the experiences and recommendations of others in making informed decisions, there may be times when these tools are less credible or less valuable than they appear to be. We believe that with tailored disclosures and other safeguards discussed herein, advisers could use testimonials, endorsements and third-party ratings in advertisements to promote their accomplishments with less risk of misleading investors. The proposed rule contains additional tailored conditions and restrictions that advertisements using performance results include certain disclosures or that the adviser provide additional information, in certain cases upon request, and in certain circumstances adopt and implement appropriate policies and procedures.[619] Certain conditions related to performance are only applicable to Retail Advertisements. Finally, the proposed rule would contain a requirement that advertisements be reviewed and approved by a designated employee prior to dissemination, with certain exceptions.[620]

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616 Proposed rule 206(4)-1(a)(5).

617 Proposed rule 206(4)-1(a)(2).

618 Proposed rule 206(4)-1(b).

619 Proposed rule 206(4)-1(c).

620 Proposed rule 206(4)-1(d).

Each requirement to disclose information, offer to provide information, or adopt policies and procedures constitutes a "collection of information" requirement under the PRA. The respondents to these collections of information requirements would be investment advisers that are registered or required to be registered with the Commission. As of September 30, 2019, there were 13,463 investment advisers registered with the Commission.[621] The use of advertisements is not mandatory, but given that: (i) advertising is an essential part of retaining and attracting clients; (ii) advertising may be disseminated easily through the internet and social media; and (iii) the proposed definition of "advertisement" expands the scope of the current rule, such as including communications that are disseminated to obtain or retain investors in pooled investment vehicles; we estimate that all investment advisers will disseminate at least one communication meeting the proposed rule's definition of "advertisement" and therefore be subject to the requirements of the proposed rule. Because the use of testimonials, endorsements, third-party ratings, and performance results in advertisements is voluntary, the percentage of investment advisers that would include these items in an advertisement is uncertain. However, we have made certain estimates of this data, as discussed below, solely for the purpose of this PRA analysis.

### 1. Testimonials and endorsements in advertisements

Under the proposed rule investment advisers are prohibited from including in any advertisement any testimonial or endorsement unless the adviser clearly and prominently discloses, or the investment adviser reasonably believes that the testimonial or endorsement clearly and prominently discloses, that the testimonial was given by a client or investor, or the endorsement was given by a non-client or non-investor and, if applicable, that cash or non-cash

621 *See supra* footnote 553.

compensation has been provided by or on behalf of the adviser in connection with obtaining or using the testimonial or endorsement.[622] We estimate that approximately 50 percent of registered investment advisers would use testimonials or endorsements in advertisements (because we estimate that 100 percent of registered investment advisers would advertise under the proposed rule, we estimate that the number of advisers that would use testimonials or endorsements in their advertisements would be 6,732 advisers (50 percent of 13,463 advisers)). We estimate that an investment adviser that includes testimonials or endorsements in advertisements would use approximately 5 testimonials or endorsements per year, and would create new advertisements with new or updated testimonials and endorsements approximately once per year. We estimate that an investment adviser that includes testimonials or endorsements in its advertisement would incur an internal burden of 1 hour to prepare the required disclosure for its testimonials and/or endorsements (approximately 0.2 hours per each testimonial and/or endorsement). Since each testimonial and/or endorsement used would likely be different, we believe this burden would remain the same each year. There would therefore be an annual cost to each respondent of this hour burden of $337.00 to draft and finalize the required disclosure for the advisers' advertisements that contain testimonials or endorsements.[623] We are not proposing an initial burden because we estimate that advisers would create new advertisements with new or updated testimonials and endorsements each year, and because we believe the disclosures would be brief and straightforward.

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622 Proposed rule 206(4)-1(b)(1).

623 This estimate is based on the following calculation: 1 hour (for preparation and review of disclosures) x $337 (blended rate for a compliance manager ($309) and a compliance attorney ($365)). The hourly wages used are from SIFMA's Management & Professional Earnings in the Securities Industry 2013, modified to account for an 1800-hour work-year and inflation and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead.

The length and content of the disclosure should not vary much across investment advisers. Once these disclosures are created they will require little, if any modification, until the adviser creates advertisements with new or updated testimonials and endorsements (which we estimate as approximately once per year, as noted above). Therefore, we estimate that the yearly total internal burden of preparing the disclosure would be 6,732 hours.[624] Thus, the aggregate internal cost of the hour burden for investment advisers is estimated to be $2,268,684 per year.[625]

**2. Third-party ratings in advertisements**

Proposed rule 206(4)-1(b)(2) would allow an investment adviser to include third-party ratings in advertisements if the adviser reasonably believes that any questionnaire or survey used in the preparation of the third-party 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, the adviser would have to clearly and prominently disclose (or reasonably believe that the third-party rating clearly and prominently discloses): (i) the date on which the rating was given and the period of time upon which the rating was based, (ii) the identity of the third-party that created and tabulated the rating, and (iii) if applicable, that cash or non-cash compensation has been provided by or on behalf of the adviser in connection with obtaining or using the third-party rating. In many cases, third-party ratings are developed by relying significantly on questionnaires or client surveys. Investment advisers may compensate the third-party to obtain or use the ratings or rankings that are calculated as a result of the survey. Due to the costs associated with third-party ratings, we estimate that approximately 50 percent,

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624 This estimate is based on the following calculation: 1 hour per adviser x 6,732 advisers.

625 This estimate is based on the following calculation: 6,732 hours per advisers in the aggregate per year x $337 per hour.

or 6,732 advisers, will use third-party ratings in advertisements, and that they will typically use one third-party rating on an annual basis.

We estimate that advisers would incur an initial internal burden of 1.5 hours to draft and finalize the required disclosure for third-party ratings. Accordingly, we estimate the initial cost to each respondent of this hour burden to be $505.50.[626] The third-party rating provision requires investment advisers to disclose up to four pieces of information. We estimate that the total burden for drafting and reviewing initial third-party rating disclosures for all investment advisers that we believe use third-party ratings in advertisements would be 10,098 hours,[627] with a total initial internal cost of the hour burden of approximately $3,403,026.[628]

In addition, since many of these ratings or rankings are done yearly *(e.g.,* 2018 Top Wealth Adviser), an adviser that continues to use a third-party rating in a retail advertisement would incur ongoing, annual costs associated with this burden. We estimate that these ongoing annual costs would be approximately 25 percent of the investment adviser's initial costs per year, since the adviser would typically only need to update its disclosures related to the date on which the rating was given and the period of time upon which the rating was based. Therefore, we estimate that an investment adviser would spend 0.375 burden hours annually associated with drafting the required third-party rating disclosure updates.[629] Accordingly, we estimate the annual ongoing cost to each respondent of this hour burden to be $126.38.[630] The aggregated

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626 $337 per hour x 1.5 hours. *See supra* footnote 623 for a discussion of the blended hourly rate for a compliance manager and a compliance attorney.

627 This estimate is based on the following calculation: 1.5 hours per adviser x 6,732 advisers.

628 This estimate is based on the following calculation: 10,098 hours per advisers in the aggregate x $337 per hour.

629 This estimate is based in the following calculation: 25 percent of 1.5 hours.

630 This estimate is based in the following calculation: 0.375 hours per adviser x $337.

ongoing burden for investment advisers updating initial third-party rating disclosures for all investment advisers that we estimate would use third-party ratings in advertisements would be 2,524.5 hours,[631] at a total ongoing annual cost of the hour burden of approximately $850,756.50.[632]

### 3. Performance Advertising

The proposed rule would impose certain conditions on the presentation of performance results in advertisements. Specifically, the proposed rule would require that advertisements that present gross performance provide or offer to provide promptly a schedule of fees and expenses deducted to calculate the net performance.[633] In addition, the proposed rule would require that advertisements that present any related performance must include all related portfolios, except that related performance may exclude any related portfolio if (a) the advertised performance results are no higher than if all related portfolios had been included and (b) the exclusion of any related portfolio does not alter the presentation of the time periods prescribed by paragraph (c)(2)(ii).[634] The proposed rule also would require that advertisements that present any extracted performance must provide or offer to provide promptly the performance results of all investments in the portfolio from which the performance was extracted.[635] Finally, the proposed rule would require, for advertisements that present hypothetical performance, that the adviser: (i) adopt and implement policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the financial situation and investment objectives of the person to

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631 This estimate is based in the following calculation: 0.375 hours x 6,732 advisers

632 This estimate is based in the following calculation: 2,524.5 hours x $337.

633 Proposed rule 206(4)-1(c)(1)(i).

634 Proposed rule 206(4)-1(c)(1)(iii).

635 Proposed rule 206(4)-1(c)(1)(iv).

whom the advertisement is disseminated; (ii) provide sufficient information to enable such person to understand the criteria used and assumptions made in calculating such hypothetical performance; and (iii) provide (or in the case of Non-Retail Persons, provides or offers to provide promptly) sufficient information to enable such person to understand the risks and limitations of using such hypothetical performance in making investment decisions.[636] As a result of these conditions, the proposed rule would include "collection of information" requirements within the meaning of the PRA for investment advisers presenting performance results in advertisements.

We estimate that almost all advisers provide, or seek to provide, performance information to their clients. Based on staff experience, we estimate that 95 percent, or 12,790 advisers, provide performance information in their advertisements. The estimated numbers of burden hours and costs regarding performance results in advertisements may vary depending on, among other things, the complexity of the calculations and whether preparation of the disclosures is performed by internal staff or outside counsel.

#### a. *Gross Performance: Provide or offer to provide promptly a schedule of fees and expenses deducted to calculate net performance*

We estimate that an investment adviser that elects to present gross performance in an advertisement will incur an initial burden of 5 hours in preparing a schedule of the fees and expenses deducted to calculate net performance, in order to provide such a schedule, which may be upon request.[637] We further estimate each adviser electing to present gross performance will include gross performance for 3 different portfolios.

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636 Proposed rule 206(4)-1(c)(1)(v).

637 This estimate includes only the time spent by an adviser in preparing the schedule initially.

Advisers' staff generally would have to conduct diligence to determine which fees and expenses were applied and how to categorize them for purposes of the schedule. We believe many advisers that currently advertise performance will have this information already, but will use compliance staff to confirm and categorize the relevant fees and expenses. We expect that an accountant or financial personnel at the adviser will extract the relevant data needed to prepare the schedule. There would therefore be an initial burden cost of 5 hours, with an estimated cost of $1,564, for each adviser to prepare its schedule with respect to each initial presentation of net performance of each portfolio.[638] We estimate that the initial burden, on a per-adviser basis, will be $4,692.[639]

For purposes of this analysis, we estimate that advisers will update their schedules 3.5 times each year.[640] We estimate that after initially preparing a schedule of fees and expenses, an adviser will incur a burden of 0.5 hours to update the schedule. Accordingly, we estimate that the amortized average annual burden with respect to preparation of schedules would be 10.25 hours per year.[641] The estimated amortized aggregate annual burden with respect to schedules is

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638 This estimate is based on the following calculation: 4.0 hours (for review of disclosures) x $337 (blended rate for a compliance manager ($309) and a compliance attorney ($365)) + 1.0 hour (for extraction of relevant fees and expenses) x $216 (senior accountant) = $1,564. *See supra* footnote 623 for a discussion of the blended rate.

639 This estimate is based on the following calculation: $1,564 for each schedule per initial presentation per portfolio X 3 portfolios per adviser.

640 This estimate takes into account the Commission's experience with the hour and cost burden estimates we have adopted for rule 482 under the Securities Act, which requires in part that advertisements with respect to RICs and BDCs to be filed with the Commission or with FINRA. In our most recent hour and cost burden estimate for rule 482, we estimated that approximately 3.5 responses are filed each year per portfolio. We believe that estimate fairly represents the number of times an advertisement is filed for purposes of rule 482, and so use that same estimate in establishing how often an advertisement's performance is updated for purposes of this analysis.

641 We estimate that the average investment adviser will have an amortized average annual burden of 10.25 hours ((1 initial schedule X 5 hours + 3.5 subsequent updates to schedule X 0.5 hours) (year 1) + (3.5 subsequent updates to schedule X 0.5 hours) (year 2) + (3.5 subsequent updates to schedule X 0.5 hours) (year 3) = 10.25 over 3 years. 10.25 hours X 3 portfolios = 30.75 hours per adviser; and 30.75 hours ÷ 3 years = 10.25 hours).

131,098 hours per year for each of the first three years,[642] and the aggregate internal cost burden is estimated to be $44,180,026 per year.[643]

We estimate that registered investment advisers may incur external costs in connection with the requirement to provide a schedule of fees and expenses. We estimate that the average annual costs associated with printing and mailing these documents upon request would be collectively $500 for all documents associated with a single registered investment adviser.[644] Accordingly, we estimate that the aggregate annual external costs associated with printing and mailing these documents in connection with Non-Retail Advertisements would be $6,395,000.[645]

### b. *Related performance*

We estimate that an investment adviser that elects to present related performance in an advertisement will incur an initial burden of 25 hours, with respect to each advertised portfolio, in preparing the relevant performance of all related portfolios. This time burden would include the adviser's time spent classifying which portfolios meet the proposed rule's definition of "related portfolio" – i.e., which portfolios have "substantially similar investment policies,

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642 We estimate that 10.25 burden hours on average per year X 12,790 advisers presenting performance results (*i.e.*, 95% of 13,463 total advisers).

643 This estimate is based on the following calculation: 131,098 hours per advisers in the aggregate per year X $337 per hour.

644 We do not have specific data regarding how the cost of printing and mailing the schedule would differ, nor are we able to specifically identify how the cost of printing and mailing the schedule might be affected by the proposed rule. For these reasons, we estimate $500 per year to collectively print and mail upon request the schedule associated with an investment adviser for purposes of our analysis. This estimate assumes only 25% of clients who receive the relevant advertisement request the schedule from the adviser and assumes that marketing personnel at the adviser would respond to each such request. However, we are requesting comment on this estimate. In addition, investors may also request to receive a schedule electronically. We estimate that there would be negligible external costs associated with emailing electronic copies of the schedules.

645 This estimate is based upon the following calculations: $500 per adviser x 12,790 advisers that provide performance information (*i.e.*, 95% of the 13,463 total advisers) = $6,395,000. For purposes of this Paperwork Reduction Act analysis, based upon our experience, we assume that the burden of emailing these documents would be outsourced to third-party service providers and therefore would be included within these external cost estimates.

objectives, and strategies as those of the services being offered or promoted."[646] This burden also would include time spent determining whether to exclude any related portfolios in accordance with the proposed rule's provision allowing exclusion of one or more related portfolios if "the advertised performance results are no higher than if all related portfolios had been included" and "the exclusion of any related portfolio does not alter the presentation of the time periods prescribed by rule 206(4)-1(c)(2)(ii)."[647] For purposes of making this determination, we assume that an adviser generally would have to run at least two sets of calculations – one with, and one without, a related portfolio, that will allow the adviser to consider whether the exclusion of the portfolio would result in performance that is inappropriately higher or performance that would not satisfy the time period requirement.[648] Finally, this time burden would include the adviser's time calculating and presenting the net performance of any related performance presented. There would therefore be an initial cost of $8,425 for each adviser to comply with this proposed requirement to present all related portfolios in connection with any related performance.[649]

Today, advisers may advertise related performance using their own definition, which may vary between advisers. For purposes of this analysis, we estimate 80 percent of advisers will have other portfolios with substantially similar investment policies, objectives, and strategies as those being offered or promoted in the advertisement and choose to include related performance, as defined under the proposal. We estimate that after initially preparing related performance for

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646 *See* proposed rule 206(4)-1(e)(12). Our estimate accounts for advisers that may already be familiar with any composites that meet the definition of "related portfolio."

647 *See* proposed rule 206(4)-1(c)(1)(iii).

648 Our estimate also accounts for firms that exclude accounts subject to investment restrictions that materially affect account holdings regardless of whether the exclusion increases or decreases overall performance, such as is required under GIPS.

649 This estimate is based on the following calculation: 25.0 hours (for review of disclosures) x $337 (blended rate for a compliance manager ($309) and a compliance attorney ($365)) = $8,425. *See supra* footnote 623 for a discussion of the blended hourly rate for a compliance manager and a compliance attorney.

each portfolio, investment advisers will incur a burden of 5 hours to update the performance for each subsequent presentation. For purposes of this analysis, we estimate that advisers will update the relevant related performance 3.5 times each year.

Accordingly, we estimate that the amortized average annual burden would be 25.8 hours for each of the first three years for each investment adviser to prepare related performance in connection with this requirement.[650] The estimated amortized aggregate annual burden with respect to Retail Advertisements is 277,866 hours per year for each of the first three years,[651] and the aggregate internal cost burden is estimated to be $93,640,842 per year.[652]

### c. *Extracted performance*

We estimate that an investment adviser that elects to present extracted performance in an advertisement will incur an initial burden of 10 hours in preparing the performance results of the entire portfolio from which the performance is extracted in order to provide such performance results to investors, which may be promptly upon request. There would therefore be an initial cost of $3,370 for each adviser to prepare such performance.[653]

For purposes of this analysis, we assume 5 percent of advisers will include extracted performance. We estimate that after initially preparing the performance of the entire portfolio

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650 We estimate that the average investment adviser will make 4.5 presentations of related performance to meet this requirement in three years, for an amortized average annual burden of 14.2 hours ((1 initial presentation X 25 hours + 3.5 subsequent updates to presentations X 5 hours) (year 1) + (3.5 subsequent updates to presentations X 5 hours) (year 2) + (3.5 subsequent updates to presentations X 5 hours) (year 3) = 77.5 hours per adviser; and 77.5 hours ÷ 3 years = 25.8 hours).

651 We estimate that 25.8 burden hours on average per year X 10,770 advisers presenting related performance (*i.e.*, 80% of 13,463 advisers).

652 This estimate is based on the following calculation: 277,866 hours per advisers in the aggregate per year X $337 per hour.

653 This estimate is based on the following calculation: 10.0 hours (for review of disclosures) x $337 (blended rate for a compliance manager ($309) and a compliance attorney ($365)) = $3,370. *See supra* footnote 623 for a discussion of the blended hourly rate for a compliance manager and a compliance attorney.

from which extracted performance is extracted, investment advisers will incur a burden of 2 hours to update the performance for each subsequent presentation. For purposes of this analysis, we estimate that advisers will update the relevant "entire portfolio" performance 3.5 times each year.

Accordingly, we estimate that the amortized average annual burden would be 10.3 hours for each of the first three years for each investment adviser to prepare the performance of the entire portfolio from which the presentation of extracted performance is extracted.[654] The estimated amortized aggregate annual burden with respect to the "entire portfolio" requirement is 6,932 hours per year for each of the first three years,[655] and the aggregate internal cost burden is estimated to be $2,336,084 per year.[656]

We estimate that registered investment advisers may incur external costs in connection with the requirement to provide performance results of an entire portfolio from which extracted hypothetical performance is extracted. We estimate that the average annual costs associated with printing and mailing this information upon request would be collectively $500 for all documents associated with a single registered investment adviser. Accordingly, we estimate that the

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654 We estimate that the average investment adviser will make 4.5 presentations of "entire portfolio" performance to meet this requirement in three years, for an amortized average annual burden of 5.7 hours ((1 initial presentation X 10 hours + 3.5 subsequent presentations X 2 hours) (year 1) + (3.5 subsequent presentations X 2 hours) (year 2) + (3.5 subsequent presentations X 2 hours) (year 3) = 31 hours; and 31 hours ÷ 3 years = 10.3 hours).

655 We estimate that 10.3 burden hours on average per year x approximately 673 advisers presenting extracted performance (*i.e.,* 5% of 13,463 advisers).

656 This estimate is based on the following calculation: 6,932 hours per advisers in the aggregate per year X $337 per hour.

aggregate annual external costs associated with printing and mailing these documents in connection with extracted performance presented would be $336,500.[657]

### d. *Hypothetical Performance*

We estimate that an investment adviser that elects to present hypothetical performance in an advertisement will incur an initial burden of 5 hours in preparing and adopting policies and procedures reasonably designed to ensure that hypothetical performance is relevant to the financial situation and investment objectives of the person to whom the advertisement is disseminated. For purposes of this analysis, we assume 50 percent of advisers will include hypothetical performance in advertisements.

Advisers' compliance personnel typically would draft policies and procedures to evaluate whether hypothetical performance is relevant to each recipient. There would therefore be an initial burden cost of 5 hours related to the adoption of such policies and procedures, with an estimated cost of $2,650, for each adviser to prepare its policies and procedures.[658]

For purposes of this analysis, we estimate that advisers that use hypothetical performance will disseminate advertisements containing hypothetical performance 20 times each year. We estimate that after adopting appropriate policies and procedures, an adviser will incur a burden of 0.25 hours to categorize each investor based on its policies and procedures. Accordingly, we estimate that the average annual burden with respect to preparation of schedules would be 10

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657 This estimate is based upon the following calculations: $500 per adviser x approximately 673 advisers presenting extracted performance (*i.e.,* 5% of 13,463 advisers) = $336,500. For purposes of this Paperwork Reduction Act analysis, based upon our experience, we assume that the burden of emailing these documents would be outsourced to third-party service providers and therefore would be included within these external cost estimates.

658 This estimate is based on the following calculation: 5 hours (for adoption of policies and procedures) x $530 (rate for a chief compliance officer). The hourly wages used are from SIFMA's Management & Professional Earnings in the Securities Industry 2013, modified to account for an 1800-hour work-year and inflation and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead.

hours per year.[659] The estimated aggregate annual burden is 67,320 hours per year,[660] and the aggregate internal cost burden is estimated to be $35,679,600 per year.[661]

Additionally, we estimate that an investment adviser that elects to present hypothetical performance in an advertisement will incur an initial burden of 16 hours in preparing the information sufficient to understand the criteria used and assumptions made in calculating, as well as risks and limitations in using, the hypothetical performance (the "underlying information"), in order to provide such information, which may in certain circumstances be upon request.[662] There would therefore be an initial cost of $5,384 for each adviser to prepare such information.[663]

We estimate that after initially preparing the underlying information, investment advisers will incur a burden of 3 hours to update the information for each subsequent presentation. For purposes of this analysis, we estimate that advisers will update their hypothetical performance, and thus the underlying information, 3.5 times each year.

Accordingly, we estimate that the amortized average annual burden would be 8.5 hours for each of the first three years for each investment adviser to prepare the underlying

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659 We estimate that the average investment adviser will have an average annual burden of 3.3 hours (5 hours for adoption of policies and procedures + 20 advertisements X 0.25 hours = 10 hours).

660 We estimate that 10 burden hours on average per year X 6,732 advisers presenting performance results (*i.e.*, 50% of 13,463 total advisers).

661 This estimate is based on the following calculation: 67,320 hours per advisers in the aggregate per year X $530 per hour.

662 This estimate includes the time spent by an adviser in preparing the information. The time spent calculating the hypothetical performance that is based on such information is not accounted for in this estimate, as the proposed rule has no requirement that an advertisement present hypothetical performance.

663 This estimate is based on the following calculation: 15.0 hours (for review of disclosures) x $337 (blended rate for a compliance manager ($309) and a compliance attorney ($365)) + 1 hour (to explain the assumptions used in creating the hypothetical performance) x $329 (senior portfolio manager) = $5,384. The hourly wages used are from SIFMA's Management & Professional Earnings in the Securities Industry 2013, modified to account for an 1800-hour work-year and inflation and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead.

information.[664] The estimated amortized aggregate annual burden with respect to the "underlying information" requirement is 57,222 hours per year for each of the first three years,[665] and the aggregate internal cost burden is estimated to be $19,283,814 per year.[666]

We estimate that registered investment advisers may incur external costs in connection with the requirement to provide this underlying information upon the request of a client or prospective client. We estimate that the average annual costs associated with printing and mailing this underlying information upon request would be collectively $500 for all documents associated with a single registered investment adviser.[667] Accordingly, we estimate that the aggregate annual external costs associated with printing and mailing these documents in connection with hypothetical performance presented in advertisements would be $3,366,000.[668]

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664 We estimate that the average investment adviser will make 4.5 presentations of hypothetical performance, and thus underlying information to meet this requirement, in three years, for an amortized average annual burden of 8.5 hours (1 initial presentation X 15 hours + 3.5 subsequent presentations X 3 hours = 25.5 hours; and 25.5 hours ÷ 3 years = 8.5 hours).

665 We estimate that 8.5 burden hours on average per year x 6,732 advisers presenting hypothetical performance (*i.e.,* 50% of 13,463 advisers).

666 This estimate is based on the following calculation: 57,222 hours per advisers in the aggregate per year X $337 per hour.

667 We do not have specific data regarding how the cost of printing and mailing the underlying information would differ, nor are we able to specifically identify how the cost of printing and mailing the underlying information might be affected by the proposed rule. For these reasons, we estimate $500 per year to collectively print and mail upon request the underlying information associated with hypothetical performance for purposes of our analysis. However, we are requesting comment on this estimate. In addition, investors may also request to receive the underlying information electronically. We estimate that there would be negligible external costs associated with emailing electronic copies of the underlying information.

668 This estimate is based upon the following calculations: $500 per adviser x 6,732 advisers presenting hypothetical performance = $3,366,000. For purposes of this Paperwork Reduction Act analysis, based upon our experience, we assume that the burden of printing and mailing the underlying information would be outsourced to third-party service providers rather than handled internally, and therefore would be included within these external cost estimates.

### 4. Additional Conditions Related to Performance Results in Retail Advertisements

The proposed rule would impose certain additional conditions on the presentation of performance results in Retail Advertisements. The proposed rule requires that Retail Advertisements that present gross performance must also present net performance: (a) with at least equal prominence to, and in a format designed to facilitate comparison with, gross performance, and (b) calculated over the same time period, and using the same type of return and methodology as, the gross performance.[669] In addition, the proposed rule requires that Retail Advertisements that present performance results of any portfolio or any composite aggregation of related portfolios must include performance results of the same portfolio or composite aggregation for 1-, 5-, and 10-year periods, each presented with equal prominence and ending on the most recent practicable date; except that if the relevant portfolio did not exist for a particular prescribed period, then the life of the portfolio must be substituted for that period.[670] As a result of these conditions, the proposed rule would include additional "collection of information" requirements within the meaning of the PRA for investment advisers presenting performance results in any Retail Advertisements.

Based on Form ADV data, approximately 62 percent, or 8,396 investment advisers registered with the Commission have some portion of their business dedicated to retail clients, including either individual high net worth clients or individual non-high net worth clients.[671]

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669 Proposed rule 206(4)-1(c)(2)(i).

670 Proposed rule 206(4)-1(c)(2)(ii).

671 *See supra* Economic Analysis discussion note 556. The number of advisers that have retail investors as clients is based on the number of advisers that report high net worth and non-high net worth clients, determined by responses to Item 5.D.(1)(a or b), or advisers who do not report individual clients per Item 5.D.(1)(a or b), but do report regulatory assets under management attributable to retail clients as per Item 5.D.(3)(a or b). If at least one of these responses was filled out as greater than 0, the firm is considered as providing business to a client that would be a "retail investor" for purposes of the proposed rule. The data

Estimating the number of advisers servicing retail investors based on a review of individual clients reported on Form ADV entails certain limitations, and this estimate is only being used for purposes of this PRA analysis.

### a. *Presentation of Net Performance in Retail Advertisements*

We estimate that an investment adviser that elects to present gross performance in a Retail Advertisement will incur an initial burden of 10 hours in preparing net performance for each portfolio, including the time spent determining and deducting the relevant fees and expenses to apply in calculating the net performance and then actually running the calculations. Based on staff experience, we estimate that the average investment adviser will present performance for three portfolios over the course of a year. Accordingly, we estimate that the initial burden, on a per-adviser basis, will be 30 hours. There would therefore be an initial estimated cost of $10,110 for the average adviser to comply with this proposed requirement to present net performance in a Retail Advertisement.[672]

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on individual clients obtained from Form ADV may not be exactly the same as who would be a "retail investor" for purposes of the proposed rule because Form ADV allows advisers to treat as a "high net worth individual" an individual who is a "qualified client" for purposes of rule 205-3 or a "qualified purchaser" as defined in section 2(a)(51)(A) of the Investment Company Act. In contrast, the proposed rule would treat any individual client who meets the definition of "qualified purchaser" or "knowledge employee" as a non-retail investor. *See also* 2018 Investment Management Compliance Testing Survey, Investment Adviser Association and ACA Compliance Group, at 67 (Jun. 14, 2018) (indicating that 60% of 454 survey respondents "provide services to individual clients (e.g. retail, high net worth, trusts)"), *available at:* https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/publications/2018-Investment-Management_Compliance-Testing-Survey-Results-Webcast_pptx.pdf.

The figure representing advisers with non-retail clients or investors is the number of advisers that have advisory clients that are retail clients subtracted from the total number of registered investment advisers. These figures do not reflect investors in pooled investment vehicles.

672 This estimate is based on the following calculation: 30.0 hours (for review of disclosures) x $337 (blended rate for a compliance manager ($309) and a compliance attorney ($365)) = $10,110. *See supra* footnote 623 for a discussion of the blended rate.

We expect that the calculation of net performance may be modified every time an adviser chooses to update the advertised performance. We estimate that after initially preparing net performance for each portfolio, investment advisers will incur a burden of 2 hours to update the net performance for each subsequent presentation. Accordingly, for each presentation of net performance after the initial presentation, we estimate that the burden, on a per-portfolio basis, will entail an estimated cost of $674.[673]

For purposes of this analysis, we estimate that advisers will update the relevant performance of each portfolio 3.5 times each year.[674] Accordingly, we estimate that the amortized average annual burden would be 17 hours for each of the first three years for each investment adviser to prepare net performance.[675] The estimated amortized aggregate annual internal burden with respect to Retail Advertisements is 135,592 hours per year for each of the first three years,[676] and the aggregate internal cost burden is estimated to be $45,694,504 per year.[677]

**b. *Time Period Requirement in Retail Advertisements***

We estimate that an investment adviser that elects to present performance results in a Retail Advertisement will incur an initial burden of 35 hours in preparing performance results of

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673 This estimate is based on the following calculation: 2 hours (for review of disclosures) x $337 (blended rate for a compliance manager ($309) and a compliance attorney ($365)) = 674. *See supra* footnote 623 for a discussion of the blended rate.

674 *See supra* footnote 640.

675 We estimate that the average investment adviser will make 13.5 presentations of net performance in three years, for an amortized average annual burden of 17 hours (1 initial presentation X 10 hours + 3.5 subsequent presentations X 2 hours = 17 hours X 3 portfolios = 51 hours per adviser; and 51 hours ÷ 3 years = 17 hours).

676 We estimate that 17 burden hours on average per year X 7,976 "retail advisers" presenting performance results (*i.e.*, 95% of 8,396 "retail advisers").

677 This estimate is based on the following calculation: 135,592 hours per advisers in the aggregate per year x $337 per hour.

the same portfolio for 1-, 5-, and 10-year periods, taking into account that these results must be prepared on a net basis (and may also be prepared and presented on a gross basis). This estimate reflects that many advisers currently prepare and present GIPS-compliant performance information, and also that many advisers, particularly private fund advisers, currently prepare annual performance for investors. There would therefore be an initial cost of $11,795 for each adviser to comply with this proposed time period requirement in a Retail Advertisement.[678]

Advisers may vary in the frequency with which they calculate performance in order to satisfy this proposed time period requirement, though presumably advisers will do so every time they choose to update the advertised performance. We estimate that after initially preparing 1-, 5-, and 10-year performance for each portfolio, investment advisers will incur a burden of 8 hours to update the performance for these time periods for each subsequent presentation. For purposes of this analysis, we estimate that advisers will update the relevant performance 3.5 times each year.

Accordingly, we estimate that the amortized average annual burden would be 21 hours for each of the first three years for each investment adviser to prepare performance in compliance with this time period requirement.[679] The estimated amortized aggregate annual

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678 This estimate is based on the following calculation: 35 hours (for review of disclosures) x $337 (blended rate for a compliance manager ($309) and a compliance attorney ($365)) = $11,795. *See supra* footnote 623 for a discussion of the blended hourly rate for a compliance manager and a compliance attorney.

679 We estimate that the average investment adviser will make 4.5 presentations of performance to meet this time period requirement (*i.e.,* 1-, 5-, and 10-year performance calculations) in three years, for an amortized average annual burden of 22.7 hours (1 initial presentation X 35 hours + 3.5 subsequent presentations X 8 hours = 63 hours per adviser; and 63 hours ÷ 3 years = 21 hours).[680] We estimate that 21 burden hours on average per year X 7,976 "retail advisers" presenting performance results in a Retail Advertisement (i.e., 95% of all 8,396 advisers that have retail clients).

burden with respect to Retail Advertisements is 167,496 hours per year for each of the first three years,[680] and the aggregate internal cost burden is estimated to be $56,446,152 per year.[681]

### 5. Review and Approval of Advertisements

The proposed rule would require that any advertisement be reviewed and approved in writing by a designated employee.[682] As noted above, the use of advertisements is not mandatory, but given that advertising is an essential part of retaining and attracting clients, and that advertising may be disseminated easily through the internet and social media, we estimate that all investment advisers will disseminate at least one communication meeting the proposed rule's definition of "advertisement".[683]

Based on staff experience, we expect 80% of investment advisers, or 10,770, are light advertisers and 20%, or 2,693, are heavy advertisers.[684] We estimate that investment advisers that are light advertisers and heavy advertisers would create new advertisements approximately 10 and 50 times, respectively, per year. We also estimate that investment advisers that are light advertisers and heavy advertisers would update existing advertisements approximately 50 and 250 times, respectively, per year. These estimates account for the proposed rule's expanded definition of "advertisement" relative to the current rule. We further estimate that an investment

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680 We estimate that 21 burden hours on average per year X 7,976 "retail advisers" presenting performance results in a Retail Advertisement (i.e., 95% of all 8,396 advisers that have retail clients).

681 This estimate is based on the following calculation: 167,496 hours per advisers in the aggregate per year X $337 per hour.[682] Proposed rule 206(4)-1(d).

682 Proposed rule 206(4)-1(d).

683 Additionally, if an adviser includes in any legal or regulatory document information beyond what is required under applicable law, and such additional information "offers or promotes" the adviser's services, then that information would be considered an "advertisement" for purposes of the proposed rule, and therefore would be subject to the employee review and approval requirement. *See supra* footnote 104 and accompanying text.

684 0.80 X 13,463 (total investment advisers) = 10,770 light advertisers. 0.20 X 13,463 (total investment advisers) = 2,693 heavy advertisers.

adviser would incur an average burden of 1.5 and 0.5 hours to review each new advertisement and review each update of an existing advertisement, respectively. Since each advertisement requiring employee review would likely be different, we believe this burden would remain the same each year. Although the proposed rule permits advisers to designate any employee to review and approve advertisements, we would anticipate many investment advisers to designate their chief compliance officers with this task. In addition, a compliance attorney would review any revisions that occur during the course of review. There would therefore be an annual cost to each respondent of this hour burden of $671.25 and $223.75 to review and approve each new or updated advertisement, respectively, that is subject to the review requirement.[685] Therefore, we estimate that the yearly total burden of reviewing and approving advertisements would be 430,800 hours and 538,600 hours for advisers that are light and heavy advertisers, respectively, or 969,400 hours across all advisers.[686] Thus, the aggregate internal cost of the hour burden for all investment advisers is estimated to be $448,347,500 per year.[687]

We estimate that light advertisers and heavy advertisers would utilize 10 and 50 hours, respectively, of external legal services per year to review advertisements. Therefore, we estimate

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685 This estimate for new advertisements is based on the following calculation: 0.75 hour (for review and approval) x $530 (hourly rate for a chief compliance officer) + 0.75 hour (for revisions) x $365 (hourly rate for a compliance attorney) = $671.25. This estimate for updates to existing advertisements is based on the following calculation: 0.25 hour (for review and approval) x $530 (hourly rate for a chief compliance officer) + 0.25 hour (for revisions) x $365 (hourly rate for a compliance attorney) = $223.75. The hourly wages used are from SIFMA's Management & Professional Earnings in the Securities Industry 2013, modified to account for an 1800-hour work-year and inflation and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead.

686 This estimate for light advertisers is based on the following calculation: [1.5 hours per adviser x 10 new advertisements per year + 0.5 hours per adviser x 50 updated advertisements per year] x 10,770 light advertisers = 430,800 hours. This estimate for heavy advertisers is based on the following calculation: [1.5 hours per adviser x 50 new advertisements per year + 0.5 hours per adviser x 250 updated advertisements per year] x 2,693 heavy advertisers = 538,600 hours. 430,800 + 538,600 = 969,400.

687 This estimate is based on the following calculation: 969,400 hours for advisers in the aggregate per year x $462.5 per hour (blended rate of a chief compliance officer and a compliance attorney).

that the average annual costs associated with external legal review of advertisements would be $4,000 for a light advertiser and $20,000 for a heavy advertiser, or $24,000 across all advisers.[688]

### 6. Total hour burden associated with proposed rule 206(4)-1

Accordingly, we estimate the total annual hour burden for investment advisers registered or required to be registered with the Commission under proposed rule 206(4)-1 to prepare testimonials and endorsements, third-party ratings, and performance results disclosures, as well as review and approve advertisements, would be 1,832,281 hours,[689] at a time cost of $736,001,832.[690] The total external burden costs would be $27,000.[691]

A chart summarizing the various components of the total annual burden for investment advisers is below.

| Rule 206(4)-1 Description of Requirements | No. of Responses | Internal Burden Hours | External Burden Costs |
|---|---|---|---|
| Ongoing annual burden for testimonials and endorsements*<br><br>* This is not broken up into initial and ongoing burden because the annual burden is estimated to be the | 33,660 (5 per adviser) | 6,732 (1 per response) | |

688 The estimated $4,000 figure for light advertisers has been calculated as follows: $400 per hour cost for outside legal services x 10 hours = $4,000. The estimated $4,000 figure for heavy advertisers has been calculated as follows: $400 per hour cost for outside legal services x 50 hours = $20,000.

These estimates are based on an estimated $400 per hour cost for external legal services. We do not have specific data regarding these external legal costs. However, we are requesting comment on this estimate.

689 This estimate is based upon the following calculations: 6,732 + 10,098 + 2,524.5 + 131,098+ 277,866 + 6,932 + 67,320 + 57,222 + 135,592 + 167,496 + 969,400 hours = 1,832,281 hours.

690 This estimate is based upon the following calculations: $2,268,684 + $3,403,026 + $850,756.50 + $29,094,221 + $93,640,842 + $1,292,732 + $35,679,600 + $19,283,814 + $45,694,504 + $56,446,152 + $448,347,500 = $736,001,832.

691 This estimate is based upon the following calculations: $500 + $500 +$500 + $500 + $500 + $500 + $24,000 = $27,000.

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| same each year, as discussed above. | | | |
| Initial burden for third-party rating | 6,732 (1 per adviser) | 10,098 (1.5 per response) | |
| Ongoing annual burden for third-party rating | 6,732 (1 per adviser) | 2,525 (0.375 per response) | |
| Initial burden for advertisements presenting gross performance and providing a schedule of fees and expenses | 38,370 (3 per adviser) | 63,950 (5 per response) | $500 per adviser |
| Ongoing annual burden for advertisements presenting gross performance and providing a schedule of fees and expenses | 134,295 (10.5 per adviser) | 6,395 (0.5 per response) | $500 per adviser |
| Initial burden for advertisements presenting related performance | 10,770 (1 per adviser presenting related performance) | 269,250 (25 per response) | |
| Ongoing annual burden for advertisements presenting related performance | 32,310 (3.5 per adviser presenting related performance) | 64,620 (5 per response) | |
| Initial burden for advertisements presenting extracted performance | 673 (1 per adviser presenting extracted performance) | 6,730 (10 per response) | $500 per adviser |
| Ongoing annual burden for advertisements presenting extracted performance | 2,356 (3.5 per adviser presenting extracted performance) | 1,346 (2 per response) | $500 per adviser |

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| Initial burden for policies and procedures for hypothetical performance | 6,732 (1 per adviser presenting hypothetical performance) | 33,660 (5 per response) | |
| Ongoing annual burden for policies and procedures for hypothetical performance | 134,640 (20 per adviser presenting hypothetical performance) | 1,683 (0.25 per response) | |
| Initial burden for advertisements presenting underlying information for hypothetical performance | 6,732 (1 per adviser presenting hypothetical performance) | 107,712 (16 hours per response) | $500 per adviser |
| Ongoing annual burden for advertisements presenting underlying information for hypothetical performance | 23,562 (3.5 per adviser presenting hypothetical performance) | 20,196 (3 hours per response) | $500 per adviser |
| Initial burden for Retail Advertisements presenting gross performance | 7,976 (1 per adviser presenting gross performance) | 79,760 (10 hours per response) | |
| Ongoing burden for Retail Advertisements presenting gross performance | 27,916 (3.5 per adviser presenting gross performance) | 55,832 (2 hours per response) | |
| Initial burden for Retail Advertisements meeting "time period" requirement | 7,976 (1 per retail adviser) | 279,160 (35 per response) | |
| Ongoing annual burden for Retail Advertisements meeting "time | 27,916 (3.5 per retail | 223,328 (8 per response) | |

| | | | |
|---|---|---|---|
| period" requirement | adviser) | | |
| Annual burden for review of advertisements for light advertisers*<br><br>* This is not broken up into initial and ongoing burden because the annual burden is estimated to be the same each year. | 107,770 and 538,500 (10 new and 50 updated per each adviser) | 161,655 and 269,250 (1.5 hours per response for new advertisements, 0.5 hours per response for updated advertisements) | $4,000 per adviser |
| Annual burden for review of advertisements for heavy advertisers*<br><br>* This is not broken up into initial and ongoing burden because the annual burden is estimated to be the same each year. | 134,650 and 673,250 (50 new and 250 updated per each adviser) | 201,975 and 336,625 (1.5 hours per response for new advertisements, 0.5 hours per response for updated advertisements) | $20,000 per adviser |

### C. Rule 206(4)-3

Rule 206(4)-3 (the "cash solicitation rule") (OMB number 3235-0242) currently prohibits investment advisers from paying cash fees to solicitors for client referrals unless certain conditions are met. These conditions include a written agreement, disclosures and receipt and retention of signed and dated acknowledgements, subject to certain exemptions.

We are proposing to amend the existing collection of information to reflect the changes we are proposing to the rule. As discussed above, we are proposing amendments to rule 206(4)-3 to expand the rule to cover solicitation arrangements involving all forms of compensation, rather than only cash compensation, and to apply to the solicitation of current and prospective investors

in any private fund, rather than only to "clients" (including prospective clients) of the investment adviser.[692] The proposed rule would generally continue to require that an adviser compensate a solicitor pursuant to a written agreement that the adviser is required to retain, and would continue to require as part of the written agreement the preparation of a solicitor disclosure containing specified information about the solicitation arrangement.[693] The proposed rule would add flexibility to the solicitor disclosure requirement by permitting the parties to designate in the written agreement either the adviser or the solicitor as the party required to deliver the disclosure to investors at the time of solicitation (or, for mass communications, as soon as reasonably practicable thereafter). The proposed rule would no longer require the written agreement to require that the solicitor provide the prospective client with a copy of the adviser's brochure, or that the adviser obtain and retain a signed and dated acknowledgment from the client that the client has received the brochure and the solicitor's disclosure. The proposed rule would retain the current rule's partial exemptions for: (i) solicitors of clients for impersonal investment advice; and (ii) certain solicitors that are affiliated with the adviser, but it would eliminate the written agreement requirement and the detailed solicitor disclosure for such solicitors. In order to avail itself of the proposed rule's partial exemption for affiliated solicitors: (i) the affiliation between the investment adviser and the solicitor must be readily apparent or be disclosed to the investor at the time of the solicitation; and (ii) and the adviser must document the solicitor's status at the time the adviser enters into the solicitation arrangement. The proposed rule also would add new exemptions for *de minimis* compensation and certain nonprofit referral programs.

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692 As discussed above, we are proposing to apply the rule to compensation by investment advisers to solicitors to obtain clients and prospective clients as well as investors and prospective investors in private funds that those advisers manage. For purposes of this release, we refer to any of these persons as "investors," unless we specify otherwise.

693 Current rule 204-2 requires advisers to keep records of documents required by rule 206(4)-3.

The proposed rule's requirements of a written agreement, the solicitor disclosure (preparation and delivery) and the adviser's oversight of the solicitor relationship would all be collections of information.[694] The rule's collections of information are necessary to provide investors with information about the solicitation relationship. The information that rule 206(4)-3 would require to be disclosed is necessary to inform investors about the nature of the solicitor's financial interest in the solicitation. With this information, investors can evaluate the solicitor's potential bias in referring them to the adviser. Solicitors would use the information required by proposed rule's written agreement requirement to understand their solicitation responsibilities. These include the solicitor disclosure requirement and the requirement to perform solicitation activities in accordance with sections 206(1), (2), and (4) of the Act. Finally, the adviser's oversight of the solicitor relationship (overseeing compliance with the terms of the written agreement) is designed to help ensure that complete and accurate information about the solicitor relationship is delivered to investors.

The likely respondents to this information collection would be each investment adviser registered with the Commission that would compensate a solicitor for solicitation under the proposed rule. Respondents would in each case typically not include investment advisers that compensate solicitors eligible for the rule's proposed new and amended exemptions (*i.e.*, affiliated solicitors whose affiliation with the adviser is "readily apparent", solicitors for impersonal investment advice, and solicitors for specified *de minimis* compensation).[695] We estimate that approximately 47.8 percent of the investment advisers registered with the

694 These requirements are collections of information under the current rule. *See* our most recent Paperwork Reduction Act submission for rule 206(4)-3.

695 The solicitors subject to some of the proposed rule's partial exemptions would still be subject to the disqualification provision of the proposed rule. However, the proposed rule's disqualification provision is not a collection of information hereunder.

Commission, or 6,432 advisers, would be subject to this collection of information. This estimate is based on a number of inputs, as follows:

- Currently, it is reported that about 27 percent of investment advisers registered with the Commission (3,655 RIAs) compensate persons other than employees to obtain one or more *clients*.[696]
- In addition, approximately 7.2 percent investment advisers registered with the Commission (976 RIAs) report that they compensate only *employees* to obtain one or more *clients*.[697] These advisers would be exempt from this proposed collection of information if the affiliation between the adviser and the solicitor is "readily apparent" (if the affiliation is not readily apparent, they would be subject to the requirement to disclose the affiliation at the time of solicitation, which would be a collection of information hereunder). For purposes of this PRA we estimate that approximately half of these advisers (488 RIAS, or approximately 3.6 percent of all RIAs) would be exempt from this collection of information because their affiliation would be readily apparent. The other 50 percent (488 RIAS, or approximately 3.6 percent of all RIAs) would be subject to only part of this collection of information, which would be an abbreviated disclosure.

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696 Estimate based on IARD data from Form ADV, Part 1, Item 8.H.1 as of September 30, 2019. This Item relates to compensation for *client* referrals. This number represents Firms that responded "Yes" to Item 8.H.1 (indicating that they or any related person, directly or indirectly, compensate any person that is not an employee for client referrals).

697 976 advisers responded "yes" to Item 8.H.2 (indicating that they or any related person, directly or indirectly, provide any *employee* compensation that is specifically related to obtaining clients for the firm) -- and responded "No" to Item 8.H.1. Under the proposed rule, an adviser that compensates only its employees for solicitation would be exempt from the written agreement and solicitor disclosure obligations of the proposed rule, except when the affiliation is not readily apparent. If the affiliation is not readily apparent, the adviser would be required to disclose the affiliation to the investor and would therefore be subject to this collection of information only with respect to such disclosure.

- The number of advisers that currently report that they compensate persons for client referrals includes advisers that use cash as well as non-cash compensation, but we estimate that even more investment advisers would be subject to this proposed collection of information. This is because advisers might not currently view directed brokerage as a type of non-cash compensation, and consequently might not be reporting on Form ADV that they compensate any person for client referrals when they use directed brokerage as a form of compensation.[698] We therefore estimate that another 5 percent of all RIAs (673 RIAs) would use proposed rule 206(4)-3 to compensate any person for *client* referrals and be subject to this collection of information.
- Approximately 4 of the advisers that currently report that they compensate persons for referrals also report that they provide only impersonal investment advisory services, and would therefore be exempt from proposed rule's requirements that are collections of information, and would not be subject to this collection of information.[699]
- In addition, approximately 1,590 registered investment advisers to private funds currently report that they use at least one marketer to obtain investors in private funds, and would likely be newly subject to the proposed rule with respect to such

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698 The Instruction to Form ADV Item 8.H and 8.I reads: "In responding to Items 8.H. and 8.I., consider all cash and non-cash compensation that you or a related person gave to (in answering Item 8.H.) or received from (in answering Item 8.I.) any person in exchange for client referrals, including any bonus that is based, at least in part, on the number or amount of client referrals."

699 Estimate based on IARD data from Form ADV. This number includes firms that responded "Yes" to Item 8.H.1 or 8.H.2, and responded in Item 5.G., that they only provide any of the following advisory services, which likely would be "impersonal investment advice" under the proposed rule: (8) Publication of periodicals or newsletters; (9) Security ratings or pricing services; (10) Market timing services; and/or (11) Educational seminars/workshops.

fund marketing arrangements.[700] Of the 1,590 registered investment advisers to private funds that use at least one solicitor, approximately 210 advisers use *only* solicitors that are "related persons" of the firm, and would be eligible to use the proposed rule's partial exemption for affiliated solicitors if the affiliation is readily apparent.[701] For purposes of this PRA, we estimate that half of these advisers, or 105 advisers, would be exempt from this collection of information because their affiliation would be readily apparent, and the other half, or 105 advisers, would be subject to only part of this collection of information, which would be an abbreviated disclosure stating the affiliation.[702]

- In addition, advisers that use nonprofit programs for solicitation would be exempt from the rule, but would be subject to the collection of information only with respect to limited disclosures. We estimate that very few advisers would use the nonprofit solicitation exemption. For purposes of this PRA, we believe that one percent of registered investment advisers – or approximately 135 advisers -- would use the nonprofit exemption.
- Therefore, we estimate that the total number of RIAs that would be subject to this

700 Estimate based on IARD data from Form ADV Part 1A, Section 7.A.(1) (Private Fund Reporting) of Schedule D, as of September 30, 2019. Firms that responded "Yes" to Question 28.(a), indicated that they use the services of someone other than the firm or the firm's employees for marketing purposes (firms must answer "yes" if they use a placement agent, consultant, finder, introducer, municipal advisor or other solicitor, or similar person). We believe that marketers reported in this Item would generally be solicitors under the proposed rule.

701 Estimate based on IARD data from Form ADV Part 1A, Section 7.A.(1) (Private Fund Reporting) of Schedule D, as of September 30, 2019..

702 Our proposed rule would partially exempt a solicitor that is one of the investment adviser's partners, officers, directors, or employees, or is a person that controls, is controlled by, or is under common control with the investment adviser, or is a partner, officer, director or employee of such a person: provided that (A) the affiliation between the investment adviser and such person is readily apparent or is disclosed to the client or private fund investor at the time of the solicitation, and (B) and the adviser documents such solicitor's status at the time the adviser enters into the solicitation arrangement.

collection of information are approximately 6,432 registered investment advisers (3,655 + 488 + 673 – 4 + 1,590 – 210 + 105 +135 registered investment advisers), or 46.7% of RIAs, would be subject to the proposed collection of information.[703] Of these advisers, (i) 5,704 advisers, or approximately 42.4 percent of all RIAs, would be subject to the complete collection of information, and (ii) 728 advisers, or approximately 5.4 percent of all RIAs, would be subject to a limited subset of this collection of information.

We are estimating that each registered investment adviser subject to the proposed solicitation rule would enter into 3 solicitation relationships each year. Even though our data shows that registered investment advisers to private funds report a median of one "marketer",[704] which would be a solicitor under the proposed rule, we are aware that many firms act as solicitors or marketers for multiple advisers and private funds.[705] In addition, we estimate that the median number of solicitors per adviser would be greater than 1 when taking into account all advisers that use solicitors (for private funds and/or other advisory services), even though solicitors for *de minimis* compensation would be exempt from this collection of information under our proposed rule. We therefore recognize that while some advisers may use only one or a

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703 We estimate that this number would both increase and decrease to account for: (i) advisers that would newly be subject to the solicitation rule with respect to compensating persons for endorsements under the proposed amendments to the advertising rule 206(4), and therefore, depending on the facts and circumstances, they would be subject to the solicitation rule for such activity (we also estimate that some of these advisers would already be subject to the solicitation rule for conducting other paid solicitations); and (ii) advisers that would newly be exempted from the solicitation rule because of the proposed *de minimis* exemption. We estimate that the addition and subtraction of these advisers would net to zero change to the total estimate of the number of registered investment advisers that would be subject to the proposed amendments to the solicitation rule.

704 For registered investment advisers to private funds that report using at least one marketer, the average number of marketers reported is 2.9, while the median reported is 1 and the maximum is 79. Based on responses to Section 7.B.(1) 28(a) as of September 30, 2019.

705 *See id*.

few solicitors to solicit a few targeted investors, other advisers may use numerous solicitors to solicit investors. In addition, we believe that many advisers that use solicitors enter into long-term multi-year solicitation relationships with their solicitors, and do not necessarily engage new solicitors each year. Therefore, we are estimating that advisers would enter into approximately three contracts with new solicitors per year (advisers that engage solicitors on a long-term basis would enter fewer contracts each year, and advisers that routinely use new solicitors would enter more contracts each year). The estimated number of contracts and disclosures per adviser and solicitor per year reflects an estimate in this variable range. We estimate for PRA purposes, and request comment below, that for each registered investment adviser that would use the proposed rule, there would be approximately 30 referrals annually. We have seen changes in solicitation practices over the years due to changes in technology and the use of social media, making it easier for advisers to use multiple solicitors to solicit multiple clients.

This collection of information consists of three components: (i) the requirement to enter into a written agreement; (ii) the requirement to prepare and deliver the solicitor disclosure (as part of the written agreement requirement), and (iii) the requirement to oversee the solicitor relationship. In addition, as discussed above, certain advisers that would use the proposed rule's exemptions for affiliated solicitors and for nonprofit programs would be subject to this collection of information only with respect to a limited subset of required disclosures, as follows: (i) advisers that use affiliated solicitors for whom the affiliation is not readily apparent would be required to disclose the affiliation at the time of solicitation; and (ii) advisers that use nonprofit programs that would be eligible for the rule's exemption would be required make certain disclosures about the nonprofit program.

Because a written agreement would be required for each solicitation relationship subject

to this collection of information (other than the relationships with affiliated advisers and nonprofit programs that would be subject to a limited subset of disclosures but not subject to the written agreement requirement), we estimate that each such adviser would be subject to this proposed collection of information regarding entering into the written agreement 17,112 times (5,704 registered investment advisers x 3 written agreements each).

For PRA purposes, we estimate that compliance with the proposed rule's solicitor disclosure preparation and delivery requirement would result in 171,120 total responses (5,704 advisers x 30 solicitor disclosures). Finally, we estimate that compliance with the proposed rule's requirements regarding oversight of the solicitor relationship would result in 17,112 total annual responses (5,704 advisers x 3 solicitor relationships per adviser).

Based on Commission staff experiencer, we believe that the proposed rule would lengthen the solicitor disclosures, particularly with respect to the proposed requirements to describe non-cash compensation and any potential material conflicts of interest on the part of the solicitor resulting from the investment adviser's relationship with the solicitor and/or the compensation arrangement. The estimated average internal burden hours each year per adviser to comply with the rule's requirement to enter into a written agreement with each solicitor would be 3 hours, or a total of 17,112 aggregate average burden hours each year.[706] We estimate that this burden would be ongoing, since we estimate that advisers would enter into approximately 3 new solicitation agreements each year. An adviser's in-house compliance managers and compliance attorneys are likely to prepare the written agreements. We estimate the blended hourly wage rate for compliance managers and compliance attorneys to be $337.[707]

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[706] 1 hour per written agreement (1 x 3 = 3 hours). 3 hours x 5,704 RIAs = 18,015 hours.

[707] This estimate is based on the following calculation: $337 (blended rate for a compliance manager ($309) and a compliance attorney ($365)). The hourly wages used are from SIFMA's Management & Professional

Accordingly, the annual cost of the burden hours to each adviser regarding the requirement to enter into a written agreement would be $1,011 per adviser ($337 x 3 hours), or $5,766,744 for advisers in the aggregate ($337 x 17,112 hours).

We estimate that the average internal burden for the adviser to prepare and deliver each solicitor disclosure would be 0.10 hours per solicitor disclosure. We therefore propose that the estimated average internal burden hours each year per adviser to prepare and deliver the solicitor disclosures would be 3 hours (0.10 hours x 30 solicitor disclosures), for a total of 17,112 hours for advisers (3 hours x 5,704 advisers). An investment adviser's in-house compliance managers and compliance attorneys would likely prepare solicitor disclosures, and in-house marketing personnel would likely deliver the solicitor disclosures. The blended rate of these professionals is $307.50.[708] Accordingly, the annual cost of the burden to each adviser to prepare the solicitor disclosure would be $5,261,940 (17,112 hours x $307.50). We estimate that 20 percent of the solicitor disclosures would be delivered by the U.S. Postal Service, with the remaining 80 percent delivered electronically or as part of another delivery of documents. We therefore estimate that respondents will incur aggregate incremental postage costs of $18,823.20 ($0.55 x 30 disclosures x 1,141 RIAs).

We estimate the average burden hours each year per adviser to oversee the solicitation

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Earnings in the Securities Industry 2013, modified by Commission staff to account for an 1800-hour work-year and inflation, and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead.

708 We estimate the hourly wage for in-house marketing personnel to be $278, which is the hourly wage used in SIFMA's Management & Professional Earnings in the Securities Industry 2013, modified by Commission staff to account for an 1800-hour work-year and inflation, and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead. We estimate the blended hourly wage rate for compliance managers and compliance attorneys to be $337 (blended rate for a compliance manager ($309) and a compliance attorney ($365)). The hourly wages used are from SIFMA's Management & Professional Earnings in the Securities Industry 2013, modified by Commission staff to account for an 1800-hour work-year and inflation, and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead. Therefore, the blended rate for both of these professionals is $307.50 (($278 + $337) / 2).

relationship would be two hours for each solicitor relationship, or six hours for each adviser that is subject to this collection of information.[709] In-house compliance managers and compliance attorneys are likely to provide oversight of the written agreement (including the solicitor disclosure) under the rule. We estimate the blended hourly wage rate for compliance managers and compliance attorneys to be $337.[710] Accordingly, the annual cost to each respondent regarding oversight of the solicitor disclosure and written agreement would be $2,022 ($674 per solicitor relationship x 3 solicitor relationships). Accordingly, the annual cost to all advisers subject to this collection of information regarding the oversight of the solicitor disclosure and written agreement would be $11,533,488 ($337 per hour x 17,112 hours).

As discussed above, advisers that use the following types of solicitors would be reflected in this collection of information only with respect to abbreviated disclosures: (i) affiliated solicitors (whose affiliation is not "readily apparent") and (ii) nonprofit solicitors. We anticipate that these advisers would incur an ongoing annual burden of 0.3 hours per year to make the abbreviated disclosures (0.01 hours per disclosure x 30 disclosures = 0.3 hours per year). This burden includes the preparation and delivery of the disclosures. Because the disclosures would be very brief, we believe that all such advisers would deliver the required disclosures either electronically or as part of another delivery of documents, and therefore would not incur any additional postage costs. Accordingly, we estimate the total annual cost of the hour burden to be approximately $22,654,596, which is the sum of: $5,766,744 (ongoing cost of the hour burden

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709 This estimate is based on the following calculation: 2 hours per each solicitor relationship x 3 solicitor relationships.

710 This estimate is based on the following calculation: $337 (blended rate for a compliance manager ($309) and a compliance attorney ($365)). The hourly wages used are from SIFMA's Management & Professional Earnings in the Securities Industry 2013, modified by Commission staff to account for an 1800-hour work-year and inflation, and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead.

for entering into written agreements), $5,261,940 (ongoing cost of the hour burden for preparation and delivery of the solicitor disclosures), $18,823.20 (postage costs for delivery), $11,533,488 (ongoing cost of the hourly burden for oversight of the solicitor relationships), and $73,600.80 (ongoing cost of the hour burden for solicitation relationships with (i) affiliated solicitors (whose affiliation is not "readily apparent") and (ii) nonprofit solicitors).

| **Rule 206(4)-3 Description of Requirements** | **No. of Responses** | **Internal Burden Hours** | **Burden Costs** |
|---|---|---|---|
| Ongoing burden for entering into written agreements | 17,112 responses (5,704 RIAs x 3 written agreements per each adviser) | 1 hour per each response | 1 hour x $337 blended rate for compliance manager and compliance attorney = $337 per response (total = $5,766,744 ) |
| Ongoing burden for preparation and delivery of the solicitor disclosures. | (30 solicitor disclosures x 5,704 RIAs) = 171,120 responses | 0.10 hours per response | 0.10 hours x $307.50 blended rate for compliance manager and compliance attorney, and in-house marketing personnel = $30.75 per response (total = $5,261,940)<br><br>+ $18,823.20 postage costs for delivery |
| Ongoing burden for oversight of | 5,704 RIAs x 3 | 2 hours per | 2 hours x $337 |

| | | | |
|---|---|---|---|
| the solicitor relationships (disclosure and written agreement requirements). | solicitor relationships per each adviser) = 17,112 responses | response | blended rate for compliance manager and compliance attorney = $674 per response (total = $11,533,488). |
| Ongoing burden for solicitation relationships with (i) affiliated solicitors (whose affiliation is not "readily apparent") and (ii) nonprofit solicitors. | 728 RIAs x 30 disclosures | 0.01 hours per response | 0.3 hours x $337 blended rate for compliance manager and compliance attorney = $101.10 per adviser, or $73,600.80 |
| **Ongoing Burden for All SEC-Regulated Entities and solicitors that would be expected to use the proposed amended solicitation rule** | | | $22,654,596 |

On a per adviser basis, the ongoing burden for each adviser that would be subject to this collection of information would be: (i) 12 hours per year for each adviser other than those that would use only affiliated solicitors whose affiliation is not "readily apparent" or nonprofit solicitors, and (ii) 0.3 hours per year per each adviser that enters into solicitation relationships with affiliated solicitors whose affiliation is not "readily apparent" or nonprofit solicitors. The estimated burden hours per year for advisers subject to this proposed collection of information would therefore be: 10.7 hours per year per adviser subject to this collection of information per

year per adviser ((12 hours x 89 percent)[711] + (0.3 hours x 11 percent)[712] =10.713 hours).

The following chart shows the changes from the approved annual hourly burden for the current cash solicitation rule.

| **Requirement** | **Estimated Burden Increase or Decrease** | **Brief Explanation** |
|---|---|---|
| Internal burden hours | **3.66 hours increase per adviser for advisers that are currently subject to the rule). The burden would be new for advisers that would newly be subject to the rule.**<br><br>The overall hour burden per adviser would increase from 7.04 hours to 10.7 hours.<br><br>The overall annual responses per adviser would increase from 11 (total responses for referrals), to: (i) 36 (3 written agreements; preparation and delivery of 30 solicitor disclosures, and oversight of 3 solicitor relationships) for advisers other than those that would use only affiliated solicitors whose affiliation is not "readily apparent" or nonprofit solicitors); and (ii) preparation and delivery of 30 abbreviated disclosures for advisers that would use only affiliated solicitors whose affiliation is not "readily apparent" or nonprofit | The currently approved burden presents the burden in terms of the aggregate number of *referrals*. We are proposing to treat as three separate burdens the requirement to enter into a contract, the preparation and delivery of the solicitor disclosure; and the oversight of the solicitor relationship. In addition, we are proposing to add a separate burden for advisers that would be partially exempt from the rule but would be subject to the collection of information with respect to only abbreviated disclosures. |

711 89 percent is the percentage of RIAs we estimate would be subject to all aspects of this collection of information (5,704 RIAs) out of all RIAs subject to this collection of information (6,432 RIAs).

712 11 percent is the percentage of RIAs we estimate would be subject to only part of this collection of information, because they would use nonprofit solicitors or are affiliated with the adviser (where the affiliation is not readily apparent) (728 RIAs) out of all RIAs subject to this collection of information (6,432 RIAs).

| | | |
|---|---|---|
| | solicitors. | |
| Burden costs | **Increase from $5,538,403 to** $22,654,596. This is an increase of $17,116,193. | This increase is due primarily to: (i) our estimate of increases in salary for compliance managers, and our belief that advisers would utilize compliance attorneys instead of general clerks (the current burden reflects that general clerks would perform 50% of the work), which would result in increased hourly wages; (ii) our estimate of 2,158 advisers that would be newly subject to this collection of information[713]; and (iii) the additional burden hours that would correspond to additional disclosures that the proposed rule would require for advisers that compensate solicitors with non-cash compensation. |

### D. Rule 204-2

Under section 204 of the Advisers Act, investment advisers registered or required to register with the Commission under section 203 of the Advisers Act must make and keep for prescribed periods such records (as defined in section 3(a)(37) of the Exchange Act), furnish copies thereof, and make and disseminate such reports as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. Rule 204-2 sets forth the requirements for maintaining and preserving specified books and

[713] 2,158 RIAs = sum of (i) 5% of all RIAs (673 RIAs), which is our estimate of advisers that might not currently view directed brokerage as a type of non-cash compensation, and consequently might not be reporting on Form ADV that they compensate any person for client referrals when they use directed brokerage as a form of compensation, plus (ii) approximately 1,590 registered investment advisers to private funds that currently report that they use at least one marketer to obtain investors in private funds, and would likely be newly subject to the proposed rule with respect to such fund marketing arrangements, minus (iii) 105 of such advisers that report that their private fund marketers are affiliated, and for which we estimate their affiliation would be readily apparent and they would therefore not be subject to the proposed collection of information.

records. This collection of information is found at 17 CFR 275.204-2 and is mandatory. The Commission staff uses the collection of information in its examination and oversight program. As noted above, responses provided to the Commission in the context of its examination and oversight program concerning the proposed amendments to rule 204-2 would be kept confidential subject to the provisions of applicable law.

We are proposing amendments to rule 204-2 that would require investment advisers to retain copies of advertisements to one or more persons.[714] The current rule requires investment advisers to retain copies of advertisements to 10 or more persons.[715] We are also proposing to require investment advisers to retain: (i) for investment advisers that use a third-party rating in any advertisement, a copy of any questionnaire or survey used in preparation of the third-party rating; and, (ii) a copy of all written approvals of advertisements required under proposed rule 206(4)-1(d).[716]

We would continue to require registered investment advisers to maintain copies of the solicitor disclosure delivered to clients pursuant to the solicitation rule. However, to correspond to changes we are proposing to make to rule 206(4)-3, we are proposing to amend the current books and records rule to replace the rule's requirement that investment advisers keep a record of all written acknowledgments of receipt obtained from clients pursuant to rule 206(4)-3(a)(2)(iii)(B) with the proposed requirement that an investment adviser retain any communication or other document related to the investment adviser's determination that it has a reasonable basis for believing that any solicitor it compensates under the solicitation rule has

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714 *See* proposed rule 204-2(a)(11); *see also supra* section II.C (discussing the proposed amendments to the books and records rule).

715 Rule 204-2(a)(11).

716 *See supra* section II.C (discussing the proposed amendments to the books and records rule).

complied with the written agreement required by the solicitation rule. Additionally, to correspond to other proposed changes to the solicitation rule, we would amend the books and records rule to require investment advisers to make and keep records of: (i) if the adviser participates in any nonprofit program pursuant to the solicitation rule, copies of all receipts of reimbursements of payments or other compensation the adviser provides relating to its inclusion in the program; (ii) any communication or other document related to the investment adviser's determination that it has a reasonable basis for believing that any solicitor it compensates under rule 206(4)-3 is not an ineligible solicitor, and that any nonprofit program it participates in pursuant to the solicitation rule meets the requirements of the solicitation rule; and (iii) the names of all solicitors who are an adviser's partners, officers, directors or employees or other affiliates, pursuant to the solicitation rule. Each of these records would be required to be maintained in the same manner, and for the same period of time, as other books and records required to be maintained under rule 204-2(a). Specifically, investment advisers would be required to maintain and preserve these records in an easily accessible place for not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in an appropriate office of the investment adviser. Requiring maintenance of these records would facilitate the Commission's ability to inspect and enforce compliance with proposed rules 206(4)-1 and 206(4)-3.[717] The information generally is kept confidential.[718]

The respondents to this collection of information are investment advisers registered or required to be registered with the Commission. The use of advertisements is not mandatory, but as discussed above, we estimate that 100 percent of investment advisers will disseminate at least

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717 *Id*.

718 *See* section 210(b) of the Advisers Act (15 U.S.C. 80b-10(b)).

one communication meeting the proposed rule's definition of "advertisement" and therefore be subject to the requirements of the proposed rule. The Commission therefore estimates that, based on Form ADV filings as of September 30, 2019, approximately 13,463 investment advisers would be subject to the proposed amendments to rule 204-2 under the Advisers Act (*i.e.*, the proposed requirements to retain copies of advertisements to one or more persons, all written approvals of advertisements, and all written approvals of advertisements as required by the proposed amendment to the advertising rule). In addition, we estimate that approximately 50 percent of these 13,463 investment advisers, or 6,732 advisers, would use third-party ratings in advertisements, and would therefore also be subject to the proposed recordkeeping amendments corresponding to the proposed amendments to the advertising rule relating to the use of third-party ratings (i.e., to retain a copy of any questionnaire or survey used in the preparation of a third-party rating included or appearing in any advertisement).[719]

The approved annual aggregate burden for rule 204-2 is currently 2,435,364 hours, with a total annual aggregate monetized cost burden of approximately $154,304,663, based on an estimate of 13,299 registered advisers, or 183 hours per registered adviser.[720] Based on Form ADV filings, as of September 30, 2019, 13,463 investment advisers were registered with the Commission. For the proposed recordkeeping amendments that correspond to proposed changes to the advertising rule, including the expanded definition of "advertisement," we estimate that the proposed amendments would result in an increase in the collection of information burden

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719 *See supra* section III.B.2.

720 *See* Form ADV and Investment Advisers Act Rules, Final Rule, Release No. IA-4509 (Aug. 25, 2016) [81 FR 60418 (Sept. 1, 2016)], at 81 FR 60454-55 ("2016 Form ADV Paperwork Reduction Analysis"). There were recent revisions to the collection of information for rule 204-2 and Form ADV as a result of the following rulemakings: Form CRS Relationship Summary; Amendments to Form ADV, Release No. IA-5247 (June 5, 2019) [84 FR 33492 (Jul. 12, 2019)]; and Regulation Best Interest, Release No. 34-86031 (June 5, 2019) [84 FR 39178 (Aug. 9, 2019)].

estimate by 10 hours for each of the estimated 13,463 registered advisers (inclusive of the additional hours required for half of these advisers to also retain a copy of any questionnaire or survey used in the preparation of a third-party rating included or appearing in any advertisement).

For the proposed recordkeeping amendments that correspond to proposed changes to the solicitation rule, we estimate that the proposed amendments would result in a collection of information burden estimate of 1.5 hours[721] for each of the estimated 6,432 registered investment advisers that we estimate would be subject to the solicitation rule.[722] We therefore estimate that the proposed amendments to both rules would result in an aggregate increase in the collection of information burden estimate by 10.7 hours for each of the estimated 13,463 registered advisers, resulting in a total of 193.7 hours per adviser.[723] This would yield an annual estimated aggregate burden of 2,607,783 hours under amended rule 204-2 for all registered advisers,[724] for a monetized cost of $165,229,131.[725]

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721 This would be for advisers that would be subject to the solicitation rule, as proposed to be amended, and the corresponding amended recordkeeping requirements. We recognize that not all advisers that would be subject to the solicitation rule would be subject to all of the recordkeeping requirements related to the solicitation rule. For example, we estimate that only a few advisers would use nonprofit programs under the proposed solicitation rule and be subject to the corresponding books and records rule related to nonprofit programs. However, for purposes of the PRA, we are estimating that all advisers that would use the proposed solicitation rule would incur an estimated 1.5 hours in complying with the recordkeeping requirements related to the solicitation rule.

722 *See* discussion above regarding the number of respondents that we estimate would be subject to proposed amended solicitation rule.

723 10 hours (advertising rule for all advisers) + 0.7 hours (solicitation rule for 6,432 advisers [1.5 hours x 47.8%]) = 10.7 hours.

724 13,463 registered investment advisers x 193.7 hours = 2,607,783 hours.

725 As with our estimates relating to the previous amendments to rule 204-2 (*see* 2016 Form ADV Paperwork Reduction Analysis, *supra* footnote 720, at 81 FR at 60454-55), we expect that performance of this function will most likely be allocated between compliance clerks and general clerks, with compliance clerks performing 17% of the function and general clerks performing 83% of the function. Data from the Securities Industry and Financial Markets Association's Office Salaries Data 2013 Report, modified to account for an 1,800-hour work-year and inflation and multiplied by 2.93 to account for bonuses, firm size,

As noted above, the approved annual aggregate burden for rule 204-2 is currently 2,435,364 hours, based on an estimate of 13,299 registered advisers, or 183 hours per registered adviser.[726] The revised annual aggregate hourly burden for rule 204-2 would be 2,607,783 hours, represented by a monetized cost of $165,229,131, based on an estimate of 13,463 registered advisers. This represents in an increase of 172,419[727] annual aggregate hours in the hour burden and an annual increase of $23,988,551 from the currently approved total aggregate monetized cost for rule 204-2.[728] These increases are attributable to a larger registered investment adviser population since the most recent approval and adjustments for inflation, as well as the proposed rule 204-2 amendments relating to advertising and solicitation as discussed in this proposing release.

A chart summarizing the various components of the total annual burden for investment advisers is below.

| **Rule 204-2 Description of proposed new requirements** | **No. of Responses** | **Internal Burden Hours** | **External Burden Costs** |
|---|---|---|---|
| Retain a copy of advertisements to one or more persons, a copy of all written approvals of advertisements required under proposed rule 206(4)-1(d), and for investment advisers that use a third-party rating in any advertisement, a copy of the questionnaire or survey used to create the third-party rating | 13,463 (all advisers) | 134,630 (10 hours per response) | |
| Retention of (i) copies of the solicitor disclosure delivered to | 6,432 (47.8% of advisers) | 4,502 (0.7 hours per response) | |

employee benefits and overhead, suggest that costs for these positions are $70 and $62, respectively. (17% x 2,607,783 hours x $70) + (83% x 2,607,783 hours x $62) = $165,229,131.

726 2,435,364 hours / 13,299 registered advisers = 183 hours per adviser.

727 2,607,783 hours – 2,435,364 hours = 172,419 hours.

728 $154,304,663 - $130,316,112 = $23,988,551.

| | | | |
|---|---|---|---|
| clients and private fund investors pursuant to §275.206(4)-3(a)(1)(iii), and, if the adviser participates in any nonprofit program pursuant to §275.206(4)-3(b)(4), copies of all receipts of reimbursements of payments or other compensation the adviser provides relating to its inclusion in the program;<br>(ii) any communication or other document related to the investment adviser's determination that it has a reasonable basis for believing that (a) any solicitor it compensates under §275.206(4)-3 has complied with the written agreement required by §275.206(4)-3(a)(1), and that such solicitor is not an ineligible solicitor, and (b) any nonprofit program it participates in pursuant to §275.206(4)-3(b)(4) meets the requirements of §275.206(4)-3(b)(4); and<br>(iii) a record of the names of all solicitors who are an adviser's partners, officers, directors or employees or other affiliates, pursuant to §275.206(4)-3(b)(2). | | | |

The following chart shows the differences from the approved annual hourly burden for the current books and records rule.

| **Requirement** | **Estimated Burden Increase or Decrease** | **Brief Explanation** |
|---|---|---|
| All collections of information under proposed rule 204-2 (including new requirements). | **10.7 hour increase.**<br><br>The overall hour burden per adviser would increase from 183 hours to 193.7 hours. | The currently approved burden reflects the current rule's requirement that investment advisers retain copies of advertisements to 10 or more persons. We have proposed that they retain copies of advertisements to one or more persons, as well as copies of questionnaires or surveys used to create third-party ratings in advertisements, written approvals of advertisements, and copies of the solicitor disclosure delivered to |

| | | |
|---|---|---|
| | | clients and private fund investors, along with additional records corresponding to proposed new requirements under the solicitation rule. |

### E. Form ADV

Form ADV (OMB Control No. 3235-0049) is the investment adviser registration form under the Advisers Act. Part 1 of Form ADV contains information used primarily by Commission staff, and Part 2A is the client brochure. Part 2B requires advisers to create brochure supplements containing information about certain supervised persons. On June 5, 2019, the Commission adopted amendments to Form ADV and related rules under the Act to add new Form ADV Part 3: Form CRS (relationship summary) requiring certain registered investment advisers to prepare and file a relationship summary for retail investors.[729] We use the information on Form ADV to determine eligibility for registration with us and to manage our regulatory and examination programs. Clients and investors use certain of the information to determine whether to hire or retain an investment adviser, as well as what types of accounts and services are appropriate for their needs. The collection of information is necessary to provide advisory clients, prospective clients, and the Commission with information about the investment adviser and its business, conflicts of interest and personnel. Rule 203-1 under the Advisers Act requires every person applying for investment adviser registration with the Commission to file Form ADV. Rule 204-4 under the Advisers Act requires certain investment advisers exempt from registration with the Commission ("exempt reporting advisers") to file reports with the Commission by completing a limited number of items on Form ADV. Rule 204-1 under the

[729] OMB approved, and subsequently extended, this collection under this control number (expiring on August 31, 2020).

Advisers Act requires each registered and exempt reporting adviser to file amendments to Form ADV at least annually, and requires advisers to submit electronic filings through IARD. The paperwork burdens associated with rules 203-1, 204-1, and 204-4 are included in the approved annual burden associated with Form ADV and thus do not entail separate collections of information. These collections of information are found at 17 CFR 275.203-1, 275.204-1, 275.204-4 and 279.1 (Form ADV itself) and are mandatory. Responses are not kept confidential.

We are proposing amendments to Form ADV to add a subsection L to Item 5 of Part 1A ("Advertising Activities") to require information about an adviser's use in its advertisements of performance results, testimonials, endorsements, third-party ratings and its previous investment advice. Specifically, we would require an adviser to state whether any of its advertisements contain performance results, and if so, whether all of the performance results were verified or reviewed by a person who is not a related person. We would also require an adviser to state whether any of its advertisements includes testimonials or endorsements, or includes a third-party rating, and if so, whether the adviser pays or otherwise provides cash or non-cash compensation, directly or indirectly, in connection with their use. Finally, we would require an adviser to state whether any of its advertisements includes a reference to specific investment advice provided by the adviser.

The collection of information is necessary to improve information available to us and to the general public about advisers' advertising practices. Our staff would use this information to help prepare for examinations of investment advisers. This information would be particularly useful for staff in reviewing an adviser's compliance with the proposed amendments to the advertising rule, including the proposed restrictions and conditions on advisers' use in advertisements of

performance presentations and third-party statements. We are not proposing amendments to Parts 2 or 3 of Form ADV.

1. Respondents

The respondents to current Form ADV are investment advisers registered with the Commission or applying for registration with the Commission and exempt reporting advisers.[730] Based on the IARD system data as of September 30, 2019, approximately 13,463 investment advisers were registered with the Commission, and 4,206 exempt reporting advisers file reports with the Commission. As discussed above, we are proposing amendments to Form ADV to add a subsection L to Item 5 of Part 1A ("Advertising Activities") to require information about an adviser's use in its advertisements of performance results, testimonials, endorsements, third-party ratings and its previous investment advice. The amendments we are proposing would increase the information requested in Part 1A of Form ADV for registered investment advisers. Because exempt reporting advisers are required to complete a limited number of items in Part 1A of Form ADV, which exclude Item 5, they would not be subject to the proposed amendments to Form ADV Part 1A and would therefore not be subject to this collection of information.[731] However, these exempt reporting advisers are included in the PRA for purposes of updating the overall Form ADV information collection. In addition, as noted above, the Commission recently adopted amendments to Form ADV to add a new Part 3, requiring registered investment advisers

730 An exempt reporting adviser is an investment adviser that relies on the exemption from investment adviser registration provided in either section 203(l) of the Advisers Act because it is an adviser solely to one or more venture capital funds or 203(m) of the Advisers Act because it is an adviser solely to private funds and has assets under management in the United States of less than $150 million.

731 An exempt reporting adviser is not a registered investment adviser and therefore would not be subject to the proposed amendments to Item 5 of Form ADV Part 1A Exempt reporting advisers are required to complete a limited number of items in Part 1A of Form ADV (consisting of Items 1, 2.B., 3, 6, 7, 10, 11 and corresponding schedules), and are not required to complete Part 2.

that offer services to retail investors to prepare and file with the Commission, post to the adviser's website (if it has one), and deliver to retail investors a relationship summary.[732] The burdens associated with completing Part 3 are included in the PRA for purposes of updating the overall Form ADV information collection.[733]

The currently approved burdens for Form ADV are set forth below:[734]

| | RIAs not obligated to prepare and file relationship summaries | RIAs obligated to prepare and file relationship summaries | Exempt reporting advisers | All advisers |
|---|---|---|---|---|
| Number of advisers included in the currently approved burden | 5,064 + 571 expected newly registered RIAs annually | 8,235 + 656 expected newly registered RIAs annually | 4,280 + 441 expected new ERAs annually | 17,597 advisers + 1,740 expected new RIAs and ERAs annually |
| Currently approved total annual hour estimate per adviser | 29.22 hours | 37.47 hours | 3.60 hours | 29.28 annual blended average hours per adviser |
| Currently approved aggregate annual hour burden | 164,655 hours | 333,146 hours | 16,996 hours | 514,797 hours |
| Currently approved aggregate monetized cost | $44,950,816 | $90,978,858 | $4,639,908 | $140,569,582 |

732 *See* Form CRS Release, *supra* footnote 227.

733 *See* Updated Supporting Statement for PRA Submission for Amendments to Form ADV Under the Investment Advisers Act of 1940 (the "Approved Form ADV PRA").

734 The information in the following table is from the Approved Form ADV PRA, *id*.

Based on updated IARD system data as of September 30, 2019, we estimate that the number of registered investment advisers that are required to complete, amend, and file Form ADV (Part 1 and Part 2) with the Commission, but who are not obligated to prepare and file relationship summaries as of the applicable compliance date for Form ADV Part 3, has increased by 3 RIAs, to 5,067, and we also continue to believe, based on IARD system data, that that 1,227 new advisers will register with us annually, 571 of which will not be required to prepare a relationship summary.[735] Based on updated IARD system data as of September 30, 2019, we estimate that the number of registered investment advisers that are required to complete, amend, and file Form ADV (Part 1 and Part 2) *and* prepare and file relationship summaries as of the applicable compliance date for Form ADV Part 3, has increased by 161 RIAs, to 8,396, and we continue to believe, based on IARD system data, that that 1,227 new advisers will register with us annually, 656 of which will be required to prepare a relationship summary.[736] Based on updated IARD system data as of September 30, 2019, we estimate that the number of exempt reporting advisers has decreased by 76, to 4,206; however, we continue to believe that, based on IARD system data, there would be 441 new exempt reporting advisers annually.[737]

2. Estimated new annual hour burden for advisers

As a result of the proposed amendments to Form ADV Part 1A discussed above, we estimate that the average total annual collection of information burden for registered investment advisers that are not obligated to prepare and file relationship summaries will increase 0.5 hours to 29.72 hours per registered investment adviser per year for Form ADV. We estimate that the average

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735 As of September 30, 2019, there are 13,463 RIAs, 8,396 of which offer services to retail investors. *See also* Approved Form ADV PRA, *id*., at text accompanying footnotes 55-56 ("[W]e estimate that 1,227 new advisers will register with us annually, 656 of which will be required to prepare a relationship summary.")

736 *See id*.

737 *Id*., at footnote 42.

total annual collection of information burden for registered investment advisers who *are* obligated to prepare and file relationship summaries will increase 0.5 hour to 38.97 hours per registered investment adviser per year for Form ADV. We do not expect that the proposed amendments would increase or decrease the currently approved total burden estimate of 3.60 per exempt reporting adviser completing Form ADV.

The currently approved annual aggregate burden for Form ADV for all registered advisers and exempt reporting advisers is 514,797, for a monetized cost of $140,569,582.[738] This is an annual blended average per adviser burden for Form ADV of 29.28 hours, and $7,996 per adviser.[739] Factoring in the proposed new questions on Part 1 of Form ADV that would be required for all registered investment advisers (but not for exempt reporting advisers), and increases due to increased number in RIAs since the burden estimate was last approved (but a decreased number in ERAs), the revised annual aggregate burden hours for Form ADV (Parts 1, 2 and 3) for all registered advisers and exempt reporting advisers would be 537,047 hours per year, with a monetized value of $146,613,831.[740] This would be an aggregate increase of 22,250 hours, or $6,044,249 in the monetized value of the hour burden, form the currently approved annual aggregate burden estimates, increases which are attributed to the factors described above.

Estimated new annual hour burden for advisers:

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738 *Id*., at footnotes 44-45 and accompanying text,

739 *Id*., at footnotes 46-47 and accompanying text.

740 537,047 aggregate annual hour burden is the sum of: ((i) 29.72 hours x (5,067 RIAs + 571 expected newly registered RIAs annually) = 167,561 total aggregate annual hour burden for RIAs not obligated to prepare and file relationship summaries; (ii) 38.97 hours x (8,396 + 656 expected newly registered RIAs annually) = 352,756 total aggregate annual hour burden for RIAs not obligated to prepare and file relationship summaries; (iii) 3.60 hours x (4,206 + 441 expected new ERAs annually) = 16,729.2 total aggregate annual hour burden for ERAs). We believe that performance of this function will most likely be equally allocated between a senior compliance examiner and a compliance manager. Data from the SIFMA Management and Professional Earnings Report suggest that costs for these positions are $237 and $309 per hour, respectively, with a blended rate of $273. Therefore: 537,047 hours x $273 = $146,613,831.

| | RIAs not obligated to prepare and file relationship summaries | RIAs obligated to prepare and file relationship summaries | Exempt reporting advisers | All advisers |
|---|---|---|---|---|
| Number of advisers to be included in the proposed burden | 5,067 + 571 expected newly registered RIAs annually | 8,396 + 656 expected newly registered RIAs annually | 4,206 + 441 expected new ERAs annually | |
| Proposed total annual hour estimate per advise | 29.72 | 38.97 | 3.60 hours | |
| Proposed aggregate burden hours | 167,561 | 352,756 hours | 16,729.2 | 537,047 |
| **Proposed aggregate monetized cost** | $45,744,251 | $96,302,508 | $4,567,072 | $146,613,831 |

### F. Request for Comments

We request comment on whether our estimates for burden hours and any external costs as described above are reasonable. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (i) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) determine whether there are ways to minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

In addition to these general requests for comment, we also request comment specifically on the following issues:

- Our analysis relies upon certain assumptions, such as that 100 percent of advisers employ advertisements to attract clients, while approximately half of advisers would use testimonials, endorsements and third-party ratings in advertisements under the proposed rule. Additionally, we assume 95 percent of advisers advertise performance figures, 80 percent of advisers advertise related performance, 50 percent of advisers advertise extracted performance, and 5 percent of advisers advertise extracted performance. Do commenters agree with these assumptions? If not, why not, and what data would commenters propose?
- Our analysis also relies on the assumptions that an adviser that uses testimonials or endorsements in advertisements uses approximately five testimonials or endorsements per year, and that an adviser that uses third-party ratings in advertisements will typically use one third-party rating at a time, and often will renew the rating for successive years. Do commenters agree with these assumptions? If not, why not, and what data would commenters propose?
- Our analysis also relies on the assumption that an investment adviser that includes testimonials or endorsements in its advertisement would incur a burden of one hour to prepare the required disclosure for its testimonials and/or endorsements (0.2 hours per each response, for a total of one hour per each adviser, since we estimate that each adviser would have five responses). We also estimate that an adviser that uses a third-party rating would incur an initial burden of 1.5 hours to draft and finalize the required disclosure for the third-party rating, and would incur additional ongoing annual hourly

costs of approximately 0.375 hours corresponding to the annual renewal of the third-party rating and related updating of disclosures. Do commenters agree with these assumptions? If not, why not, and what data would commenters propose? We assume that compliance managers and compliance attorneys are likely to prepare the disclosures for testimonials, endorsements, and third-party ratings. Do commenters agree with this assumption? Do most advisers have in-house lawyers who could be tasked with preparing these disclosures, or would they use outside attorneys or other persons? What positions within or outside the adviser's organization would perform these functions?

- Our analysis relies on the assumptions that 80 percent of investment advisers are light advertisers (creating 10 new advertisements per year and updating 50 existing advertisements times per year) and 20 percent are heavy advertisers (creating 50 new advertisements per year and updating 250 existing advertisements times per year). Do commenters agree with these assumptions? If not, why not, and what data would commenters propose?
- Out analysis also relies on the assumptions that light advertisers and heavy advertisers would utilize 10 and 50 hours, respectively, of external legal services per year to review advertisements. Do commenters agree with these assumptions? If not, why not, and what data would commenters propose?
- Our analysis for certain advertisements is based on an estimated $400 per hour cost for external legal services. We do not have specific data regarding these external legal costs. Do commenters agree with this estimate? If not, why not, and what estimate would commenters propose?

- We understand that a number of investment advisers currently review and approve advertisements for compliance with current rule 206(4)-1. Should our analysis be revised to account for this customary industry practice? If so, how much should the total annual burden hours and total annual costs for the review and approval requirement be adjusted?
- Our analysis for the proposed advertising rule PRA assumes that investment advisers would designate their chief compliance officers and compliance attorneys with the task of reviewing and approving advertisements and making appropriate revisions. Would advisers use other personnel for this task?
- We generally assume that in-house personnel deliver various disclosures to investors under the proposed advertising and solicitation rules, but that printing and mailing underlying information related to hypothetical performance may incur external costs. Do commenters agree with these assumptions? Would advisers use broker-dealers or consultants with respect to these disclosures?
- We also assume that advisers that use solicitors to attract clients use approximately three different solicitors in the course of a year, and that the solicitors make approximately 30 solicitation referrals per year (in the aggregate). Do commenters agree with these assumptions? Does this sufficiently account for advisers that employ long-term solicitors, and therefore do not enter into new solicitor contracts each year? Does this sufficiently account for advisers that frequently use new solicitors?
- Our analysis for the proposed solicitation rule PRA also relies on the assumption that an investment adviser that uses a solicitor pursuant to the rule (and is not exempt) would incur a burden of three hours to prepare the required written agreements (1 hour x 3 written agreements), a burden of 3 hours to prepare and deliver the solicitor disclosures

(0.10 hours x 30 solicitor disclosures), and six hours to oversee the solicitor relationships (2 hours x 3 solicitor relationships). Do commenters agree with these assumptions? If not, why not, and what data would commenters propose?

- In addition, our analysis for the proposed solicitation rule PRA relies on the assumption that advisers that would use solicitors who are employees, affiliates and nonprofit programs would incur a burden of 0.3 hours to prepare and deliver the brief disclosures that would be required under the rule (*i.e.*, the disclosure that the employee or affiliate is an affiliate of the adviser, if such affiliation is not "readily apparent" to the investor, and the required disclosure about the nonprofit program, as applicable). Do commenters agree with these assumptions? If not, why not, and what data would commenters propose? Do commenters agree that for advisers who use employees or other affiliated solicitors, the affiliation would be "readily apparent" to investors about 50 percent of the time? If not, what percentage do commenters propose?
- We assume that, for the proposed solicitation rule PRA, compliance managers and compliance attorneys are likely to prepare the written solicitor agreement and the solicitor disclosure and oversee the solicitor relationship. We assume that advisers' in-house marketing personnel are likely to deliver the solicitor disclosures. Do commenters agree with these assumptions? If not, what positions within or outside the adviser's organization would perform these functions? We also assume that advisers would deliver the solicitor disclosure by U.S. postal service approximately 20 percent of the time (in the other instances, they would either deliver the disclosures electronically or as part of other mailings). Do commenters agree? If not, why not?

The agency is submitting the proposed collections of information to OMB for approval. Persons wishing to submit comments on the collection of information requirements of the proposed amendments should direct them to the Office of Management and Budget, Attention Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy to Vanessa A. Countryman, Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549 1090, with reference to File No. S7-21-19. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this release; therefore, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-21-19, and be submitted to the Securities and Exchange Commission, Office of FOIA Services, 100 F Street NE, Washington, DC 20549-2736.

## V. INITIAL REGULATORY FLEXIBILITY ANALYSIS

The Commission has prepared the following Initial Regulatory Flexibility Analysis ("IRFA") in accordance with section 3(a) of the Regulatory Flexibility Act ("RFA").[741] It relates to: (i) proposed amendments to rule 206(4)-1 under the Investment Advisers Act; (ii) proposed amendments to rule 206(4)-3; (iii) proposed amendments to rule 204-2, and (iv) proposed amendments to Form ADV Part 1A.

[741] 5 U.S.C. 603(a).

### A. Reason for and Objectives of the Proposed Action

#### 1. Proposed rule 206(4)-1

We are proposing amendments to rule 206(4)-1 (the "advertising rule"), which we adopted in 1961 to target advertising practices that the Commission believed were likely to be misleading. The current rule imposes four *per se* prohibitions, which are described above in section II.A. In addition to the four *per se* prohibitions, the current rule prohibits any advertisement which contains any untrue statement of a material fact, or which is otherwise false or misleading.

As discussed above, we are proposing amendments to rule 206(4)-1 to impose: (i) general prohibitions of certain advertising practices applicable to all advertisements; (ii) tailored restrictions or conditions on specific practices applicable to all advertisements; (iii) tailored requirements for the presentation of performance results, based on the intended audience; and (iv) a compliance requirement that advertisements be reviewed and approved in writing by a designated employee before dissemination. The proposed rule is designed to restrict or place conditions on specific practices we believe may cause investors to be misled without appropriate conditions or limitations. The proposed new rule would also include a new definition of "advertisement" that is intended to be flexible enough to remain relevant and effective in the face of advances in technology and evolving industry practices. The reasons for, and objectives of, the proposed amendments are discussed in more detail in sections I and II, above. The burdens of these requirements on small advisers are discussed below as well as above in sections III and IV, which discuss the burdens on all advisers. The professional skills required to meet these specific burdens are also discussed in section IV.

### 2. Proposed amendments to rule 206(4)-3

We are proposing amendments to rule 206(4)-3 (currently referred to as the "cash solicitation rule"), which we adopted in 1979 to help ensure clients are aware that paid solicitors who refer them to advisers have a conflict of interest.[742] The current rule prohibits investment advisers from paying cash fees to solicitors for client referrals unless certain conditions are met. These conditions include a written agreement, disclosures, and receipt and retention of a signed and dated acknowledgement of the required disclosures, subject to certain exemptions. The current rule also prohibits advisers 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.[743]

As discussed above, we are proposing amendments to rule 206(4)-3 to expand the rule to cover solicitation arrangements involving all forms of compensation, rather than only cash compensation. We are also proposing to expand the rule to apply to the solicitation of current and prospective investors in any private fund, rather than only to clients (including prospective clients) of the investment adviser.[744] The proposed rule would generally continue to require that an adviser compensate a solicitor pursuant to a written agreement, and would continue to require as part of the written agreement that the investor receive a solicitor disclosure containing specified information and that the solicitor comply with certain provisions of the Act.[745]

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742 *See supra* section I.B.

743 *See* rule 206(4)-3(a)(1)(ii).

744 As discussed above, we are proposing to apply the rule to compensation by investment advisers to solicitors to obtain clients and prospective clients as well as investors and prospective investors in private funds that those advisers manage. For purposes of this analysis, we refer to any of these persons as "investors," unless we specify otherwise.

745 The proposed rule would eliminate the written agreement requirement (and the written agreement's solicitor disclosure requirement) for certain exempt solicitations. In addition, the proposed rule's written agreement would specify that the solicitor would be required to comply with certain provisions of the Act (rather than, generally, the provisions of the Act and the rules thereunder), and would remove the existing

However, the proposed rule would no longer require that the solicitor provide the investor with a copy of the adviser's brochure, or that the adviser obtain and retain a signed and dated acknowledgment from the investor that the investor has received the disclosure documents. The proposed rule would generally maintain the current rule's exceptions for solicitors for impersonal investment advice, and solicitors that are affiliated with the adviser, provided that such solicitors disclose their affiliation to clients at the time of solicitation. It would also add two new exemptions, for *de minimis* compensation and for certain nonprofit programs. Finally, we are proposing to refine the rule's solicitor disqualification provision to expand the types of disciplinary events that would trigger the rule's disqualification provision, and also provide a conditional carve-out for enumerated events for which the Commission has brought an enforcement action but has neither barred or suspended the person or prohibited the person from acting in any capacity under the Federal securities laws, nor has issued certain types of cease and desist orders. All of these requirements are discussed in detail above in sections II.B.1 through II.B.8. The burdens of these requirements on small advisers are discussed below as well as above in our Economic Analysis and Paperwork Reduction Act Analysis, which discuss the burdens on all advisers.[746] The professional skills required to meet these specific burdens are also discussed in Section IV.

We believe that our proposed amendments are appropriate and in the public interest and will improve investor protection. We are proposing amendments to the current rule because while we believe that the concerns that motivated the Commission to adopt rule 206(4)-3 still exist today, we also believe that we can achieve our regulatory goals in a more tailored manner.

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rule's written agreement requirement that the solicitor undertake to perform his duties under the agreement in a manner consistent with the instructions of the investment adviser.

[746] *See* Sections III and IV. I.A.6.

We believe that our proposed amendments would update the rule's coverage to reflect regulatory changes and evolution of industry practices, improve the quality of disclosures to investors, and streamline elements of the rule our 40 years of experience has suggested may no longer be necessary for investor protection.

### 3. Proposed rule 204-2

We are also proposing related amendments to rule 204-2, the books and records rule, which sets forth requirements for maintaining, making, and retaining advertisements. We are proposing to amend the current rule to require investment advisers to make and keep records of advertisements distributed to one or more person. The current rule requires investment advisers to keep a record of advertisements sent to 10 or more persons. In addition, we are proposing to add provisions to the books and records rule that would explicitly require investment advisers: (i) that use third-party ratings in an advertisement to record and keep a record of the questionnaire or survey used to create the third-party rating; (ii) to record and keep a copy of all written approvals of advertisements required by the proposed rule. We are also proposing to add recordkeeping requirements that correspond to the proposed amendments to the solicitation rule, as follows: replace the rule's requirement that investment advisers keep a record of all written acknowledgments of receipt obtained from clients pursuant to the current cash solicitation rule with the proposed requirement that an investment adviser retain any communication related to the investment adviser's determination that it has a reasonable basis for believing that any solicitor it compensates under the solicitation rule has complied with the written agreement required by the solicitation rule. Additionally, to correspond to other proposed changes to the solicitation rule, we would amend the books and records rule to require investment advisers to make and keep records of: (i) copies of the solicitor disclosure delivered to investors pursuant to rule 206(4)-3(a)(1)(iii) (this is also a requirement of the current recordkeeping rule); (ii) if the

adviser participates in any nonprofit program pursuant to the solicitation rule, copies of all receipts of reimbursements of payments or other compensation the adviser provides relating to its inclusion in the program; (iii) any communication related to the investment adviser's determination that it has a reasonable basis for believing that any solicitor it compensates under rule 206(4)-3 is not an ineligible solicitor, and any nonprofit program it participates in pursuant to the solicitation rule meets the requirements of the solicitation rule; and (iv) the names of all solicitors who are an adviser's partners, officers, directors or employees or other affiliates, pursuant to the solicitation rule.

As discussed above, we are proposing these amendments to rule 204-2 to: (i) conform the books and records rule to the proposed advertising rule and proposed amendments to the solicitation rule; (ii) help ensure that an investment adviser retains records of all its advertisements and solicitations; and (iii) facilitate the Commission's inspection and enforcement capabilities. The reasons for and objectives of, the proposed amendments to the books and records rule are discussed in more detail in section II.C above. The burdens of these requirements on small advisers are discussed below as well as above in our Economic Analysis and Paperwork Reduction Act Analysis, which discuss the burdens on all advisers. The professional skills required to meet these specific burdens are also discussed in Section IV.

#### 4. Proposed amendments to Form ADV

We are also proposing to amend Item 5 of Part 1A of Form ADV to improve information available to us and to the general public about advisers' advertising practices. Item 5 currently requires an adviser to provide information about its advisory business. We propose to add a subsection L ("Advertising Activities") to require information about an adviser's use in its

advertisements of performance results, testimonials, endorsements, third-party ratings and its previous investment advice.

Specifically, we would require an adviser to state whether any of its advertisements contain performance results, and if so, whether all of the performance results were verified or reviewed by a person who is not a related person. We would also require an adviser to state whether any of its advertisements includes testimonials or endorsements, or includes a third-party rating, and if so, whether the adviser pays cash or non-cash compensation, directly or indirectly, in connection with their use. Finally, we would require an adviser to state whether any of its advertisements includes a reference to specific investment advice provided by the adviser. Our staff would use this information to help prepare for examinations of investment advisers. This information would be particularly useful for staff in reviewing an adviser's compliance with the proposed amendments to the advertising rule, including the proposed restrictions and conditions on advisers' use in advertisements of performance presentations and third-party statements. The reasons for and objectives of, the proposed amendments to Form ADV are discussed in more detail in section II.A.8 above. The burdens of these requirements on small advisers are discussed below as well as above in our Economic Analysis and Paperwork Reduction Act Analysis, which discuss the burdens on all advisers. The professional skills required to meet these specific burdens are also discussed in Section IV.

**B. Legal Basis**

The Commission is proposing amendments to rule 206(4)-1 under the Advisers Act under the authority set forth in sections 203(d), 206(4), 211(a) and 211(h) of the Investment Advisers Act of 1940 [15 U.S.C. 80b-3(d), 10b-6(4) and 80b-11(a) and (h)]. The Commission is proposing amendments to rule 206-4(3) under the Advisers Act under the authority set forth in

sections 203(d), 206(4), 211(a) and 211(h) of the Investment Advisers Act of 1940 [15 U.S.C. 80b-2(d), 80b-6(4), and 80b-11(a) and (h)]. The Commission is proposing amendments to rule 204-2 under the Advisers Act under the authority set forth in sections 204 and 211 of the Investment Advisers Act of 1940 [15 U.S.C. 80b-4 and 80b-11]. The Commission is proposing amendments to Form ADV under section 19(a) of the Securities Act of 1933 [15 U.S.C. 77s(a)], sections 23(a) and 28(e)(2) of the Securities Exchange Act of 1934 [15 U.S.C. 78w(a) and 78bb(e)(2)], section 319(a) of the Trust Indenture Act of 1939 [15 U.S.C. 7sss(a)], section 38(a) of the Investment Company Act of 1940 [15 U.S.C. 80a-37(a)], and sections 203(c)(1), 204, and 211(a) of the Investment Advisers Act of 1940 [15 U.S.C. 80b-3(c)(1), 80b-4, and 80b-11(a)].

### C. Small Entities Subject to the Rule and Rule Amendments

In developing these proposals, we have considered their potential impact on small entities that would be subject to the proposed amendments. The proposed amendments would affect many, but not all, investment advisers registered with the Commission, including some small entities.

Under Commission rules, for the purposes of the Advisers Act and the RFA, an investment adviser generally is a small entity if it: (1) has assets under management having a total value of less than $25 million; (2) did not have total assets of $5 million or more on the last day of the most recent fiscal year; and (3) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had total assets of $5 million or more on the last day of its most recent fiscal year.[747] Our proposed new rules and amendments

[747] Advisers Act rule 0-7(a).

would not affect most investment advisers that are small entities ("small advisers") because they are generally registered with one or more state securities authorities and not with the Commission. Under section 203A of the Advisers Act, most small advisers are prohibited from registering with the Commission and are regulated by state regulators. Based on IARD data, we estimate that as of September 30, 2019, approximately 575 SEC-registered advisers are small entities under the RFA.[748]

### 1. Small entities subject to amendments to advertising rule

As discussed above in section III.C (the Economic Analysis), the Commission estimates that based on IARD data as of September 30, 2019, approximately 13,463 investment advisers would be subject to the proposed amendments to rule 206(4)-1 under the Advisers Act and the related proposed amendments to rule 204-2 under the Advisers Act.[749]

All of the approximately 575 SEC-registered advisers that are small entities under the RFA would be subject to the amended rule 206(4)-1 and corresponding amendments to rule 204-2. This is because, as discussed above in the PRA, we estimate that all investment advisers will disseminate at least one communication meeting the proposed rule's definition of "advertisement" and therefore be subject to the requirements of the proposed rule.[750] Furthermore, the rule's additional conditions and restrictions on testimonials, endorsements and third-party ratings, as well as certain presentations of performance, would apply to many advertisements under the rule.[751] Approximately 172[752] SEC-registered advisers that are small

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748 Based on SEC-registered investment adviser responses to Items 5.F. and 12 of Form ADV.

749 *See supra* footnote 553 and accompanying text.

750 *See* PRA discussion, above, at sections IV.A and B.

751 As discussed above, the use of testimonials, endorsements, third-party ratings in advertisements is voluntary but we estimate that approximately 50% of registered investment advisers would use testimonials

entities are advisers to retail clients, and therefore could be subject to the rule's additional conditions for certain presentations of performance in advertisements.[753] Approximately 403 SEC-registered advisers that are small entities are advisers to non-retail clients,[754] and therefore could be subject to the rule's additional limited conditions related to the presentation of hypothetical performance.

### 2. Small entities subject to amendments to solicitation rule

As discussed in section III.G, above, the Commission estimates that based on IARD data as of September 30, 2019, approximately 6,432 investment advisers would be subject to the proposed amendments to rule 206(4)-3 under the Advisers Act.

We estimate that, of the approximately 575 SEC-registered advisers that are small entities under the RFA, 115 of these advisers would be subject to rule 206(4)-3.[755]

### 3. Small entities subject to amendments to the books and records rule *206(4)-2*

As discussed above, there are approximately 575 small advisers currently registered with us, and we estimate that 100 percent of advisers registered with us would be subject to amendments to the books and records rule.

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or endorsements in advertisements, and approximately 50% of registered investment advisers would use third-party ratings in advertisements. *See* PRA discussion, above, at sections IV.A and B.

752 Based on SEC-registered investment adviser responses, as of September 30, 2019, to, Items 5.D.(a), 5.D.(b), 5.F. and 12 of Form ADV, which indicate that the adviser has clients that are high net worth individuals and/or individuals (other than high net worth individuals) and that the adviser is a small entity.

753 *See supra* section II.A.5.

754 This number is equal to the total number of small entities (575) minus the total number of small entities that are advisers to individual high net worth and individual non-high net worth clients (172).

755 101 small entity firms responded "Yes" to Item 8.H.1. or 8.H.2, based on SEC-registered investment adviser responses, as of September 30, 2019, and to Items 5.F. and 12 of Form ADV. However, as discussed above, we anticipate that approximately 47% of registered investment advisers would be subject to the proposed amended solicitation rule. Because we estimate that small entity advisers would be more likely than larger advisers to provide *de minimis* compensation for solicitation, we expect that the percentage of small entity advisers subject to the proposed amended solicitation rule would be 20%, or 115 advisers.

#### 4. Small entities subject to amendments to Form ADV

As discussed above, there are approximately 575 small advisers currently registered with us, and we estimate that 100 percent of advisers registered with us would be subject to amendments to Form ADV.

### D. Projected Reporting, Recordkeeping and Other Compliance Requirements

#### 1. Proposed rule 206(4)-1

Proposed rule 206(4)-1 would impose certain reporting and compliance requirements on certain investment advisers, including those that are small entities. All registered investment advisers that distribute advertisements under the rule, which we estimate to be all advisers, would be required to comply with the proposed rule's general prohibition of fraudulent or misleading advertisements and review requirement. In addition, all advisers that include testimonials, endorsements and third-party ratings in advertisements would be required to include disclosures and comply with other conditions. Small entity advisers that have retail clients would be required to comply with restrictions and other conditions related to the presentation of certain performance results in advertisements. Finally, small entity advisers that include certain performance in any Retail Advertisement would be required to offer to provide promptly certain additional information. The proposed requirements and rule amendments, including compliance and recordkeeping requirements, are summarized in this IRFA (section V.C, above). All of these proposed requirements are also discussed in detail, above, in sections I and II, and these requirements and the burdens on respondents, including those that are small entities, are discussed above in sections III and IV (the Economic Analysis and Paperwork Reduction Act Analysis, respectively) and below. The professional skills required to meet these specific burdens are also discussed in section IV.

As discussed above, there are approximately 575 small advisers currently registered with us, and we estimate that 100 percent of advisers registered with us would be subject to amendments to the advertising rule. As discussed above in our Paperwork Reduction Act Analysis in section III above, the proposed amendments to rule 206(4)-1 under the Advisers Act, which would require advisers to prepare disclosures for testimonials and endorsements, third-party ratings, and performance results, as well as review and approve advertisements, would create a new annual burden of approximately 115.7 hours per adviser, or 66,528 hours in aggregate for small advisers.[756] We therefore expect the annual monetized aggregate cost to small advisers associated with our proposed amendments would be $27,789,932.[757]

### 2. Proposed amendments to rule 206(4)-3

Proposed amendments to rule 206(4)-3 would impose certain reporting and compliance requirements on certain investment advisers, including those that are small entities, requiring them to enter into written agreements containing specified information, to prepare disclosures and deliver them to investors (unless the written agreement designates the solicitor as responsible for delivery), and to conduct ongoing oversight and compliance. The proposed requirements and rule amendments, including recordkeeping requirements, are summarized in this IRFA (section V.A.2 above). All of these proposed requirements are also discussed in detail, above, in sections II.B and II.C (Proposed Amendments to the Solicitation Rule, and Recordkeeping), and these requirements and the burdens on respondents, including those that are small entities, are discussed above in sections III and IV (the Economic Analysis and Paperwork Reduction Act

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[756] 1,557,044 hours / 13,463 advisers = 115.7 hours per adviser. 115.7 hours x 575 small advisers = 66,528 hours.

[757] $650,671,048 total cost x (575 small advisers / 13,463 advisers) = $27,789,932.

Analysis) and below. The professional skills required to meet these specific burdens are also discussed in section IV.

Our Economic Analysis, discussed in section III, above, discusses these costs and burdens for respondents, which include small advisers. All advisers that use solicitors under the current rule are required to prepare a written agreement that, among other requirements, requires the solicitor to deliver the solicitor disclosure. The proposed rule would continue to require the written agreement and its solicitor disclosure requirement, but would permit either the adviser or the solicitor to deliver the solicitor disclosure, provided that the written agreement specifies the responsible party. In addition, similar to the current rule, the proposed rule would require that the adviser must have a reasonable basis for believing that the solicitor has complied with the proposed rule's required written agreement. Such requirement would also replace the current rule's requirement that each adviser obtain a signed and dated acknowledgment from the client that the client has received the solicitor's disclosure.

As discussed above, approximately 115 small advisers currently registered with us would be subject to the proposed new solicitation rule. As discussed above in our Paperwork Reduction Act Analysis, we expect these 115 small advisers to spend, on average, an additional total of 1,231 annual hours, or approximately 10.7 hours per adviser,[758] which translates into an approximate monetized cost for the burden hours of $406,123,[759] or $3,531.50 per adviser for the

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758 *See supra* section IV.C (Paperwork Reduction Act Analysis discussion of the burden hours per adviser).

759 89 percent x ((3 hour x $337) + (3 hours x 307.50) + (6 hours x $337)) + 11 percent x (0.3 hours x $337) = $3,531.50 per adviser for complying with the solicitation rule. This is a blended rate taking into account that we estimate that some smaller advisers that we estimate would be subject to the rule (11percent) would be subject to only part of this collection of information, and we estimate that 89 percent of smaller advisers that we estimate would be subject to the rule would be subject to the entire collection of information.

burden hours, attributable to the written agreement, solicitor disclosure, and oversight requirements.[760]

### 3. Proposed amendments to rule 204-2

Proposed amendments to rule 204-2 would require investment advisers to retain copies of advertisements to one or more persons, whereas the current rule requires investment advisers to retain copies of advertisements to 10 or more persons.[761] We are also proposing to require investment advisers that use a third-party rating in a retail advertisement to retain a copy of the questionnaire or survey used to create the third-party rating, as well as a copy of all written approvals of advertisements required under proposed rule 206(4)-1(d).[762] Finally, to correspond to changes we are proposing to make to the solicitation rule, rule 206(4)-3, we are proposing to amend the current books and records rule to require investment advisers to make and keep records of: (i) copies of the solicitor disclosure delivered to investors pursuant to rule 206(4)-3(a)(1)(iii) (this is also a requirement under the current rule 204-2), and, if the adviser participates in any nonprofit program pursuant to rule 206(4)-3(b)(4), copies of all receipts of reimbursements of payments or other compensation the adviser provides relating to its inclusion in the program; (ii) any communication related to the investment adviser's determination that it has a reasonable basis for believing that any solicitor it compensates under rule 206(4)-3 has complied with the written agreement required by rule 206(4)-3(a)(1); that such solicitor is not an ineligible solicitor, and; that any nonprofit program it participates in pursuant to rule 206(4)-3(b)(4) meets the requirements of rule 206(4)-3(b)(4); and (iii) a record of the names of all solicitors who are an adviser's partners, officers, directors or employees or other affiliates,

760 *See supra* section IV.C.

761 *See* proposed rule 204-2(a)(11).

762 *See* proposed rule 204-2 (a)(11)(ii) and (iii).

pursuant to rule 206(4)-3(b)(2).[763] Each of these records would be required to be maintained in the same manner, and for the same period of time, as other books and records required to be maintained under rule 204-2(a).

As discussed above, there are approximately 575 small advisers currently registered with us, and we estimate that 100 percent of advisers registered with us would be subject to amendments to the books and records rule. As discussed above in our Paperwork Reduction Act Analysis in section IV.D above, the proposed amendments to rule 204-2 under the Advisers Act would increase the annual burden by approximately 10.7 hours per adviser, or 6,152.5 hours in aggregate for small advisers.[764] We therefore believe the annual monetized aggregate cost to small advisers associated with our proposed amendments would be $7,056,878.[765]

#### 4. Proposed amendments to Form ADV

Proposed amendments to Form ADV would impose certain reporting and compliance requirements on certain investment advisers, including those that are small entities, requiring them to provide information about their use in its advertisements of performance results, testimonials, endorsements, third-party ratings and previous investment advice. The proposed requirements and rule amendments, including recordkeeping requirements, are summarized above in this IRFA (section V.A). All of these proposed requirements are also discussed in detail, above, in section II.A.8, and these requirements and the burdens on respondents, including those that are small entities, are discussed above in sections III and IV (the Economic Analysis

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763 *See* proposed rule 204-2(a)(15)(i) through (iii).

764 10.7 hour x 575 small advisers = 6,152.5 hours.

765 575 registered investment advisers x 193.7 hours = 111,377.5 hours. (17% x 111,377.5 hours x $70) + (83% x 111,377.5 hours x $62) = $7,056,878.

and Paperwork Reduction Act Analysis) and below. The professional skills required to meet these specific burdens are also discussed in section IV.

Our Economic Analysis, discussed in section III above, discusses these costs and burdens for respondents, which include small advisers. As discussed above in our Paperwork Reduction Act Analysis in section IV.E above, the proposed amendments to Form ADV would increase the annual burden for advisers (other than exempt reporting advisers, who would not be required to respond to the new Form ADV questions we are proposing) by approximately 0.5 hours per adviser, or 287.5 hours in aggregate for small advisers (other than exempt reporting advisers).[766] We therefore expect the annual monetized aggregate cost to small advisers (other than exempt reporting advisers, for whom there would be no additional cost) associated with our proposed amendments would be $78,487.50.[767]

### E. Duplicative, Overlapping, or Conflicting Federal Rules

#### 1. Proposed rule 206(4)-1

Other than existing rule 206(4)-1 and the prohibitions contained in section 208(a)-(c) of the Act, investment advisers do not have obligations under the Act specifically for adviser advertisements. As discussed above in section II.A, we recognize that advisers to pooled investment vehicles, who would be included in the scope of the proposed rule 206(4)-1, are prohibited from making misstatements or materially misleading statements to investors under rule 206(4)-8.[768] To the extent there is any overlap between the proposed rule and rule 206(4)-8 with respect to advertisements, we believe that any additional costs to advisers to pooled

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766 10.3 hour x 561 small advisers = 5,778.3 hours.

767 287.5 hours x $273. *See supra* 740 for a discussion of who we believe would perform this function, and the applicable blended rate.

768 There may be other legal protections of investors from fraud. *See, e.g.,* section 17(a) of the Securities Act, as well as section 10(b) of the Exchange Act and rule 10b-5 thereunder.

investment vehicles will be minimal, as they can assume that an advertisement that would raise issues under a specific provision of the proposed rule would also be prohibited under rule 206(4)-8. There are no duplicative, overlapping, or conflicting Federal rules with respect to the proposed amendments to rule 204-2.

### 2. Proposed amendments to rule 206(4)-3

Other than existing rule 206(4)-3, investment advisers do not have obligations under the Act to enter into written agreements with solicitors.[769] However, they do have other compliance oversight obligations under the Federal securities laws, including the Act. For example, advisers are subject to the Act's compliance rule, which we adopted in 2003.[770] When an adviser utilizes a solicitor as part of its business, therefore, the adviser must have in place under the Act's compliance rule policies and procedures that address this relationship and are reasonably designed to ensure that the adviser is in compliance with rule 206(4)-3. We believe the proposed solicitation rule's compliance provision would work well with the Act's compliance rule, as both are principles-based and would allow advisers to tailor their compliance with the solicitation rule as appropriate for each adviser.

Our proposed amendments to rule 206(4)-3 would eliminate some regulatory duplication, such as the current rule's duplicative requirement that a solicitor deliver to clients the adviser's Form ADV brochure. As discussed above, advisers are required to deliver their ADV brochures to their clients under rule 204-3. To the extent that both advisers and solicitors currently deliver

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769 Persons that receive compensation in connection with the purchase or sale of securities may be subject to broker-dealer registration requirements of the Securities Exchange Act of 1934 and any applicable state securities statutes, which may include obligations with respect to agreements with certain finders.

770 *See supra* footnote 33 and accompanying text. The compliance rule contains principles-based requirements for advisers to adopt compliance policies and procedures that are tailored to their businesses. *Id*.

the adviser's Form ADV brochure, the proposed rule would reduce the redundancy of disclosures. As discussed above, the rule's proposed disqualification provisions for solicitors would newly apply to solicitors of private fund investors. Such solicitors may also be subject to "bad actor" disqualification requirements, which disqualify securities offerings from reliance on exemptions if the issuer or other relevant persons (such as underwriters, placement agents and the directors, officers and significant shareholders of the issuer) have been convicted of, or are subject to court or administrative sanctions for, securities fraud or other violations of specified laws.[771] To the extent that a person is subject to both disqualification provisions, there would be some overlapping categories of disqualifying events (*i.e.*, certain bad acts would disqualify a person under both provisions). For instance, certain types of final orders of certain state and Federal regulators would be disqualifying events under both provisions. However, some types of bad acts could disqualify a person from engaging in certain capacities in a securities offering under Rule 506 of Regulation D under the Securities Act of 1933, but not from engaging as a solicitor under the solicitation rule, and *vice versa*. Given that the two regimes are separate, we do not believe that any conflicting disqualification provisions between the regimes would be inappropriate. We believe the investor protection benefits of the disqualification provision of the proposed rule justify the additional costs of its application.

### 3. Proposed amendments to Form ADV

Our proposed new subsection L ("Advertising Activities") to Item 5 of Part 1A of Form ADV would require information about an adviser's use in its advertisements of performance results, testimonials, endorsements, third-party ratings and its previous investment advice. These

[771] *See* Bad Actor Disqualification Adopting Release, *supra* footnote 457.

proposed requirements would not be duplicative of, or overlap with, other information advisers are required to provide on Form ADV.

### F. Significant Alternatives

#### 1. Proposed rule 206(4)-1

The RFA directs the Commission to consider significant alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. We considered the following alternatives for small entities in relation to the proposed amendments to the advertising rule and the corresponding proposed amendments to rule 204-2 under the Advisers Act and to Form ADV: (i) differing compliance or reporting requirements that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the proposed rule for such small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the proposed rule, or any part thereof, for such small entities.

Regarding the first and fourth alternatives, the Commission believes that establishing different compliance or reporting requirements for small advisers, or exempting small advisers from the proposed rule, or any part thereof, would be inappropriate under these circumstances. Because the protections of the Advisers Act are intended to apply equally to clients of both large and small firms, it would be inconsistent with the purposes of the Advisers Act to specify differences for small entities under the proposed advertising rule and corresponding changes to rule 204-2 and Form ADV. As discussed above, we believe that the proposed amendments to the advertising rule would result in multiple benefits to clients. For example, conditions and disclosures on advertisements would provide investors with information they need to assess the adviser's advertising claims (for performance results) and third-party claims about the adviser

(for testimonials, endorsements, and third-party ratings). We believe that these benefits should apply to clients of smaller firms as well as larger firms. In addition, as discussed above, our staff would use the corresponding information that advisers would report on the proposed amended Form ADV to help prepare for examinations of investment advisers. Establishing different conditions for large and small advisers that advertise their services to investors would negate these benefits.

Regarding the second alternative, we believe the current proposal is clear and that further clarification, consolidation, or simplification of the compliance requirements is not necessary. As discussed above: the proposed rule would provide general anti-fraud principles applicable to all advertisements under the rule; would provide further restrictions and conditions on certain specific types of presentations, such as testimonials in advertisements; and would provide additional conditions for advertisements containing certain performance information to retail investors. These provisions would address a number of common advertising practices that the current rule either does not explicitly address or broadly restricts (*e.g.*, the current rule prohibits testimonials concerning the investment adviser or its services, and direct or indirect references to specific profitable recommendations that the investment adviser has made in the past). The proposed provisions would clarify the advertising regime, which has come to depend on a large number of no-action letters over the years to fill the gaps.

Regarding the third alternative, we determined to use a combination of performance and design standards. The general prohibition would be principles-based and would give advisers a broad framework within which to determine how best to present advertisements so they are not false or misleading. The proposed rule would also contain design standards, as it would contain additional conditions for certain third-party statements in Retail and Non-Retail advertisements,

and certain restrictions and conditions on performance claims, in both Retail and Non-Retail Advertisements. These restrictions and conditions are narrowly tailored to prevent certain types of advertisements that are not a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of section 206(4) of the Act from misleading investors. The corresponding changes to rule 204-2 and Form ADV are also narrowly tailored to address the proposed changes to the advertising rule.

We also considered an alternative that would not have included design standards, and that would have relied entirely on performance standards. In this alternative, as discussed in the Economic Analysis at section III above, we would reduce the limitations on investment adviser advertising, and rely on the general prohibitions to achieve the programmatic costs and benefits of the rule. As discussed in the Economic Analysis, we believe that many of the types of advertisements that would be prohibited by the proposed rule's limitations have the potential to be fraudulent or misleading. We do not believe that removal of the limitations on advertisements we are proposing would, in comparison with the proposed rule, permit advertisements that would not be inherently fraudulent or misleading. In addition, we believe that the removal of limitations may create uncertainty about what types of advertisements would fall under the general prohibitions.

On the other hand, we also considered an alternative that would have increased the scope of the proposed rule's design standards. As discussed in the Economic Analysis in section III above, it would have applied the conditions to a greater universe of advertisements, such as advisers to "accredited investors," as defined in rule 501(a) of Regulation D under the Securities Act of 1933 ("Securities Act"), or as "qualified clients," instead of qualified purchaser standard. However, as we describe therein, we believe that the qualified purchaser standard provides a

more appropriate standard for determining whether an investor has sufficient knowledge, experience, financial sophistication, and bargaining power to receive different treatment under the proposed rule.

### 2. Proposed rule 206(4)-3

The RFA directs the Commission to consider significant alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. We considered the following alternatives for small entities in relation to the proposed solicitation rule and the corresponding proposed amendments to rule 204-2 under the Advisers Act: (i) differing compliance or reporting requirements that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the proposed rule for such small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the proposed rule, or any part thereof, for such small entities.

Regarding the first and fourth alternatives, the Commission believes that establishing different compliance or reporting requirements for small advisers, or exempting small advisers from the proposed rule, or any part thereof, would be inappropriate under these circumstances. Because the protections of the Advisers Act are intended to apply equally to clients of both large and small firms, it would be inconsistent with the purposes of the Advisers Act to specify differences for small entities under the proposed solicitation rule. However, we are proposing an exception for *de minimis* compensation, which we expect would apply to some small entities that offer *de minimis* compensation to solicitors.[772] Although, as discussed above, we believe

[772] Specifically, under the proposal the rule would not apply if the solicitor has performed solicitation activities for the investment adviser during the preceding twelve months and the investment adviser's compensation

heightened safeguards would generally be appropriate for an investor solicitation because a solicitor's incentives to defraud an investor likely would be greater than a promoter's, the solicitor's incentives are significantly reduced when receiving *de minimis* compensation. We believe the need for heightened safeguards for *de minimis* compensation is likewise reduced.

As discussed above, we believe that the solicitation rule and the proposed amendments thereto would result in multiple benefits to investors, including: (i) helping to ensure that investors are aware that solicitors have a conflict of interest in referring them to advisers that compensate them for the referral; (ii) extending the rule's investor protection to investors whose advisers compensate their solicitors with non-cash compensation; (iii) extending the rule to private fund investors; and (iv) eliminating duplicative disclosures. We believe that these benefits should apply to clients and investors of smaller firms as well as larger firms. In addition, we believe that the proposed rule's solicitor disqualification provisions would result in transparency and consistency for advisory clients, solicitors and advisers, as the provisions would generally eliminate the need for advisers to seek separate relief from the rule. Establishing different solicitor disqualification provisions for large and small advisers would negate this benefit.

Regarding the second alternative, we believe the current proposal is clear and that further clarification, consolidation, or simplification of the compliance requirements is not necessary. Our proposal would streamline the current rule in several ways, including by eliminating the duplicative requirement that solicitors provide the client with the adviser's Form ADV brochure and the rule's reminders of advisers' other requirements under the Act, and by eliminating the

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payable to the solicitor for those solicitation activities is $100 or less (or the equivalent value in non-cash compensation).

requirement that the adviser obtain client acknowledgments of the solicitor disclosure. It would also make clear that certain types of solicitation relationships (*e.g.*, certain affiliated and in-house solicitors) would be exempt from the rule or from certain of the rule's requirements. In addition, as discussed above, we believe that the proposed rule's solicitor disqualification provisions would result in transparency and consistency for advisory clients, solicitors and advisers, as the provisions would eliminate the need for advisers to seek separate relief from the rule. The corresponding changes to rule 204-2 are also narrowly tailored to address the proposed changes to the solicitation rule.

Regarding the third alternative, we are proposing to use performance rather than design standards for all advisers, regardless of size. For example, our proposal would eliminate the current rule's requirement that an adviser obtain a signed and dated acknowledgment from the client that the client has received the solicitor's disclosure, and replace it with the principles-based requirement that an adviser must have a reasonable basis for believing that the solicitor has complied with the written agreement. We believe that providing advisers with the flexibility to determine how to implement the requirements of the rule allows them the opportunity to tailor these obligations to the facts and circumstances of the particular solicitation arrangements.

### G. Solicitation of Comments

We encourage written comments on the matters discussed in this IRFA. We solicit comment on the number of small entities subject to the proposed amendments to rules 206(4)-1, 206(4)-3, and 204-2, and Form ADV, as well as the potential impacts discussed in this analysis; and whether the proposal could have an effect on small entities that has not been considered. We request that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of such impact. In addition, we are including in this proposal

a "Feedback Flyer" as Appendix C hereto. The "Feedback Flyer" solicits feedback from smaller advisers on the effects on small entities subject to our proposal, and the estimated compliance burdens of our proposal and how they would affect small entities.

## VI. CONSIDERATION OF IMPACT ON THE ECONOMY

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or "SBREFA,"[773] we must advise OMB whether a proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results in or is likely to result in (1) an annual effect on the economy of $100 million or more; (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effects on competition, investment or innovation. We request comment on the potential effect of the proposed amendments on the U.S. economy on an annual basis; any potential increase in costs or prices for consumers or individual industries; and any potential effect on competition, investment or innovation. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

## VII. STATUTORY AUTHORITY

The Commission is proposing amendments to rule 206(4)-1 under the Advisers Act under the authority set forth in sections 203(d), 206(4), 211(a) and 211(h) of the Investment Advisers Act of 1940 [15 U.S.C. 80b-3(d), 10b-6(4) and 80b-11(a) and (h)]. The Commission is proposing amendments to rule 206-4(3) under the Advisers Act under the authority set forth in sections 203(d), 206(4), 211(a) and 211(h) of the Investment Advisers Act of 1940 [15 U.S.C. 80b-2(d), 80b-6(4), and 80b-11(a) and (h)]. The Commission is proposing amendments to rule

[773] Public Law 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C., 15 U.S.C. and as a note to 5 U.S.C. 601).

204-2 under the Advisers Act under the authority set forth in sections 204 and 211 of the Investment Advisers Act of 1940 [15 U.S.C. 80b-4 and 80b-11]. The Commission is proposing amendments to Form ADV under section 19(a) of the Securities Act of 1933 [15 U.S.C. 77s(a)], sections 23(a) and 28(e)(2) of the Securities Exchange Act of 1934 [15 U.S.C. 78w(a) and 78bb(e)(2)], section 319(a) of the Trust Indenture Act of 1939 [15 U.S.C. 7sss(a)], section 38(a) of the Investment Company Act of 1940 [15 U.S.C. 80a-37(a)], and sections 203(c)(1), 204, and 211(a) of the Investment Advisers Act of 1940 [15 U.S.C. 80b-3(c)(1), 80b-4, and 80b-11(a)].

**List of Subjects in 17 CFR Parts 275 and 279**

Reporting and recordkeeping requirements; Securities.

**TEXT OF PROPOSED RULES**

For the reasons set out in the preamble, title 17, chapter II of the Code of Federal Regulations is proposed to be amended as follows:

**PART 275 – RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940**

1. The authority citation for part 275 continues to read in part as follows:

**Authority**: 15 U.S.C. 80b-2(a)(11)(G), 80b-2(a)(11)(H), 80b-2(a)(17), 80b-3, 80b-4, 80b-4a, 80b-6(4), 80b-6a, and 80b-11, unless otherwise noted.

* * * * *

Section 275.204-2 is also issued under 15 U.S.C 80b-6.

* * * * *

2. Section 275.204-2 is amended by revising paragraphs (a)(7)(iv), (a)(11), (a)(15), and (a)(16) to read as follows:

**§ 275.204-2 Books and records to be maintained by investment advisers**

(a) * * *

(7) * * *

(iv) The performance or rate of return of any or all managed accounts, portfolios (as defined in §206(4)-1(e)(10) of this title), or securities recommendations: *Provided, however:*

(A) That the investment adviser shall not be required to keep any unsolicited market letters and other similar communications of general public distribution not prepared by or for the investment adviser; and

(B) That if the investment adviser sends any notice, circular or other advertisement offering any report, analysis, publication or other investment advisory service to more than 10 persons, the investment adviser shall not be required to keep a record of the names and addresses of the persons to whom it was sent; except that if such notice, circular or advertisement is distributed to persons named on any list, the investment adviser shall retain with the copy of such notice, circular or advertisement a memorandum describing the list and the source thereof.

* * * * *

(11)(i) A copy of each advertisement that the investment adviser disseminates, directly or indirectly, to one or more persons (other than persons associated with such investment adviser) and a copy of each notice, circular, newspaper article, investment letter, bulletin or other communication that the investment adviser disseminates, directly or indirectly, to ten or more persons (other than persons associated with such investment adviser); and if such notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication recommends the purchase or sale of a specific security and does not state the reasons for such recommendation, a memorandum of the investment adviser indicating the reasons therefor;

(ii) A copy of any questionnaire or survey used in the preparation of a third-party rating included or appearing in any advertisement; and

(iii) A copy of all written approvals of advertisements as required by §275.206(4)-1(d) of this title.

* * * * *

(15)(i) Copies of the solicitor disclosure delivered to clients and private fund investors pursuant to §275.206(4)-3(a)(1)(iii) of this title, and, if the adviser participates in any nonprofit program pursuant to §275.206(4)-3(b)(4) of this title, copies of all receipts of reimbursements of payments or other compensation the adviser provides relating to its inclusion in the program;

(ii) Any communication or other document related to the investment adviser's determination that it has a reasonable basis for believing that (a) any solicitor it compensates under §275.206(4)-3 has complied with the written agreement required by §275.206(4)-3(a)(1), and that such solicitor is not an ineligible solicitor, and (b) any nonprofit program it participates in pursuant to §275.206(4)-3(b)(4) meets the requirements of §275.206(4)-3(b)(4); and

(iii) A record of the names of all solicitors who are an adviser's partners, officers, directors or employees or other affiliates, pursuant to §275.206(4)-3(b)(2).

(16) All accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts, portfolios (as defined in §206(4)-1(e)(10) of this title), or securities recommendations in any notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser disseminates, directly or indirectly, to any person (other than persons associated with such investment adviser), including copies of all information provided or offered pursuant to §206(4)-1(c)(1)(v) of this title; provided, however, that, with respect to the performance of managed accounts, the retention of all account statements, if they reflect all debits, credits, and other transactions in a client's

account for the period of the statement, and all worksheets necessary to demonstrate the calculation of the performance or rate of return of all managed accounts shall be deemed to satisfy the requirements of this paragraph.

* * * * *

3. Section 275.206(4)-1 is revised to read as follows:

**§ 275.206(4)-1 Advertisements by investment advisers.**

As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts, practices, or courses of business within the meaning of section 206(4) of the Act [15 U.S.C. 80b-6(4)], it is unlawful for any investment adviser registered or required to be registered under section 203 of the Act [15 U.S.C. 80b-3], directly or indirectly, to disseminate any *advertisement* that violates any of paragraphs (a) through (d) of this section.

(a) *General prohibitions*. An *advertisement* may not:

(1) Include any untrue statement of a material fact, or omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading;

(2) Include a material claim or statement that is unsubstantiated;

(3) Include an untrue or misleading implication about, or reasonably be likely to cause an untrue or misleading inference to be drawn concerning, a material fact relating to the investment adviser;

(4) Discuss or imply any potential benefits to clients or investors connected with or resulting from the investment adviser's services or methods of operation without clearly and prominently discussing any associated material risks or other limitations associated with the potential benefits;

(5) Include a reference to specific investment advice provided by the investment adviser where such investment advice is not presented in a manner that is fair and balanced;

(6) Include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced; or

(7) Otherwise be materially misleading.

(b) *Testimonials, endorsements, and third-party ratings.* An *advertisement* may not include any *testimonial*, *endorsement*, or *third-party rating,* unless:

(1) For a *testimonial* or *endorsement*, the investment adviser clearly and prominently discloses, or the investment adviser reasonably believes that the *testimonial* or *endorsement* clearly and prominently discloses, that:

(i) The *testimonial* was given by a client or investor, and the *endorsement* was given by a non-client or non-investor, as applicable; and

(ii) If applicable, cash or non-cash compensation has been provided by or on behalf of the adviser in connection with obtaining or using the *testimonial* or *endorsement;*

(2) For a *third-party rating*, the investment adviser reasonably believes that any questionnaire or survey used in the preparation of the *third-party 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; and the investment adviser clearly and prominently discloses, or the investment adviser reasonably believes that the *third-party rating* clearly and prominently discloses:

(i) The date on which the rating was given and the period of time upon which the rating was based;

(ii) The identity of the third party that created and tabulated the rating; and

(iii) If applicable, that cash or non-cash compensation has been provided by or on behalf of the adviser in connection with obtaining or using the *third-party rating.*

(c) *Performance.* An investment adviser may not include:

(1) In any *advertisement:*

(i) Any presentation of *gross performance,* unless the *advertisement* provides or offers to provide promptly a schedule of the specific fees and expenses (presented in percentage terms) deducted to calculate *net performance;*

(ii) Any statement, express or implied, that the calculation or presentation of performance results in the *advertisement* has been approved or reviewed by the Commission;

(iii) Any *related performance*, unless it includes all *related portfolios;* provided that *related performance* may exclude any *related portfolios* if:

(A) The advertised performance results are no higher than if all *related portfolios* had been included; and

(B) The exclusion of any *related portfolio* does not alter the presentation of the time periods prescribed by section (c)(2)(ii);

(iv) Any *extracted performance*, unless the *advertisement* provides or offers to provide promptly the performance results of all investments in the *portfolio* from which the performance was extracted; or

(v) Any *hypothetical performance* unless the investment adviser:

(A) Adopts and implements policies and procedures reasonably designed to ensure that the *hypothetical performance* is relevant to the financial situation and investment objectives of the person to whom the *advertisement* is disseminated;

(B) Provides sufficient information to enable such person to understand the criteria used and assumptions made in calculating such *hypothetical performance;* and

(C) Provides (or, if such person is a *non-retail person,* provides or offers to provide promptly) sufficient information to enable such person to understand the risks and limitations of using such *hypothetical performance* in making investment decisions.

(2) In any *retail advertisement*:

(i) Any presentation of *gross performance,* unless the *advertisement* also presents *net performance*:

(A) With at least equal prominence to, and in a format designed to facilitate comparison with, the *gross performance;* and

(B) Calculated over the same time period, and using the same type of return and methodology as, the *gross performance*; and

(ii) Any performance results of any *portfolio* or any composite aggregation of *related portfolios*, unless the *advertisement* includes performance results of the same *portfolio* or composite aggregation for one-, five-, and ten-year periods, each presented with equal prominence and ending on the most recent practicable date; except that if the relevant *portfolio* did not exist for a particular prescribed period, then the life of the *portfolio* must be substituted for that period.

(d) *Review and approval.* An investment adviser may not, directly or indirectly, disseminate an *advertisement* unless the *advertisement* has been previously reviewed and approved as being consistent with the requirements of this section by a designated employee, except for *advertisements* that are:

(1) Communications that are disseminated only to a single person or household or to a single investor in a *pooled investment vehicle;* and

(2) Live oral communications that are broadcast on radio, television, the internet, or any other similar medium.

(e) *Definitions.* For purposes of this section:

(1) *Advertisement* means 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. *Advertisement* does not include:

(i) Live oral communications that are not broadcast on radio, television, the internet, or any other similar medium;

(ii) A communication by an investment adviser that does no more than respond to an unsolicited request for information specified in such request about the investment adviser or its services, other than:

(A) Any communication to a *retail person* that includes performance results; or

(B) Any communication that includes *hypothetical performance*;

(iii) An advertisement, other sales material, or sales literature that is about an investment company registered under the Investment Company Act of 1940 or about a business development company and that is within the scope of rule 482 or rule 156 under the Securities Act; or

(iv) Any information required to be contained in a statutory or regulatory notice, filing, or other communication.

(2) *Endorsement* means any statement by a person other than a client or investor indicating approval, support, or recommendation of the investment adviser or its *advisory affiliates,* as defined in the Form ADV Glossary of Terms.

(3) *Extracted performance* means the performance results of a subset of investments extracted from a *portfolio.*

(4) *Gross performance* means the performance results of a *portfolio* before the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the investment adviser's investment advisory services to the relevant *portfolio.*

(5) *Hypothetical performance* means performance results that were not actually achieved by any *portfolio* of any client of the investment adviser. *Hypothetical performance* includes, but is not limited to:

(i) Performance derived from representative model *portfolios* that are managed contemporaneously alongside *portfolios* managed for actual clients;

(ii) Performance that is backtested by the application of a strategy to market data from prior periods when the strategy was not actually used during those periods; and

(iii) Targeted or projected performance returns with respect to any *portfolio* or to the investment services offered or promoted in the *advertisement.*

(6) *Net performance* means 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 the investment adviser's investment advisory services to the relevant *portfolio*, including, if applicable, advisory fees, advisory fees paid to underlying investment vehicles, and payments by the investment adviser for which the client or investor reimburses the investment adviser. For purposes of this rule, *net performance* may reflect one or more of the following:

(i) The deduction of a model fee when doing so would result in performance figures that are no higher than if the actual fee had been deducted;

(ii) The deduction of a model fee that is equal to the highest fee charged to the relevant audience of the *advertisement;* and

(iii) The exclusion of custodian fees paid to a bank or other third-party organization for safekeeping funds and securities.

(7) *Non-retail advertisement* means any *advertisement* for which an investment adviser has adopted and implemented policies and procedures reasonably designed to ensure that the *advertisement* is disseminated solely to *non-retail persons.*

(8) *Non-retail person* means one or more of the following:

(i) A "qualified purchaser," as defined in section 2(a)(51) of the Investment Company Act of 1940 and taking into account rule 2a51-1 under the Investment Company Act; and

(ii) A "knowledgeable employee," as defined in rule 3c-5 under the Investment Company Act of 1940, with respect to a company that would be an investment company but for the exclusion provided by section 3(c)(7) of the Investment Company Act and that is advised by the investment adviser.

(9) *Pooled investment vehicle* means any pooled investment vehicle as defined in Rule 206(4)-8(b).

(10) *Portfolio* means a group of investments managed by the investment adviser. A *portfolio* may be an account or a *pooled investment vehicle*.

(11) *Related performance* means the performance results of one or more *related portfolios*, either on a *portfolio*-by-*portfolio* basis or as one or more composite aggregations of all *portfolios* falling within stated criteria.

(12) *Related portfolio* means a *portfolio* with substantially similar investment policies, objectives, and strategies as those of the services being offered or promoted in the *advertisement*. *Related portfolio* includes, but is not limited to, a *portfolio* for the account of the investment adviser or its *advisory affiliate,* as defined in the Form ADV Glossary of Terms.

(13) *Retail advertisement* means any *advertisement* other than a *non-retail advertisement*.

(14) *Retail person* means any person other than a *non-retail person*.

(15) *Testimonial* means any statement of a client's or investor's experience with the investment adviser or its *advisory affiliates*, as defined in the Form ADV Glossary of Terms.

(16) *Third-party rating* means a rating or ranking of an investment adviser provided by a person who is not a *related person*, as defined in the Form ADV Glossary of Terms, and such person provides such ratings or rankings in the ordinary course of its business.

4. Section 275.206(4)-3 is revised to read as follows:

**§ 275.206(4)-3 Compensation for solicitations.**

(a) As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts, practices, or courses of business within the meaning of section 206(4), it is unlawful for an investment adviser that is registered or required to be registered under section 203 of the Act to compensate a solicitor, directly or indirectly, for any solicitation activities, unless the investment adviser complies with paragraphs (1) through (3) of this section.

(1) *Written agreement*. The investment adviser's compensation to the solicitor is pursuant to a written agreement with the solicitor that:

(i) Describes with specificity the solicitation activities of the solicitor and the terms of the compensation for the solicitation activities;

(ii) Requires the solicitor to perform its solicitation activities in accordance with Sections 206(1), (2), and (4) of the Act; and

(iii) Requires and designates the solicitor or the adviser to provide the client or private fund investor, at the time of any solicitation activities (or in the case of a mass communication, as soon as reasonably practicable thereafter) with a separate disclosure that states the following:

(A) The investment adviser's name;

(B) The solicitor's name;

(C) A description of the investment adviser's relationship with the solicitor;

(D) The terms of any compensation arrangement, including a description of the compensation provided or to be provided to the solicitor;

(E) A description of any potential material conflicts of interest on the part of the solicitor resulting from the investment adviser's relationship with the solicitor and/or the compensation arrangement; and

(F) The amount of any additional cost to the client or private fund investor as a result of solicitation.

(2) *Adviser oversight and compliance*. The investment adviser must have a reasonable basis for believing that the solicitor has complied with the written agreement required by paragraph (a)(1) of this section.

(3) *Disqualification*. (i) An investment adviser cannot compensate a solicitor, directly or indirectly, for any solicitation activity if the adviser knows, or, in the exercise of reasonable care, should have known, that the solicitor is an *ineligible solicitor*.

(ii) For purposes of paragraph (a)(3)(i) of this section, *ineligible solicitor* means:

(A) A person who at the time of the solicitation is subject to a *disqualifying Commission action* or is subject to any *disqualifying event*;

(B) Any employee, officer or director of an *ineligible solicitor* and any other individuals with similar status or functions;

(C) If the *ineligible solicitor* is a partnership, all general partners;

(D) If the *ineligible solicitor* is a limited liability company managed by elected managers, all elected managers; and

(E) Any person directly or indirectly controlling or controlled by the *ineligible solicitor* as well as any person listed in clauses (a)(3)(ii)(B) through (D) with respect to such person;

(iii) For purposes of paragraph (a)(3)(ii) of this section:

(A) A *disqualifying Commission action* means a Commission opinion or order barring, suspending, or prohibiting the person from acting in any capacity under the Federal securities laws, or ordering the person to cease and desist from committing or causing a violation or future violation of:

(*1*) any scienter-based antifraud provision of the Federal securities laws, including without limitation section 17(a)(1) of the Securities Act of 1933 (15 U.S.C. 77q(a)(1)), section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b)) and 17 CFR 240.10b-5, section 15(c)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(c)(1)), and section 206(1) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-6(1)), or any other rule or regulation thereunder; or

(*2*) Section 5 of the Securities Act of 1933.

(B) A *disqualifying event* is any of the following events:

(*1*) A conviction by court of competent jurisdiction within the United States, within the previous ten years, of any felony or misdemeanor involving conduct described in paragraph (2)(A) through (D) of section 203(e) of the Act;

(*2*) A conviction by a court of competent jurisdiction within the United States, within the previous ten years, of engaging in, any of the conduct specified in paragraphs (1), (5), or (6) of section 203(e) of the Act;

(*3*) The entry of any final order of the U.S. Commodity Futures Trading Commission, a self-regulatory organization (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(26))), a State securities commission (or any agency or officer performing like functions), a State authority that supervises or examines banks, savings associations, or credit unions, a State insurance commission (or any agency or office performing like functions), an appropriate Federal banking agency (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813(q))), or the National Credit Union Administration, that:

(*i*) Bars such person from association with an entity regulated by such commission, authority, agency, organization, or officer, or from engaging in the business of securities, insurance, banking, savings association activities, or credit union activities; or

(*ii*) Constitutes a final order, entered within the previous ten years, based on violations of any laws, regulations, or rules that prohibit fraudulent, manipulative, or deceptive conduct.

(*4*) The entry of an order, judgment or decree described in paragraph (4) of section 203(e) of the Act, by any court of competent jurisdiction within the United States.

(C) If the same act(s) or omission(s) that are the subject of a *disqualifying event* for a person are also the subject of a *non-disqualifying Commission action* with respect to that person, such *disqualifying event* will be disregarded in determining whether the person is an *ineligible solicitor*. For purposes of paragraph (a)(3)(iii), *non-disqualifying Commission action* means:

(*1*) An order pursuant to section 9(c) of the Investment Company Act of 1940; or

(*2*) A Commission opinion or order that is not a *disqualifying Commission action*, provided:

(*i*) The person has complied with the terms of the opinion or order, including, but not limited to, the payment of disgorgement, prejudgment interest, civil or administrative penalties and fines;

(*ii*) For a period of 10 years following the date of each opinion or order, the solicitor disclosure required under paragraph (a)(1)(iii) includes a description of the acts or omissions that are the subject of, and the terms of, the opinion or order.

(b) *Exemptions.*

(1) *Impersonal investment advice.* Paragraphs (a)(1) and (a)(2) of this section do not apply to solicitation that is solely for impersonal investment advice, as defined in the Form ADV Glossary of Terms.

(2) *Partners, officers, directors or employees and certain other affiliates.*

Paragraphs (a)(1) and (a)(2) of this section do not apply if the solicitor is one of the investment adviser's partners, officers, directors, or employees, or is a person that controls, is controlled by, or is under common control with the investment adviser, or is a partner, officer, director or employee of such a person; provided that:

(i) The affiliation between the investment adviser and such person is readily apparent to or is disclosed to the client or private fund investor at the time of the solicitation; and

(ii) The adviser documents such solicitor's status at the time the adviser enters into the solicitation arrangement.

(3) De minimis *compensation.* Paragraph (a) of this section does not apply if the solicitor has performed solicitation activities for the investment adviser during the preceding 12 months

and the investment adviser's compensation payable to the solicitor for those solicitation activities is $100 or less (or the equivalent value in non-cash compensation).

(4) *Nonprofit programs.* Paragraph (a) of this section does not apply to an adviser's participation in a program:

(i) When the adviser has a reasonable basis for believing that:

(A) The solicitor is a nonprofit program;

(B) Participating investment advisers compensate the solicitor only for the costs reasonably incurred in operating the program; and

(C) The solicitor provides clients a list of at least two investment advisers the inclusion of which is based on non-qualitative criteria such as, but not limited to, type of advisory services provided, geographic proximity, and lack of disciplinary history; and

(ii) The solicitor or the investment adviser prominently discloses to the client, at the time of any solicitation activities:

(A) The criteria for inclusion on the list of investment advisers; and

(B) That investment advisers reimburse the solicitor for the costs reasonably incurred in operating the program.

(c) Definitions. For purposes of this section,

(1) *Client* includes a prospective client.

(2) *Private fund* has the same meaning as in Section 2(a)(29) of the Act.

(3) *Private fund investor* includes a prospective private fund investor.

(4) *Solicitor* means any person who, directly or indirectly, solicits any client or private fund investor for, or refers any client or private fund investor to, an investment adviser.

**PART 279 – FORMS PRESCRIBED UNDER THE INVESTMENT ADVISERS ACT OF 1940**

5. The authority citation for part 279 continues to read as follows:

**Authority:** The Investment Advisers Act of 1940, 15 U.S.C. 80b-1, *et seq.*, Pub. L.111-203, 124 Stat. 1376.

6. Form ADV [referenced in §279.1] is amended by:

a. In the form, revising Part 1A. The revised section of Form ADV, Part 1A – the addition of Item 5.L – is attached as Appendix A.

**Note: The text of Form ADV does not and the amendments will not appear in the Code of Federal Regulations.**

By the Commission.

Dated: November 4, 2019

Vanessa A. Countryman,
Secretary.

## IV. APPENDIX A: CHANGES TO FORM ADV

**Note: This Appendix will not appear in the Code of Federal Regulations.**

Item 5: Information About Your Advisory Business
ADVISORY ACTIVITIES

L. Advertising Activities

For Items 5.L.(1)-(5), the terms *advertisement*, *testimonial*, *endorsement* and *third-party rating* have the meanings ascribed to them in rule 206(4)-1.

(1) Do any of your *advertisements* contain performance results?

Y N

(2) If you answer "yes" to L.(1) above, are all of the performance results verified or reviewed by a person who is not a *related person*?

Y N

(3) Do any of your *advertisements* include testimonials, endorsements, or third-party ratings?

Y N

(4) If you answer "yes" to L.(3) above, do you pay or otherwise provide cash or non-cash compensation, directly or indirectly, in connection with the use of *testimonials*, *endorsements*, or *third-party ratings*?

Y N

(5) Do any of your *advertisements* include a reference to specific investment advice provided by you?

Y N

## V. APPENDIX B: INVESTOR FEEDBACK FLYER

**Note: This Appendix will not appear in the Code of Federal Regulations.**

**Tell Us About Your Experiences With Investment Adviser Marketing**

We're asking everyday investors like you what you think about how investment advisers market their services. Your responses will help us update the marketing rules for investment advisers.

It's important to us at the SEC to hear from individual investors so we can make it easier for you to choose an investment adviser that is right for you. Please take a few minutes to answer any or all of these questions. Please provide your comments by [INSERT DATE 60 DAYS AFTER PUBLICATION OF THE PROPOSAL IN THE FEDERAL REGISTER] - and thank you for your feedback!

If you are interested in background information on the proposed rule, click here ([link to the proposed rule]).

All required fields are marked with an asterisk *

Contact Info

* First Name:

* Last Name:

* Email: (Your email address will not be published on the website)

1. Have you ever hired, or considered hiring, an investment adviser? Because investment advisers are the subject of this proposed rulemaking, please focus your responses in this questionnaire on investment advisers rather than brokers. Yes/no/don't know

2. Have you viewed any investment adviser advertisements? For example, have you looked at an adviser's website or a presentation? Yes/no/don't know

3. Have you looked at an adviser's past performance results when considering hiring an investment adviser? Yes/no/don't know

    a. If yes, did the performance results affect your decision to hire an investment adviser? Yes/no/don't know

4. Have you ever specifically requested past performance results from the investment adviser? Yes/no/don't know

5. If you have viewed an adviser's past performance results, have you discussed them with the adviser? Yes/no/don't know

6. If you have viewed an adviser's past performance results, did you believe that those past performance results would predict the future performance that the adviser could achieve for you? Yes/no/don't know

7. How important is it to know the following information when reviewing the past performance results of an adviser?

| Information | 1 (very important) | 2 | 3 | 4 | 5 (not important) | Don't know |
|---|---|---|---|---|---|---|
| Performance results *minus* fees and expenses (*i.e.*, ***net performance***) | | | | | | |
| A schedule of the specific fees and expenses deducted to calculate ***net performance*** | | | | | | |
| Performance results for one-, five-, and ten-year periods | | | | | | |
| Other information (if any, please describe) | [free text] | | | | | |

8. Have you reviewed hypothetical performance results that demonstrated how an investment strategy "could have" or "would have" worked? Yes/no/don't know

    a. If yes, did you discuss with the adviser how the adviser calculated those hypothetical performance results? Yes/no/don't know

    b. If yes, did you discuss with the adviser that those performance results were not actual results? Yes/no/don't know

    c. If yes, how confident are you that you could tell whether the hypothetical performance results were misleading or not? Very confident/somewhat confident/not at all confident/don't know

9. Have you reviewed targeted performance returns or projected performance returns? Yes/no/don't know

    a. If yes, did you discuss with the adviser the underlying assumptions on which those targets or projections were based? Yes/no/don't know

10. Would other people's opinions of the adviser (*e.g.*, testimonials by advisory clients, and endorsements by non-clients), or an adviser's rating by a third-party (*e.g.*, "Rated B+ by Adviser Reports") help you choose an investment adviser? Yes/no/don't know

11. How important is it to know the following information when considering a testimonial, endorsement, or rating of an adviser?

| Information | 1 (very important) | 2 | 3 | 4 | 5 (not important) | Don't know |
|---|---|---|---|---|---|---|
| Whether the person giving the testimonial or endorsement is a current client | | | | | | |
| Whether the adviser pays the person giving the testimonial, endorsement, or the rating | | | | | | |
| How recent the rating is, and the period of time it covers | | | | | | |
| Other information (if any, please describe) | [free text] | | | | | |

12. What other information do you think would make the advertisements not misleading? [free text]

13. Has a paid salesperson (a solicitor) ever referred you to an investment adviser? Yes/no/don't know

14. Would it affect your decision to hire an investment adviser if you knew that the adviser paid a salesperson to refer you to the adviser? Yes/no/don't know

15. How important is it to know the following information about a paid salesperson's referral?

| Information | 1 (very important) | 2 | 3 | 4 | 5 (not important) | Don't know |
|---|---|---|---|---|---|---|
| Amount paid to the solicitor for referring you to the adviser | | | | | | |
| Whether there will be any additional cost to you | | | | | | |
| The solicitor's relationship to the adviser | | | | | | |
| Whether the solicitor has been disciplined for financial-related misconduct | | | | | | |

| | |
|---|---|
| Other information (if any, please describe) | [free text] |

Other Ways to Submit Your Feedback

You can also send us feedback in the following ways (include the file number S7-21-19 in your response):

| | |
|---|---|
| Print your responses and Mail | Secretary,<br>Securities and Exchange Commission<br>100 F Street, NE<br>Washington, DC, 20549-1090 |
| Print a PDF of Your Responses and Email | Use the printer friendly page and select a PDF printer to create a file you can email to: rule-comments@sec.gov |
| Print a Blank Copy of this Flier, Fill it Out, and Mail | Secretary,<br>Securities and Exchange Commission<br>100 F Street, NE<br>Washington, DC, 20549-1090 |

We will post your feedback on our website. Your submission will be posted without change; we do not redact or edit personal identifying information from submissions. You should only make submissions that you wish to make available publicly.

**Thank you!**

## VI. APPENDIX C: SMALLER ADVISER FEEDBACK FLYER

**Note: This Appendix will not appear in the Code of Federal Regulations.**

**Feedback Flier: Proposed Amended Adviser Advertising and Solicitation Rules**

We are proposing reforms of rules under the Advisers Act relating to how advisers advertise to and solicit clients and investors. First, we are proposing a rule addressing advertisements by investment advisers that would replace the rule that we adopted in 1961, rule 206(4)-1. We are also proposing to amend the Advisers Act cash solicitation rule, rule 206(4)-3, to update its coverage to reflect regulatory changes and the evolution of industry practices since we adopted the rule in 1979. We are also proposing related amendments to Form ADV that are designed to provide additional information regarding advisers' advertising practices, and amendments to the Advisers Act books and records rule, rule 204-2, related to the proposed changes to the advertising and solicitation rules. More information about our proposal is available at [URL].

We are interested in learning what smaller investment advisers think about the requirements of proposed new and amended advertising and solicitation rules for investment advisers. Hearing from smaller investment advisers could help us learn how our proposal would affect these entities, and evaluate how we could address any unintended consequences resulting from the cost and effort of regulatory compliance while still promoting investor protection. Please also note the following:

- While some smaller investment advisers may offer both advisory and brokerage services, please focus your responses on investment advisory advertising and referral activities.

- Because the advertising rules for registered investment companies (RICs) and business development companies (BDCs) are not the subject of this proposal, please focus your responses on advertising to non-RIC and non-BDC investors.

We would appreciate your feedback on any or all of the following questions. At your option, you may include general identifying information that would help us contextualize your other feedback on the proposal. This information could include responses to the following questions, as well as any other general identifying information you would like to provide. **All of the following questions are optional, including any questions that ask about identifying information.** ***Please note that responses to these questions – as well as any other general identifying information you provide – will be made public.***

1) General Information about the adviser

   a. How big is the adviser in terms of assets under management?

   b. Approximately how many employees work for the adviser (include independent contractors in your answer)? _____

   c. Does the adviser advise a registered investment company (RIC) or a business development company (BDC)? [Y/N]

   d. Does the adviser advise a private fund or a pooled investment vehicle other than a RIC or BDC? [Y/N]

   e. Does the adviser advise non-retail investors (qualified purchasers – *e.g.*, entities with $25 million in investments; natural persons with $5 million in investments; the adviser's knowledgeable employees)? [Y/N] Please exclude from your answer investors in any RIC, BDC, private fund or other pooled investment vehicle.

f. Does the adviser advise retail investors (all investors other than investors listed in c-e)? [Y/N] Please exclude from your answer investors in any RIC, BDC, private fund or other pooled investment vehicle.

g. Does the adviser advertise its advisory business? [Y/N]

2) Questions about presentation of performance results in advertisements

Our proposed advertising rule would generally treat performance advertising as follows:

| **Performance results in Retail Advertisements** | **Performance results in both Retail and Non-Retail Advertisements** |
|---|---|
| • *Performance results generally*. If presenting performance results, the advertisement must include results of the same portfolio for one-, five-, and ten-year periods, each presented with equal prominence and ending on the most recent practicable date (except for portfolios not in existence during a particular prescribed period in which case the life of the *portfolio* must be substituted for that period).<br>• *Gross performance*. Can present it only if the advertisement also presents net performance with at least equal prominence and in a format designed to facilitate comparison with gross performance. <u>*See also*</u> *schedule of fees*. | • *Schedule of fees*. If *any* advertisement presents gross performance, it must also provide or include an offer to provide, a schedule of the specific fees and expenses deducted to calculate net performance.<br>In addition:<br>• Any such schedule of fees must itemize the specific fees and expenses that were incurred in generating the performance of the specific portfolio being advertised.<br>• Where an adviser does not otherwise present or calculate net performance, such schedule should show the fees and expenses that the adviser would apply in calculating net performance as though such adviser were presenting net performance. |

a. As noted above, the proposed advertising rule would distinguish between advertisements to qualified purchasers and certain knowledgeable employees (defined as "Non-Retail Advertisements" in the proposed rule) and all other advertisements (defined as "Retail Advertisements" in the proposed rule).

1. Does the adviser currently have policies and procedures that help track which communications are given to qualified purchasers and knowledgeable employees, and which are given to retail investors? [Y/N]

2. If the adviser answered "yes" to question 1, do its policies and procedures help track the distribution of advertisements by third parties such as fund placement agents, capital introduction programs and third-party broker-dealers? [Y/N]

b. Presentation of gross and net performance, time period requirement, and schedule of fees

1. In the past, has the adviser provided investors with information about fees and expenses that were deducted to calculate net performance? Check all that apply.

| Provided fee schedule within advertisements | Offered to provide separate fee schedule | Did not advertise performance results | Don't know |
|---|---|---|---|
| [ ] | [ ] | [ ] | [ ] |

2. Has the adviser calculated net performance by deducting "model" fees or expenses (instead of fees and expenses actually incurred)? [Y/N/Don't know]

3. If the adviser answered "yes" to questions 1 or 2, please provide any details you believe could provide helpful context for our rulemaking (*e.g.*, what categories of fees has the adviser typically deducted, or under what circumstances has the adviser deducted "model" fees?). [free text]

4. Are there types of fees and expenses for which providing a schedule would be particularly difficult and/or present compliance challenges? If so, what are they?

5. Approximately how much do you think it would cost the adviser, on an initial and ongoing basis, to comply with the proposed requirements for the presentation of certain time periods (one-, five-, and ten-year periods), the presentation of gross and net performance and the presentation or offer of schedule of fees, as applicable?

| Estimated **initial** cost ($) | | | | | | |
|---|---|---|---|---|---|---|
| $0 - $5,000 | $5,001 - $10,000 | $10,001 - $50,000 | $50,001 - $100,000 | >$100,001 | Does not expect to advertise performance results | Does not know |
| [ ] | [ ] | [ ] | [ ] | [ ] | [ ] | [ ] |

| Estimated **ongoing** cost per year ($) | | | | | | |
|---|---|---|---|---|---|---|
| $0 - $5,000 | $5,001 - $10,000 | $10,001 - $50,000 | $50,001 - $100,000 | >$100,001 | Does not expect to advertise performance results | Does not know |
| [ ] | [ ] | [ ] | [ ] | [ ] | [ ] | [ ] |

6. Would there be circumstances in which the adviser might have to provide proprietary or sensitive information to comply with these proposed requirements? Should we take those circumstances into account? If so, how? [free text]

c. Presentation of hypothetical performance

| Under our proposal, hypothetical performance generally is performance results that were not actually achieved by any portfolio of any client of the investment adviser. |
|---|
| The proposed advertising rule would allow an adviser to provide hypothetical performance in an advertisement only if:<br>• the adviser adopts and implements policies and procedures reasonably designed to ensure that hypothetical performance is given only to persons for which it is relevant to their financial situation and investment objectives;<br>• the adviser provides in the advertisement additional information that is tailored to the audience receiving it, that provides sufficient information to understand the criteria used and assumptions made in calculating the hypothetical performance; and<br>• the adviser provides in the advertisement additional information tailored to the audience receiving it that provides sufficient information to understand the risks and limitations of using hypothetical performance. For "qualified purchasers" and "knowledgeable employees," an adviser could provide this information promptly upon request rather than providing it in the advertisement. |

1. In the past, has the investment adviser presented in an advertisement any of the following types of hypothetical performance? Check all that apply.

| Performance derived from representative model portfolios that are managed contemporaneously alongside portfolios managed for actual clients | Performance that is backtested by the application of a strategy to market data from prior periods when the strategy was not actually used during those periods | Targeted or projected performance returns with respect to any portfolio or to the investment services offered or promoted in the advertisement | Did not advertise hypothetical performance | Other (please explain) |
|---|---|---|---|---|
| [ ] | [ ] | [ ] | [ ] | [free text ] |

2. Does the adviser believe that, if the proposed advertising rule is adopted, the adviser would present hypothetical performance results in advertisements? [Y/N]

3. If the adviser answered "yes" to question 2, how much do you think it would cost the adviser, on an initial and ongoing basis, to comply with the

proposed requirements for advertisements presenting hypothetical performance (*e.g.*, preparing and adopting policies and procedures that address the distribution of advertisements containing hypothetical performance)?

| Estimated **initial** cost ($) | | | | | | |
|---|---|---|---|---|---|---|
| $0 - $5,000 | $5,001 - $10,000 | $10,001 - $50,000 | $50,001 - $100,000 | >$100,001 | Does not expect to advertise hypothetical performance results | Does not know |
| [ ] | [ ] | [ ] | [ ] | [ ] | [ ] | [ ] |

| Estimated **ongoing** cost per year ($) | | | | | | |
|---|---|---|---|---|---|---|
| $0 - $5,000 | $5,001 - $10,000 | $10,001 - $50,000 | $50,001 - $100,000 | >$100,001 | Does not expect to advertise hypothetical performance results | Does not know |
| [ ] | [ ] | [ ] | [ ] | [ ] | [ ] | [ ] |

d. Presentation of related and extracted performance

| Presentation of Related Performance | Presentation of Extracted Performance |
|---|---|
| • Under the proposed rule, related performance is generally performance results of one or more related portfolios, either on a portfolio-by-portfolio basis or as one or more composite aggregations of all portfolios falling within stated criteria. | • Under the proposed rule, "extracted performance" is generally the performance results of a subset of investments extracted from a portfolio.<br><br>• The proposed rule would allow the |

| | |
|---|---|
| • The proposed rule would allow the presentation in any advertisement of related performance, if the performance generally includes all related portfolios, which would generally be portfolios managed by the investment adviser, with substantially similar investment policies, objectives, and strategies as those of the services being offered or promoted in the advertisement. | presentation in any advertisement of extracted performance if the advertisement provides or offers to provide promptly the performance results of all investments in the portfolio from which the performance was extracted. |

1. In the past, has the investment adviser presented in an advertisement any related or extracted performance? Check all that apply.

| Related performance | Extracted performance | Did not advertise performance | Don't know |
|---|---|---|---|
| [ ] | [ ] | [ ] | [ ] |

2. Does the adviser believe that, if the proposed advertising rule is adopted, the adviser would present related or extracted performance in advertisements? [Y/N]

3. If the adviser answered "yes" to question 2, how much do you think it would cost the adviser, on an initial and ongoing basis, to comply with the proposed requirements for advertisements presenting related or extracted performance?

| Estimated **initial** cost ($) | | | | | | |
|---|---|---|---|---|---|---|
| $0 - $5,000 | $5,001 - $10,000 | $10,001 - $50,000 | $50,001 - $100,000 | >$100,001 | Does not expect to advertise performance results | Does not know |
| [ ] | [ ] | [ ] | [ ] | [ ] | [ ] | [ ] |

| Estimated **ongoing** cost per year ($) | | | | | | |
|---|---|---|---|---|---|---|
| $0 - $5,000 | $5,001 - $10,000 | $10,001 - $50,000 | $50,001 - $100,000 | >$100,001 | Does not expect to advertise performance results | Does not know |
| [ ] | [ ] | [ ] | [ ] | [ ] | [ ] | [ ] |

e. Additional performance advertising question

1. If the adviser disseminates advertisements by or through third parties, what steps would the adviser expect to take in order to comply with the proposed requirements for performance advertising? [free text]

3) Use of testimonials, endorsements, and third-party ratings in adviser advertisements.

Under our proposal:

- A testimonial generally means a statement of a client or investor's experience with the adviser.
- An endorsement generally means a statement by a person other than a client or investor indicating approval, support, or recommendation of the investment adviser.
- A third-party rating generally means a rating of an investment adviser provided by a third-party that provides such ratings in the ordinary course of its business.

In addition to the conditions described below, under our proposal an adviser could not use a testimonial, endorsement, or third-party rating in an advertisement if it violates the proposed advertising rule's general prohibitions of certain advertising practices (*e.g.*, it could not include an untrue or misleading implication about a material fact relating to the investment adviser).

| Testimonials and Endorsements in Advertisements | Third-Party Ratings in Advertisements |
|---|---|
| Our proposed advertising rule would permit investment advisers to use testimonials and endorsements only if:<br>• They clearly and prominently disclose:<br>▪ that the statement was given by an investor (if a testimonial) or a non-investor (if an endorsement); and | Our proposed advertising rule would permit investment advisers to use third-party ratings in adviser advertisements, only if:<br>• They contains disclosures similar to, and in addition to, those required for testimonials and endorsements; and |

| | |
|---|---|
| ▪ that cash or non-cash compensation has been provided by or on behalf of the adviser in connection with the testimonial or endorsement, if applicable | • the adviser reasonably believes that any questionnaire or survey used in the preparation of the third-party 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 pre-determined results |

1. Does the adviser currently use endorsements and/or third-party ratings in adviser advertisements? [Y/N]
2. Do you anticipate that, if the proposed advertising rule is adopted, the adviser would use testimonials, endorsements, or third-party ratings in adviser advertisements? [Y/N]
3. If an adviser advertises a testimonial, endorsement, or third-party rating that is made available by a third-party (such as on a third-party hosted website), what procedures would the adviser implement to form a reasonable belief that the third-party includes the required disclosures in the testimonials, endorsements, or third-party ratings?
4. If the adviser answered "yes" to either question 1 or 2, approximately how much do you think it would cost the adviser, per year on an initial and ongoing basis, to implement the proposed requirements for testimonials, endorsements, and third-party ratings (*e.g.*, the required disclosures and the additional conditions for using third-party ratings)? If applicable, include in your answer the costs of forming a reasonable belief that any testimonial, endorsement, or third-party rating in an adviser advertisement that is made available by a third-party contains the required disclosures.

| Estimated **initial** cost ($) | | | | | | |
|---|---|---|---|---|---|---|
| $0 - $5,000 | $5,001 - $10,000 | $10,001 - $50,000 | $50,001 - $100,000 | >$100,001 | Does not expect to use testimonials or third party ratings | Does not know |
| [ ] | [ ] | [ ] | [ ] | [ ] | [ ] | [ ] |

| Estimated **ongoing** cost per year ($) | | | | | | |
|---|---|---|---|---|---|---|
| $0 - $5,000 | $5,001 - $10,000 | $10,001 - $50,000 | $50,001 - $100,000 | >$100,001 | Does not expect to use testimonials or third party ratings | Does not know |
| [ ] | [ ] | [ ] | [ ] | [ ] | [ ] | [ ] |

4) Review and approval of advertisements

The proposed advertising rule would generally require an adviser to designate an employee that would be required to review the adviser's advertisements before each advertisement is given to any client or investor. The following are exceptions to this requirement:

- communications that are disseminated only to a single person or household or to a single investor in a pooled investment vehicle; or
- live oral communications that are broadcast on radio, television, the internet, or any other similar medium.

1. Does the adviser already have internal policies and procedures that require reviews of adviser advertisements? [Y/N]

2. If so, who reviews the adviser's advertisements? (check all that apply)

| Personnel who have reviewed adviser advertisements |
|---|

| In-house compliance employee(s) | Chief Compliance Officer | In-house attorney(s) | In-house paralegal | In-house business analyst and/or portfolio manager | In-house marketing personnel | Outside consultant or outside attorney | Other (please describe) |
|---|---|---|---|---|---|---|---|
| [ ] | [ ] | [ ] | [ ] | [ ] | [ ] | [ ] | [ free text ] |

3. If the adviser answered "yes" to question 1, would the adviser need to expand the scope of existing reviews as a result of the proposed rule (*e.g.*, so that the employee review process would apply to advertisements emailed to more than 1 person)? [Y/N]

4. Approximately how much do you think it would cost the adviser, per year on an initial and ongoing basis, to comply with the proposed employee review requirements (*e.g.*, preparing, adopting, implementing and overseeing any new or revised policies and procedures for review of advertisements)?

| Estimated **Initial** cost ($) | | | | | |
|---|---|---|---|---|---|
| $0 - $25,000 | $25,000 - $50,000 | $50,000 - $100,000 | $100,000 - $500,000 | > $500,000 | Does not know |
| [ ] | [ ] | [ ] | [ ] | [ ] | [ ] |

| Estimated **ongoing** cost, per year ($) | | | | | |
|---|---|---|---|---|---|
| $0 - $25,000 | $25,000 - $50,000 | $50,000 - $100,000 | $100,000 - $500,000 | > $500,000 | Does not know |
| [ ] | [ ] | [ ] | [ ] | [ ] | [ ] |

5. If the adviser already has policies and procedures that require reviews of adviser advertisements, would the adviser designate a different employee or employees to review advertisements under the proposed advertising rule? [Y/N]

6. If the proposed advertising rule is adopted, which employee or employees would the adviser designate to review the advertisements?

| Personnel who would review adviser advertisements | | | | | | | |
|---|---|---|---|---|---|---|---|
| Same personnel who currently review advertisement (see above) | Compliance employee(s) | Chief Compliance Officer | Attorney(s) (legal and/or compliance attorney) | Paralegal | Business analyst and/or portfolio manager | Marketing personnel | Other (please describe) |
| [ ] | [ ] | [ ] | [ ] | [ ] | [ ] | [ ] | [ free text ] |

7. If we were to require that the employee who reviews a firm's advertisements be someone other than the employee who created the advertisements, would the adviser be able to comply with the rule? [Y/N]

5) Overall effect of proposed advertising rule on smaller advisers

1. If the proposed advertising rule is adopted, which of the following impacts do you think the amended rule would have on your firm's advertising and related compliance budget?

__ No impact (budget would be unchanged)
__ Budget would be the same overall amount but allocated differently
__ Budget would be increased
__ Budget would be decreased
__ Don't know

6) General Information about the adviser's referral activities

1. Does the adviser, directly or indirectly, provide any person compensation that is specifically related to obtaining advisory clients? Do not include regular salaries paid to your employees. [Y/N]

2. If the adviser advises any private funds, does the adviser, directly or indirectly, provide any person compensation that is specifically related to obtaining investors in the firm's private funds? Do not include regular salaries paid to your employees. [Y/N/Adviser does not advise any private funds]

3. If you answered "yes" to questions (1) or (2), who does the adviser compensate for referrals (other than regular salary)? (Check either or both)

____ the adviser compensates its own personnel
____ the adviser compensates a third-party

4. If you answered "yes" to questions (1) or (2), does the adviser pay cash compensation, non-cash compensation, or both? Non-cash compensation can be, for example, gifts and sending business to the adviser's solicitors (*e.g.*, directing brokerage to brokers who solicit for the adviser).

____ cash compensation
____ non-cash compensation

5. If the adviser pays solicitors non-cash compensation, can the adviser briefly describe the type of non-cash compensation? [free text]

6. If applicable, which of the below options best represents the typical dollar amount or value of compensation paid per referral (in cash or converted to cash equivalent)?

| Estimated cost (in dollar or equivalent amount) | | | | | |
|---|---|---|---|---|---|
| $1 - $20 | $21 - $100 | $101 - $1,000 | > $1,001 | A percentage of assets under management | Does not know |
| [ ] | [ ] | [ ] | [ ] | [ ] | [ ] |

7) Questions about the proposed solicitation rule

| Under the proposed solicitation rule, an adviser that pays cash or non-cash compensation to a solicitor for investor referrals would be subject to the proposed rule's requirements, generally as follows: |
|---|
| • The adviser and solicitor must enter into a written agreement that describes the solicitation activities to be performed along with the terms of the compensation for the solicitation activities, and contains an undertaking by the solicitor to perform its duties under the agreement in a manner consistent with certain Advisers Act rules<br>• the solicitor or the adviser must provide the client with a separate solicitor disclosure describing the solicitation arrangement and the solicitor's compensation<br>• The adviser must oversee the solicitor's solicitation activities<br>• The adviser may not hire a disqualified solicitor (a list of disqualifying misconduct is enumerated in the rule). |
| The proposed solicitation rule would contain certain exemptions from most or all of the above for:<br>• an adviser's employees and other affiliates<br>• solicitors that refer client solely for impersonal investment advice<br>• solicitors that are provided *de minimis* compensation of $100 or less during a 12-month period<br>• solicitors that are nonprofit programs that satisfy certain conditions and disclosures under the proposed rule. |

1. If the proposed solicitation rule were adopted, would the adviser be required to enter into additional written agreements with solicitors, given the proposed rule's expanded application to non-cash compensation and compensated solicitations for private fund investors?

___ the adviser would be required to enter into additional written agreements with solicitors because of the proposed rule's new inclusion of non-cash compensation
___ the adviser would be required to enter into additional written agreements with solicitors because of the proposed rule's new inclusion of compensation to solicitors of private fund investors
___ both of the above
___ the adviser does not expect enter into any solicitation arrangements that would be subject to the proposed rule

2. If the proposed rule is adopted, does the adviser think that it would use any of the proposed rule's exemptions? [Y/N]

3. If yes, please check all that apply:

____ exemption for compensation to an adviser's employees or other affiliates
____ exemption for compensation to solicitors that refer clients solely for impersonal investment advice
____ exemption for *de minimis* compensation to solicitors ($100 or less during a 12-month period)
____ exemption for compensation to solicitors that are nonprofit programs

4. Does the adviser currently have policies and procedures to determine that a solicitor is not disqualified under the rule (*e.g.*, the solicitor did not engage in the rule's enumerated misconduct), and that the solicitor complies with the proposed rule's written agreement requirements (including delivering the solicitor disclosure)?

5. If the adviser answered "yes" to question 4, what steps does the adviser take to oversee its solicitors? (free text)

6. What does the adviser expect the cost would be, per year on an initial and ongoing basis, in order to comply with the proposed solicitation rule's requirements (*e.g.*, overseeing its solicitors, overseeing any policies and procedures around solicitor disqualification, entering into required written solicitation agreements, preparing and delivering solicitor disclosures or

overseeing the solicitor's delivery of the disclosures, and tracking the firm's use of any applicable exemptions)?

| Estimated **initial** cost ($) | | | | |
|---|---|---|---|---|
| $0 - $5,000 | $5,001 - $10,000 | $10,001 - $50,000 | > $50,001 | Does not know |
| [ ] | [ ] | [ ] | [ ] | [ ] |

| Estimated **ongoing** cost per year ($) | | | | |
|---|---|---|---|---|
| $0 - $5,000 | $5,001 - $10,000 | $10,001 - $50,000 | > $50,001 | Does not know |
| [ ] | [ ] | [ ] | [ ] | [ ] |

7. If the adviser anticipates that it would use employees or other affiliates as compensated solicitors under the proposed rule, does the adviser believe that the affiliation between the employee/affiliate, on the one hand, and the adviser, on the other hand, would be readily apparent to the solicited client or investor? [Y/N/not applicable]

8. If the adviser answered "no" to the previous question, would it be impractical or difficult for the employee or affiliate to disclose its affiliation with the adviser at the time of solicitation? [Y/N/don't know] If yes, what practical difficulties would arise? [free text]

9. If the proposed amendments to the solicitation rule are adopted, do you think your firm's solicitation or referral and related compliance budget would be:

__ No impact (budget would be unchanged)
__ Budget would be the same overall amount but allocated differently

__ Budget would be increased
__ Budget would decreased
__ Don't know

8) Questions about the proposed amendments to the books and records rule

| Advisers are currently required to make and keep certain books and records relating to their investment advisory businesses. Our proposal would update the recordkeeping rule to conform to the proposed changes to the advertising and solicitation rules, as follows: |
|---|
| • an adviser would be newly required to keep copies of advertisements to one or more persons (rather than to ten or more persons, as is generally required now)<br>• an adviser would be newly required to keep copies of written approvals of advertisements required under proposed advertising rule's employee review<br>• an adviser that uses a third-party rating in any advertisement under the proposed rule would be newly required to retain copies of questionnaires or surveys used in preparation of the third-party rating<br>• an adviser that compensates a solicitor under the proposed solicitation rule would no longer be required to keep written acknowledgments of each client's receipt of the solicitor disclosure, but would be newly required to keep certain records related to its belief that each solicitor has complied with the required written agreement<br>• an adviser that compensates a nonprofit program under the proposed solicitation rule would be newly required to keep certain records relating to the nonprofit program<br>• an adviser that compensates a solicitor under the proposed solicitation rule would be newly required to keep certain records related to its belief that any such solicitor is not disqualified under the proposed solicitation rule<br>• an adviser that compensates a solicitor under the proposed solicitation rule would be newly required to keep records of the names of all solicitors that are employees or other affiliates |

1. Approximately how much do you think it would cost the adviser, on an initial and ongoing basis, to comply with the proposed amendments to the books and records rule?

| Estimated **initial** cost ($) | | | | | |
|---|---|---|---|---|---|
| $0 - $1,000 | $1,001 - $5,000 | $5,001 - $10,000 | $10,001 – $15,000 | > $15,001 | Does not Know |
| [ ] | [ ] | [ ] | [ ] | [ ] | [ ] |

| Estimated **ongoing** cost per year ($) | | | | | |
|---|---|---|---|---|---|
| $0 - $1,000 | $1,001 - $5,000 | $5,001 - $10,000 | $10,001 – $15,000 | > $15,001 | Does not Know |
| [ ] | [ ] | [ ] | [ ] | [ ] | [ ] |

2. Would complying with these proposed amendments to the books and records rule be particularly difficult and/or present compliance challenges? Please explain.

9) Additional overall feedback

1. Are there any less expensive alternatives to any of these proposed requirements you can suggest that would still preserve the proposed amendments' intended investor protection safeguards? [free text]

Other Ways to Submit Your Feedback

You can also send us feedback in the following ways (include the file number S7-21-19 in your response):

| | |
|---|---|
| Print your responses and Mail | Secretary,<br>Securities and Exchange Commission<br>100 F Street, NE<br>Washington, DC, 20549-1090 |
| Print a PDF of Your Responses and Email | Use the printer friendly page and select a PDF printer to create a file you can email to: rule-comments@sec.gov |
| Print a Blank Copy of this Flier, Fill it Out, and Mail | Secretary,<br>Securities and Exchange Commission<br>100 F Street, NE<br>Washington, DC, 20549-1090 |

We will post your feedback on our website. Your submission will be posted without change; we do not redact or edit personal identifying information from submissions. You should only make submissions that you wish to make available publicly.

**Thank you!**