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PERFORMANCE ADVERTISING

Impact of the New Marketing Rule: What Constitutes an "Advertisement" and How to Adhere to Principles-Based Standards (Part One of Two)

By Kasey L. Lekander, Pablo J. Man and Michael W. McGrath, *K&L Gates LLP*

On December 22, 2020, the SEC adopted its first substantive amendments (Marketing Rule) to the advertising and cash solicitation rules in Rule 206(4)-1 under the Investment Advisers Act of 1940 (the Advisers Act) since their adoption in 1961 and 1979, respectively. The new rule will have a material impact on the business practices of PE and private credit fund sponsors; the marketing of services and products to investors; and all fundraising communications related to the offering of private funds.

This two-part article series discusses particularly notable features of the Marketing Rule and identifies certain key challenges fund sponsors will face under the new rule. This first article summarizes the revised definition of "advertisement" under the Marketing Rule, as well as the principles-based standards it prescribes. The second article will explain restrictions in disclosures of non-standard performance calculations to investors, as well as requirements when using placement agents and consultants for promotional purposes.

See our three-part series on operational deficiencies in non-standard performance calculations: "Common Process Issues" (Feb. 9, 2021); "Common Recordkeeping and Disclosure Issues" (Feb. 16, 2021); and "Nuts and Bolts of Upgrading Controls" (Feb. 23, 2021).

Contextual Overview

Overview of the Marketing Rule

The Marketing Rule is intended to modernize the regulation of investment adviser advertising in light of the evolution of the industry and marketing technology since the 1960s. In addition to updating the definition of advertisement to make it more evergreen in light of current and future technologies, the Marketing Rule now encompasses communications by placement agents, solicitors and other promotors. The Marketing Rule also replaces the current broad prohibitions on advertising content with certain tailored restrictions and requirements on specific types of marketing communications – most notably performance presentations – and a principles-based anti-fraud framework for all other marketing content.

See our two-part series on navigating the new Marketing Rule: "Updated Testimonial Rule and Differences From the Proposed Advertising Rule" (Feb. 16, 2021); and

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"Form ADV Updates and Changes to Non-Standard Performance Calculations" (Feb. 23, 2021).

Effective Date and Compliance Timeline

The Marketing Rule will become effective on May 4, 2021, and firms are required to be in compliance with the rule by November 4, 2022. Advertisements disseminated on or after the compliance date will be subject to the Marketing Rule's requirements.

The transition to compliance with the Marketing Rule will be a significant undertaking for many fund sponsors, particularly given the expanded scope of the Marketing Rule beyond traditional advertising activities to expressly cover placement agents and private placement memoranda (PPMs). Most fund sponsors will need to carefully revise existing policies and prepare new policies as to the practices subject to the new rule, as well as amend existing placement agent agreements.

Some fund sponsors may consider early adoption after the effective date and before the compliance date to benefit from certain practices that will be permitted under the Marketing Rule. SEC staff has repeatedly stated, however, that an investment adviser seeking to come into early compliance must comply fully with the Marketing Rule.

Sponsors raising new funds within one year of the compliance date should consider coming into early compliance with the Marketing Rule at the beginning of the fundraising. Given that offering periods for PE funds are sometimes protracted, early compliance would enable those sponsors to avoid making material revisions to offering materials and other disruptions to the offering process before the final close.

Which Fund Sponsors Are Subject to the Marketing Rule?

The Marketing Rule will apply to all fund sponsors that are registered with the SEC under the Advisers Act. Venture capital sponsors, exempt reporting advisers and non-U.S. fund sponsors relying on the foreign private adviser exemption are not subject to the rule. Communications by those sponsors remain subject, however, to the general antifraud provisions of Section 206 of the Advisers Act and to the prohibitions in Rule 206(4)-8 under the Advisers Act, which apply to "any adviser to a pooled investment vehicle."

See "Notable SEC Examination Methods and Substantive Focus Areas for Exempt Reporting Advisers and Tips for Avoiding Violations (Part Two of Two)" (Jul. 28, 2020).

What Is an Advertisement?

The first step to understanding the implications of the Marketing Rule for fund sponsors is identifying the communications are subject to the Marketing Rule. Only communications that are advertisements are subject to the rule; however, the definition of advertisement includes many communications that are not traditionally considered advertising and includes most communications to prospective investors during the fundraising process.

Revised Definition

The Marketing Rule defines advertisement in two prongs; the first includes communications traditionally considered investment adviser advertising, as well as marketing

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communications in connection with the offering of interests in private funds. In its entirety, the first prong defines advertisement to include:

> any direct or indirect communication an investment adviser makes to more than one person, or to one or more persons if the communication includes hypothetical performance, that offers the investment adviser's investment advisory services with regard to securities to prospective clients or investors in a private fund advised by the investment adviser or offers new investment advisory services with regard to securities to current clients or investors in a private fund advised by the investment adviser. . . .

The second prong includes compensated testimonials and endorsements by third parties that are currently treated as solicitations under the solicitation rule. That prong defines an advertisement to also include:

> any endorsement or testimonial for which an investment adviser provides compensation, directly or indirectly, but does not include any information contained in a statutory or regulatory notice, filing, or other required communication, provided that such information is reasonably designed to satisfy the requirements of such notice, filing, or other required communication. . . .

Most private fund sponsors already take into account the current requirements of the advertising rule and related SEC guidance in their marketing communications. The new definition of advertisement explicitly includes, however, promotional communications disseminated to prospective investors in private funds. Therefore, it expressly applies both the principles-based framework and new specific restrictions and requirements of the Marketing Rule on fund marketing materials.

Specifically, communications subject to the Marketing Rule are not limited to traditional "pitch books," but also include standardized request for proposal (RFP) responses and promotional material posted to data rooms. Further, although information contained in a PPM on material terms, objectives and risks of a fund offering would generally not be considered an advertisement, PPM content that promotes the fund or the adviser – *e.g.*, descriptions of the market opportunity and related fund performance – will be subject to the Marketing Rule.

Excluded Communications

Although the SEC has broadly defined advertisement, certain communications are excluded from treatment as advertisements under the Marketing Rule. Although the categories of communications are excluded from the definition of advertisement, they remain subject to the general antifraud provisions of the Advisers Act and other applicable federal securities laws.

One-on-One Communications

Consistent with the current rule, one-on-one communications with prospective investors are excluded from the definition of advertisement. Template or standardized information included in one-on-one communications (including RFPs and pitch decks) would not be considered a "one-on-one" communication, however. Therefore, simply addressing a pitch book or even sending an email to a single recipient

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would not avoid application of the Marketing Rule if the content therein is drawn from template, standard or otherwise recycled content.

Market Commentary and White Papers

SEC staff confirmed in the Marketing Rule's adopting release that it would not consider general market commentary and educational materials advertisements subject to the rule. Material would be considered an advertisement, however, if it discusses the products or services of a fund sponsor or otherwise promotes the sponsor.

Extemporaneous, Live, Oral Communications

The definition of advertisement excludes extemporaneous, live, oral communications, regardless of whether they are broadcast. Prepared remarks and speeches, however, such as those delivered from scripts, as well as slides or other written materials distributed to an audience in connection with a presentation, are not excluded if they otherwise meet the definition of an advertisement.

Likewise, further distribution of a recorded oral communication that otherwise would be an advertisement would not be excluded. Notably, the exclusion is not available to extemporaneous, live, written communications, such as texts or electronic chats.

See "Understanding OCIE's Focus on Electronic Communications, Liquidity-Related Issues and Affiliate Transactions (Part Two of Two)" (Dec. 15, 2020).

Reporting to Existing Private Fund Investors

Importantly, the SEC clarified in the final Marketing Rule that statements to existing investors that do not offer new investment advisory services are not advertisements. For fund sponsors, that means that reporting to, and discussions with, existing LPs will not be considered advertisements unless the communications are in connection with an offering of fund interests.

See "The Dos and Don'ts of Investor Calls That Investment Managers Must Consider" (Jun. 16, 2020).

Information in Mandatory Notices and Filings

Information included in a regulatory filing, such as Form ADV, that is reasonably designed to satisfy the fund sponsor's obligations under the filing will not be considered advertising.

Indirect Communications

Advertisements include "indirect" communications to prospective LPs, which includes information provided by a fund sponsor to intermediaries for use with prospective investors – *e.g.*, performance or portfolio information provided to platform providers, funds of funds and third-party dedicated feeder funds – even if the ultimate marketing materials were not actually prepared or distributed by the fund sponsor. In addition, a fund sponsor could be responsible for materials distributed by a consultant or third-party feeder fund when the fund sponsor has participated in the creation of, or otherwise authorized or endorsed, the materials.

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See our two-part series on closed-end funds of PE funds: "Relative Merits of Registration Options and an Infinite-Life Structure" (Jun. 2, 2020); and "Considering Bespoke Valuation, Co-Investment, Director and Tax Issues" (Jun. 16, 2020).

Consequently, although the Marketing Rule does not expressly require a fund sponsor to oversee all intermediary marketing activities, fund sponsors are generally responsible for ensuring all marketing communications attributed to them comply with the Marketing Rule, even when the fund sponsors did not directly create or disseminate the materials. Fund sponsors that currently use a "negative consent" process to approve marketing materials created by feeder fund platforms, consultants and other intermediaries (for use with their own clients and investors) should consider implementing tighter controls on those materials, such as ensuring the negative consent period allows sufficient time for the sponsor to review the materials.

Testimonials

A final key takeaway for fund sponsors is that the definition of advertisement now includes compensated testimonials, endorsements and other solicitation activities by third parties. "Testimonials" are defined to include statements by current clients or private fund investors about their experience with a fund sponsor. Further, "endorsements" include statements by a person other than a current client or private fund investor that indicate approval, support or a recommendation of the sponsor, or which describes the person's experience with the sponsor. That could include, for example, statements from portfolio company management extolling the benefits of working with the fund sponsor.

A testimonial or endorsement would be considered "compensated" if provided in exchange for any cash compensation or non-cash benefit. Non-cash benefits could include, for example, fee waivers or reductions; gifts and entertainment; or preferential co-investment opportunities. The SEC specifically declined to define what may or may not be considered indirect compensation, and the term will likely be subject to broad interpretation.

Principles-Based Content Standards

The Marketing Rule replaces the current advertising rule's broad prohibitions on past specific recommendations and testimonials with a more flexible and adaptable principles-based approach to advertising content that recognizes the wide range of sophistication among investors and allows fund sponsors to tailor content accordingly.

Conduct to Avoid

In the place of inflexible prohibitions on practices such as the presentation of case studies, the Marketing Rule includes the following principles-based prohibitions:

- making an untrue statement of material fact, or omitting a material fact necessary to render a statement not misleading;
- making a material claim or statement that is unsubstantiated;
- including information that would be reasonably likely to cause an untrue inference or implication to be drawn about a material fact;
- discussing potential benefits without a fair and balanced discussion of associated material risks or other limitations;

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- referring to specific investment advice provided by the adviser that is not presented in a fair and balanced manner;
- including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced; and
- being otherwise materially misleading.

See "How the Proposed Amendments to the SEC Advertising Rule Would Affect PE Managers" (Jan. 14, 2020).

Whether an advertisement runs afoul of those prohibitions generally depends on the facts and circumstances, but fund sponsors should continue to be mindful of advertisements that:

- highlight positive performance, or include case studies reflecting favorable results, without providing appropriate contextual or other relevant information to make the discussion of the results fair and balanced;
- make material claims that the fund sponsor does not believe it could substantiate upon request in an SEC examination;
- make a series of statements that are literally true when read individually, but the overall effect of which creates an untrue or misleading implication about the adviser;
- present performance results over a selective period of time, or inconsistent periods of time, that are not reflective of the fund sponsor's overall results; or
- make unsupportable claims about the past or future performance or profitability of the fund sponsor's investments.

In short, although the Marketing Rule provides more flexibility, particularly around the discussion of specific portfolio companies and case studies, fund sponsors must continue to exercise good judgment when considering what information to share in advertisements, and how that information is presented.

Key Takeaways for Fund Sponsors

Under the existing advertising rule and no-action letter guidance, fund sponsors are constrained to showing information related to past investments in very limited ways. In a welcome evolution of the SEC's current approach, the Marketing Rule significantly liberalizes the use of case studies by fund sponsors, provided they are presented in a manner that is "fair and balanced."

To meet the standards in the Marketing Rule, fund sponsors should ensure the communication does not "cherry pick" the sponsor's best investments and provides sufficient information and context for investors to evaluate the merits of past investments. For example, highlighting the internal rate of return of a single successful portfolio company exit without disclosing the overall performance of the portfolio generally would not be fair and balanced. The SEC noted that existing no-action relief may provide useful guidance as to whether a communication is fair and balanced, but reliance on existing relief is not the sole means of satisfying the fair and balanced standard.

As noted above, whether information is presented in a fair and balanced manner depends on the facts and circumstances surrounding the communication, including the nature and sophistication of the audience. The SEC and its staff recognize that sophisticated institutional investors are likely to understand the limitations and risks associated with certain

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practices (*e.g.*, case studies) and therefore may require less disclosure to render a discussion fair and balanced as compared to a retail investor.

See "Policy Considerations and Next Steps for Fund Managers From the Revised Accredited Investor Standards" (Oct. 6, 2020).

Finally, SEC staff has historically taken the position that disclosures must be contained within the four corners of a communication to be effective. In acknowledgment of today's use of electronic materials such as data rooms, however, the Marketing Rule permits "layered" disclosure, including hyperlinked disclosure, in certain circumstances. The adopting release explicitly notes, however, that for content such as case studies that must be presented in a fair and balanced manner, each layer of disclosure must itself be fair and balanced – *i.e.*, material contextual information cannot be buried in multiple layers of disclosure.

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PERFORMANCE ADVERTISING

Impact of the New Marketing Rule: Disclosures in Non-Standard Calculations and Requirements When Using Promoters (Part Two of Two)

By Kasey L. Lekander, Pablo J. Man and Michael W. McGrath, *K&L Gates LLP*

The SEC's amendments to Rule 206(4)-1 under the Investment Advisers Act of 1940 created a single rule (Marketing Rule) governing registered investment advisers' advertising and cash solicitation arrangements. The Marketing Rule introduces several new obligations for investment advisers marketing their services and products to investors, in some cases regardless of investor sophistication. Most notably, it will require reforms of almost all fundraising communications when offering private funds, including by placement agents or other intermediaries.

The Marketing Rule will become effective on May 4, 2021, and firms are required to be in compliance with the rule by November 4, 2022. This two-part article series discusses facets of the Marketing Rule of particular import to fund sponsors and identifies certain key challenges they will face when becoming compliant with the new rule.

This second article details restrictions in how certain non-standard performance calculations are disclosed to current and prospective investors, as well as the Marketing Rule's requirements for using placement agents and consultants for promotional purposes. The first article described the revised definition of "advertisement" under the Marketing Rule, as well as the principles-based standards it prescribes.

See our two-part series on navigating the new Marketing Rule: "Updated Testimonial Rule and Differences From the Proposed Advertising Rule" (Feb. 16, 2021); and "Form ADV Updates and Changes to Non-Standard Performance Calculations" (Feb. 23, 2021).

Investment Performance

Non-Standard Performance Restrictions

Broadly speaking, the Marketing Rule prohibits presenting any performance results unless they are provided for one-, five- and ten-year time periods. Although that requirement does not apply to the performance results of a private fund, it is applicable where PE managers use the performance results of a strategy to market to prospective managed account clients or to fund-of-one investors, including institutional clients and investors.

See our three-part series on operational deficiencies in non-standard performance calculations: "Common Process Issues"

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(Feb. 9, 2021); "Common Recordkeeping and Disclosure Issues" (Feb. 16, 2021); and "Nuts and Bolts of Upgrading Controls" (Feb. 23, 2021).

Beyond that general requirement, the Marketing Rule also includes the following restrictions on performance presentations commonly used by fund sponsors.

Gross Performance

Gross performance results (including hypothetical performance and extracted performance presented on a gross basis) may only be presented if the advertisement also presents net performance results:

1. with at least equal prominence to, and in a format designed to facilitate comparison with, the gross performance results; and
2. calculated over the same time period, and using the same type of return and methodology, as the gross performance results.

See "Distorting Alpha: How Omitted Inputs and Deferred Carry Can Inflate IRR Calculations (Part One of Three)" (Sep. 10, 2019).

Related Performance

Performance results of funds or other portfolios similar to an offered fund or strategy may only be presented if the related performance includes all funds or portfolios with substantially similar investment policies, objectives and strategies as those of the fund or strategy being offered in the advertisement. One or more portfolios may be excluded from the performance presentation, however, if the exclusion does not materially improve the performance.

Extracted Performance

Performance results of a subset of investments extracted from a portfolio (commonly known as a "carve-out" or "segmented" performance), may only be shown if the advertisement provides or offers to promptly provide the performance results of the total portfolio from which the performance was extracted. Total portfolio performance could be hyperlinked in a layered disclosure as well.

"Track-record" performance of investments extracted from a multiple portfolios, however, are considered "hypothetical performance" and receive separate treatment, as discussed below.

Hypothetical Performance

The Marketing Rule defines hypothetical performance to include target, projected and most track record performance commonly used by fund sponsors. In light of the SEC's view of the limitations and high level of risk associated with presenting hypothetical performance, the Marketing Rule includes enhanced requirements in connection with its use. In particular, a fund sponsor may not include hypothetical performance in advertisements unless the sponsor:

- adopts and implements policies and procedures reasonably designed to ensure the hypothetical performance is relevant to the likely financial situation and investment objectives of prospective LPs;
- provides sufficient information to enable prospective LPs to understand the criteria used and assumptions made when calculating the hypothetical performance; and
- provides or offers to promptly provide prospective LPs sufficient information

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to enable them to understand the risks and limitations of using hypothetical performance when making investment decisions.

See "Distorting Alpha: How Curated Past Performance Results Can Produce Misleading IRRs (Part Three of Three)" (Sep. 24, 2019).

Key Takeaways for Fund Sponsors

Net Performance

As noted above, a fund sponsor may not present any gross performance unless it also includes net performance with at least equal prominence and in a format designed to facilitate comparison with gross performance. That requirement applies to all gross performance presentations, including those prepared for institutional clients and case studies.

"Net performance" is defined to mean performance results after the deduction of all fees and expenses that a client or investor has paid or would have paid in connection with the fund sponsor's advisory services to the assets shown. Expenses and fees to be considered when preparing net performance include payments by the fund sponsor for which the fund reimburses the sponsor, as well as fees and expenses payable to underlying funds or vehicles.

On the other hand, administrative fees and expenses the fund sponsor agrees to bear as a result of negotiations with LPs in a private fund, or expenses that an LP has agreed to bear directly, do not need to be included in the calculation of net performance (at least when marketing advisory services). Capital gains taxes paid outside of the portfolio likewise would not need to be included in net performance.

Most notably for fund sponsors, "advisory fees" include carried interest distributions and other performance-based compensation, which need to be deducted in net performance presentations. That requirement poses a challenge when seeking to present the internal rates of return (IRRs) and multiples on invested capital (MOICs) for individual portfolio companies because carried interest is typically charged only after a fund-level hurdle rate has been exceeded, rather than on an investment-by-investment basis.

For more on calculating hurdle rates, see "How Different Waterfalls Affect GP Receipt of Carried Interest (Part One of Two)" (Jun. 4, 2019).

Fund sponsors typically address that issue by presenting a table showing the gross IRRs of fund investments, the gross IRR of the fund and the net IRR of the fund. It is unclear whether that convention meets the "equal prominence" standard in the Marketing Rule, and that is a likely topic for interpretive guidance from SEC staff in the coming months and years.

Target and Projected Performance

Fund sponsors frequently include target returns of the offered fund, as well as projected returns of related funds and specific investments held in related funds, in their offering materials. Hypothetical performance is defined to specifically include those target or projected performance returns. That means the enhanced requirements related to the use of hypothetical performance will apply to statements about target or projected IRR or MOIC, even if the fund sponsor does not include backtested, track record or other more traditional forms of hypothetical performance in advertisements.

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Of particular concern is the requirement to adopt policies and procedures to ensure that hypothetical performance is relevant to the likely financial situation and investment objectives of prospective LPs. Unlike traditional investment advisory materials, which may be created after the adviser has discussions with a prospective client to learn its financial situation and investment objectives, fund marketing materials are drafted before an offering without knowledge of the situations and objectives of each prospective LP that may ultimately receive them.

The SEC recognized that dilemma and stated in the adopting release that fund sponsors and other private fund managers would not be subject to an express obligation to inquire into the specific financial situation and investment objectives of each potential recipient. Instead, the SEC permits fund sponsors to develop policies and procedures that take into account its experience with LPs in predecessor fund offerings, and whether prospective LPs in those offerings valued a particular type of hypothetical performance.

Treatment of Placement Agent and Consultant Activities

The Marketing Rule's requirements reach the activities of current "solicitors" under the solicitation rule, as well as a new, broader group of other "promoters." Notably for fund sponsors, the SEC expanded the application of the Marketing Rule to cover the solicitation of private fund investors (rather than just direct advisory clients). As a result, placement agents, consultants, capital introduction groups and other parties involved in marketing a PE fund to prospective LPs will be considered promoters in most cases.

Fund sponsors need to examine their relationships with those parties to determine:

- whether compensation is paid directly or indirectly (*e.g.*, through reduced or waived fees, gifts and entertainment) for their services;
- how to exercise and demonstrate sufficient oversight over those promoters to ensure their communications are consistent with the Marketing Rule; and
- whether amendments to existing agreements are necessary to comply with the Marketing Rule.

See "Marketing to Public Pension Plans: Honest Services Fraud, Use of Placement Agents and Lobbyist Registration Issues (Part Two of Two)" (Jun. 4, 2019); and "Current Scope of PE-Specific Side Letter Provisions: Industry Trends, Excusal Rights and Placement Agent Representations (Part One of Three)" (Mar. 19, 2019).

Solicitation Requirements

Compensated solicitation activities under the Marketing Rule, as well as uncompensated testimonials that are distributed directly by a fund sponsor, are generally subject to the following requirements.

Clear and Prominent Disclosure

For advertisements that contain testimonials or endorsements, fund sponsors must disclose, or reasonably believe the person giving the testimonial or endorsement discloses, the following in a clear and prominent manner upon distribution to a prospective LP:

- that the testimonial was given by a current client or LP, or that the endorsement was given by a person other than a current client or LP, as applicable;

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- that cash or non-cash compensation was provided for the testimonial or endorsement, if applicable; and
- a brief statement of any material conflicts of interest of the person giving the testimonial or endorsement resulting from the fund sponsor's relationship with such person.

Other Disclosures

Fund sponsors must also disclose the following information to recipients of testimonials and endorsements:

- the material terms of any compensation arrangement, including a description of the compensation provided or to be provided, directly or indirectly, to the person for the testimonial or endorsement; and
- a description of any material conflicts of interest of the person giving the testimonial or endorsement resulting from the fund sponsor's relationship with that person and any compensation arrangement.

To be clear, those disclosures are not subject to the "clear and prominent" standard and may be provided through hyperlinks or other means of layered disclosure.

Oversight by Fund Sponsor

All testimonials and endorsements are subject to enhanced oversight and compliance requirements. Specifically, the fund sponsor must have:

- a reasonable basis for believing the testimonial or endorsement complies with the Marketing Rule's requirements; and
- a written agreement with any person giving a compensated testimonial or endorsement that (1) describes the scope of the agreed-upon activities; and (2) sets forth the terms of the compensation, direct or indirect, for those activities, where the compensation exceeds $1,000 over a 12-month period.

Disqualification

The Marketing Rule prohibits a fund sponsor from directly or indirectly compensating a person for a testimonial or endorsement if the sponsor knows, or reasonably should know, that the person giving the testimonial or endorsement is subject to certain disqualification provisions of the Marketing Rule. The disqualification provision does not apply to uncompensated testimonials or endorsements.

Excluded Promoters

Statements by certain categories of promoters are excluded from certain requirements of the Marketing Rule.

Affiliated Personnel

Although a testimonial or endorsement by an employee or other affiliate of a fund sponsor is not subject to the disclosure requirements or the written agreement requirement, it does remain subject to the disqualification and general oversight requirements discussed above. The affiliation between the fund sponsor and that individual must be readily apparent to or disclosed to the prospective LP at the time the testimonial or endorsement is disseminated, and the sponsor must document that person's status.

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Broker-Dealers

A testimonial or endorsement by a broker or dealer registered under Section 15(b) of the Securities Exchange Act of 1934 (Exchange Act) is not required to comply with:

- any disclosure requirements if the testimonial or endorsement is a "recommendation" subject to Regulation Best Interest;
- the "other disclosure" requirements if the testimonial or endorsement is provided to a person that is not a retail customer (as that term is defined in Regulation Best Interest); and
- the disqualification provision if the broker or dealer is not subject to statutory disqualification under the Exchange Act.

See "SEC Chair Defends Regulation Best Interest and Investment Adviser Fiduciary Duty" (Sep. 10, 2019).

Covered Persons Under Rule 506(d) of Regulation D

A testimonial or endorsement by a person covered by Rule 506(d) of the Securities Act of 1933 (the "bad actor" provision) for a fund offered pursuant to Rule 506, and whose involvement would not disqualify the offering under Rule 506, is also excluded from the disqualification provision.

As a practical matter, that means placement agents that are not broker-dealers, including banks and other intermediaries like registered investment advisers and family offices, do not have the burden of complying with two different standards of disqualification when recommending private funds offering interests pursuant to Rule 506 of Regulation D.

Key Takeaways for Fund Sponsors

Negotiating Written Agreements

As discussed above, the Marketing Rule requires the written agreement between a fund sponsor and a promoter (*e.g.*, a placement agent or consultant) to:

1. describe the scope of the agreed-upon activities; and
2. set forth the terms of compensation for those activities, including non-cash compensation that could be construed as indirect compensation under the Marketing Rule.

The agreements should be drafted to enable the fund sponsor to satisfy its requirement to oversee the placement agent or consultant and to form a reasonable basis for believing any testimonial or endorsement created by the placement agent or consultant under the agreement complies with the Marketing Rule. Although most placement agent agreements already set forth the scope of activities and compensation, fund sponsors should carefully review, and if necessary, renegotiate their existing agreements to facilitate the Marketing Rule's oversight provisions.

When crafting arrangements and agreements, fund sponsors should consider specifying the respective roles and responsibilities of the sponsor and the placement agent or consultant regarding creation, review and delivery of required disclosures to prospective LPs. The documentation should also specify how to document any circumstances that may allow endorsements by the placement agent or consultant to qualify for exemptions under the Marketing Rule.

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Further, fund sponsors should consider including representations, warranties and covenants requiring placement agents or consultants to periodically provide, or provide upon request, sample endorsements and related disclosures for the fund sponsors' review. Provisions should also be included that require the placement agent or consultant to notify the sponsor of any change in eligibility status or other material terms of the promoter's compliance with the agreement.

Direct or Indirect Compensation

Fund sponsors should consider whether they provide any benefits to other participations in the PE industry that may be considered direct or indirect compensation for endorsements or testimonials.

Business relationships with institutional investment consultants, LPs, operating partners or portfolio company management could be characterized as the basis for a compensated testimonial or endorsement if there is an express or implicit expectation that any compensation or other benefit – even gifts and entertainment – is provided in exchange for testimonials and endorsement.

See "Compliance Considerations for PE Firms Engaging Operating Partners" (May 14, 2019); and "SEC Fines PE Sponsor for Passing Operating Partner Expenses Through to Investors Without Adequate Disclosure" (Jun. 9, 2020).

Fund sponsors and LPs alike should consider whether LPs' statements about a fund sponsor would be considered testimonials subject to the Marketing Rule (even if not compensated) and, if so, how a fund sponsor may form a reasonable belief that any such testimonials comply with the Marketing Rule.

Final Thoughts

Although the Marketing Rule introduces significant changes to the rules surrounding investment adviser advertising and will expressly regulate communications offering interests in private funds, many fund sponsors already comply with the anti-fraud themes of the existing advertising rule and related SEC staff guidance. Consequently, many fund sponsors will benefit from the liberalization of the treatment of case studies; that benefit will be outweighed, however, by the practical implications of the Marketing Rule's new prescriptive requirements.

Fund sponsors should be focused on performance presentations, in particular track record, target and projected performance, as well as relationships with placement agents and consultants, which will require increased oversight and disclosure considerations. In addition, the SEC's express position that the Marketing Rule extends to many sections of private placement memoranda will likely result in deeper involvement by compliance departments in the drafting and distribution of offering documents.

Fund sponsors of all sizes should perform reviews of their policies and procedures well in advance of the compliance date to ensure they are prepared to come into full compliance with the Marketing Rule. To avoid disruptions in the fundraising process, many sponsors will want to come into compliance at the beginning of a fundraising.

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