

Locke Lord QuickStudy: SEC Proposes New Rules to Modernize the Advertising and Cash Solicitation Rules for Investment Advisers, and the SEC Staff Considers Changes to Custody Rule

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The US Securities and Exchange Commission (SEC) has proposed to amend and modernize certain rules under the Investment Advisers Act that deal with investment adviser advertising and payments to solicitors¹. The proposed amendments are intended to address changes in technology, expectations of investors who seek advisory services, and the evolving nature of industry practices to keep pace with changing technologies. The proposed amendments would apply to Rules 206(4)-1 and 206(4)-3.

Advertising Rule.

Proposed amendments to Rule 206(4)-1 under the Investment Advisers Act (the “Advertising Rule”) would supplant the Rule’s current specific advertising prohibitions with principles-based provisions. Among other things, the proposed amendment would change the definition of advertisement to try to capture ever-evolving media and technology, to “include any communication, disseminated by any means, by or on behalf of an investment adviser, that offers or promotes investment advisory services or that seeks to obtain or retain advisory clients or investors in any pooled investment vehicle advised by the adviser.” As proposed, the definition would specifically exclude “(1) live oral communications that are not broadcast; (2) responses to certain unsolicited requests for specified information; (3) advertisements, other sales material, or sales literature about a registered investment company or a business development company and is within the scope of other SEC rules; and (4) information required to be contained in a statutory or regulatory notice, filing, or other communication.”

The proposed amendments would also see a major change that would allow (i) certain testimonials and endorsements subject to inclusion of specified disclosures, including details regarding whether the person giving the testimonial or endorsement is a client and whether compensation has been provided by or on behalf of the adviser and (ii) third-party ratings, subject to disclosures of certain criteria pertaining to the preparation of the rating. As currently contemplated, the proposal would prohibit including in an advertisement, (i) gross performance results, unless it also provides (or offers to provide promptly) a schedule of fees and expenses deducted to calculate net performance, (ii) any statement that the calculation or presentation of performance results has been

approved or reviewed by the SEC, (iii) performance results from fewer than all portfolios with substantially similar investment policies, objectives, and strategies as those being offered or promoted in the advertisement, with limited exceptions, (iv) performance results of a subset of investments extracted from a portfolio, unless it provides or offers to provide promptly the performance results of all investments in the portfolio, and (v) hypothetical performance, unless the adviser adopts and implements policies and procedures reasonably designed to ensure that the performance is relevant to the financial situation and investment objectives of the recipient and the adviser provides certain specified information underlying the hypothetical performance.

Solicitation Rule.

The proposed amendments to Rule 206(4)-3 (the “Solicitation Rule”) would expand coverage to include (i) any solicitation of current and prospective investors in private funds, rather than only to the solicitation of current and prospective clients of the adviser, subject to certain current partial exemptions for solicitors that refer investors for impersonal investment advice and solicitors who are employees or otherwise affiliated with the adviser, and (ii) payment of both cash and non-cash compensation, subject to a new de minimis threshold. For this purpose, non-cash compensation would include directed brokerage, awards or prizes, and free or discounted services. In addition, the proposed rule would expand the list of disciplinary events for which persons would be disqualified from acting as a solicitor. Under the proposed rule, (i) solicitors would be required to disclose any financial interest in the client's choice of an investment adviser and include additional information about any solicitor conflict of interest and (ii) the adviser would have to demonstrate a reasonable basis for believing that the solicitor has complied with the rule's written agreement, including complying with the solicitor disclosure requirement.

Based on the foregoing, the SEC also proposes to amend Form ADV to affect the proposed amendments to the Advertising Rule and Solicitation Rules.

The proposed amendments to the Advertising Rule and the Solicitation Rule can be found [here](#).

The Custody Rule.

In the fall of 2019, the SEC added a [long-term goal](#) to its priorities list to review Rule 206(4)-2 (the “Custody Rule”). The Release, entitled “Amendments to the Custody Rules for Investment Advisers”, provides that “the Division is considering recommending that the Commission propose amendments to existing rules and/or propose new rules under the Investment Advisers Act of 1940 to improve and modernize the regulations around the custody of funds or investments of clients by Investment Advisers.”

The Custody Rule was last amended in 2009, in part in response to the Madoff scandal and other financial crisis inputs. Since that time, the SEC staff has provided the investment adviser community with clarifications and supplemental information to interpret the Custody Rule through issuances of FAQs, updated guidance, no-action letters, and enforcement actions. Over this time, there has been a significant evolution in digital securities and interest in such digital securities by both investment sponsors and the investing community. As currently drafted and interpreted, it is difficult if not impossible to meet the qualified custodian requirements of the Custody Rule with respect to digital securities because of their decentralized recording structure. This has resulted in considerable confusion and efforts by the investing community to find avenues to meet the markets desire for digital securities within the current regulatory framework surrounding custody. In light of these factors and ever evolving technologies that impact the investment management sector, the staff of the SEC's Division of Investment Management has been reviewing the Custody Rule and has indicated in recent speeches that it is considering amendments to the Custody Rule to address future needs and to improve efficiencies, including with respect to digital assets, while maintaining protection of client funds and securities.

As we have in the past, we will continue to monitor these issues and will provide future client updates. This QuickStudy is for guidance only and is not intended to be a substitute for specific legal advice.

1. [SEC Proposes to Modernize the Advertising and Cash Solicitation Rules for Investment Advisers](#)

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