THE NEW SEC MARKETING RULE – GUIDANCE FOR CLO MANAGERS

Beginning today, November 4, 2022, all investment advisers registered with the U.S. Securities and Exchange Commission ("***SEC***") are required to comply with Rule 206(4)-1 (the "***Marketing Rule***") under the Investment Advisers Act of 1940, as amended (the "***Advisers Act***") in connection with marketing advisory services and products – including the marketing of collateralized loan obligations ("***CLOs***") – to investors.[1] This client briefing discusses the applicability of the Marketing Rule to CLOs and relevant requirements for CLO managers to be aware of, and offers practical recommendations to assist CLO managers in complying with the Marketing Rule's requirements.

Applicability of the Marketing Rule to CLOs

The Marketing Rule divides the definition of an "advertisement" into two prongs.[2]

- The first prong covers any direct or indirect communication an investment adviser[3] 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 covers any endorsement or testimonial for which an investment adviser provides compensation, directly or indirectly.

Both prongs explicitly include communications made to *private fund* investors. A "private fund" for these purposes is any issuer that relies on the Section 3(c)(1) or 3(c)(7) exception under the Investment Company Act of 1940, as amended. As most CLOs currently rely on the 3(c)(7) exception, communications made directly or indirectly to their investors by an SEC-registered CLO manager are now subject to the Marketing Rule.[4]

1 For purposes of the applicable Marketing Rule requirements, "investors" would include both CLO equity and debt investors.
2 Advisers Act Rule 206(4)-1(e)(1)(i).
3 For purposes of clarity, for the remainder of the briefing we will use the term "CLO manager" when the Marketing Rule refers to an "investment adviser," but will use the latter term when directly quoting the rule itself. As noted, the Marketing Rule only applies to CLO managers that are registered with the SEC as an investment adviser, and such registration is assumed in the discussion herein.
4 We note that certain CLOs are structured to comply with the exclusion in Rule 3a-7 under the Investment Company Act (excluding certain issuers of asset-backed securities). Because such CLOs are not "private funds" within the meaning of the Marketing Rule, communications to investors in such CLOs would not be subject to the Marketing Rule.

When do CLO solicitation activities constitute "Advertising"?

The Marketing Rule's definition of "advertisement" captures both (i) certain direct or indirect communications by the CLO manager (subject to certain exemptions) and (ii) certain third-party communications (endorsements or testimonials) for which a CLO manager provides compensation, directly or indirectly.

Clearly, a direct communication made by the CLO manager to a prospective CLO investor soliciting their investment in a CLO relying on the Section 3(c)(7) exception constitutes "advertising" under the Marketing Rule. Furthermore, solicitation activities of a CLO arranger, if the CLO arranger is engaged by an SEC-registered CLO manager to market a CLO relying on the Section 3(c)(7) exception, are also likely to constitute "advertising" under the Marketing Rule. Such arrangements are captured under the second prong of the definition of "advertisement," which covers, in part, *endorsements* for which the CLO manager provides direct or indirect compensation.[5]

For purposes of the Marketing Rule, an endorsement is any statement by a person other than a current client or investor in a CLO (or other private fund) managed by the CLO manager that –

- indicates approval, support or recommendation of the CLO manager (or its supervised persons[6]) or describes that person's experience with the CLO manager (or its supervised persons);
- directly or indirect solicits any current or prospective investor to be an investor in a CLO advised by the CLO manager; or
- refers any current or prospective investor to be an investor in a CLO advised by the CLO manager.[7]

The SEC historically regulated third-party solicitations and referrals in Rule 206(4)-3 (the "**Cash Solicitation Rule**") under the Advisers Act. However, in adopting the Marketing Rule, the SEC eliminated the Cash Solicitation Rule and brought the solicitation activities covered by that rule under the Marketing Rule. The SEC staff has also previously taken the position that the Cash Solicitation Rule did not apply to solicitations of *private fund* investors.[8] The Marketing Rule explicitly reverses this position. CLO managers must therefore be cognizant of when CLO solicitation activities fall under the Marketing Rule because of the rule's applicability to CLO investors.

5 The requirements discussed herein applicable to endorsements also apply to "testimonials" under the Marketing Rule. A testimonial, in contrast to an endorsement, is a statement by a *current investor* in a CLO or other account advised by the CLO manager. This briefing's focus on endorsements is reflective of the fact that they are more likely to be relevant in the context of CLO marketing.

6 The term "supervised person" has the same meaning in the Marketing Rule as it is defined in Section 2(a)(25) of the Advisers Act ("any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser").

7 Advisers Act Rule 206(4)-1(e)(5).

8 *Mayer Brown LLP*, SEC No-Action Letter (Jul. 28, 2008).

We have highlighted a few key issues to which CLO managers should be particularly vigilant with respect to triggering the application of the Marketing Rule.

Oral/One-on-One Communications: While the first prong of the definition of advertisement explicitly *excludes* extemporaneous, live, oral communications or one-on-one communications, the second prong, which addresses traditional solicitation activity, *includes* such communications as being the very types of communications that the second prong is meant to address.[9] This means that *any* statement (whether oral or written) to a prospective investor by a CLO arranger may be treated as an advertisement, *if* the statement is considered a solicitation or referral to invest in a CLO or indicates approval, support or a recommendation of the CLO manager.

Offering Memoranda: In the Adopting Release, the SEC stated that information included in a private placement memorandum about the material terms, objectives, and risks of a fund offering is *not* an advertisement.[10] The Marketing Rule itself further excludes from both prongs of the definition of advertisement "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."[11] On that basis, to the extent that an offering memorandum ("**OM**") or similar document used and disseminated in connection with a CLO offering only includes (i) the material terms, objectives and risks of the CLO notes and the CLO and (ii) information mandated by statute or regulation, our view is that the OM should *not* be treated as an advertisement. However, any additional content included in an OM, *particularly* content related to the performance of other CLOs or accounts managed by the CLO manager, may render the OM an advertisement, the dissemination of which may constitute an endorsement under the Marketing Rule. Additionally, materials accompanying the OM (such as a pitchbook) could themselves be an advertisement.[12]

Compensation: The Marketing Rule's definition of advertisement only includes endorsements for which *compensation* was paid by the CLO manager – whether cash or non-cash compensation.[13] Whether compensation is provided for an endorsement is a facts and circumstances determination based on whether there is a mutual understanding of a *quid pro quo* (whether explicit or inferred).[14] Furthermore, while the SEC declined to provide specific guidance on this point, it noted that the timing of compensation relative to an endorsement is relevant in determining whether compensation is being paid *for* the endorsement.[15] Finally, CLO managers should note that compensated endorsements *may or may not be* contingent on the solicitation of

9 SEC, Investment Adviser Marketing, Investment Advisers Act Release No. 5653 (Dec. 22, 2020) ("**Adopting Release"), at 55.**
10 *Id*. at 62.
11 Advisers Act Rule 206(4)-1(e)(1)(i)(B)
12 Adopting Release, *supra* note 9, at 62.
13 Examples of covered forms of compensation cited by the SEC include fees based on a percentage of assets under management or amounts invested, flat fees, retainers, hourly fees, reduced advisory fees, fee waivers, and any other methods of cash compensation, rewards that advisers provide for endorsements (including referral and solicitation activities), directed brokerage that compensates brokers for soliciting investors, sales awards or other prizes, gifts and entertainment, such as outings, tours, or other forms of entertainment, that an adviser provides as compensation for endorsements. *Id.* at 48.
14 *Id*. at 51.
15 *Id*.

an investor by the CLO arranger resulting in a new investment in a CLO.[16] With that said, we would expect a typical engagement letter, under which a CLO manager will cause the CLO issuer to pay a CLO Arranger fees based on the amount of CLO securities sold in exchange for the CLO arranger assisting in the placement of such securities, to be treated as the provision of compensation for an endorsement by the CLO arranger for purposes of the Marketing Rule.

What is required when a CLO manager engages an Sec-Registered broker-dealer as a CLO arranger?

For purposes of this briefing, we will assume that any CLO arranger engaged by the CLO manager to market CLO securities will be (i) registered as a broker-dealer with the SEC under the Securities Exchange Act of 1934, as amended (the "**Exchange Act**") and (ii) soliciting persons other than persons that are "retail customers" as defined in Regulation Best Interest ("**Regulation BI**") under the Exchange Act. **The Marketing Rule prohibits a CLO manager from providing compensation, directly or indirectly, for an endorsement unless it complies with certain specified conditions under the rule**.

Disclosures: The Marketing Rule specifies required disclosure for advertisements that are or include endorsements, even in cases where an SEC-registered broker-dealer solicits a non-retail investor. Specifically, a CLO manager must disclose, or *must reasonably believe that the person giving the endorsement is disclosing*, the following at the time at the endorsement is disseminated:[17]

- *Clearly and prominently* –
  - that the endorsement was given by a person other than a current investor;
  - that cash or non-cash compensation was provided for the endorsement; and
  - a brief statement of any material conflicts of interest on the part of the person giving the endorsement (i.e., the CLO arranger) resulting from the CLO manager's relationship with such person.[18]

Disqualification: The Marketing Rule prohibits a CLO manager from directly or indirectly compensating a person for an endorsement if the CLO manager knows, or in the exercise of reasonable care should know, such person is an "ineligible person" at the time the endorsement is disseminated.[19] If the CLO arranger (or other endorsement provider) is an SEC-registered broker-dealer, this prohibition does not apply *unless* the broker-dealer is subject to "statutory disqualification" as defined in Section 3(a)(39) of

16 *Id*. at 48.

17 If the person being compensated for the endorsement is any person *other* than an SEC-registered broker-dealer, the disclosure must additionally include (i) a description of 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 endorsement and (ii) a description of any material conflicts of interest on the part of the person giving the endorsement resulting from the CLO manager's relationship with such person and/or any compensation arrangement. *See* Advisers Act Rule 206(4)-1(b)(1)(ii)-(iii).

18 Advisers Act Rule 206(4)-1(b)(1)(i).

19 Advisers Act Rule 206(4)-1(b)(3). An "ineligible person" is a person subject to a "disqualifying Commission action" or any disqualifying event as set forth in the Marketing Rule, and also include certain persons (such as employees, officers and directors) associated with an ineligible person.

the Exchange Act.[20] Because this prohibition applies at the time the endorsement is disseminated, monitoring of this status is required throughout the engagement.

Oversight and Compliance: The Marketing Rule requires a CLO manager to exercise oversight over any person compensated to provide an endorsement. Specifically, the CLO manager must have –

- a reasonable basis for believing that the endorsement complies with the requirements of the Marketing Rule; and
- a written agreement with any person giving an endorsement that describes the scope of the agreed-upon activities and the terms of compensation for those activities.[21]

What should a CLO manager do to ensure appropriate compliance with the Marketing Rule?

With SEC-registered CLO managers now required to comply with the Marketing Rule, it is critical that CLO managers continue to assess their current practices and work collaboratively with their CLO arrangers to ensure that their CLO marketing activities satisfy the requirements of the Marketing Rule. To that end, we offer several practical recommendations below.

Implement Policies and Procedures

- CLO managers must continue to implement written policies and procedures that are reasonably designed to prevent violations of the Marketing Rule by the CLO manager and its supervised persons, including but not limited to the elements discussed in this briefing. The SEC's Division of Examinations issued a risk alert in September 2022 (the "**Marketing Rule Risk Alert**") that highlighted this as an area of focus as part of its examination of investment advisers.[22]

Assess Whether A Communication is an Advertisement

- CLO managers should take a broad view of what types of CLO arranger communications are likely to be treated as "endorsements." The Adopting Release specifically states that endorsements include "opinions or statements by persons about the investment advisory expertise or capabilities of the adviser or its supervised persons" and "statements in an advertisement about an adviser or its supervised person's qualities (e.g., trustworthiness, diligence, or judgment) or expertise or capabilities in other contexts, when the statements suggest that the qualities, capabilities, or expertise are relevant to the advertised investment advisory

20 A person subject to "statutory disqualification" under the Exchange Act includes, but is not limited to, a person that (i) is subject to an SEC order denying, suspending for a period not exceeding 12 months, or revoking the person's registration as a broker or dealer or barring or suspending for a period not exceeding 12 months the person's being associated with a broker or dealer; (ii) is subject to an order of the U.S. Commodity Futures Trading Commission denying, suspending, or revoking his registration under the Commodity Exchange Act; and (iii) has been convicted of any specified offense or other felony within 10 years of the date of filing of an application for membership of a self-regulatory organization (*i.e.*, FINRA).

21 Advisers Act Rule 206(4)-1(b)(2). The Marketing Rule provides a de *minimis* exemption to the written agreement requirement if the adviser provides compensation to such person for an endorsement in an amount equal to or less than $1,000 over a 12-month period. We do not expect that this will be applicable to most CLO solicitation arrangements.

22 SEC Division of Examinations, Risk Alert: Examinations Focused on the New Investment Adviser Marketing Rule (Sept. 19, 2022), *available at* https://www.sec.gov/files/exams-risk-alert-marketing-rule.pdf.

services."[23] Perhaps the most reasonable way to think about an endorsement is as a suggestion to purchase the CLO's securities, whether explicit or inferred in the context of the information provided to the prospective investor. Given the nature of the relationship between a CLO manager and arranger, it is likely that most, if not all, communications in furtherance of the sale of CLO securities would constitute an "endorsement" of the CLO manager.

- The CLO manager should ensure that both existing and new engagement letters and similar agreements contain provisions that provide the CLO manager with sufficient oversight (and approval, to the extent possible) of any CLO arranger communication with an investor, including any OM or similar offering document (and any accompanying materials, such as a pitchbook). With respect to oral communications, CLO managers should either directly participate in such meetings/calls or agree in advance with the CLO arranger as to what information may be supplied to a prospective investor.
- If it has not done so already, the CLO manager should develop policies and procedures governing the content of an OM or similar offering document and provide clear guidance as to the type of content that may be included without the document being deemed an "advertisement." If the OM or offering document is an advertisement, the CLO manager should track and keep a record of exactly who receives the document and place clear limitations (including in any engagement letter) on such person's ability to disseminate it.
- If a CLO manager does not currently pay cash compensation to a third party in connection with CLO solicitation efforts, it should assess whether it may be directly or indirectly providing such person with non-cash compensation within the meaning of the Marketing Rule.

Furnish Clear and Prominent Disclosure

- If the CLO manager is not itself providing the required disclosures, it must reasonably believe that the CLO arranger is doing so. The CLO manager can demonstrate such a reasonable belief, by, among other things, including in its engagement letter a requirement that the CLO arranger provide such disclosures to investors in instances where it communicates separately with such investors. The CLO manager could additionally periodically contact a subset of CLO investors to check whether the CLO arranger complied with such requirements (and maintain documentation in connection with this process).
- In order for the disclosures to be made clearly and prominently, they must be at least as *prominent* as the endorsement itself.[24] The SEC's view is that this requires the disclosures be included within the endorsement (or, in the case of an oral endorsement, provided at the same time).[25] The disclosures should appear close to the associated statement such that the statement and disclosures are read *at the same time*, and should not simply refer the reader somewhere else to obtain the

23 Adopting Release, supra note 9, at 45. Although not determinative, the CLO manager may also wish to review and consider the list of "recommendations" that trigger the application of Regulation BI in the context of a communication to a retail investor.
24 Adopting Release, *supra* note 9, at 90.
25 *Id*.

disclosures (such as through a hyperlink[26]). In cases in which an oral endorsement is provided, the disclosures could be provided in a written format (if they are provided at the time of the testimonial or endorsement).

- While the first two required disclosures (that the CLO arranger is not a current investor and is receiving compensation for providing the endorsement) are relatively simple, the third (regarding material conflicts of interest) requires the CLO manager and arranger to collectively assess their broader commercial relationship and determine whether any such conflicts may exist (including in relation to affiliates of each). Once such conflicts, if any, are identified, the Marketing Rule does not require a full description, but simply a statement, of the conflict. For example, it is sufficient to state that an endorsement was provided by an affiliate.[27]

Ensure Recipients of Compensation Are Not Disqualified

- CLO managers should obtain assurances (such as through a representation in the engagement letter) at the time it enters into an engagement with a CLO arranger that the arranger is an SEC-registered broker-dealer and is not subject to statutory disqualification under the Exchange Act.
- Because of the ongoing nature of the prohibition (*i.e.*, it applies at the time of each endorsement, rather than merely at the commencement of the relationship or at the time of payment), the CLO manager should develop a mechanism for monitoring the status on an ongoing basis (with a frequency appropriate to the facts and circumstances of the particular engagement/broker-dealer) of any person engaged in the marketing of the CLO. For example, this could include factual inquiry by means of questionnaires or certifications (possibly accompanied by contractual representations, covenants and undertakings).[28]

Provide Appropriate Oversight of Compliance by CLO Arrangers

- Based on our discussions to date, we expect that engagement letters will generally have provisions that cover the following:
  - Representation that the CLO arranger will maintain books and records of endorsements (and any required disclosures thereto) in connection with the marketing of the CLO.
  - Covenant that statements made by the CLO arranger (or any of its employees, officers, directors, etc. giving the endorsement) to a prospective investor in connection with services provided under the engagement letter constitute an "endorsement" as defined in the Marketing Rule of the CLO, the CLO manager (and personnel thereof).
  - Representation that the CLO arranger has policies and procedures in place to ensure that endorsements contain the disclosures required under the Marketing Rule.
  - Agreement to permit the CLO manager to make periodic inquires to investors with which the CLO arranger has communicated to ensure the CLO arranger is complying with these terms.

26 However, information other than that required by the Marketing Rule may be furnished through a hyperlink. *Id*. at 92.
27 *Id*. at 95.
28 Adopting Release, *supra* note 9, at 121.

  - Representation that the CLO arranger (or any of its relevant employees, officers, directors, etc. giving the endorsement) has not been subject to any "disqualifying event" or "disqualifying Commission action" (each as defined in the Marketing Rule).
  - Covenant that the CLO arranger will promptly notify the CLO manager if any of the above representations and covenants become inaccurate at any time during the duration of the engagement.
- In drafting an engagement letter with a CLO arranger, the CLO manager should consider the types of endorsements that will be made pursuant to the letter, as well as the risks associated with the particular arrangement, and tailor the agreement accordingly.
- Whether a CLO manager has a reasonable basis to believe that endorsements made on its behalf are Marketing Rule-compliant is ultimately a facts and circumstances determination. The simple fact of having a written agreement with the CLO arranger is insufficient to establish a reasonable basis on its own.[29] A CLO manager could form such a reasonable basis by putting terms in an engagement letter that allow the CLO manager to pre-review endorsements or otherwise impose limitations on the content of those statements.[30] Alternatively, the CLO manager could periodically survey a sample of investors solicited by the CLO arranger to assess whether the CLO arranger's statements are Marketing Rule compliant.[31]

Pay Attention to Recordkeeping and Form ADV Requirements

- The SEC's Division of Examinations has indicated in the Marketing Rule Risk Alert that it will check for compliance with the new recordkeeping requirements under the Marketing Rule.[32] In the context of endorsements, this includes keeping a record of each written endorsement that would constitute an advertisement, and, in the case of oral endorsements, a written record of the required disclosures provided to investors (as described herein).[33] Furthermore, a CLO manager must maintain documentation substantiating its reasonable basis for believing that an endorsement complies with the requirements under the Marketing Rule.[34]
- SEC-registered CLO managers will now be required to report certain information regarding their marketing practices on their Form ADV. This includes indicating whether its advertisements include endorsements and whether compensation was provided for those endorsements.[35] The SEC's Division of Examinations has specifically reminded investment advisers of this obligation.[36]

29 *Id*. at 110.
30 *Id*.
31 *Id*.
32 See *supra* note 22.
33 Advisers Act Rule 204-2(a)(11)(i)(A).
34 Advisers Act Rule 204-2(a)(15)(ii).
35 Adopting Release, supra note 9, at 241-242.
36 See *supra* note 22.

Revise SEC Registration Disclosure in Offering Materials

- In a footnote to the Marketing Rule's adopting release, the SEC reiterated that an adviser's statements in an advertisement are subject to Section 208(a) of the Advisers Act, which makes it unlawful for any SEC-registered adviser "to represent or imply in any manner whatsoever that it has been sponsored, recommended, or approved, or that his abilities or qualifications have in any respect been passed upon by the United States or any agency or any officer thereof." The SEC stated that an adviser's use of the phrase "registered investment adviser" (or a similar formulation) could therefore be misleading under the Marketing Rule if it is used to imply a certain level of competence, training or education.[37] Accordingly, SEC-registered CLO managers should ensure that any OM or similar document that mentions their SEC registration status includes a statement to the fact that "[s]uch registration is not an endorsement of the [CLO Manager] by the SEC, nor does it indicate that the adviser has attained any particular level of skill or ability."
- The SEC also reiterated in the adopting release that most of the substantive provisions of the Advisers Act (including the Marketing Rule) do not apply with respect to the non-U.S. clients (including CLOs) of an SEC-registered offshore adviser. We would recommend that offshore CLO managers that mention their SEC registration status in an OM or similar offering document used for an offshore CLO add the following statement: "While the [CLO Manager] is registered with the SEC as an investment adviser, Prospective Investors should note that the [CLO Manager] is only required to comply with the Advisers Act with respect to its U.S. clients. Non-U.S. clients, including the [CLO] (and, accordingly, the investors therein), will not be afforded the protections of the Advisers Act."

37 Adopting Release, *supra* note 9, at 72.

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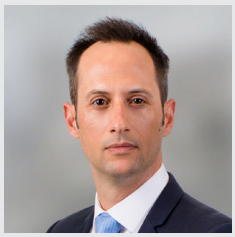

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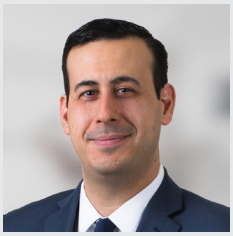

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