

**Morgan Lewis**

**MORGAN LEWIS HEDGE FUND  
UNIVERSITY™ AND THE  
MORGAN LEWIS GLOBAL  
SPONSOR FORUM**

**The SEC's New Marketing Rule:  
Private Fund Perspectives**

February 24, 2021



# Speakers



**CHRISTINE M. LOMBARDO**  
+1.215.963.5012  
[christine.lombardo@morganlewis.com](mailto:christine.lombardo@morganlewis.com)



**JOHN J. "JACK" O'BRIEN**  
+1.215.963.4969  
[john.obrien@morganlewis.com](mailto:john.obrien@morganlewis.com)



**STEVEN W. STONE**  
+1.202.739.5453  
[steve.stone@morganlewis.com](mailto:steve.stone@morganlewis.com)



**JOSEPH D. ZARGARI**  
+1.212.309.7020  
[joseph.zargari@morganlewis.com](mailto:joseph.zargari@morganlewis.com)



**MONICA PARRY**  
+1.202.373.6179  
[monica.parry@morganlewis.com](mailto:monica.parry@morganlewis.com)

# The SEC's New Marketing Rule

- Extension of rule to investors in private funds
- Expanded definition of "advertisement"
  - Types of private fund communications in and out of scope
- New general prohibitions
- New framework for use of performance advertising
  - Case studies, track record, and related private fund matters
- Use of testimonials and endorsements
- Considerations for referral and solicitation arrangements for private fund managers
- Related books and records requirements

# Introduction and Key Changes

- Advertising and Cash Solicitation Rules first adopted in 1961 and 1979, respectively.
- SEC merged the rules in the adopted Marketing Rule (will rescind Cash Solicitation Rule).
- Replacing per se prohibitions with principles-based prohibitions.
- New rule includes communications with private fund investors.
- Definition of “advertisement” expanded from current rule (includes endorsements, testimonials).
- Endorsements and testimonials are permitted, but require certain disclosures.
- New standards for presentations of performance, including use of hypothetical performance.
- Rule does not include proposed distinction between “retail” and “non-retail” communications, but has certain exceptions for private funds.
- Books and records rule will require retention of advertisements and certain related materials.
- Certain SEC staff no-action letters will be rescinded—a list will be posted on the SEC’s website.

# What Is an Advertisement

## 1. Any direct or indirect communication an adviser makes

To more than one person

To one person if the communication includes *hypothetical performance* except where provided

- in response to an unsolicited request for such information from a prospective or current client or investor in a private fund advised by the adviser
- to a prospective or current investor in a private fund advised by the adviser in a one-on-one communication

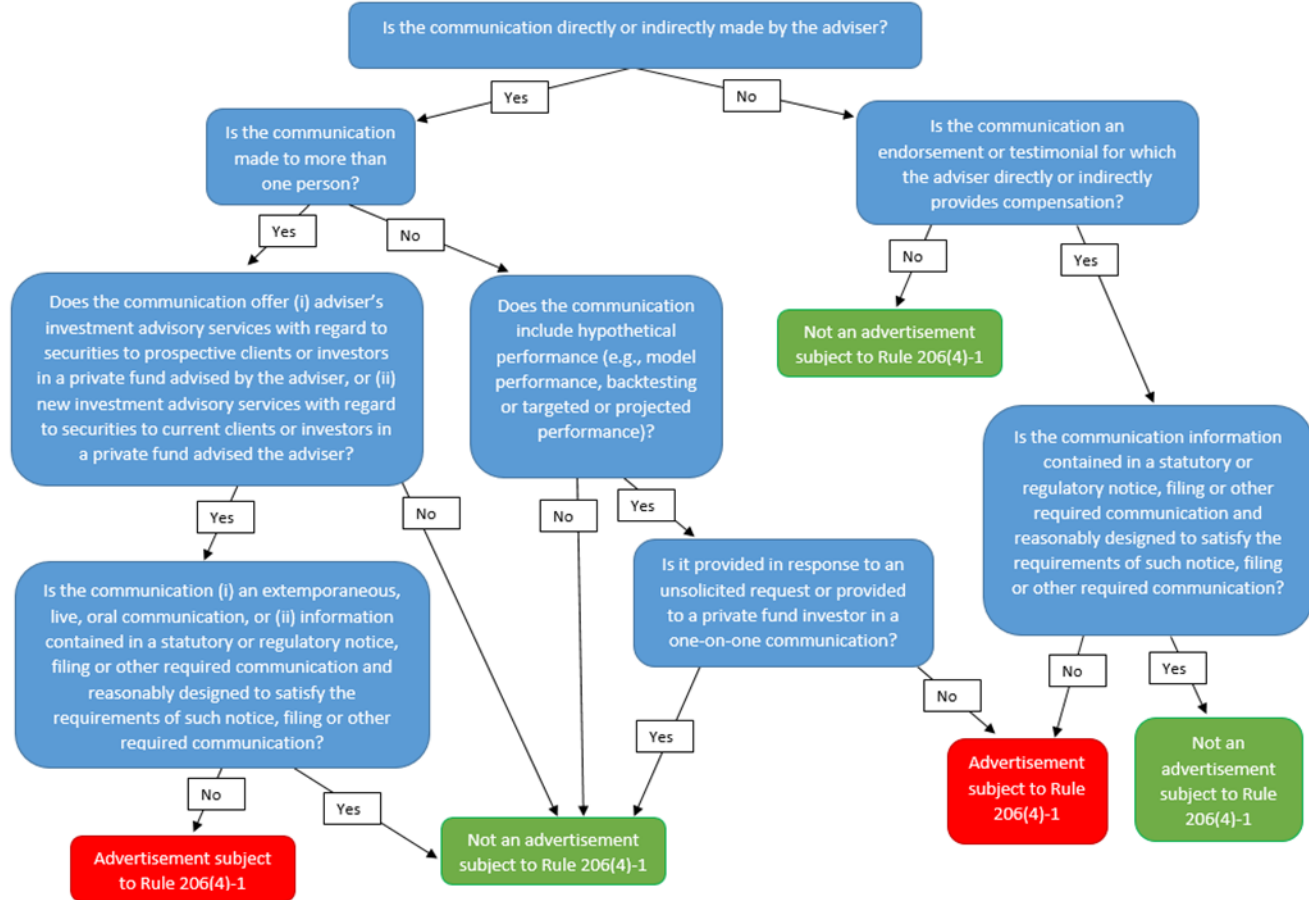
That offers (i) the adviser's investment advisory services with regard to securities to prospective clients or investors in a *private fund* advised by the adviser or (ii) new investment advisory services with regard to securities to current clients or investors in a *private fund* advised by the adviser

Other than

- Extemporaneous, live, oral communications
- Information contained in a statutory or regulatory notice, filing, or other required communication if such information is reasonably designed to satisfy the requirements of such notice, filing, or other required communication

## 2. Any endorsement or testimonial for which the adviser provides compensation, directly or indirectly, but does not include information contained in a statutory or regulatory notice, filing, or other required communication if such information is reasonably designed to satisfy the requirements of such notice, filing, or other required communication

# What Is an Advertisement?



# “Advertisement” Definition: Private Fund Considerations

- “Private Fund” = 3(c)(1) or 3(c)(7) Funds
- Private Placement Memoranda
- Market commentary and communications with existing investors
- Direct vs Indirect Communications
  - Placement agents
  - Third-party marketers
  - Introducers
  - Social media?
- “Unsolicited” requests from investors or clients

# General Prohibitions

1

Untrue statement of a material fact, or omission of a material fact necessary to make the statement made not misleading.

2

Material statement of fact that adviser does not have a reasonable basis to believe it will be able to substantiate on SEC demand.

3

Information reasonably likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the adviser.

4

Potential benefits to clients or investors connected with or resulting from adviser's services or methods without fair and balanced treatment of material risks or limitations.

5

Reference to specific advice provided by adviser not presented in a fair and balanced manner.

6

Include or exclude performance, or present performance time periods, not in a fair and balanced manner.

7

Otherwise materially misleading information.



# Testimonials and Endorsements: Key Definitions

|  | Testimonial                                    | Endorsement |
|--|--|-------------|
| Giver of Statements  | Current client <b>or private fund investor</b> | Others      |
| Substance of Statements  |  |             |
| <ul style="list-style-type: none"> <li>About the maker's experience with the adviser or its supervised persons</li> </ul>  | ✓  |             |
| <ul style="list-style-type: none"> <li>Indicates approval, support, or recommendation of the adviser or its supervised persons or describes that person's experience with them</li> </ul>                          |  | ✓           |
| <ul style="list-style-type: none"> <li>Directly or indirectly solicits any current or prospective client or investor to be a client of, or an <b>investor in a private fund</b> advised by, the adviser</li> </ul> | ✓  | ✓           |
| <ul style="list-style-type: none"> <li>Refers any current or prospective client or investor to be a client of, or an <b>investor in a private fund</b> advised by, the adviser</li> </ul>                          | ✓  | ✓           |

# Testimonials and Endorsements: Requirements

- *Advertisements* may not include, and adviser may not provide compensation for, a *testimonial* or *endorsement* unless:
  - Disclosures: Adviser discloses, or reasonably believes the giver discloses, at the time the *testimonial* or *endorsement* is disseminated:
    - Clearly and prominently, as applicable:
      - *Testimonial* was given by a current client or investor or *endorsement* was given by a person other than a current client or investor
      - Cash or non-cash compensation was provided for the *testimonial* or *endorsement*
      - Brief statement of any material conflicts of the giver resulting from adviser's relationship;
    - Material terms of compensation arrangement, including description of direct or indirect compensation
    - Description of giver's material conflicts resulting from adviser relationship and compensation arrangement
  - *Adviser oversight and compliance* – Adviser must have:
    - Written agreement with giver that describes the scope of agreed activities and terms of compensation
    - Reasonable basis for believing that the arrangement complies with the Rule
  - Disqualification – Adviser may not compensate a giver if the adviser knows, or in the exercise of reasonable care should know, that the giver is an ineligible person at the time of dissemination
    - Carveout of matters occurring before Rule effective date if not disqualify giver from being a solicitor

# Testimonials and Endorsements: Exceptions

|  | Clear and Prominent Disclosure of Summary Information | Additional Disclosure of Material Terms of Compensation & Conflicts | Adviser Oversight & Compliance | Adviser Must Have a Written Agreement with Promoter | Promoter Must be Eligible and Cannot be Disqualified (i.e., not a bad actor)                     |
|--|---|---|--------------------------------|---|--|
| Compensation paid to promoter is \$1,000 or less during prior 12 months                  | <i>Required</i>                                       | <i>Required</i>   | <i>Required</i>                | <i>Not applicable</i>                               | <i>Not applicable</i>  |
| Promoter is an Affiliated Person of adviser  | <i>Not applicable</i>                                 | <i>Not applicable</i>   | <i>Required</i>                | <i>Not applicable</i>                               | <i>Required</i>  |
| Promoter is a broker-dealer making a recommendation under Reg BI                         | <i>Not applicable</i>                                 | <i>Not applicable</i>   | <i>Required</i>                | <i>Required</i>                                     | <i>Not applicable if broker-dealer is SEC-registered and not disqualified under the 1934 Act</i> |
| Promoter is a broker-dealer making a testimonial or endorsement to a non-retail customer | <i>Required</i>                                       | <i>Not applicable</i>   | <i>Required</i>                | <i>Required</i>                                     |  |
| Testimonial or endorsement regarding Reg D offering                                      | <i>Required</i>                                       | <i>Required</i>   | <i>Required</i>                | <i>Required</i>                                     | <i>Not applicable</i>  |

# Testimonials & Endorsements: Private Fund Considerations

- Extends to private fund investor referrals
  - Mayer Brown No Action Letter
- Cash and ***Non-Cash*** Compensation
  - Fee waivers
  - Non-cash benefits
  - Gifts, entertainment, etc.
- Applicability to placement agent arrangements
- Permissibility of use of testimonials and endorsements in pitch books and other advertisements
  - Still subject to Reg D (where applicable) and ICA public offering limitations with regard to funds

# Social Media

- Discussion in Adopting Release about the adviser's use of social media
- Flexibility of rule to account for evolving technology
  - Text messages, podcasts, instant messages, etc.
- Applicability to associated persons of an adviser
  - SEC indicated it could be hard to distinguish communications from a persons associated with an adviser from communications by the adviser itself
  - Policies and procedures
- Private Fund considerations:
  - Still subject to Reg D restrictions on general solicitation when relying on Section 506(b)
  - ICA limitations on "public offerings"

# Third-Party Ratings

- Defined as rating or ranking of an 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.
- *Advertisement* may not include third-party ratings unless adviser:
  - Has reasonable basis to believe any questionnaire or survey used to prepare rating is structured to make it equally easy for participant to provide favorable and unfavorable responses—not designed or prepared to produce predetermined result
  - Clearly and prominently discloses (or adviser reasonably believes rating clearly and prominently discloses)
    - Date rating was given and the time period on which rating was based
    - Identity of the third party that created and tabulated the rating
    - If applicable, that compensation has been provided directly or indirectly by the adviser when obtaining or using the rating

# Performance Advertising

- The Rule expressly sets out conditions for using performance results in marketing materials.
- SEC identifies several categories, with defined requirements for using each type of performance information in an advertisement:
  1. Gross and Net Performance
  2. 1-, 5-, 10-Year or Since-Inception Performance
  3. Related Performance
  4. Extracted Performance
  5. Hypothetical Performance
  6. Predecessor Performance (Portability)

# Performance Advertising: Gross and Net

- *Gross performance* means the performance results of a portfolio (or its relevant portions) before the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the adviser's investment advisory services to the relevant portfolio.
- *Net performance* means performance results of a portfolio (or its relevant portions) after the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the adviser's investment advisory services to the relevant portfolio.
- The Rule mandates the use of *net performance* when using *gross*, regardless of the intended audience.
- When using *gross performance*, an adviser must also display *net performance*:
  - In an equally prominent manner to gross performance
  - In a format designed to facilitate comparison with gross performance
  - Calculated over the same period of time, and using the same type of return



# Performance Advertising: 1, 5, 10 Year or Since Inception

- The Rule requires that advisers present performance results of any portfolio or any composite aggregation of related portfolios (***excluding private funds***) by including performance for 1, 5, and 10 year periods.
- If the portfolio does not exist for a given period, then the adviser should include information since inception.
- Performance for each period must be presented with equal prominence, and end on a date no less recent than the most recent calendar year-end.
- An adviser may advertise performance results for periods other than 1, 5, and 10 years, so long as the advertisement also presents results for the required 1-, 5-, and 10-year time periods.
- This standard tracks Securities Act Rule 482 (for registered funds).

# Performance Advertising: Related Performance

- Defined as performance results of one or more *related portfolios*, either on a *portfolio-by-portfolio* basis or as a composite aggregation of all *portfolios* falling within stated criteria.
- Conditions – Related performance must include all related portfolios (portfolios with substantially similar investment policies, objectives, and strategies) other than related portfolios if:
  - Advertised performance results are not materially higher than if all related portfolios included.
  - Exclusion of any related portfolio does not alter presentation of applicable 1-, 5-, and 10-year/since inception periods required by the rule.

# Performance Advertising: Extracted Performance

- Defined as performance results of a subset of investments extracted from a *portfolio*.
- Conditions – Advertisement provides, or offers to provide promptly, performance results of the total portfolio from which the performance was extracted.

# Performance Advertising: Hypothetical Performance

- Defined as performance results that were not actually achieved by any portfolio of the adviser, including:
  - Performance derived from **model performance**
  - Performance **backtested** by the application of a strategy to data from prior time periods when the strategy was not actually used
  - **Targeted or projected performance** returns for any *portfolio* or investment advisory services with regard to securities
  - *Hypothetical performance* does **not** include:
    - Interactive analysis tool used by prospective or current client or investor to produce simulations and statistical analyses presenting likelihood of various investment outcomes if certain investments are made or certain investment strategies or styles are undertaken, if adviser: (i) provides a description of the criteria and methodology used, including the investment analysis tool's limitations and key assumptions; (ii) explains that the results may vary with each use and over time; (iii) if applicable, describes the universe of investments considered, explains how the tool determines which investments to select, discloses if the tool favors certain investments and, if so, explains the reason for the selectivity, and states that investments not considered may have characteristics similar or superior to those analyzed; and (iv) discloses that the tool generates outcomes that are hypothetical in nature
    - *Predecessor performance* presented in compliance with the rule
- Conditions – Adviser must:
  - Adopt and implement policies and procedures reasonably designed to ensure hypothetical performance is “relevant to the likely financial situation and investment objectives” of the intended audience
  - Provide sufficient information to enable the intended audience to understand the criteria used and assumptions made
  - Provide (**or, if the intended audience is an investor in a private fund, offers to provide promptly**) sufficient information to enable the intended audience to understand the risks and limitations of using such *hypothetical performance*
    - Adviser need not comply with conditions on showing 1-, 5-, and 10-year/since inception performance, related performance and extracted performance

# Performance Advertising: Portability of Performance

- Refers to limitations on adviser advertising performance achieved at a predecessor firm.
- Defined as investment performance achieved by a group of investments consisting of an account or a private fund that was not advised at all times during the period shown by the adviser advertising the performance.
- Conditions:
  - The person or persons primarily responsible for achieving prior performance results manage accounts at the advertising adviser
  - Accounts managed at predecessor adviser are sufficiently similar to accounts managed at advertising adviser that performance results would provide relevant information
  - All accounts managed in a substantially similar manner are advertised unless exclusion of any account would not
    - Result in materially higher performance
    - Alter presentation of any 1-, 5-, and 10-year/since inception periods required by the rule
  - *Advertisement* clearly and prominently includes all relevant disclosures, including that the performance results were from accounts managed at another entity

# Review and Approval

- No explicit pre-approval requirement.
- SEC encourages advisers to adopt “objective and testable” compliance policies and procedures (e.g., internal pre-review and approval), risk-based sampling, pre-approved templates, and periodic reviews.
- This is a departure from the proposed approach, which would have required advisers to appoint a designated employee to review and approve advertisements before use.

# Books and Records

- *"Ten or more."* The "ten or more persons" rule was removed, but one-on-one communications are not "advertisements" under the first prong of the definition and excluded from this part of the recordkeeping rule unless they contain hypothetical performance, in which case they are required records.
  - *Oral advertisements, endorsements, or testimonials.* Advisers must keep either actual recordings or materials used in their preparation, such as scripts and disclosures.
  - *Hypothetical performance.* Advisers must keep copies of all information provided or offered under the hypothetical performance provisions of the amended Rule.
    - Advisers will have to make and keep a record of the "intended audience."
  - *Predecessor performance/portability.* Advisers must keep copies of "communications" relating to predecessor performance, and not simply supporting records.
- *Testimonials, endorsements, and third-party ratings.*
    - Retain records evidencing adviser's reasonable basis for believing that a testimonial, endorsement, or third-party rating complies with the Rule.
    - An adviser that employs affiliated solicitors must keep a list of their names and document their affiliates' status at the time the adviser disseminates the testimonial or endorsement.
    - When an adviser uses a third-party rating in any advertisement, it must retain a copy of the questionnaire or survey *only* if it received it.

# Transition Planning

- Compliance: 18-months starts on effective date, 60 days after publication
- Break down analysis into ads and promoter arrangements
- Analyze changed requirements in relation to your practices
- Develop new templates (and checklists) for both ads and promoter arrangements
- Catalog and conform ads and promotional arrangements to new framework
- Review and revise your policies and procedures
- Update Form ADV Part 1A
- Watch for SEC and staff guidance, including regarding existing no-action guidance



# Attorney Biographies

Morgan Lewis

# Christine M. Lombardo



## **Philadelphia**

T +1.215.963.5012

F +1.215.963.5001

## **New York**

T +1.212.309.6629

F +1.212.309.6001

[christine.lombardo@morganlewis.com](mailto:christine.lombardo@morganlewis.com)

Christine Lombardo advises investment managers and broker-dealers on financial regulatory matters. She concentrates her practice on securities regulation for a broad range of financial firms including retail asset managers, private fund managers, family offices, broker-dealers, other professional traders, and high-net-worth individuals. Christine also counsels legal, compliance, and business personnel on the structure, operation, and distribution of advisory programs, including digital advisory offerings, and investment products, including hedge funds, private equity funds, venture capital funds, real estate funds, and other alternative investment products. She is admitted in New York only, and her practice is supervised by PA Bar members.

Christine also counsels financial firms through examinations by industry regulators, as well as on enforcement related matters. Before joining Morgan Lewis, she was an associate at an international law firm in New York and worked for the Division of Enforcement at FINRA.

# John J. “Jack” O’Brien



## Philadelphia

T +1.215.963.4969

F +1.215.963.5001

[john.obrien@morganlewis.com](mailto:john.obrien@morganlewis.com)

John J. “Jack” O’Brien counsels registered and private funds and fund managers in connection with organizational, offering, transactional, and compliance matters. He regularly works with a variety of different fund structures, including open-end and closed-end funds, exchange-traded funds, and hedge funds. He also counsels investment adviser and broker-dealer clients on various matters, particularly with respect to registration and disclosure, marketing regulations, pay-to-play issues, and transactions in exchange-traded funds.

# Steven W. Stone



## Washington, DC

T +1.202.739.5453

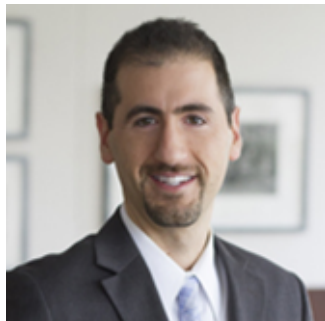
F +1.202.739.3001

steve.stone@morganlewis.com

Steven W. Stone is a securities lawyer who counsels clients on regulations governing broker-dealers, investment advisers and bank fiduciaries, and pooled investment vehicles. Head of the firm's financial institutions practice, Steve counsels most of the largest and most prominent US broker-dealers, investment banks, investment advisers, and mutual fund organizations. He regularly represents clients before the US Securities and Exchange Commission (SEC), both in seeking regulatory relief and assisting clients in enforcement or examination matters. 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 and retail clients as well as broker-dealers serving self-directed clients. In this connection, Steve has counseled numerous broker-dealers and investment advisers on the SEC's new retail advice regulations, including Regulation Best Interest and Form CRS. He also advises broker-dealers and investment advisers in the managed account or wrap fee area, and serves as counsel to the Money Management Institute, the principal trade association focused on managed accounts. Steve also counsels various institutional investment advisers and banks on investment management issues, including conflicts, trading, disclosure, advertising, distribution, and other ongoing regulatory compliance matters. He also works as counsel on various matters to the Securities Industry and Financial Markets Association's (SIFMA) and the Investment Company Institute (ICI).

Steve's practice includes counseling clients on varied regulatory and transactional matters including the development of innovative products and services; regulation and operation of managed account (or wrap fee) programs and hedge funds; trading issues affecting broker-dealers and investment advisers; soft dollar arrangements; interpretive and no-action letter requests; insider trading issues; and related matters. He guides clients through SEC, Financial Industry Regulatory Authority (FINRA), and state investigations and enforcement actions. Additionally, he counsels clients on mergers, acquisitions, and joint ventures involving broker-dealers and investment advisers.

# Joseph D. Zargari



## New York

T +1.212.309.7020

F +1.212.309.6001

joseph.zargari@morganlewis.com

Joseph D. Zargari focuses on the private investment fund industry, including the structuring, formation, governance, and regulation of and investment in US and non-US hedge funds, private equity funds, venture capital funds, managed accounts, and other products. In addition, Joe has a significant practice representing buyers, sellers, and general partners in secondary transactions (including portfolio sales of fund interests and GP-led transactions). He also provides legal, regulatory, and transactional advice for investment managers and institutional investors. Joe is the practice group leader for the New York office investment management practice.

Actively engaged in all aspects of the private funds practice, Joe's experience covers all types of private investment funds, including hedge funds, private equity funds, venture capital funds, secondary funds, real estate funds, credit funds, infrastructure funds, energy funds, funds of funds, hybrid funds, and funds of one. He counsels sponsors through all stages of product development and capital raising, including management company and fund formation, placement agent agreements, seed and lead investor arrangements, regulatory and compliance issues, and investment activities (including direct investments and co-investments). He also advises funds of funds, pension plans, endowments, family offices, and other institutions in connection with their investments in private funds.

In addition, Joe regularly represents clients engaged in secondary transactions (including traditional purchases and sales of fund interests, fund recapitalizations and restructurings, tender offers, and structured, stapled, and synthetic secondary deals) and is a frequent speaker on the subject. He advises secondary funds, institutional investors, pension plans, endowments, family offices, and other institutions in their capacities as buyers and sellers of private fund interests on the secondary market, and has counseled clients in many leading secondary transactions.

Joe has presented at a number of industry conferences on investment management-related matters, including at conferences sponsored by the Managed Funds Association and the National Association of Public Pension Attorneys, as well as at conferences sponsored by Morgan Lewis in New York, London, Chicago, Boston, and Dallas.

Joe has also published articles on fund formation, investment management, and secondary transaction matters in *Hedge Fund Legal & Compliance Digest*, HedgeFund Intelligence's *Absolute Return* magazine, PEI's *Secondaries Investor* publication, and the Morgan Lewis *Hedge Fund Deskbook*.

# Monica L. Parry



**Washington, DC**

T +1.202.373.6179

F +1.202.373.6001

[monica.parry@morganlewis.com](mailto:monica.parry@morganlewis.com)

Monica L. Parry's practice focuses on investment advisers and closed-end investment companies. Her background includes drafting and reviewing contracts and disclosure documents for wrap fee programs, drafting service contracts and registration statements, conducting mock exams, and counseling registered and unregistered advisers and funds on compliance issues.

Prior to entering private practice, Monica was a senior counsel in the Office of Chief Counsel, Division of Investment Management, US Securities and Exchange Commission. She joined that office as a staff attorney before becoming a senior counsel. Monica also served as counsel to Commissioner Richard Y. Roberts. Monica has co-authored numerous articles.

# THANK YOU

© 2021 Morgan, Lewis & Bockius LLP  
© 2021 Morgan Lewis Stamford LLC  
© 2021 Morgan, Lewis & Bockius UK LLP

Morgan, Lewis & Bockius UK LLP is a limited liability partnership registered in England and Wales under number OC378797 and is a law firm authorised and regulated by the Solicitors Regulation Authority. The SRA authorisation number is 615176.

Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP. In Hong Kong, Morgan, Lewis & Bockius is a separate Hong Kong general partnership registered with The Law Society of Hong Kong. Morgan Lewis Stamford LLC is a Singapore law corporation affiliated with Morgan, Lewis & Bockius LLP.

This material is provided for your convenience and does not constitute legal advice or create an attorney-client relationship. Prior results do not guarantee similar outcomes. Attorney Advertising.