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Hedge Fund Global Marketing Series

MAJOR (POTENTIAL) CHANGES TO THE

REGULATION OF US PRIVATE FUND MARKETING

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Overview

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 - General Prohibitions of Advertising Practices
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3. Proposed Amendments to Rule 206(4)-3 (Solicitation Rule)
 - Solicitation of Existing and Prospective Investor and All forms of Compensation
 - Solicitor Disclosure
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4. Proposed Amendments to Books and Records Rule

Key Areas of Potential Impact for Private Fund Managers

- Advertising Rule
 - Explicitly expand protections of the rule to “investors in any pooled investment vehicle” rather than merely to adviser’s “clients”
 - Differentiate between the standards applicable to advertisements to Retail investors vs. Non-Retail investors. Non-Retail investors would be limited to Qualified Purchasers and Knowledgeable Employees, effectively establishing different standards for marketing materials as between 3(c)(7) and 3(c)(1) funds (or other types of non-QP clients or investors).
 - Review and approval requirements
- Solicitation Rule
 - Extend the rule to referrals involving investors in private funds and not merely advisory clients of a manager

Expanded Definition of Advertisement

Proposed definition of Advertisement would:

- Include communications “disseminated by any means”
- Contemplate the use of electronic media (email, and social media), mobile communications, and other advances in technology
- Apply to an advertisement disseminated “on behalf of” an adviser through intermediary or third-party website
- Include communications that “promote” advisory services, even if such communications do not explicitly “offer” services
- Educational materials and client reporting (account statements) do not fall within the proposed definition
- **Expand protections of the rule to “investors in any pooled investment vehicle” rather than merely to adviser’s “clients”**

Exemptions:

- Live oral communications that are not broadcast
- With some exceptions, unsolicited requests
- Registered fund advertisements

General Prohibitions of Advertising Practices

Current rule includes catch-all provision forbidding use of “any advertisement which contains any untrue statement of a material fact, or which is otherwise misleading”

Proposed rule would expand this concept with a list of 6 “ever-green” general principles and a seventh catch-all. An adviser would be prohibited from using an advertisement that:

1. Includes any untrue statement of a material fact, or 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;
2. Includes a material claim or statement that is unsubstantiated;
3. Includes 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;
4. Discusses or implies 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. Includes 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; or
6. Includes or excludes performance results, or presents performance time periods, in a manner that is not fair and balanced

Testimonials, Endorsements, and Third-Party Ratings

Testimonials: Current rule expressly prohibits testimonials. Proposed rule would permit use of testimonials under certain conditions and defines as “any statement of a client’s or investor’s experience with the investment adviser or its advisory affiliates”

Endorsements: Current rule is silent. Proposed Rule would define as “any statement by a person other than a client or investor indicating approval, support, or recommendation of the investment adviser or its advisory affiliates”

Advisers may use testimonials or endorsements in an advertising if they *clearly and prominently* disclose

- ❖ (1) that any testimonial was given by a client or investor, and any endorsement was given by a non-client or non-investor, as applicable, and (2) if applicable, any compensation provided by the adviser in connection with obtaining or using the testimonial or endorsement
- ❖ *Clear and Prominent* = Disclosure must be at least as prominent as the testimonial itself (e.g. no obscure footnotes)

Testimonials, Endorsements, and Third-Party Ratings

Third-Party Ratings: Proposed rule would define as “rating or ranking of an investment adviser provided by a person who is not a related person ... and such person provides such ratings or rankings in the ordinary course of its business.”

- Permitted so long as the adviser reasonably believes that the process used to determine the rating was not designed to create a predetermined result
- Adviser also required to disclose (or would have to reasonably believe that the rating party discloses):
 - ❖ Date of the rating;
 - ❖ Time period used to determine the rating;
 - ❖ Identity of the rating provider; and
 - ❖ Any compensation provided by, or on behalf of, the adviser in connection with obtaining or using the rating.

Performance Advertising Differentiation Between Retail and Non-retail Communications

Proposed rule would apply different requirements to communications to Retail Persons and Non-Retail Persons

- **Non-Retail Persons**: “qualified purchasers” under 2(a)(51) of the Investment Company Act, and “knowledgeable employees” as defined in Rule 3c-5 under the Investment Company Act
- **Retail Persons**: Any other person other than a QP and KE
- Retail Persons and Non-Retail Persons not aligned with definitions of “retail investor” and “retail customer” for purposes of Form CRS and Reg BI or applicable FINRA standards.
- SEC considered, but opted not to, propose using the Accredited Investor or Qualified Client concepts

Performance Advertising

❖ **Gross and Net Performance**

- Must provide a schedule of specific fees and expenses deducted to calculate net performance
- *Retail Advertisements* must include net performance, calculated over the same time period as the gross performance, and displayed with at least equal prominence and in format designated to facilitate comparison with gross performance
- *Non-Retail Advertisements* can include only gross performance of a portfolio but must offer to provide promptly the information necessary to calculate net performance

❖ **Related Performance**

- Can exclude certain related portfolios as long as the advertised performance results are no higher than if all related portfolios had been included
- Some flexibility for advisers to select which portfolios to highlight or present on portfolio-by-portfolio basis
- *Retail Advertisements*: present the performance results across one-, five-, and ten-year periods (or since inception)
 - This will be a change for private fund managers with Retail Person investors or clients

❖ **Extracted Performance**

- 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

Performance Advertising

❖ Hypothetical Performance

- May include backtested results, representative performance and targets or projections in an advertisement (subject to providing audience with requisite and calculation criteria and assumption associated with the data)
- Need policies and procedures to ensure the performance is “relevant to the financial situation and investment objectives” of the recipient
- Need to provide sufficient information for the recipient to understand: (1) how the hypothetical performance was calculated, including any criteria used and assumptions made, and (2) the risks and limitations of using hypothetical performance in making investment decisions
- *Non-Retail Advertisements*: Note required to provide the risk and limitation information in the advertisement itself. Could offer to provide promptly such information

❖ Portability of Performance

- Not addressed in the proposed rule
- SEC requests comments on whether the proposed rule should include specific provisions addressing presentation of predecessor performance results

Amendments to Form ADV

- Proposed Rules would add Subsection L (“Advertising Activities”) to Item 5 of Form ADV Part 1A
 - Would require information about an adviser’s use of performance results, testimonials, endorsements, third-party ratings, and its previous investment advice in its advertisements
 - Proposed section includes five “yes” or “no” questions about these activities

Solicitation of Existing and Prospective Investors and All Forms of Compensation

Definition of Solicitor

- ❖ Current definition: “any person who directly or indirectly solicits any client for, or refers any client to, an investment adviser”
- ❖ Proposed definition: **includes solicitation of current and prospective investors in private funds (defined to include funds relying on Sections 3(c)(1) or 3(c)(7) of the Investment Company Act, and not just to the adviser’s “clients”)**

Extension to All Forms of Compensation

- ❖ Current rule: covers any adviser that pays a cash fee
- ❖ Proposed rule: expands to solicitors operating under all forms of compensation arrangements (i.e. directed brokerage, sales awards and prizes, training or education meeting, outing, tours, other forms of entertainment, and free or discounted advisory services)

Solicitor Disclosure

Similar to current rule, the disclosure provided to solicited clients or investors must include:

- ❖ Name of investment adviser
- ❖ Name of solicitor
- ❖ Description of adviser's relationship with solicitor
- ❖ Terms of any compensation arrangement
- ❖ Amount of any additional cost to the investors as a result of solicitation
- ❖ Describe any potential material conflicts of interest on the part of the solicitor resulting from adviser's relationship with solicitor and/or the compensation arrangement. [new]

Proposed rule adds flexibility:

- Solicitor or Adviser may deliver the disclosure
- Modifies the timing of delivery, promptly after an investor responds to a mass communication
- Eliminates requirement for adviser to obtain a signed and dated acknowledgement of receipt of disclosure from solicited client
- Removes requirement that solicitor disclosure must be "written" (electronic or recorded media now permitted)

Mayer Brown no-action letter is one of dozens of no-action letters that have been identified as under review and subject to potential rescission by the SEC as part of final rulemaking.

Written Agreement

The Proposed Solicitation Rule:

- Retains current rule's requirement that an adviser may only compensate a solicitor pursuant to a written agreement describing terms of compensation
- Eliminates current rule's requirement that the solicitor deliver the adviser's Form ADV brochure to solicited clients
- Removes current rule's requirement that solicitor includes a provision in the written agreement to undertake to perform its duties with the instructions of the adviser
- Requires solicitor to agree to perform its solicitation activities in accordance with sections 206(1), (2), and (4) of the Advisers Act

Exemptions

- Proposed rule retains current rule's partial exemptions for *Solicitors that refer investors for impersonal investment advice; and solicitors that are employees or affiliated with the adviser*. But, these arrangements would no longer be subject to current rule's written agreement requirement
- De minimis compensation exemption
 - ❖ \$100 or less during the preceding twelve months
- Non-profit program exemption
 - ❖ Would apply when an adviser has a reasonable basis for believing that the solicitor is a non-profit program that provides a list of advisers based on non-qualitative criteria (e.g. geographic proximity, lack of disciplinary history)
 - ❖ Adviser is required to limit compensation to the costs reasonably incurred in operating the program
 - ❖ Would codify SEC guidance, such as the National Football League Players Association no-action letter

Disqualifications

Current rule:

- ❖ Bars persons with a history of misconduct (“ineligible solicitor”) from compensation by an adviser for acting as a solicitor

Proposed rule:

- ❖ Would create a “reasonable care standard”. Instead of absolute bar, an adviser violates the disqualification provisions as a result of a disqualifying event that they should have known, in the exercise of reasonable care, existed
- ❖ Would require adviser to determine if a solicitor is an ineligible person at the time of solicitation (mass communication: as soon as reasonably practicable)
- ❖ Would not consider a firm to be an ineligible solicitor if the firm’s only bad actors do not conduct solicitation activities
- ❖ Expand types of disciplinary events that triggers disqualifying provisions
 - Commission opinion barring, suspending or prohibiting a person from acting in any capacity under the Federal securities laws
 - Cease and desist from violating any scienter-based antifraud provision of the Federal securities laws
 - Conviction by a United States Court (not foreign)
 - Final orders from the CFTC and self-regulatory organizations

Amendments to Books and Records Rule

Advertising Rule

- ❖ Retain records around any advertisements sent, regardless of number of individuals to which the advertisement is disseminated (in contrast to current rule which requires such rule if sent to ten or more persons)
- ❖ Maintain records related to third-party questionnaires and surveys used in preparation of third-party ratings
- ❖ Retain copies of all written approvals by designated employees
- ❖ Require advisers to make and keep written communications relating to, and any records supporting calculations underlying, the performance of any portfolio contained in any advertisement or other communication

Solicitation Rule

- ❖ Make and keep records of the solicitor disclosure delivered to investors
- ❖ Maintain records demonstrating it has a reasonable basis for believing that any solicitor it compensates has complied with the written agreement requirement
- ❖ Non-profit program, the adviser would need to (1) retain records demonstrating its reasonable basis for believing that the non-profit meets the requirements of the non-profit program exemption; and (2) retain copies of all receipts of compensation the adviser provides relating to its inclusion in the program
- ❖ Maintain a record of names of all solicitors who are an adviser's partners, officers, directors or employees or other affiliates

Timing

- Comment Period: Comments are due by February 10, 2020
- SEC currently reviewing dozens of SEC staff's no-action letters to determine whether any such letters should be withdrawn in connection with the proposed rule

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Jack sits on the board of directors of Philadelphia VIP Inc., which coordinates the provision of civil legal services to low-income individuals and families.

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Steve advises major US broker-dealers in the private wealth and private client businesses that offer investment advice and brokerage services to high-net-worth clients as well as broker-dealers serving self-directing clients. He also works as counsel on various matters to the Securities Industry and Financial Markets Association's (SIFMA) private client committee and represents most of the best-known US broker-dealers in this area. *(continued)*

Jedd H. Wider



Jedd H. Wider focuses on global private investment funds and managed accounts, particularly global hedge, private equity, secondary, and venture capital funds. As co-leader of the global hedge funds practice, he represents leading financial institutions, fund managers, and institutional investors in their roles as fund sponsors, placement agents, and investment entities. He assists clients through all stages of product development and capital raising as well as customized arrangements, seed and lead investor arrangements, and joint ventures. He specializes in all aspects of secondary transactions, and complex financial structurings.

Jedd concentrates on all aspects of bespoke fund products and arrangements including funds of one and managed accounts and regularly advises clients on all aspects of regulatory compliance.

Members of the international media often seek out Jedd for his views on the hedge fund and private equity fund industries and capital markets. His analysis can be found in US and international publications, including *The Wall Street Journal*, *The Economist*, and *Financial Times*, as well as on television networks such as Bloomberg and CNN.

Jedd lectures and serves as a panelist on private investment fund topics for trade programs and organizations around the world. He has delivered speeches and presentations to numerous private fund conferences such as the Hedge Fund Institutional Forum, Dow Jones Private Equity Analyst Limited Partners Summit, Endowments & Foundations Roundtable, Association of Life Insurance Counsel, National Association of Public Pension Fund Attorneys (NAPPA), West Legalworks, InfoVest21 Hedge Fund Conference, the Annual Euromoney Summit of European Hedge Funds in London, Capital Roundtable Fund Conferences, the Annual International Conference on Private Investment Funds in London, the Wharton Private Equity and Venture Capital Conference, the On Point Investors and Hedge Fund Risk Summit, and the Lazard Capital Markets Hedge Fund Conference.

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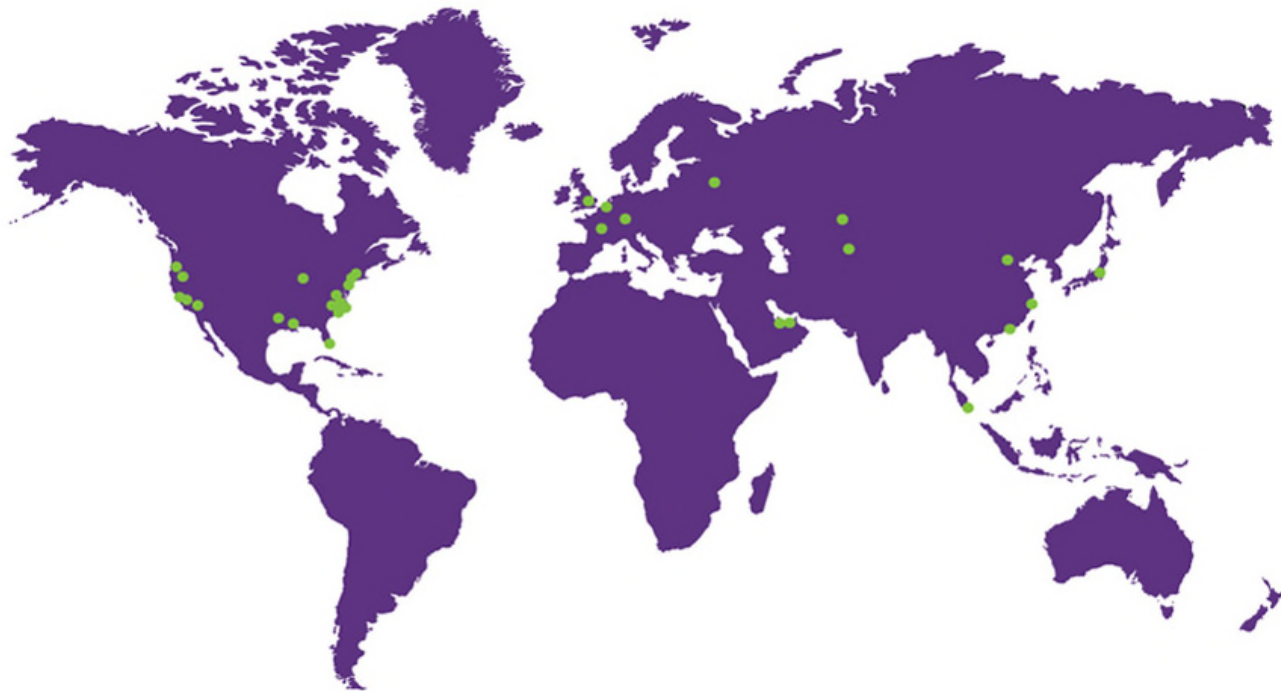
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