Milbank

Insights

**Structured Credit Practice**

# New Adviser Marketing Rule – Impact on CLO Arrangers

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On November 4, 2022 – exactly three years after amended Rule 206(4)-1 (the **Marketing Rule**) was first issued in proposed form[1] – compliance with the new rule becomes mandatory for all registered investment advisers (**RIAs**) and will impact virtually all CLOs. In a recent risk alert, the staff of the Securities and Exchange Commission (**SEC** or **Commission**) warned that upcoming examinations will focus on Marketing Rule compliance and urged RIAs to adapt their policies and procedures accordingly. While the industry has been given a long transition period in which to prepare for the new rule's requirements, the broad reach of the amended rule has seemingly taken the CLO market by surprise.

"Advertisements" under the Marketing Rule include not only traditional advertising but also compensated third-party solicitations, including solicitations of prospective investors in private funds, notwithstanding that private fund solicitations are concurrently addressed by broker-dealer regulation and have historically been excluded from separate Advisers Act regulation of solicitations. "Private funds" for this purpose include any issuer that relies on the Section 3(c)(1) or Section 3(c)(7) exception under the Investment Company Act of 1940 (the **ICA**) and therefore include not only most hedge funds and private equity funds but also many structured finance vehicles, including virtually all CLOs.

This client alert focuses on the Marketing Rule as it applies to the relationship between collateral managers and the placement agents or arrangers they engage to market CLOs to prospective investors. The solicitation activities of a CLO arranger will constitute "advertising" under the Marketing Rule if the arranger is engaged by a collateral manager that is an RIA, as nearly all CLO collateral managers are, to market a CLO that relies on ICA Section 3(c)(7), as nearly all CLOs do. Compliance with the Marketing Rule is not as onerous as it may first appear, however, and once the elements are understood, collateral managers and arrangers can work together to develop and implement appropriate practices before the mandatory compliance date.

[1] SEC Release No. IA-5407 (Nov. 4, 2019) (the Proposing Release). The Marketing Rule was issued in final form on December 22, 2020 (SEC Release IA-5653) (the Adopting Release) and went into effect on May 4, 2021. RIAs were given 18 months in which to elect to comply with the amended rule, but most have chosen to defer compliance until the November 4, 2022 mandatory compliance date.

## I. When is an Arranger Communication an "Advertisement"?

The SEC adopted a two-prong definition of "advertisement" to regulate the advertising and marketing practices of investment advisers under a single rule.

The first prong of the advertisement definition[2] captures certain communications by the adviser itself – "[a]ny direct or indirect communication an investment adviser makes to more than one person … 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," subject to certain exceptions – and generally corresponds in scope to the prior advertisement definition.

The second prong of the definition[3] captures certain third-party communications – any "endorsement or testimonial" for which an investment adviser provides compensation, directly or indirectly. In relevant part, the second prong covers compensated "endorsements," which include solicitations and referrals, as discussed below.

### *A. Scope of "Endorsement"*

Under the Marketing Rule definitions:

*Endorsement* means any statement by a person other than a current client or investor in a private fund advised by the investment adviser that:

i. 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;

ii. 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 investment adviser; or

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[2] Under the first prong of the definition in Rule 206(4)-1(e)(1), an "advertisement" includes:

(i) 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, but does not include:

(A) Extemporaneous, live, oral communications;

(B) 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; or

(C) A communication that includes hypothetical performance that is provided:

(*1*) In response to an unsolicited request for such information from a prospective or current client or investor in a private fund advised by the investment adviser; or

(*2*) To a prospective or current investor in a private fund advised by the investment adviser in a one-on-one communication;

[3] An "advertisement" under the second prong of the definition includes:

(ii) 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.

"Testimonial" and "endorsement" are defined similarly and generally include solicitations, referrals, and certain other statements; such statements are "testimonials" if made by a current client or investor in a private fund advised by the adviser and "endorsements" if made by any other person.

iii. Refers any current or prospective client or investor to be a client of, or an investor in a private fund advised by, the investment adviser.

Historically, third-party solicitations and referrals were regulated under a separate Advisers Act rule, the cash solicitation rule, but only as applied to direct client solicitations. Based on the 2006 D.C. Circuit Court holding that the "client" of a private fund manager is generally the private fund itself and not the investors in the fund, [4] the SEC staff took the position that the cash solicitation rule did not apply to solicitations of private fund investors.[5] The explicit inclusion of private fund investors in the new definition reverses this interpretation.

*No exception for oral or one-on-one communications*

The first prong of the advertisement definition (capturing certain direct and indirect communications by the adviser itself) generally excludes one-on-one communications and "extemporaneous, live, oral communications," in order avoid an undue compliance burden on advisers and a chilling effect on their communications with investors.[6] The second prong of the definition, which the Commission views as traditional solicitation activity, *does not* exclude oral or one-on-one communications. Indeed, the Commission states in the Adopting Release, "[t]hese types of communications are precisely what the second prong of the definition seeks to address."[7]

Therefore, any form of statement by an arranger to a prospective investor, including statements made in person or in a call or email, may potentially be an endorsement, *if* it is considered a solicitation or referral to invest in CLO securities or indicates approval, support, or recommendation of the collateral manager or its personnel.

*Qualified exception for OMs and PPMs*

Based on commentary in the Adopting Release relating to private placement memoranda for private funds,[8] as well as the explicit exclusion from both prongs of the advertisement definition for certain "information contained in a statutory or regulatory notice filing, or other required communication,"[9] an arranger's dissemination of an offering memorandum (OM) or similar offering document should not be considered an endorsement to the extent the content includes a description of the material terms, objectives, and risks of the notes and the CLO and other information reasonably designed to satisfy legal disclosure requirements. OM content that goes beyond the foregoing (for example, by including related performance information of other funds or accounts managed by the collateral manager)[10] may constitute an endorsement and an

[4] *Goldstein v. S.E.C.*, 451 F.3d 873 (D.C. Cir. 2006).

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

[6] Rule 204(6)-1(e)(1)(i), quoted in note 2 above; Adopting Release at 39.

[7] Adopting Release at 55.

[8] Adopting Release at 62 ("We agree that information included in a PPM about the material terms, objectives, and risks of a fund offering is not an advertisement of the adviser.").

[9] Rule 206(4)-1(e)(1)(i) and (ii) (An advertisement "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.").

[10] Adopting Release at n. 194 ("Whether particular information included in a PPM constitutes an advertisement of the adviser depends on the relevant facts and circumstances. For example, if a PPM contained related performance information of separate accounts the adviser manages, that related performance information is likely to constitute an advertisement.").

advertisement. The Adopting Release also notes that "pitch books or other materials accompanying PPMs could fall within the definition of advertisement."[11]

### *B. Direct or Indirect Provision of Compensation*

An endorsement will not fall within the second prong of the advertisement definition unless it is a *compensated* endorsement. Any compensation an RIA provides for an endorsement, cash or non-cash, directly or indirectly, triggers the Marketing Rule's requirements, based on the Commission's belief that all forms of compensation for sales or referrals create an incentive to mislead investors and therefore call for heightened safeguards.[12]

The compensation need not come out of the adviser's pocket; for example, an adviser that directs client or fund brokerage to brokers that refer them investors is deemed to be providing direct or indirect compensation for solicitations.[13]

Whether compensation is provided *for* an endorsement is a fact-specific question as to whether there is "a mutual understanding of a *quid pro quo*, whether explicit or inferred." The rule may be triggered whether compensation is provided before or after an endorsement, although the Commission acknowledged that the timing of compensation relative to an endorsement is generally relevant in determining whether an adviser is providing compensation for the endorsement.[14]

A typical engagement letter in which an arranger agrees to, among other things, assist in the placement of CLO securities in exchange for fees based on the amount of securities sold, would be expected to constitute provision by an RIA of direct or indirect compensation as contemplated by the second prong of the advertisement definition.

### *C. Practical Implications*

At a minimum, some subset of an arranger's communications with prospective CLO investors will constitute solicitations and therefore endorsements; the challenge is where to draw the line, if there is a line, between an informal preliminary communication and a "solicitation" or "referral," neither of which is defined. The question is an important one because, as discussed further below, arranger communications that rise to the level of solicitations or referrals must include certain concurrent clear and prominent disclosures, and RIAs are responsible for reasonably ensuring that the arranger complies.

Collateral managers will be expected to formulate guidelines as to what arranger communications should be treated as endorsements triggering the rule's disclosure requirements. Although specific guidance on the scope of "endorsements" is limited, relevant considerations would include the regulatory intent that the definition capture statements that have the potential to mislead investors unless accompanied by clear disclosure regarding conflicts.[15] It may also be relevant to consider, by analogy, the scope of "recommendations" that trigger application of Regulation Best Interest (**Regulation BI**). The Commission states in the Adopting Release that the Marketing Rule's disclosure requirements are unnecessary where

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[11] Id.

[12] Proposing Release at 206-07.

[13] Proposing Release at 206; Adopting Release at 99.

[14] Adopting Release at 51.

[15] Adopting Release at 16.

Regulation BI applies;[16] the implication is that, in the Commission's view, any communication that constitutes an "endorsement" would also (if made to a retail investor) constitute a "recommendation."[17]

The SEC and FINRA have provided extensive guidance over the years on when a communication by a broker should be considered a "recommendation." An important factor is whether the recipient of the communication would reasonably view it as a "call to action" or a suggestion to purchase a security, considering the content and context of the communication and the way it is presented.[18] A broker's communication of unrequested information about a security does not necessarily constitute a recommendation, in the regulators' view, but requires careful review of the overall facts, particularly if the communication is to a specific or targeted group of potential investors.[19]

To the extent it is reasonable to infer that a communication that is not a "recommendation" would also not be an "endorsement," the above interpretations may form a basis for a collateral manager to determine that certain arranger communications – e.g., calls or emails that reference a CLO but do not express approval or include any non-objective information – need not be treated as endorsements in the absence of facts and circumstances that would reasonably cause the recipient to view the communication as a suggestion to invest. Provision by an arranger of marketing materials such as a flip book would likely be seen as a suggestion to invest, and therefore an endorsement and a prong two advertisement, as well as a direct or indirect adviser communication that constitutes a prong one advertisement. However, as discussed below, the requirements specific to endorsements are not generally onerous where the endorsement is provided by a registered broker-dealer.

## II. Requirements Applicable to Covered Arranger Activities

The discussion below focuses on Marketing Rule requirements that apply where an arranger is a broker or dealer registered with the SEC under the Securities Exchange Act of 1934 (the **Exchange Act**) and solicits persons that are not "retail customers" (generally, natural persons) as defined in Regulation BI.[20]

### *A. Required Disclosures – Who, What, When, and How*

In addition to the broad general prohibitions that apply to all advertisements, the Marketing Rule includes specific disclosure requirements for advertisements that are or include endorsements. Paragraph (b)(1) of the Marketing Rule prohibits an RIA from directly or indirectly providing compensation for any endorsement unless:

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[16] See, for example, Adopting Release at 102: "[I]n circumstances where Regulation BI applies to a broker-dealer's activity as a promoter, we believe the Disclosure Obligation under Regulation BI is sufficiently similar to satisfy the disclosure provisions under our final rule."

[17] Regulation BI applies where a broker-dealer makes a recommendation of a securities transaction or investment strategy involving securities to a "retail customer," which as defined includes only natural persons. Whether a recommendation has been made for purposes of Regulation BI is determined in a manner "consistent with precedent under the anti-fraud provisions of the federal securities laws as applied to broker-dealers and with how the term ["recommendation"] has been applied under the rules of self-regulatory organizations (such as FINRA)." https://www.sec.gov/info/smallbus/secg/regulation-best-interest#What_recommendations_are_covered.

[18] Id.; see also FINRA Reg. Notice 01-23, text preceding note 10.

[19] FINRA Reg. Notice 01-23, text following note 18.

[20] As noted, solicitations of retail persons are generally excluded from the Marketing Rule disclosure requirements because Regulation BI is deemed to provide comparable protections. Such solicitations (if compensated) are nonetheless "advertisements" subject to the general prohibitions and requirements of the Marketing Rule.

**Required disclosures**. The investment adviser discloses, or reasonably believes that the person giving the testimonial or endorsement discloses, the following at the time the testimonial or endorsement is disseminated:

i. Clearly and prominently:

A. That the testimonial was given by a current client or investor, and the *endorsement* was given by a person other than a current client or investor, as applicable;

B. That cash or non-cash compensation was provided for the *testimonial* or *endorsement,* if applicable; and

C. 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;[21]

These disclosures, which are held to the "clear and prominent" standard because they are considered integral to the concerns associated with third-party endorsements,[22] are the only endorsement-specific disclosures required where a registered broker-dealer solicits an institutional (non-retail) investor.

Below we break down the who, what, when, and how of the required clear and prominent disclosures as applied to a typical CLO engagement:

*Who must provide the clear and prominent disclosures?*

To the extent the collateral manager itself does not provide the required disclosures, it must reasonably believe that the arranger is doing so. Collateral managers will be expected to include arrangements, in the engagement letter or elsewhere,[23] to reasonably ensure that the arranger makes the required disclosures where it separately communicates with prospective investors and the collateral manager is not itself in a position to do so.

*What clear and prominent disclosures are required?*

The required clear and prominent disclosures are intended to be concise and straightforward.[24] Simple statements that the arranger making the communication is not a current client of, or investor in a private fund advised by, the collateral manager and is receiving cash or non-cash compensation for providing the communication would generally suffice for purposes of clauses A and B.

Further disclosure pursuant to clause C is not required unless the arranger is subject to material conflicts of interest arising from its relationship with the collateral manager *apart from* the provision of compensation under the engagement. Collateral managers will be expected to consider with their arrangers whether their overall relationship gives rise to material conflicts outside of the specific engagement. Judgments of materiality may depend on facts outside the collateral manager's knowledge; for example, if the arranger and/or its affiliates separately act as service providers to the collateral manager and/or its affiliates, the

[21] Rule 206(4)-1(b)(1). Endorsements by persons that are not registered broker-dealers require additional disclosures, per clauses (ii) and (iii) of Rule 206(4)-1(b)(1).

[22] Adopting Release at 91.

[23] Adopting Release at 104 ("The adviser may choose to include provisions in its written agreement with the promoter, requiring the promoter to provide the required disclosures to investors. The aforementioned ways are only examples of how an adviser may demonstrate that it has a reasonable belief.") (footnote omitted).

[24] Adopting Release at 90, 94-95.

collateral manager may be dependent on the arranger to assess whether revenue derived from the relationship is material in the context of the arranger's and/or its affiliates' business as a whole.

Once a collateral manager and arranger identify any material conflicts, crafting the required disclosure should be relatively simple. The clear and prominent disclosure need only state the conflict, not describe it; for example, per the Adopting Release, it should be sufficient to simply state that the endorsement was provided by an affiliate of the adviser, if this relationship is the source of the conflict.[25]

As noted, the clear and prominent disclosure requirement applies in addition to, and not in lieu of, the rule's general prohibitions of the rule, and more detailed disclosure may be called for to the extent necessary to make any statements made not misleading or to avoid giving rise to a misleading inference.[26]

*When and how must clear and prominent disclosures be provided?*

The Commission's initial proposal would have permitted required disclosures to be delivered as soon as reasonably practicable after the time of solicitation or, in the case of a mass solicitation, promptly after a solicited investor expresses an initial interest.[27] In the final rule, the Commission declined to permit later provision for those integral disclosures held to the "clear and prominent" standard. Delivery must occur *concurrently with* the provision of an endorsement, in the Commission's view, to have full impact and protect against investor confusion.[28]

Moreover, disclosures must generally be provided *within* the endorsement and not separately in order to be clear and prominent. Hyperlinks, while permissible for certain purposes, do not suffice.[29] The clear and prominent disclosures must be no less prominent than the statements that constitute an endorsement and sufficiently close that they are read at the same time as those statements. In the case of an oral solicitation, the required disclosures can be provided either orally or in writing, but if in writing, the person providing the solicitation should alert the investor to the written disclosures and their importance.[30]

### *B. Disqualification Prohibition*

Paragraph (b)(3) of the Marketing Rule prohibits an RIA from directly or indirectly compensating a person for an endorsement if the RIA knows, or reasonably should know, that the person is an "ineligible person" as defined in the rule at the time the endorsement is disseminated. Where an arranger or other endorsement provider is a registered broker-dealer, this prohibition does not apply so long as the broker-dealer is not subject to "statutory disqualification" as defined in the Exchange Act.[31]

*Timing considerations*

Collateral managers would be expected to obtain assurances at the time of engagement that an arranger is a registered broker-dealer and is not subject to statutory disqualification. However, the disqualification prohibition applies throughout the engagement. If an arranger becomes subject to statutory disqualification

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[25] Adopting Release at 95.

[26] Adopting Release at note 295.

[27] Proposing Release at 222-23.

[28] Adopting Release at 105.

[29] Adopting Release at 92.

[30] Adopting Release at 91, note 289 and accompanying text.

[31] Rule 206(4)-1(b)(4)(iii)(C). Under Section 3(a)(39) of the Exchange Act, a person is subject to "statutory disqualification" with respect to membership in FINRA or another self-regulatory organization is subject to certain sanctions or has been found to have been involved in various "bad acts."

but continues to market the CLO, it will generally be in breach of applicable broker-dealer regulation, but the collateral manager will also potentially be in breach of the Marketing Rule unless it does not know and should not reasonably know of the arranger's disqualified status.

The prohibition is tied to the timing of the impermissible endorsement and not to the timing of payment. If an arranger becomes disqualified in the course of an engagement, it may still receive compensation for solicitations or other endorsements made before the disqualification applied.[32]

*Reasonable care standard*

RIAs must have a reasonable basis for believing a broker-dealer is not subject to disqualification at the time it provides an endorsement. This is both an exception from the disqualification prohibition, which does not apply to an adviser that does not know and should not reasonably know that an endorser is ineligible, and an independent obligation under the Marketing Rule's oversight requirements,[33] as described below.

## *C. Adviser Oversight and Compliance*

The Marketing Rule requires RIAs to oversee compliance by any person compensated to provide endorsements. The oversight obligation has two components:

> The investment adviser must have:
>
> i. A reasonable basis for believing that the testimonial or endorsement complies with the requirements of this section; and
>
> ii. A written agreement with any person giving a testimonial or endorsement that describes the scope of the agreed-upon activities and the terms of compensation for those activities.[34]

*Written agreement*

The written agreement requirement will generally be satisfied by the engagement letter between a collateral manager and an arranger. As initially proposed, the rule would have required the agreement to include explicit undertakings by the solicitor to perform its activities in compliance with relevant Advisers Act provisions.[35] In the final Marketing Rule, the Commission chose not to prescribe specific provisions, in order to give advisers flexibility to determine whether and how to address disclosure and other requirements in their written agreements with promoters based on the nature of the arrangement and the associated risks.[36]

*Reasonable basis and monitoring*

Similarly, the rule and Adopting Release do not prescribe the steps an adviser must take to establish a reasonable basis for believing a solicitor's endorsements are compliant. The question of what would constitute a reasonable basis depends on the facts and circumstances. Having a written agreement does not by itself satisfy the reasonable basis requirement,[37] although including provisions in the written

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[32] Adopting Release at 119-20.

[33] Adopting Release at note 499.

[34] Rule 206(4)-1(b)(2).

[35] Proposing Release at 229-30.

[36] Adopting Release at 111.

[37] Adopting Release at note 358.

agreement requiring a promoter to provide the required disclosures or implement other compliance-related mechanisms may help an adviser to form a reasonable belief. [38]

The requirement applies to compliance with the Marketing Rule as a whole, not solely the endorsement-specific disclosure and disqualification provisions discussed above. The Adopting Release places particular importance, however, on the need for an adviser to monitor third-party statements that constitute endorsements when the adviser does not disseminate the endorsements directly. [39]

## III. Devising a Practical Plan of Compliance

It is important for collateral managers and arrangers to work together to develop and document procedures, whether in the engagement letter or separately, that are workable for both parties and satisfy the collateral manager's oversight responsibilities. Given that endorsement requirements are relatively streamlined where an arranger is a registered broker-dealer, collateral managers may be expected to err on the side of caution in determining what types of arranger communications should be treated as endorsements triggering the rule's requirements. For engagements that are already in place and will continue past November 4, 2022, the parties may need to amend or supplement their existing agreements, if they have not already done so, to reasonably ensure that the arranger's post-compliance date activities satisfy the amended rule.

In attempting to devise solutions to comply with the Marketing Rule, we have found ourselves confronted by the usual knee-jerk reactions, including "this could not have been the intent," "this doesn't work for CLOs," and "isn't there a practical approach that doesn't technically comply?" Such reactions are understandable, given the Marketing Rule's departure from the prior regime, and arrangers are undoubtedly resistant to take on additional responsibility to address regulatory issues of the collateral manager. Yet the reality is that arrangers and collateral managers must work together to achieve compliance in order for the CLO pipeline to continue.

[38] Adopting Release at 104, 110.

[39] Adopting Release at 113.

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