The New Investment Adviser Marketing Rule: Implications for CLO Managers and Arrangers

October 2022

I. Introduction

On December 20, 2020, the Securities and Exchange Commission (the "SEC") adopted reforms under the Investment Advisers Act of 1940 (the "Advisers Act") which modernized rules that govern investment adviser advertising and payments to solicitors.[1] On September 19, 2022, the SEC Division of Examinations published a Risk Alert[2] to inform SEC-registered investment advisers ("Advisers") that examinations will soon be focused on compliance with the new Advisers Act Rule 206(4)-1 (the "Marketing Rule"), and to urge Advisers to update or revise their written policies and procedures accordingly.

Commencing on the November 4, 2022 (the "Compliance Date"), investor solicitation by CLO arrangers and placement agents engaged by collateral managers that are Advisers will constitute "advertising" under the Marketing Rule in respect of any CLO that relies on Section 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act"). Since substantially all CLO collateral managers are Advisers, and nearly all CLOs rely on Section 3(c)(7) of the Investment Company Act (and thus constitute "private funds" for purposes of the Marketing Rule), collateral managers and arrangers will need to collaborate in developing practices and procedures to enable CLO adherence to the Marketing Rule in anticipation of the Compliance Date.

II. Rules Governing Advertisements

Restrictions on Advertisements: Not only does the Marketing Rule prohibit advertisements[3] from including untrue statements of material facts or making material omissions, but it also requires

[1] Seward & Kissel's prior alerts on the Marketing Rule can be found here: December 23, 2020; January 26, 2021; September 13, 2021; September 22, 2022; and October 4, 2022.

[2] SEC, Examinations Focused on the New Investment Adviser Marketing Rule, available at https://www.sec.gov/files/exams-risk-alert-marketing-rule.pdf.

[3] An "advertisement" is any direct or indirect communication an adviser makes to more than one person that offers the adviser's investment advisory services with regard to securities to prospective clients or investors in a private fund advised by the adviser, or offers new investment advisory services with regard to securities to current clients or investors in a private fund advised by the adviser. See Marketing Rule 206(4)-1(e)(1)(i).

that Advisers have a reasonable basis for believing they will be able to substantiate material statements of fact in their advertisements.[4] Advisers should be prepared to demonstrate that performance results or performance time periods included in advertisements are presented in a fair and balanced manner.[5]

Conditions for Testimonials or Endorsements: Testimonials[6] or endorsements[7] that result in direct or indirect compensation[8] may only be included in advertisements if such advertisements clearly and prominently disclose (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, as 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 Adviser's relationship with such person (such conditions, the "Required Disclosure Condition"). [9] The Marketing Rule also requires disclosure of the material terms of any compensation arrangement and a description of any material conflicts of interest, as applicable.[10] Advisers are also prohibited from compensating a person 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 of solicitation.[11]

The endorsement prong of the Marketing Rule is intended to apply to traditional solicitation and referral activity, and, according to the SEC's Adopting Release (the "Release"), seeks to address oral and one-on-one communications. As a result, any statement made by arrangers to prospective investors (whether by email, telephonically, in person or otherwise) may constitute a potential endorsement, so long as it indicates approval, support or recommendation of a CLO collateral manager or its staff, or constitutes a solicitation or referral to invest in CLO securities.

The endorsement prong applies solely to compensated endorsements, which compensation may be cash, non-cash, direct or indirect, and need not be out-of-pocket. Thus, the Marketing Rule is likely to be triggered by customary CLO engagement letters, where an arranger is agreeing to

---

[4] Advisers must have (i) a reasonable basis for believing that the testimonial or endorsement complies with the requirements of the Marketing Rule; and (ii) a written agreement with any promoter that describes the scope of the agreed-upon activities and the terms of compensation for those activities (such condition, the "Adviser Oversight and Compliance Condition"). *See* Marketing Rule 204-1(b)(2).

[5] For further discussion of the performance advertising requirements of the Marketing Rule, please see our September 22, 2022 and October 4, 2022 Client Alerts on the Marketing Rule.

[6] A "testimonial" includes any statement by a current private fund investor that directly or indirectly solicits any investor to be a client of the Adviser or an investor in a private fund advised by the Adviser. *See* Marketing Rule 206(4)-1(e)(5).

[7] An "endorsement" is any statement by a person other than a current client or investor in a private fund that directly or indirectly solicits any investor to be a client of the Adviser or an investor in a private fund advised by the Adviser. *See* Marketing Rule 206(4)-1(e)(17).

[8] "Compensation" includes both cash and non-cash compensation. *See* Investment Adviser Marketing, Release No. IA-5653 (Dec. 22, 2020) (the "Release") at 46, *available at* https://www.sec.gov/rules/final/2020/ia-5653.pdf.

[9] SEC, Adopting Release, Investment Adviser Marketing, Release No. IA-5653; File No. S7-21-19, available at https://www.sec.gov/rules/final/2020/ia-5653.pdf, (hereafter, the "Adopting Release") at 86-87.

[10] *See* Adopting Release at 87.

[11] Advisers 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 promoter is an "ineligible person" at the time the testimonial or endorsement is disseminated (such condition, the "Disqualification Condition"). *See* Marketing Rule 204-1(b)(3). Under the Marketing Rule, an "ineligible person" is a person who is subject either to a "disqualifying Commission action" or to any "disqualifying event," and certain of that person's employees and other persons associated with an ineligible person. *See* Marketing Rule 204-1(e).

exchange its securities placement services for fees.

Notably, the Release indicates that the customary information in a CLO offering document "about the material terms, objectives and risks of a fund offering"[12] that is reasonably designed to satisfy legal requirements does not constitute an advertisement. Whether particular disclosure, however, is characterized as an advertisement depends on the relevant facts and circumstances. For example, "related performance information of separate accounts the adviser manages"[13] contained in an offering document (although not typically contained in an offering document for a CLO) is likely to constitute an advertisement, and "pitch books or other materials"[14] may also fall within the definition.

Moreover, CLO collateral managers should strive to obtain assurances from their CLO arrangers that such arrangers are registered broker dealers and not subject to disqualification under the Securities Exchange Act of 1934, as amended (the "Exchange Act") both prior to and throughout the related engagement, since a failure of the arranger to remain statutorily eligible throughout the CLO marketing period may result in a breach by the collateral manager of the Marketing Rule.

Exemptions: The Marketing Rule provides exemptions from certain of the requirements described above for testimonials and endorsements disseminated: (a) for no compensation or de minimis compensation;[15] (b) by a partner, officer, director or employee of the Adviser or its affiliates;[16] (c) by an SEC-registered broker-dealer in certain circumstances;[17] or (d) by a person that is covered by rule 506(d) of the Securities Act of 1933 (the "Securities Act") with respect to a rule 506 securities offering and whose involvement would not disqualify the offering under the rule.[18]

Books and Records: The SEC also adopted: (i) changes to Item 5 of Form ADV Part 1A that will require Advisers to report its use of certain advertising practices, including, among other kinds of advertising practices, the extent to which the adviser uses performance results; and (ii) amendments to Rule 204-2 under the Advisers Act (the "Books and Records Rule") that will require an adviser to maintain certain records regarding all advertisements it disseminates, subject to

---

[12] *See* Adopting Release at 62.
[13] *See* Adopting Release at 194.
[14] *See* Adopting Release at 194.
[15] De minimis compensation is defined as compensation paid to a person for providing a testimonial or endorsement of a total of $1,000 or less (or the equivalent value in non-cash compensation) during the preceding twelve months. *See* Marketing Rule 206(4)-1(e)(2). A testimonial or endorsement disseminated for no compensation or de minimis compensation is exempt from the written agreement requirement of the Adviser Oversight and Compliance Condition and the Disqualification Condition that would otherwise apply to a testimonial or endorsement. *See* Marketing Rule 206(4)-1(b)(4)(i).
[16] A testimonial or endorsement by a partner, officer, director or employee of the adviser or its affiliates is exempt from the Required Disclosures Condition and written agreement requirement of the Adviser Oversight and Compliance Condition that would otherwise apply to a testimonial or endorsement, provided that the affiliation between the adviser and such person is readily apparent to or is disclosed to the client or investor at the time the testimonial or endorsement is disseminated. *See* Marketing Rule 206(4)-1(b)(4)(ii).
[17] A testimonial or endorsement by a SEC-registered broker-dealer is exempt from the following requirements that would otherwise apply to a testimonial or endorsement: (i) the Required Disclosure Condition, provided, that the testimonial or endorsement is a recommendation subject to Regulation Best Interest under the Exchange Act; (ii) the disclosure of the material terms of any compensation arrangement and any material conflicts of interest requirement of the Required Disclosure Condition, provided, that the testimonial or endorsement is provided to a person that is not a retail customer as defined under Regulation Best Interest under the Exchange Act; and (iii) the Disqualification Condition, provided, that the broker or dealer is not subject to statutory disqualification, as defined in 3(a)(39) of the Exchange Act. *See* Marketing Rule 206(4)-1(b)(4)(iii).
[18] A testimonial or endorsement by a person that is covered by rule 506(d) of the Securities Act with respect to a rule 506 securities offering and whose involvement would not disqualify the offering under that rule is not required to comply with the Disqualification Condition that would otherwise apply to a testimonial or endorsement. *See* Marketing Rule 206(4)-1(b)(4)(iv).

certain exemptions or different requirements with respect to oral advertisements.

III. Analysis

The responsibility for reasonably ensuring that any endorsement is accompanied by the clear and prominent disclosures required by the Marketing Rule falls on the collateral manager, even when an arranger separately communicates with a CLO investor without direct collateral manager involvement. It is therefore incumbent on the collateral manager to collaborate with the CLO arranger to draw parameters around the scope of arranger communications that would constitute the type of solicitation or referral contemplated by the Marketing Rule. While neither "solicitation" nor "referral" is expressly defined in the Marketing Rule, the regulatory intent would suggest that any statement having the potential to mislead should be accompanied by the mandated disclosures.

If you have any questions or comments about this publication, please feel free to contact Greg B. Cioffi at (212) 574-1439, Andrew Robertson at (212) 574-1676 or Grace Nealon at (212) 574-1677.