

SEC Staff Clarifies that Cash Solicitation Rule Does Not Apply to Investment Pool Referrals

An investment adviser that is required to be registered with the US Securities and Exchange Commission ("SEC") is not permitted to pay cash compensation to a solicitor for client referrals unless the investment adviser complies with certain conditions specified in Rule 206(4)-3 (the "Cash Solicitation Rule") under the US Investment Advisers Act of 1940, as amended (the "Advisers Act"). The Cash Solicitation Rule is intended to address the conflicts of interest inherent in certain solicitation arrangements, and the requirements of the Cash Solicitation Rule (including that the payment must be pursuant to a written agreement and that clients of the investment adviser must be provided certain prescribed disclosure) are intended to alert a potential client who is approached by a solicitor that the solicitor is being compensated by the investment adviser for making such a recommendation.

The staff of the SEC recently confirmed that the Cash Solicitation Rule does not apply to a registered investment adviser's cash payments to a person soliciting investors solely to invest in an unregistered investment pool managed by the investment adviser, such as a hedge fund or private equity fund.¹

Clarification of Guidance Under the Cash Solicitation Rule

The staff's response in the Letter confirms that the Cash Solicitation Rule applies only to the solicitation of direct *clients* who will enter into an advisory relationship with a registered investment adviser, and not to *investors* in investment pools managed by the investment adviser.

The definition of "client" was called into question following *Goldstein v. SEC*,² in which the US Court of Appeals for the District of Columbia Circuit held that investors in an investment pool are not "clients" of the pool's investment adviser for purposes of Section 203 of the Advisers Act. Prior to *Goldstein*, the SEC staff had issued several no-action letters indicating that the Cash Solicitation Rule applied to payments made by a registered investment adviser to a person soliciting investors to invest in an investment pool managed by the investment adviser.³ Post-*Goldstein*, some senior SEC officials had commented publicly that the Cash Solicitation Rule does not apply in that scenario.⁴

In the Letter, the SEC staff reasoned that the Cash Solicitation Rule does not apply to payments made by a registered investment adviser to a person soliciting investors for an investment pool managed by the investment adviser because:

- Neither the proposing nor adopting release for the Cash Solicitation Rule references payments to persons soliciting investors

¹ *Mayer Brown LLP*, SEC No-Action Letter (15 July 2008) (the "Letter"). The Mayer Brown enquiry letter sought clarification under the Cash Solicitation Rule only with respect to private investment pools. In its response, the SEC staff defined the term "investment pool" more broadly to include both US-registered investment companies and investment pools relying on any of the exclusions from the definition of "investment company" included in Section 3(c) of the US Investment Company Act of 1940, as amended (the "Investment Company Act"). Most hedge funds and private equity funds rely on the exclusions from the definition of "investment company" provided by Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act.

² 451 F.3d 873 (D.C. Cir. 2006).

³ See, e.g., *Dana Investment Advisors, Inc.*, SEC No-Action Letter (12 Oct. 1994); *Dechert Price & Rhoads*, SEC No-Action Letter (4 Dec. 1990); *Stein Roe & Farnham Inc.*, SEC No-Action Letter (29 June 1990).

⁴ See, e.g., *Plaze Says Letter on Cash Solicitations Was Misinterpreted*, Compliance Reporter (14 July 2006).

for a registered investment adviser's investment pool;

- The Cash Solicitation Rule is designed to apply to solicitations and referrals in which the solicited or referred persons might ultimately enter into an *advisory contract* with a registered investment adviser;
- The references to "client" and "prospective client" in the Cash Solicitation Rule suggest that the Cash Solicitation Rule was intended to apply to solicitations of persons ultimately entering into advisory contracts with a registered investment adviser; and
- The *Goldstein* decision supports the conclusion that the term "client", as used in the Cash Solicitation Rule, applies to a person who enters into an advisory contract with a registered investment adviser—not an investor in an investment pool managed by a registered investment adviser.

The SEC staff emphasised that its interpretation is limited to circumstances in which a registered investment adviser is *solely* compensating a solicitor for referring investors or potential investors to a registered investment adviser so that they may invest in an investment pool managed by the registered investment adviser. The SEC will look to the facts and circumstances of a particular scenario (such as the nature of the arrangement and relationship between the solicitor and the registered investment adviser and the purpose for the registered investment adviser's cash payment to the solicitor) in order to determine if the solicitation relates "solely" to participation in an investment pool.

Conflict of Interest Disclosure

Although registered investment advisers are not required to comply with the Cash Solicitation Rule when making cash payments to a person soliciting investors solely to invest in an investment pool managed by the registered investment adviser, certain disclosures must still be made.

All investment advisers, whether or not registered with the SEC, remain subject to the anti-fraud provisions of the Advisers Act. The SEC recently sought to clarify the parameters of the anti-fraud provisions of the Advisers Act post-*Goldstein* by adopting Rule 206(4)-8.⁵ Rule 206(4)-8 prohibits investment advisers from making false or misleading statements

⁵ *Prohibition of Fraud by Advisors to Certain Pooled Investment Vehicles*, Rel. No. IA-2628 (3 Aug. 2007).

to investors or prospective investors in investment pools managed by the investment adviser or otherwise defrauding those investors or prospective investors. In addition, investment advisers must disclose conflicts of interest to investors in an investment pool. Because cash payments to a solicitor may give rise to conflict of interest situations, such payments should be disclosed to investors in investment pools managed by the investment adviser.

Potential Registration Requirements

Section 202(a)(11) of the Advisers Act defines an investment adviser as someone who "advise[s] others . . . as to the advisability of investment in . . . securities". Accordingly, a solicitor may be acting as an investment adviser when directing a potential investor towards a certain investment pool. If so, the solicitor would be subject to the anti-fraud requirements under the Advisers Act and may be required to register as an investment adviser with the SEC. The SEC staff did not address these issues in the Letter.

Further, Section 3(a)(4)(A) of the US Securities Exchange Act of 1934, as amended ("Exchange Act"), broadly defines the term "broker" to include "any person engaged in the business of effecting transactions in securities for the account of others". Persons meeting that definition are required to register as such with the SEC, a self-regulatory organisation, and/or a state's securities regulator except in certain circumstances. The Letter did not explicitly address whether a solicitor's receipt of cash compensation in exchange for directing investors to invest in particular investment pools would result in the solicitor being considered a "broker" by the SEC. Depending on the facts, receipt of cash compensation could result in a solicitor being required to register as a broker with the SEC.

In addition to compliance with SEC registration requirements, states have their own broker-dealer regulatory regimes, and in some cases certain states take a more restrictive view than the SEC on the activities that may give rise to a registration requirement.

Increased SEC Focus on Solicitation Activities

The Letter may be viewed as evidence of the SEC's increasing interest in solicitations. Other SEC actions, such as the *Public Alert: Unregistered Soliciting Entities*

program,⁶ through which the SEC publishes a list of soliciting firms that have been the subject of investor complaints, as well as recent amendments to Form D under Regulation D of the US Securities Act of 1933, as amended, which require investors to provide information about any recipients of direct or indirect cash compensation—including unregistered finders—in connection with the sale of securities in private placement transactions, are additional examples of the SEC's recent interest in solicitations.⁷

Given the SEC's increasing focus on this area, soliciting firms may wish to reevaluate the application of SEC registration requirements to their business arrangements.



This update was authored by Jennifer O. Epstein.
(+44 20 7184 7403; jennifer.epstein@dechert.com).

⁶ New SEC Program Discloses Information about Unregistered Soliciting Entities, *Dechert OnPoint*, US Issue 8 (May 2008).

⁷ SEC Adopts Amendments to Form D and Mandates Electronic Filing, *Dechert OnPoint*, UK Issue 8 (February 2008).

Practice group contacts

For more information, please contact one of the lawyers listed, or the Dechert lawyer with whom you regularly work. Visit us at www.dechert.com/financialservices.

Karen L. Anderberg
London
+44 20 7184 7313
karen.anderberg@dechert.com

Richard Heffner
London
+44 20 7184 7665
richard.heffner@dechert.com

Patrick W. Dennis
London
+44 20 7184 7571
patrick.dennis@dechert.com

Keith T. Robinson
Hong Kong
+852 3518 4705
keith.robinson@dechert.com

Jennifer O. Epstein
London
+44 20 7184 7403
jennifer.epstein@dechert.com



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