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Private Equity Compliance Update: Conflicts of Interest, Fees and Expenses, Nonpublic Information, and the New Marketing Rule

Current SEC Focus and What to Expect From the Incoming Administration

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Today's faculty features:

Justin L. Browder, Partner, **Willkie Farr & Gallagher**, Washington, D.C.

Anne C. Choe, Partner, **Willkie Farr & Gallagher**, Washington, D.C.

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Private Equity Compliance Update: Conflicts of Interest, Fees and Expenses, Nonpublic Information, and the New Marketing Rule

Justin L. Browder | Anne C. Choe

February 25, 2021

Agenda

I. OCIE Regulation of PE funds by the Division of Examinations generally: types of funds and activities subject to examination
II. Highlights from recent Risk Alert
   A. Conflicts of interest
   B. Fees and expenses
   C. Restricting the use of MNPI
III. Other compliance issues
IV. What to expect from the Biden administration
V. Marketing Rule
   A. Expanded Definition of Advertisement
   B. Performance Advertising
   C. Endorsements and Testimonials

Division of Examinations (formerly OCIE)

- The Division of Examinations ("Division") conducts the SEC's exam program. The Division's mission is to protect investors, ensure market integrity and support responsible capital formation through risk-focused strategies.
- The Private Funds Unit ("PFU") is the dedicated arm of the Division focused on examining advisers of private funds, including private equity advisers. The PFU identifies risk areas, conducts examinations, and analyzes the data produced from those examinations.
  - Types of Funds – private equity, venture capital, hedge funds, real estate funds, CLOs
  - Activities subject to examination:
    - Disclosure practices
    - Fee practices
    - Compliance policies and procedures
    - Expenses and expense allocation
    - Co-investment allocation
    - Conflicts of interest

Observations from Examinations of Investment Advisers Managing Private Funds

Overview

- The Division published a Risk Alert on June 23, 2020, offering its observations and guidance for registered investment advisers that manage private equity funds or hedge funds.
- The Risk Alert addresses compliance deficiencies in three general areas:
  - Conflicts of interest;
  - Fees and expenses; and
  - Policies and procedures relating to material non-public information ("MNPI").
- The specific issues that the Division addresses have been the subject of numerous SEC enforcement actions since the adoption of the Dodd-Frank Act, and include investment and expense allocation, coinvestment opportunities, and the use of affiliated services providers by funds and portfolio companies.

Conflicts of Interest

- Under Section 206 of the Advisers Act, an investment adviser must either eliminate or make full and fair disclosure of all conflicts of interest that may induce the adviser to provide clients with advice that is not disinterested.
  - Full and fair disclosure should be sufficiently specific, such that a client is able to understand the material fact or conflict of interest and make an informed decision on whether to provide consent.
- Rule 206(4)-8 under the Advisers Act prohibits investment advisers from:
  - Making any materially untrue statements or omissions to any investor or prospective investor in a pooled investment vehicle; or
  - Engaging in fraud, deceit, or manipulation with respect to any investor or prospective investor in a pooled investment vehicle.
- The Division highlights several conflicts of interest that appeared to be disclosed inadequately under these provisions in its risk alert.

Conflicts of Interest

- Conflicts related to allocations of investments
  - Advisers did not adequately disclose conflicts relating to allocations of investments among clients.
    - Limited investment opportunities were preferentially allocated to new clients, higher fee-paying clients, or proprietary accounts or proprietary-controlled clients.
    - Securities were allocated at different prices or “inequitable amounts” among investors with either inadequate disclosure about the allocation process or in a manner inconsistent with the disclosed allocation process.
- Conflicts related to multiple clients investing in the same portfolio company
  - Advisers did not adequately disclose conflicts caused by investing client funds at different levels of a portfolio company’s capital structure.
- Conflicts related to financial relationships between investors or clients and the adviser
  - Advisers did not adequately disclose economic relationships between themselves and select investors or clients.

Conflicts of Interest

- Conflicts related to preferential liquidity rights
  - Advisers did not adequately disclose the existence of side letters that provided for preferential liquidity terms.
- Conflicts related to private fund adviser interests in recommended investments
  - Advisers did not adequately disclose their preexisting ownership interests or other financial interests (including, but not limited to, referral fees and stock options) in investments recommended to clients.
  - Notable Enforcement Actions: *In re Fortress Investment Management, LLC* (Feb. 27, 2020); *In re Sica Wealth Management, LLC* (Feb. 27, 2020).
- Conflicts related to coinvestments
  - Advisers did not adequately disclose conflicts related to investments made by coinvestment vehicles and other coinvestors.
  - Advisers failed to act in accordance with disclosed processes for allocating coinvestment opportunities, and did not adequately disclose enacted agreements with select investors for coinvestment opportunities.

Conflicts of Interest

- Conflicts related to service providers
  - Advisers did not adequately disclose service agreements between portfolio companies controlled by private funds and entities controlled by the adviser, its affiliates, or family members of principals.
  - Advisers did not adequately disclose financial incentives for portfolio companies to use certain service providers.
  - Advisers also represented to investors that services provided by affiliates would be provided on terms no less favorable than those that could be obtained from unaffiliated third parties, but did not establish procedures to ensure that the representations were fulfilled.
  - Notable Enforcement Action: *In re Monomoy Capital Management, L.P.* (Apr. 22, 2020).

Conflicts of Interest

- Conflicts related to fund restructurings
  - Advisers did not adequately disclose conflicts related to fund restructurings and stapled secondary transactions.
    - Example: advisers purchased fund interests from investors at discounts without adequately disclosing the value of the fund interests.
- Conflicts related to cross-transactions
  - Advisers did not adequately disclose conflicts related to purchases and sales between clients.

Fees and Expenses

- Allocation of fees and expenses
  - Advisers did not adequately allocate fees and expenses, and distributed shared expenses in a manner that was inconsistent with disclosure or policies and procedures. Additionally, advisers:
    - Charged private fund clients for expenses that were not permitted by the fund operating agreements;
    - Failed to comply with contractual limits on certain expenses that could be charged to investors; and
    - Failed to follow their own travel and entertainment expense policies.
  - Notable Enforcement Actions: *In re Lightyear Capital LLC* (Dec. 26, 2018); *In re First Reserve Management, L.P*. (Sept. 14, 2016); *In re Cherokee Investment Partners, LLC* (Nov. 5, 2015); *In re Kohlberg Kravis Roberts & Co. L.P.* (June 29, 2015).
- Operating Partners
  - Advisers did not adequately disclose the role and compensation of "operating partners" who provided services to a fund or portfolio company but were not employees of the adviser (and were therefore not compensated out of the adviser's advisory fee revenue earned from the fund).

Fees and Expenses

- Valuation
  - Advisers did not adequately value client assets in accordance with their disclosed valuation processes and, in some instances, overcharged management fees and carried interest.
- Monitoring/board/deal fees and fee offsets
  - Advisers failed to apply management fee offsets in accordance with disclosures and did not maintain adequate policies and procedures to track the receipt of fees from portfolio companies, including monitoring fees, board fees, or deal fees.
  - Advisers also failed adequately to disclose to investors monitoring fee agreements with portfolio companies, pursuant to which monitoring fees were accelerated upon the sale of a portfolio company.
  - Notable Enforcement Actions*: In re Aisling Capital LLC* (June 29, 2018)*; In re Apollo Management V, L.P. (*Aug. 23, 2016); *In re Fenway Partners, LLC* (Nov. 3, 2015); *In re Blackstone Management Partners L.L.C.* (Oct. 7, 2015).

Restricting the use of MNPI

- Section 204A Issues
  - Section 204A of the Advisers Act requires investment advisers to establish, maintain, and enforce written policies and procedures designed to prevent the misuse of material, nonpublic information the adviser may possess.
  - Advisers did not have adequate policies and procedures to address risks posed by their employees interacting with:
    - Insiders of publicly traded companies;
    - Outside consultants arranged by "expert network" firms; or
    - "Value added investors"
      - (*e.g.*, corporate executives or financial professional investors who have information about investments).
  - Advisers did not address risks posed by their employees who:
    - Could obtain MNPI through their ability to access office space or systems of the adviser or its affiliates that possessed MNPI; or
    - Periodically had access to MNPI about issuers of public securities
      - (*e.g.*, in connection with a private investment in public equity).
  - Notable Enforcement Action: *In re Cannell Capital, LLC* (Feb. 4, 2020); *In re Ares Management, LLC* (May 26, 2020).

Other Compliance Issues

- Code of Ethics Rule Issues
  - The Code of Ethics Rule, Rule 204A-1 under the Advisers Act, requires registered investment advisers to establish, maintain, and enforce a code of ethics that sets out standards of conduct of supervised persons.
  - Advisers did not adequately enforce trading restrictions on securities that had been placed on the adviser's "restricted list," and had inadequate policies and procedures for adding securities to, or removing securities from, restricted lists.
  - Advisers failed to enforce requirements relating to receipt of gifts and entertainment from third parties.
  - Advisers also failed to identify certain individuals as "access persons," and failed to require timely transactions and holdings reports from access persons.

Takeaways

- The Risk Alert offers insight into the issues that have resulted in a range of enforcement actions against private fund advisers over the last five to seven years.
- We have observed that the SEC staff remains focused on the following areas:
  - Conflicts of interest;
  - Fees and expenses; and
  - Policies and procedures relating to MNPI.
- The staff continues to focus on fiduciary standards and inadequate disclosures provided to private fund investors over merit-based regulation of specific practices.
- Private fund advisers should continue to remain vigilant and enhance their compliance programs in these areas.

What to Expect from the Biden Administration

What to Expect From the Biden Administration

- Gary Gensler is the nominee for SEC Chairman.
  - Former CFTC head (2009-2014); served in the Clinton Treasury; Goldman Sachs co-head of finance.
- Reputation as a bold regulator
  - Is expected to ramp up enforcement efforts and push for new disclosure rules.
  - Possible return to more prescriptive rule-making.
  - Potential focus on broken-windows enforcement.
  - Increased fines in enforcement actions are also likely.
- Anticipated focus on climate-change risk, workforce diversity, and political spending given that President Biden campaigned on transparency of ESG statistics and corporate political spending.
- Potential rollout of more comprehensive regulatory framework for digital asset securities.

The Marketing Rule

Overview of Marketing Rule

- Adopted December 22, 2020, the new Marketing Rule amends and combines the existing Advertising and Solicitation Rules
  - The Marketing Rule represents the first significant amendment to the Advertising and Solicitation Rules since their adoption in 1961 and 1979, respectively.
  - SEC staff guidance under Advertising and Solicitation Rules to be withdrawn.
- The Marketing Rule represents a significant change to the regulation of adviser marketing activities.
  - Extends to private fund investors.
  - Includes principles-based standards and general prohibitions in lieu of existing prohibitions.
  - Permits past specific recommendations, testimonials, and third-party ratings.
  - Rule-based framework for performance advertising.
- Negligence, rather than scienter is required to establish a violation of the Marketing Rule
- Compliance date is 18 months after the Marketing Rule's effective date.
  - The effective date is 60 days after publication in the Federal Register.

Expanded Definition of Advertisement

Element One – Traditional Advertising

- The Marketing Rule's definition of an advertisement includes two elements.
  - The first element captures traditional advertising.
  - The second element covers compensated testimonials and endorsements, which encompasses a similar scope of activity as traditional solicitations under the Solicitation Rule.
- The first element includes any direct or indirect communication an investment adviser makes to more than one person, or to one or more persons if the communications includes hypothetical performance (other than in the case of communications with private fund investors or responses to unsolicited requests), which:
  - 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 private fund investors.

Element One – Traditional Advertising (cont'd)

- A communication is attributable to an adviser that participates in the creation or dissemination of, or authorized, the communication.
  - Whether third-party information is attributable to an adviser depends on:
    - Whether the adviser has explicitly or implicitly endorsed or approved the information after its publication ("adoption"); or
    - The extent to which the adviser has involved itself in the preparation of the information ("entanglement").
  - Limited forms of editing are permitted if based on pre-established, objective criteria that are documented in the adviser's policies and procedures and that are not designed to favor or disfavor the adviser.
- Generally does not include:
  - Communications to one person;
  - Generic brand content, educational material, and market commentary;
  - Extemporaneous, live, oral communications; and
  - Information contained in a statutory or regulatory notice, filing, or other required communication.

Element Two – Compensated Testimonials and Endorsements

- The second element of the definition of advertisement includes any endorsement or testimonial for which an investment adviser provides cash or non-cash compensation, directly or indirectly.
- Does not exclude:
  - Extemporaneous, live, oral communications;
  - One-on-one communications; or
  - Testimonials or endorsements that refer to hypothetical performance information.
- Applies to testimonials for which an adviser provides either cash or non-cash compensation.
  - Examples of non-cash compensation:
    - Directed brokerage;
    - Sales awards or other prizes; and
    - Outings, tours, or other forms of entertainment.
  - Compensation does not include regular salary or bonuses paid to an adviser's personnel.

Definition of “Testimonial” and “Endorsement”

- “Testimonials” include any statement by a current client or private fund investor about the client’s or private fund investor’s experience with an investment adviser or its supervised persons.
- “Endorsements” include any statement by a person other than a current client or private fund investor that indicates approval, support, or recommendation of the investment adviser or its supervised persons or describes that person’s experience with the investment adviser or its supervised persons.
- Both definitions capture persons that directly or indirectly solicit or refer any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser.
- Includes opinions or statements about:
  - The investment advisory expertise or capabilities of the adviser or its supervised persons; and
  - An adviser or its supervised person’s qualities (*e.g.*, trustworthiness, diligence, or judgment), expertise or capabilities in other contexts.

Private Fund Investors

- Both elements of the definition of advertisement expressly include marketing communications to private fund investors.
  - This marks a significant change in the regulation of the solicitation or referral of private fund investors.
- Common forms of communication to private fund investors are subject to the Marketing Rule.
  - Information included in a PPM (*e.g.*, related performance of separate accounts), pitch books or other materials accompanying a PPM, and materials in a due diligence room could constitute an advertisement.
  - However, information included in a PPM about the material terms, objectives, and risks of a fund offering is not an advertisement of the adviser.
  - Private fund account statements, transaction reports, and other similar materials delivered to existing private fund investors, and presentations to existing clients concerning the performance of funds in which they have invested are **not** considered advertisements.

General Prohibitions

General Prohibitions

- The Marketing Rule includes seven general prohibitions that apply to any advertisement directly or indirectly disseminated by an adviser.
- The general prohibitions do not represent substantive departures from positions in existing SEC staff no-action letters and guidance.
  - However, the ability for an adviser to highlight a specific past recommendation in a fair and balanced manner represents a notable departure from the existing prohibition on certain past specific recommendations under the Advertising Rule.
- In applying the general prohibitions, an adviser should consider the facts and circumstances of each advertisement.
- The nature of the audience to which the advertisement is directed is a key factor in determining how the general prohibitions should be applied.

General Prohibitions (cont'd)

- In any advertisement, an adviser may not:
  1. Include any untrue statement of a material fact, or omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading;
  2. Include a material statement of fact that the adviser does not have a reasonable basis for believing it will be able to substantiate upon demand by the SEC;
  3. Include information that would reasonably be likely to cause an untrue or misleading implication or inference to be drawn concerning a material fact relating to the investment adviser;
  4. Discuss any potential benefits to clients or investors connected with or resulting from the investment adviser's services or methods of operation without providing fair and balanced treatment of any material risks or material limitations associated with the potential benefits;
  5. Include a reference to specific investment advice provided by the investment adviser when the investment advice is not presented in a manner that is fair and balanced;
  6. Include or exclude performance results, or present performance time periods, in a manner that is not fair and balanced; or
  7. Present information that would otherwise be materially misleading.

Fair and Balanced

- The “fair and balanced” standard was drawn from the general standards in FINRA Rule 2210, which governs communications with the public by FINRA members.
- FINRA Rule 2210 and its body of decisions are not controlling or authoritative interpretations with respect to the Marketing Rule.
  - Advisers may, however, still wish to consider FINRA’s interpretations related to the meaning of “fair and balanced” for issues the SEC has not specifically addressed.
- A fair and balanced portrayal may require disclosing information related to:
  - The state of the market at the time;
  - Any unusual circumstances; and
  - Other material factors that contributed to the information presented.

Performance Information

Conditions on Presentation of Performance

- The Marketing Rule places a number of conditions on the presentation of performance results.
- All advertisements that include performance results must comply with requirements regarding:
  - Presentation of net performance with gross performance; and
  - Statements about SEC review or approval.
    - The Marketing Rule prohibits any statement, express or implied, that the calculation or presentation of performance results was reviewed or approved by the SEC.
- Advertisements also must comply with additional conditions if they include the following types of performance information:
  - Related performance
  - Extracted performance
  - Hypothetical performance
  - Predecessor performance

Gross and Net Performance

- An advertisement may not present gross performance unless net performance is:
  - Included alongside gross performance with at least equal prominence to, and in a format designed to facilitate comparison with, the gross performance; and
  - Calculated over the same time period and using the same type of return and methodology as the gross performance.
- An adviser generally should disclose what elements (*e.g.*, transaction costs) are included in the return presented.
- Any fees or expenses deducted when calculating gross performance should be deducted in calculating net performance.
  - Transaction costs and underlying fund fees and expenses should be deducted in calculating gross performance.
  - Custodian fees paid to a bank or other third party may be excluded from gross performance.
  - Net performance may reflect the deduction of a model fee if the resulting performance is no higher than if the actual fee had been deducted.

Related Performance

- "Related performance" is the 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 the stated criteria.
  - "Related portfolios" are portfolios with substantially similar investment policies, objectives, and strategies as those being offered or promoted in the advertisement.
- An advertisement may not present related performance unless it includes all related portfolios.
- An adviser may determine that a portfolio with material client constraints or other material differences, for example, does not have substantially similar investment policies, objectives, and strategies and should not be included as a related portfolio.
- A related portfolio may be excluded if the advertised performance results are not materially higher than if all related portfolios had been included, and the exclusion does not alter the presentation of any applicable prescribed time period.

Extracted Performance

- "Extracted Performance" is the performance results of a subset or "sleeve" of investments extracted from a larger portfolio.
  - Performance that is extracted from a composite from multiple portfolios is not extracted performance but is hypothetical performance.
- Extracted performance may not be included in an advertisement unless the advertisement provides, or offers to provide promptly, the performance results of the entire portfolio from which the extracted performance was taken.
- An adviser generally is not required to provide detailed information regarding the selection criteria and assumptions underlying extracted performance.

Hypothetical Performance

- "Hypothetical performance" is defined broadly to mean performance results that were not actually achieved by any portfolio of the investment adviser.
  - Includes model performance, backtested performance, and targeted or projected performance returns.
- Hypothetical performance does not include the performance generated by "investment analysis tools," so long as an investment adviser meets certain conditions.
  - The SEC imported the definition of "investment analysis tool" from FINRA Rule 2214, except that a current or prospective investor must use the tool (*i.e.,* input information into the tool or provide information to the adviser to put into the tool).
- The Marketing Rule does not prescribe any particular methodology or calculation for the different categories of hypothetical performance, just as it does not prescribe methodologies or calculations for actual performance.

Hypothetical Performance (cont'd)

- The Marketing Rule prohibits an investment adviser from using hypothetical performance results in an advertisement unless the adviser meets three conditions.
- First, the adviser must adopt and implement policies and procedures reasonably designed to ensure that the hypothetical performance is relevant to the likely financial situation and investment objectives of the intended audience of the advertisement.
  - Not required to inquire into the specific financial situation and investment objectives of each potential recipient.
  - Must make a reasonable judgment about the likely investment objectives and financial situation of the advertisement's intended audience.
  - An adviser may draw on its prior experience with particular types of investors in crafting its policies and procedures.

Hypothetical Performance (cont'd)

- Second, the adviser must provide sufficient information to enable the intended audience to understand the criteria used and assumptions made in calculating the hypothetical performance.
  - A general description of the methodology used would be sufficient information for an investor to understand how it was generated.
  - Should provide information that includes any assumptions on which the hypothetical performance rests.
- Finally, the adviser must provide – or, if the intended audience is a private fund investor, provide or offer to provide promptly – sufficient information to enable the intended audience to understand the risks and limitations of using the hypothetical performance in making investment decisions.
  - Should provide information about risks and limitations that would apply to both hypothetical performance generally and to the specific hypothetical performance presented.
  - Risk information should also include any known reasons why the hypothetical performance might differ from actual performance of a portfolio.

Predecessor Performance

- "Predecessor performance" is the performance results of a fund an investment adviser previously managed.
- Predecessor performance may not be displayed in an advertisement, unless the following requirements are satisfied:
  - The person or persons who were primarily responsible for achieving the prior performance results manage accounts on behalf of the advertising adviser;
    - A person or group of persons is "primarily responsible" for achieving prior performance results if the person makes or the group makes investment decisions.
  - The accounts managed at the predecessor investment adviser are sufficiently similar to the accounts managed at the advertising adviser that the performance results would provide relevant information to investors;
  - All accounts that were managed in a substantially similar manner are advertised unless the exclusion of any such account would not result in materially higher performance and the exclusion of any account does not alter the presentation of any prescribed time periods;
    - Accounts that are managed in a substantially similar manner are those with substantially similar investment policies, objectives, and strategies; and
  - The advertisement clearly and prominently includes all relevant disclosures, including that the performance results were from accounts managed at another entity.

Endorsements and Testimonials

Conditions for Testimonials and Endorsements

- The Marketing Rule effectively withdraws the current general prohibition on testimonials under the Advertising Rule and permits advisers to include testimonials and endorsements in an advertisement, subject to the Marketing Rule's general prohibitions and additional conditions:
  - Disclosure requirements;
  - Oversight requirements; and
  - A prohibition against compensated endorsements made by certain "bad actors" and other ineligible persons.
- The conditions differ depending on whether the testimonial or endorsement is compensated or uncompensated.

Required Disclosures

- At the time the testimonial or endorsement is disseminated, an adviser must disclose, or reasonably believe that the person giving the testimonial or endorsement discloses, the following:
  - Clearly and prominently:
    - That the testimonial was given by a current client or private fund investor, and the endorsement was given by a person other than a current client or private fund investor, as applicable;
    - 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 on the part of the person giving the testimonial or endorsement resulting from the investment adviser's relationship with such person;
  - 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 on the part of the person giving the testimonial or endorsement resulting from the investment adviser's relationship with such person and/or any compensation arrangement.

Required Disclosures (cont'd)

- To be clear and prominent, disclosures must be at least as prominent as the testimonial or endorsement.
  - The clear and prominent standard requires that the disclosures be included within the testimonial or endorsement, or in the case of an oral testimonial or endorsement, provided at the same time.
- Disclosure should address the structure and amount of compensation sufficiently to convey the nature and magnitude of the conflict, including:
  - The specific amount of any cash compensation;
    - If the compensation takes the form of a percentage of the total advisory fee over a period of time, the percentage and time period should be disclosed.
  - The value of non-cash compensation if readily ascertainable; and
  - Whether compensation for endorsements and testimonials is contingent on a future event, such as a new advisory relationship or a new investment in a private fund.
- The description of the compensation arrangement with a promoter should include only information about the relevant compensation arrangement between the adviser and the promoter.

Investment Adviser Oversight

- All testimonials and endorsements are subject to an adviser's ongoing oversight.
  - An adviser must have a reasonable basis for believing that any testimonial or endorsement complies with the requirements of the Marketing Rule.
  - A reasonable basis would generally involve periodically making inquiries of a sample of investors or clients referred by the solicitor to ascertain whether the solicitor has made improper representations or has otherwise violated the agreement with the adviser.
  - The oversight and compliance provision differs from the Solicitation Rule's requirements for adviser oversight with respect to solicitors.
- An adviser must enter into a written agreement with any person giving a compensated testimonial or endorsement that describes the scope of the agreed upon activities and the terms of the compensation for those activities.
  - The required written agreement provision differs in some respects from the similar requirement under the Solicitation Rule.

Disqualification of Promoters

- An adviser may not compensate a person, directly or indirectly, for a testimonial or endorsement if the adviser knows, or in the exercise of reasonable care should know, that the person giving the testimonial or endorsement is an "ineligible person" at the time the testimonial or endorsement is disseminated.
  - Knowledge or Reasonable Care
    - This standard applies at the time the compensated endorsement or testimonial is disseminated. An adviser is not required to continuously monitor the eligibility of compensated promoters, but must exercise reasonable care with respect to a particular set of facts and circumstances. Inquiries should be completed annually.
  - "Ineligible person"
    - A person who is subject either to a "disqualifying Commission action" or to any "disqualifying event."
    - Any employee, officer, or director of an ineligible person and any other individuals with similar status or functions within the scope of association with an ineligible person. Can depend on whether an entity is a partnership, limited liability company, or a control affiliate.
  - Disqualifying Commission Action
    - An SEC opinion or order barring, suspending, or prohibiting a person from acting in any capacity under the Federal securities laws.
  - Disqualifying Event
    - Disqualifying events include certain felony or misdemeanor court convictions, orders by various securities, commodities, banking, and insurance regulators

Partial Exemptions

- With respect to the requirements applicable to testimonials and endorsements, the Marketing Rule provides partial exemptions for affiliated solicitors, broker-dealers, covered persons, and testimonials or endorsements for zero or *de minimis* compensation.
- Investment Advisers' In-House Solicitors and other Affiliated Solicitors:
  - Exempt from the disclosure and written agreement requirements if the affiliation is "readily apparent" or disclosed and the promoter's status is documented.
- Broker-Dealers:
  - Exempt from the disqualification provisions if not subject to statutory disqualification under the Exchange Act.
  - Exempt from the disclosure provisions when providing a testimonial or endorsement to a retail customer that is a recommendation subject to Regulation Best Interest.
  - Exempt from the requirement to disclose the material terms of any compensation arrangement or a description of any material conflicts of interest when providing a testimonial or endorsement to an investor who is *not* a retail customer as defined in Regulation BI.

Partial Exemptions (cont'd)

- Covered Persons under Rule 506(d) of Regulation D
  - Exempt from the disqualification provisions, so long as the person's involvement would not disqualify the offering under Rule 506.
- *De Minimis* Compensation
  - Applies to testimonials or endorsements for which an adviser provides zero or *de minimis* compensation.
  - Exempt from the disqualification provisions and the written agreement requirement.
  - The *de minimis* threshold is $1,000 (or the equivalent value in non-cash compensation) during the preceding 12 months.
- Impersonal Investment Advice and Nonprofit Programs
  - The SEC did not adopt exemptions for impersonal investment advice and nonprofit programs for which the SEC staff has previously provided no-action relief.

Questions?