

## SEC Proposed Changes to Investment Adviser Rules

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The Securities and Exchange Commission (SEC) has proposed in a release (Release)<sup>1</sup> revising (Changes) certain rules pertaining to investment advisers (Current Rules and Advisers, respectively). Current Rules were, and Changes are to be, adopted by the SEC pursuant to the Investment Advisers Act of 1940 (Act).

### Scope of Changes—

**Itemization.** Changes pertain to four areas (applying to Rules 204 and 206 under the Act):

- **Advertising (Advertisements).**
- **Forms of, and compensation for, solicitations (Solicitations).**
- **SEC Form ADV (Form ADV).**
- **Required books and records (Recordkeeping).**

**Public Comment Period; Release Size.** The Release sought public comment on Changes through February 10, 2020. The SEC may proceed to final rule adoption after that date.

The Release is over 500 pages long and contains over 1,200 questions seeking comments on specific Changes.

**Focus of Release.** The Release focuses on reforms relating to Advertisements by, and use of Solicitations by or for, Advisers in seeking or maintaining clients and investors (collectively, Clients). Form ADV and Recordkeeping complement the other Changes.

Advertisements replace broadly drawn Current Rule-limitations, first adopted in 1961, with a more principles-based approach (PBA) to regulation. Solicitations use PBA in addressing changes in regulatory and industry practices occurring since adoption of relevant Current Rules in 1979. Changes include disclosing all compensation forms for, and expanding the disciplinary-events list which can be the basis for disqualifying a person from acting as a solicitor for an Adviser in, Solicitations (Solicitor).

While Current Rules require recordkeeping for advertisements sent to 10 or more persons, Advertisements require it for such activity to *one or more* persons. This Change subjects individual, personalized services to Advertisements and Recordkeeping.

**What's an Adviser or Solicitor?** Under the Act, an Adviser is a person who, for compensation, engages in the business of providing advice to others or issuing reports or analyses regarding securities. Under Current Rules, a Solicitor is a person who, directly or indirectly, solicits a client for, or refers the client to, an Adviser, i.e., the subject of Solicitations.

## **Bi-Level Securities Regulation—**

**Federal and State Levels.** Adviser regulation in the United States is not only at the federal level. Under the Act, regulation of an Adviser with less than \$25 million of assets under management (Small Adviser) is deferred to state regulation, with limited exception. That exception applies where the state, in which a Small Adviser has a principal office and place of business, has no laws regulating Small Advisers.

Alaska does regulate Small Advisers and Solicitor-type activity. It is accomplished under the Alaska Securities Act (AS 45.56, effective January 1, 2019, Alaska Act).

Several persons are excluded from the Adviser definition under both the Act and the Alaska Act. They include lawyers, accountants, engineers and teachers, whose performance of that service is incidental to the respective practice or profession.

**Effect on Small Advisers.** States are not required to follow Change-related provisions in regulating Small Advisers. However, Changes which end-up as final SEC rules might be of interest to states in interpreting their respective Small Adviser laws.

Some Change-related ideas may influence future Alaska Act regulations. If made a part of those regulations, they could prove useful to Alaska in administering, and to those persons seeking to function as Small Advisers or Solicitors under, the Alaska Act.

## **Some Further Changes Through Advertisements—**

**Overview.** The following is given as descriptive of some further provisions of Advertisements.

The Release notes advertisements are useful for Advisers. They are disseminated as to Adviser services to inform, persuade and provide information to Clients. However, it also notes advertisements can present risk of misleading Clients.

The Release states, aside from an interest in attracting or retaining Clients, an Adviser has a duty not to mislead them. That duty may conflict with Adviser-personal-interest. Balance between Adviser and Client interests is further challenged by the manner in which a Client receives information from the Adviser.

**Current Rule Approach.** To address these advertising-related issues, Current Rules impose *four prohibitions of actions* thought by the SEC to be *per se misleading* (Current Prohibitions):

- **Testimonials, endorsements and third-party ratings (Testimonials)--** As to Adviser and Adviser services.
- **References to specific profitable recommendations--** Previously made by Adviser.
- **Representations as to graphs or other devices--** That they can independently be used to determine which securities are to be bought or sold.
- **Statements as to free services--** Cannot be made, unless the services are actually so provided, without condition or obligation.

Current Rules also prohibit advertisements containing any untrue statement of a material fact or which are otherwise false or misleading. This caveat was adopted to address advertisements which,

although not containing violations of Current Prohibitions, could nevertheless be fraudulent and misleading.

**Changes in Marketplace.** The Release notes changes have occurred since Current Rule adoption, including:

- ***New and expanded uses of communications technology--*** Advent of internet, mobile applications and social media.
- ***Expectations of investors shopping for advisory services--*** Greater reliance upon internet.
- ***Changes in nature of investment advisory industry--*** Moving away from newsletters to personalized services.

It outlines a new approach through Advertisements.

**Change Approach Through Advertisements.** To remedy these perceived Current Rule-shortcomings, the SEC sets forth and describes need for significant revisions as contained in Advertisements, including the following:

- ***Modifying definition of “advertisement” (Modifications).***
- ***Replacing Current Prohibitions.***
- ***Allowing limited Testimonials.***
- ***Including tailored requirements for presentation of performance results (Tailored Requirements).***

The Release states Modifications are needed to address ever-changing technology. Modifications’ redefinition includes any communication, disseminated by any means by, or on behalf of, an Adviser. They further include an effort seeking to retain a Client in a pooled investment vehicle advised by the Adviser.

Modifications set forth specific exclusions from the definition as follows:

- ***Certain communications--*** Live, oral communications, not broadcasted on radio, television, internet or similar medium.
- ***Certain responses--*** To unsolicited requests for specific information.
- ***Other limited exclusions.***

Advertisements contain a list of prohibited practices, e.g., including making a material claim without substantiation. They also use PBA to replace Current Prohibitions. For example, Advertisements exclude advertising containing an untrue statement of material fact or omission of material fact “necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading.”

The Release proffers Testimonials can be useful and important for investors when evaluating Advisers. Tailored Requirements provide necessary disclosures and other safeguards to avoid investor deception through Testimonials.

The Release states advertising Adviser-performance results can be useful for investors when presented in a manner neither false nor misleading, i.e., in accordance with Tailored Requirements. In

that context, they also require attention to the intended audience, e.g., level of sophistication in, and access to analytical information on, proposed investments.

### **Some Further Changes Through Solicitations—**

**Overview.** The following is given as descriptive of some further provisions of Solicitations.

**Use of Solicitors.** The Release notes Advisers sometimes retain and use Solicitors to attract Clients. It states, without appropriate Solicitor disclosure to Clients, compensation under that retention creates risk that Clients might mistakenly view Solicitor-recommendations as being unbiased opinion.

**Current Rule Approach.** Current Rules make a cash-fee paid to a Solicitor for referrals to the Adviser unlawful, with limited exception. The exception requires the Adviser and Solicitor to have entered into a written agreement stating the terms of their relationship (Agreement). The Agreement must require the Solicitor to provide a Client with a current copy of the Adviser’s Form ADV brochure (generally descriptive of Adviser and Adviser services, Brochure) and other specified disclosures.

**Moving to PBA.** While continuing the Current Rule-Agreement requirement, Solicitations expand it to include specificity of solicitation-activity and terms of all compensation forms. Solicitations make several other Changes, moving away from prescriptive-based requirements. For example, they eliminate the express Solicitor requirement to provide a Client with a copy of the Brochure.

Solicitations use PBA, e.g., requiring disclosure to investors as to the effect of compensation on Solicitor-incentive in making an Adviser referral.

**Expansion of Disqualifications.** Current Rules set forth restrictions on who may function as a Solicitor, e.g., the restriction imposed when the person is barred or suspended by the SEC from association with an Adviser. Changes expand those restrictions to include other events, e.g., disciplinary actions by other regulators and self-regulatory organizations.

### **Summary—**

Efforts by the SEC on Changes are comprehensive. While this article covers some Changes, prudent practitioners, in advising Advisers, Solicitors or their Clients, ought to be aware of all Changes and what eventually may become SEC rules.

Good luck on your read of the Release!

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<sup>1</sup> “Investment Adviser Advertisements; Compensation for Solicitations,” SEC Release Nos. IA-5407; File No. S7-21-19, RIN: 3235-AM08; November 4, 2019.

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