Milbank

Insights

London Structured Credit Group

The Marketing Rule and its implications for European CLOs

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November 4, 2022 marked the deadline for compliance with amended Rule 206(4)-1 (the "**Marketing Rule**")[1] under the Investment Advisers Act of 1940 (the "**Advisers Act**"), imposing additional obligations on certain investment advisers registered ("**RIAs**") with the U.S. Securities and Exchange Commission (the "**SEC**") and their relying advisers ("**Relying Advisers**")[2].

In this client alert, we examine the impact of the Marketing Rule on the collateralised loan obligation ("**CLO**") industry, the additional implications that European CLO market participants will need to consider, and how a consensus is developing between in-scope CLO managers ("**In-scope Managers**") and arranging banks as to Marketing Rule compliance in the context of CLO marketing activities.

Executive Summary

- In-scope Managers are now subject to an enhanced disclosure regime, ongoing diligence requirements and restrictions on the engagement of third parties marketing their advisory services.
- The majority of US-based CLO managers, and certain of their European affiliates, are impacted, with the activities of arrangers appointed to market their transactions likely to constitute "advertisements" under the Marketing Rule.
- In-scope Managers are working with arrangers to agree on the contractual framework for arrangers' solicitation activities, ensuring In-scope Managers have a reasonable basis for believing any "endorsements"[3] are compliant with the Marketing Rule.
- A case-by-case analysis should be undertaken by European CLO managers to determine whether the Marketing Rule applies to their marketing activities.
- Ongoing diligence as to the eligibility of arrangers and an enhanced disclosure regime, necessitating the disclosure of the material terms of the fee structure agreed between the In-scope Manager and the arranger, is required where an arranger is not a Registered Broker-Dealer (as defined below).
- The market is coalescing around a 'cleansing notice' approach, whereby the "required disclosures" under the Marketing Rule are provided *en masse* to prospective investors at the outset of marketing activities.

Applicability to CLOs

Are CLOs Private Funds?

As noted in our recent alert, *New Adviser Marketing Rule – Impact on CLO Arrangers*, compensated third-party solicitations, including solicitations of prospective investors in "private funds"[4], are subject to the Marketing Rule where made on behalf of in-scope investment advisers. In the context of a CLO managed by an In-scope Manager[5], the endorsements made by the arranger to prospective investors in the CLO notes will therefore be captured under the Marketing Rule as an "advertisement"[6] assuming the CLO is a

"private fund". Most CLOs are "private funds" for purposes of the rule by virtue of their reliance on the Section 3(c)(7) exemption under the U.S. Investment Company Act of 1940.[7]

Although the Marketing Rule is not directly applicable to arrangers, their investor-facing role is indirectly subject to the regime, making the compliance of their communications of utmost importance to In-scope Managers. In recognition of this, arrangers and In-scope Managers need to take a collaborative approach in navigating the Marketing Rule requirements and work together in establishing an appropriate compliance framework.

Applicability to European CLOs

The applicability of the Marketing Rule to European CLOs is fact-specific and will need to be assessed on a case-by-case basis. As a starting point, the marketing activities of an arranger of a European CLO will be within scope where:

- the CLO manager is an RIA that has its principal place of business in the US ("onshore");
- the CLO manager is a Relying Adviser that, whether based in or outside the US, is treated as "onshore" for Advisers Act purposes; or
- subject to certain considerations, the CLO manager delegates investment advisory functions to an affiliate onshore RIA or Relying Adviser (e.g. as a sub-adviser).

An RIA that has its principal place of business outside the US is out of scope of the Marketing Rule to the extent its activities relate solely to non-US clients. A CLO organized outside the US is considered a non-US client for these purposes, even if it is marketed to US investors.

The Marketing Rule will *de facto* apply to European CLOs managed by onshore RIAs (including Relying Advisers) (each an "**Onshore RIA**"), irrespective of whether the CLO itself is marketed in the US. For European CLOs where the primary CLO manager is not an Onshore RIA but there is an element of delegation to, or sub-management by, an Onshore RIA, the application of the Marketing Rule is more nuanced. Marketing may be in scope to the extent the Onshore RIA (as opposed to, or in addition to, the primary manager) is seen as directly or indirectly providing compensation to the arranger for marketing a private fund that the Onshore RIA advises. Relevant considerations in this analysis would generally include, among other possible factors:

- the extent to which management activities and fees are, respectively, delegated and paid by the CLO manager to an Onshore RIA(s);
- the involvement (direct or indirect) of the Onshore RIA in the engagement and compensation of the arranger; and
- the degree to which the Onshore RIA, and its advisory services, is specifically referenced in the marketing/offering materials relating to the CLO.

The factors above may be indicative that the solicitation of the relevant investor is predicated, at least in part, on the advisory services of the Onshore RIA. Ultimately, each CLO manager will need to analyse the structure of their advisory services with counsel to determine whether the Marketing Rule applies to their European platform.

So what does the Marketing Rule say?

Regulation of Advertisements

As discussed in Milbank's recent Client Alert, the Marketing Rule seeks to regulate the advertising and marketing practices of RIAs under a single rule, covering both communications by investment advisers themselves and, more pertinently, certain third-party communications.

Significantly, whilst "extemporaneous, live, oral communications" of investment advisers are outside of the scope of the Marketing Rule, oral or one-on-one communications of agents of investment advisers (such as arrangers) are not excluded where that communication amounts to an endorsement or solicitation of a

prospective investor to invest in a "private fund" advised by such investment adviser and the agent (in this case, the arranger) is compensated (directly or indirectly) for such endorsement.

Required Disclosures

In addition to regulating the content of "advertisements"[8], the Marketing Rule includes specific disclosure requirements for advertisements that are, or include, endorsements. Such "**Required Disclosures**" are enhanced where the relevant arranger does not constitute a "Registered Broker-Dealer"[9] (as will generally be the case for European CLOs), and require an In-scope Manager to disclose, or reasonably believe[10] that the arranger giving the endorsement will disclose, the following at the time of its dissemination:

1. Clearly and prominently:
    a. that the endorsement was given by a person other than a current client or investor;[11]
    b. that cash or non-cash compensation was provided for the endorsement; and
    c. a brief statement of any material conflicts of interest on the part of the endorsing agent arising from its relationship with the investment adviser;
2. The material terms of any compensation arrangement, including a description of the compensation provided or to be provided, directly or indirectly, to the endorser; and
3. A description of any material conflicts of interest on the part of the endorser resulting from its relationship with the investment adviser and/or any compensation arrangement.

A particular irony of the Marketing Rule is that the Required Disclosures are generally more extensive where an arranger is soliciting non-US investors; the obligations at paragraphs 2 and 3 above do not apply where the arranger is a Registered Broker-Dealer (as is typically the case for US CLOs) and is not soliciting retail customers.[12]

Accordingly, although arising from US legislation, In-scope Managers and arrangers in the European CLO market are working together to address these disclosure requirements, including the level of detail required regarding compensation arrangements. In most cases, the engagement letter sets forth an agreed framework for compensation, but the ultimate terms and amount of compensation are not determined until closing of the issuance and depend on the success of the placement, among other factors. Moreover, the arranger's duties are not typically limited to marketing, and it is unclear what portion of its fees represents compensation for providing endorsements as opposed to, for example, providing structuring advice or liaising with rating agencies. As a result, disclosure of specific amounts or percentages may not be feasible or appropriate during the marketing phase of an engagement. In order to satisfy the policies underlying the rule, however, disclosure should be sufficiently detailed to convey those terms that are material to a prospective investor's understanding of the nature and magnitude of the endorsing party's incentives.

Disqualification

Under the Marketing Rule, In-scope Managers are prohibited from directly or indirectly compensating a person for an endorsement if they know, or reasonably should know, that the person is an "ineligible person"[13] at the time the endorsement is disseminated.

Whilst in the US there is an assumption[14] that a person is not an "ineligible person" where it is a Registered Broker-Dealer and is not subject to "statutory disqualification" at the time of making any "endorsement", in Europe, the bases for ineligibility are broader and more difficult for an In-scope Manager to verify through independent diligence. Therefore, in order for In-scope Managers to be able to establish a reasonable basis for believing an arranger is not an "ineligible person" at the time of making any "endorsement", they will need to obtain reasonable comfort to that effect from the arranger. Given the breadth of the definition, arrangers will necessarily need to undertake greater internal diligence to be in a position to provide the necessary comfort.

Oversight and Compliance

As part of their compliance requirements, In-scope Managers must also (i) establish a reasonable basis for believing that any endorsement given by an arranger complies with the Marketing Rule in its entirety and (ii) establish a written framework with any arranger giving an endorsement, describing the scope of the

agreed-upon activities and the terms of compensation for those activities. In-scope Managers are therefore seeking to agree these processes at the outset of their transactions in the engagement letter between the parties.

In-scope Managers are additionally subject to recordkeeping requirements. In the context of endorsements, this includes maintaining a record of each written endorsement constituting an advertisement and, in the case of oral endorsements, a written record of the Required Disclosures provided to investors. Again, this ultimately requires the arranger to agree an "indirect compliance" approach by implementing processes to provide such records to its In-scope Manager clients.

How should In-scope Managers ensure compliance?

In-scope Managers must adopt and implement policies and procedures reasonably designed both to ensure compliance with the Marketing Rule and to enable them to substantiate to the regulators their reasonable basis for believing that any marketing activities undertaken on their behalf are compliant. Ultimately, the framework grounding this determination will be set out in the engagement letter with the arranger, which has led recently to such letters being subject to extensive negotiation as both parties adapt to the practicalities and requirements of Marketing Rule compliance. With respect to existing engagements of In-scope Managers for CLOs currently being marketed, we are advising In-scope Managers to amend their engagement letters to agree a framework with the relevant arranger to comply with the Marketing Rule.

Whilst the exact terms agreed by market participants will invariably differ, in our view, a consensus has developed around compliance with the key principles of the Marketing Rule in the following manner:

- to ensure that no oral endorsements are made to prospective investors who have not received the Required Disclosures, the market is settling on a 'cleansing notice' approach whereby the initial endorsement provided to prospective investors consists of a deal announcement, through a 'Bloomberg blast' or widely distributed email to all such investors, that includes the Required Disclosures;
- all written materials furnished to prospective investors clearly and prominently incorporate the Required Disclosures and are subject to In-scope Manager approval;
- the content of the Required Disclosures is agreed in advance between the parties;
- arrangers typically agree to use commercially reasonable efforts to assist the Manager in ensuring compliance with the rule;
- arrangers agree to provide In-scope Managers with a copy of any initial written communication or the Required Disclosures provided in connection with any initial oral communication;
- the arranger represents that it is not an "ineligible person", undertakes to notify the In-scope Manager if it becomes so and, thereafter, refrain from providing any endorsements; and
- no compensation is payable to the arranger to the extent payment thereof would cause the In-scope Manager to violate the Marketing Rule.

Whilst agreeing a framework governing the arranger's marketing activities in this manner is an important component of establishing a reasonable basis for believing endorsements are compliant, the question of what constitutes a reasonable basis depends on the overall facts and circumstances and In-scope Managers may wish to consider whether supplemental diligence, such as an arranger questionnaire or by obtaining confirmation of compliance from a sample of individual investors in the applicable CLO, is appropriate in each given case.

Conclusion

In an industry where the participants are intimately familiar with the processes and commercial dynamics of the relevant relationships, certain segments of the market feel that CLOs have been somewhat unfairly swept up in a tide of increased regulatory focus on providing transparency for investors. Despite this,

observance of the Marketing Rule is inherently achievable provided that the necessary policies and procedures are put in place by affected parties at the outset.

Whilst the subtle differences in application of the Marketing Rule requirements in Europe remain subject to ongoing market consideration, a consensus appears to be developing meeting the concerns of both In-scope Managers and arrangers. In this regard, where an In-scope Manager determines that the Marketing Rule applies to its CLO management services, the ultimate focus should be on working with its designated arranger to agree a framework as to compliance at the initial stages of the engagement.

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1 17 CFR § 275.206(4)-1.

2 Relying Advisers are a subset of RIAs that do not file a separate Form ADV registration, but rather are included on the registration of an affiliated "filing RIA" under a single umbrella registration with the SEC. Umbrella registration is permitted only when the filing RIA is based in the US ("onshore"); the SEC has said that it considers all Relying Advisers, even those based outside the US, to be "onshore" RIAs fully subject to the substantive provisions of the Advisers Act, including the Marketing Rule.

3 See § 275.206(4)-1(e)(5) which, in summary, defines "endorsements" as statements that indicate approval, support or recommendation of the In-scope Manager, or solicit or refers investors to be a client of, or investor in, a private fund advised by the In-scope Manager. Such statements are defined as "testimonials" rather than endorsements where they are made by a current client of, or investor in a private fund advised by, the adviser. The requirements under the Marketing Rule are substantially the same for compensated testimonials as for compensated endorsements, and for purposes of readability we refer to both as "endorsements" in this Client Alert, although technically an arranger's solicitations would be "testimonials" as opposed to "endorsements" where the arranger is a current client of, or investor in a private fund advised by, the In-scope Manager.

4 A "Private Fund" is defined under the Marketing Rule, by reference to section 202(a)(29) of the Advisers Act, as an issuer of securities that would be an investment company, as defined in section 3 of the Investment Company Act of 1940 (the "ICA") (15 U.S.C. 80a–3), but for the exceptions provided for in section 3(c)(1) or 3(c)(7) of the ICA.

5 For a discussion as to whether a CLO manager constitutes an "In-scope Manager", see "*Applicable to CLOs - Applicability to European CLOs*".

6 See § 275.206(4)-1(e)(1).

7 The vast majority of US and European CLO issuers rely on the Section 3(c)(1) or Section 3(c)(7) exemption from registration under the ICA and therefore constitute "private funds". To the extent a CLO or other structured issuer has an In-scope Manager but relies on a different ICA exemption (such as Rule 3a-7 or Section 3(c)(5)), it would not be a "private fund" and marketing activities would not be in scope, although general Advisers Act anti-fraud principles would still apply.

8 See § 275.206(4)-1(a) which specifies the prohibitions applicable to advertisements under the Marketing Rule, including both general prohibitions and specific prescriptive prohibitions, in particular where advertising of performance results is concerned.

9 A broker or dealer registered with the SEC (a "Registered Broker-Dealer") under section 15(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(a)) (the "Exchange Act") (a "Registered Broker-Dealer").

10 See § 275.206(4)-1(b)(1).

11 See note 3 above.

12 See § 275.206(4)-1(b)(4)(iii)(B) which provides that a testimonial or endorsement by a Registered Broker-Dealer is not required to comply with such paragraphs (§ 275.206(4)-1(b)(1) (ii) and (iii)) if the testimonial or endorsement is provided to a person that is not a retail customer (as that term is defined in § 17 CFR § 240.15l-1(b)(1) (Regulation Best Interest) under the Exchange Act).

[13] An “ineligible person” includes a person who is subject to a “disqualifying Commission action”, taking in, for example, any SEC opinions or orders barring, suspending, or prohibiting a person from acting in any capacity under Federal securities laws, or is subject to specified “disqualifying events”. See § 275.206(4)-1(e).

[14] See § 275.206(4)-1(b)(4)(iii)(C) which provides that the prohibition on compensating a disqualified person under the Marketing Rule shall not apply to testimonial or endorsement by a Registered Broker Dealer if that agent is not subject to “statutory disqualification” (as defined under section 3(a)(39) of that Exchange Act).

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