

Morgan Lewis

THE SEC'S NEW MARKETING RULE

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The SEC's New Marketing Rule

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SEC Marketing Rule Initiative



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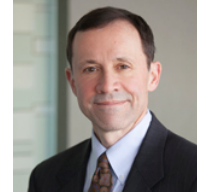
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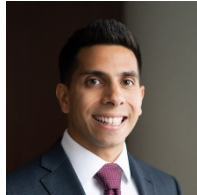
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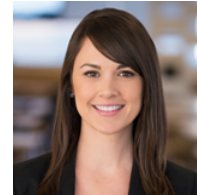
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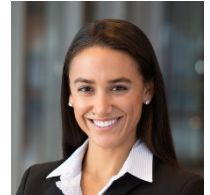
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Introduction and Key Changes

- 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 representations 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- Certain staff no-action letters will be rescinded – a list will be posted on the SEC’s website.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 or more persons 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

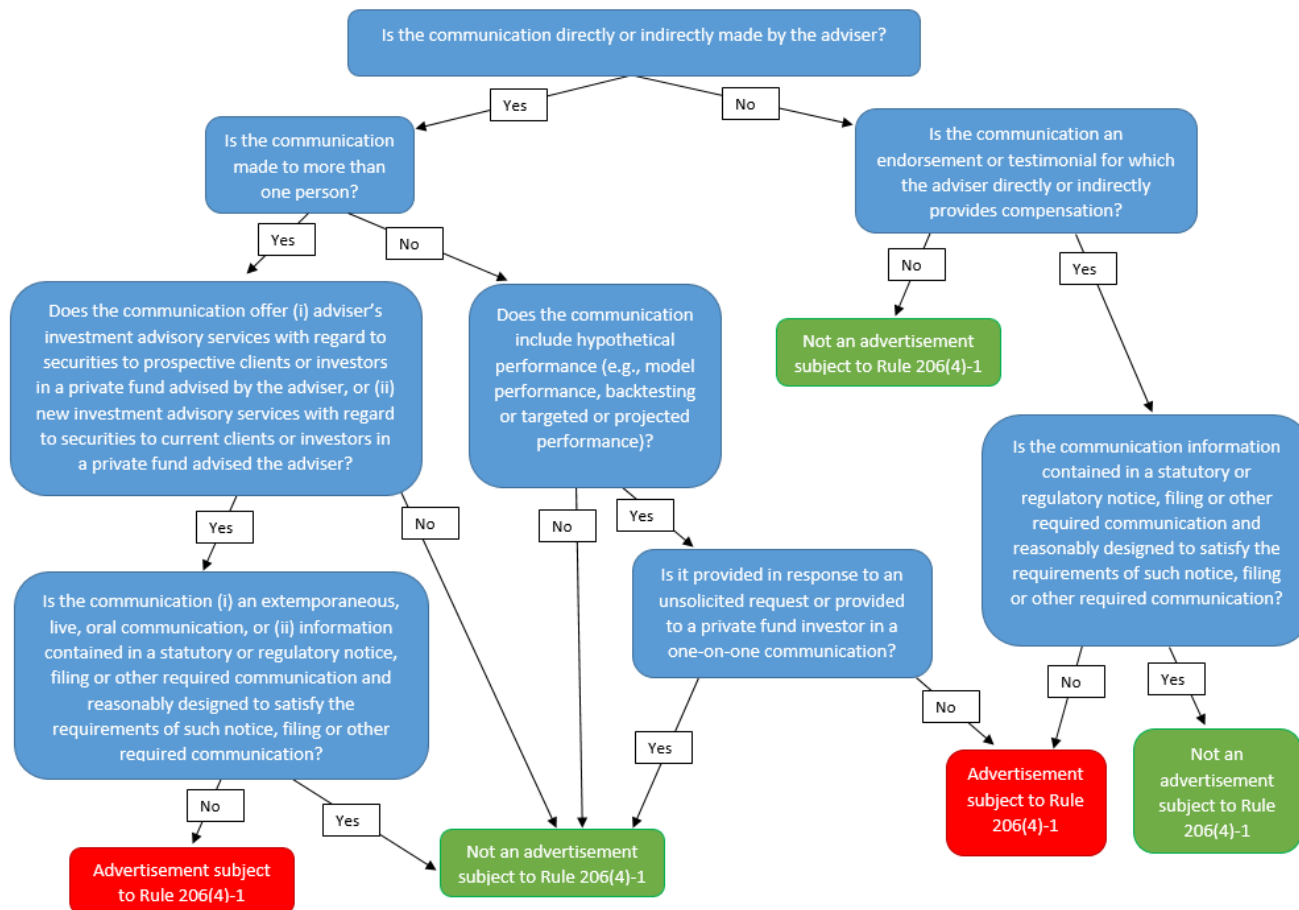
That offers (i) adviser's investment advisory services with regard to securities to prospective clients or investors in a *private fund* advised by the adviser or (ii) new investment advisory services with regard to securities to current clients or investors in a *private fund* advised by the adviser

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 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?



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 fair and balanced manner.

7

Otherwise materially misleading information.

Testimonials and Endorsements: Key Definitions

- *Testimonial* means any statement by a current client or investor in a *private fund* advised by the adviser:
 - About the client or investor's experience with the adviser or its supervised persons
 - That directly or indirectly solicits any current or prospective client or investor to be a client of, or an investor in a *private fund* advised by, the adviser
 - That refers any current or prospective client or investor to be a client of, or an investor in a *private fund* advised by, the adviser
- *Endorsement* means any statement by a person other than a current client or investor in a *private fund* advised by the adviser that:
 - Indicates approval, support, or recommendation of the adviser or its supervised persons or describes that person's experience with the adviser or its supervised persons
 - Directly or indirectly solicits any current or prospective client or investor to be a client of, or an investor in a *private fund* advised by, the adviser
 - Refers any current or prospective client or investor to be a client of, or an investor in a *private fund* advised by, the adviser

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 *testimonial* or *endorsement* giver discloses, at the time the *testimonial* or *endorsement* is disseminated (time of dissemination):
 - 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 with the giver;
 - Material terms of any compensation arrangement, including a description of compensation directly or indirectly to giver
 - Description of any material conflicts of giver resulting from adviser's relationship with giver and compensation arrangement
 - *Adviser oversight and compliance* – Adviser must have:
 - Written agreement with *testimonial* or *endorsement* giver that describes the scope of agreed-on activities and terms of compensation
 - Reasonable basis for believing that the *testimonial* or *endorsement* 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 for matters occurring before Rule publication if not disqualify from reliance on Cash Referral Fee Rule

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 is 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 and Endorsements: Disciplinary Definitions

Ineligible person means a person subject to a *disqualifying Commission action* or is subject to any *disqualifying event*, and the following persons with respect to the *ineligible person*:

- Any employee, officer, or director of the *ineligible person* and any other individuals with similar status or functions within the scope of association with the *ineligible person*
- If the *ineligible person* is a partnership, all general partners
- If the *ineligible person* is a limited liability company managed by elected managers, all elected managers

Exclusions – A *disqualifying event* does not include an event described in the rule as to a person subject to:

- An order pursuant to section 9(c) of the Investment Company Act of 1940 with respect to such event
- An SEC opinion or order for such event that is not a *disqualifying Commission action*, if for each applicable order or opinion:
 - The person is in compliance with the terms of the order or opinion, including, but not limited to, the payment of disgorgement, prejudgment interest, civil or administrative penalties, and fines; and-
 - For a period of 10 years following the date of each order or opinion, the advertisement containing the *testimonial* or *endorsement* must include a statement that the person providing the testimonial or endorsement is subject to an SEC order or opinion regarding one or more disciplinary action(s), and include the order or opinion or a link to the order or opinion on the SEC's website.



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 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.

Form ADV Amendments

- SEC is adding Item 5L to Form ADV Part 1A, and six new definitions to the Glossary.
- Item 5L will require “yes” or “no” answers, and ask:
 1. Whether an adviser’s advertisements contain performance results, a reference to specific investment advice, hypothetical performance, predecessor performance, testimonials, endorsements, or third-party ratings.
 2. If the adviser pays or otherwise provides cash or non-cash compensation, directly or indirectly, in connection with the use of testimonials, endorsements, or third-party ratings.
- Form ADV Item 5 does not generally require an “other-than-annual” (prompt) amendment.

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

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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.

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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.

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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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.

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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.

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Brian J. Baltz focuses his practice on the regulation of investment advisers, broker-dealers, and bank fiduciaries. Brian counsels clients offering investment advice and brokerage services through their private wealth and private client businesses on issues arising under regulation by the Securities and Exchange Commission (SEC), Financial Industry Regulatory Authority (FINRA), and Office of the Comptroller of the Currency (OCC). Brian advises investment advisers, broker-dealers, and banks on investment management issues, including conflicts, disclosure, trading, wrap fee programs, soft dollar arrangements, advertising, and other ongoing regulatory compliance matters.

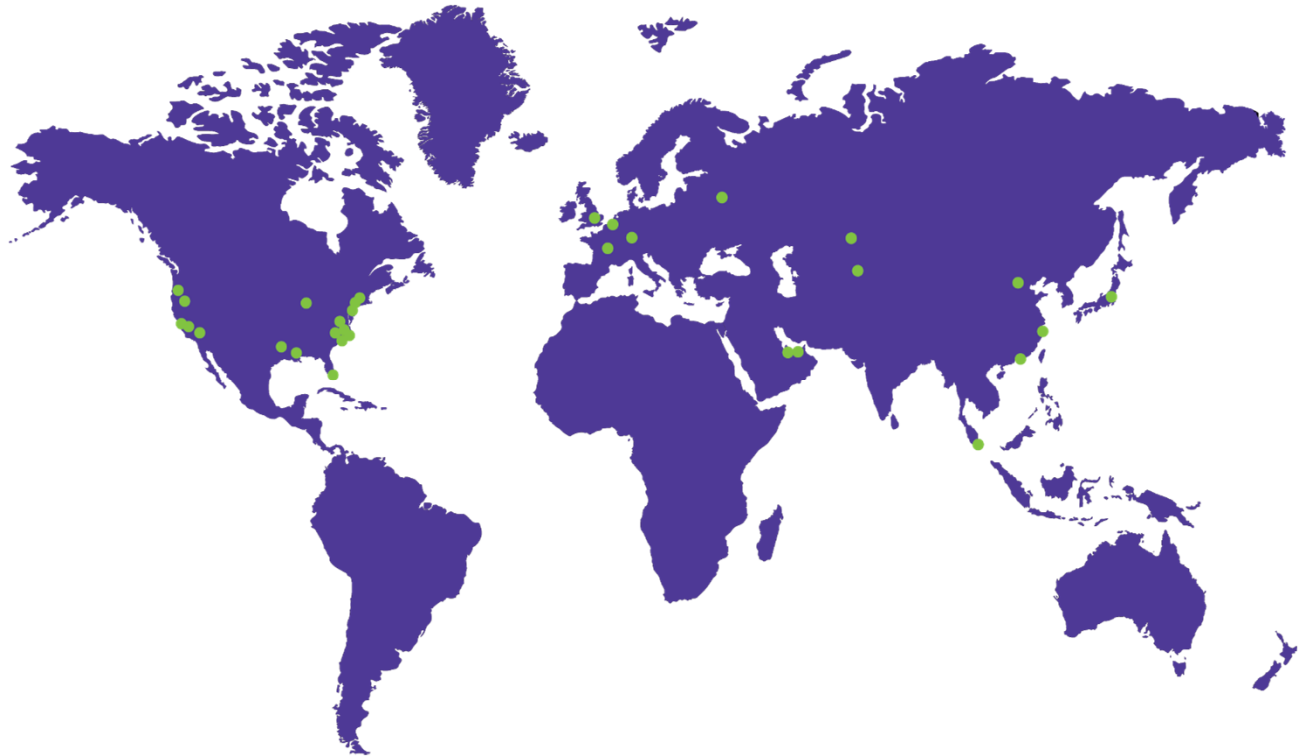
Before joining Morgan Lewis, Brian held multiple positions in the SEC's Division of Trading and Markets, including in the Office of Chief Counsel and Office of Market Supervision. While in the Office of Chief Counsel, he was part of the team responsible for drafting a proposed rule to establish a uniform standard of conduct for broker-dealers and investment advisers. Prior to his work at the SEC, Brian was public policy counsel to a financial services industry trade association based in Washington, DC, where he worked on legislative and regulatory issues impacting broker-dealers and investment advisers, including the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Abu Dhabi
Almaty
Beijing*
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
Moscow
New York
Nur-Sultan
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