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SEC States that "Cash Solicitation Rule" Does Not Apply to Private Fund Referrals

A question that frequently arises in the private fund context is whether and how a registered investment adviser may compensate third parties for soliciting investors to invest in a fund managed by the registered investment adviser. That question received a partial answer in a no-action letter issued to Mayer Brown LLP by the staff of the SEC's Division of Investment Management on July 15, 2008 ("Letter")**[1]** which advised that Rule 206(4)-3 under the Investment Advisers Act of 1940 ("Advisers Act"), which is often referred to as the "cash solicitation rule" ("Rule") does not apply to cash payments by a registered investment adviser to a person solely to compensate that person for soliciting investors to invest in an investment pool managed by the registered investment adviser.

Background

The Rule makes it unlawful for any investment adviser that is required to be registered under Section 203 of the Advisers Act (for purposes of this letter, an "adviser") to pay a cash fee, directly or indirectly, to a third-party solicitor**[2]** with respect to solicitation of clients for the adviser except in accordance with its conditions.**[3]**

It has been clear since its adoption that the Rule applies to payments made by an adviser to compensate a person for referring prospective advisory clients who would engage the adviser to provide investment advisory services to the client. However, the question of whether payments made to a referrer for soliciting persons to invest in an fund managed by the adviser, such as a hedge or other private investment fund, has evolved. Previously, the SEC staff took the position that the Rule could apply to the solicitation of persons to invest in a fund.**[4]** More recently, SEC staff members have informally advised that action would not be recommended against advisers who fail to comply with the Rule for referrals of fund investors. This evolution in the SEC staff's views was apparently influenced by the decision of the U.S. Court of Appeals for the District of Columbia Circuit in Goldstein, et al. v. Securities and Exchange Commission ("Goldstein").**[5]** Goldstein ruled that that the antifraud provisions of Sections 206(1) and 206(2) of the Advisers Act apply only to "clients" of advisers, such as hedge funds, but not to investors in the funds. The Goldstein decision vacated the SEC's Rule 203(b)(3)-2 adopted in 2004 which would have required advisers to hedge funds and other pooled investment vehicles to register with the SEC. The implication from Goldstein is that since fund investors are not "clients" as to which Sections 206(1) and 206(2) of the Advisers Act would apply, then the Rule, adopted pursuant to Section 206 of the Advisers Act, is inapplicable to the solicitation of those investors.

The Letter

Citing both informal oral staff views and Goldstein, the Letter states that the Rule generally does not apply to an adviser's cash payment to a person solely to compensate that person for soliciting investors to invest in a fund managed by the adviser. The SEC staff states that while the Rule literally could apply to such payments, it was not the intention of the SEC that the Rule should apply to those payments for the following reasons:

- First, the SEC releases proposing and adopting the Rule did not suggest that the Rule would apply to advisers' cash payments to others solely to compensate them for soliciting investors for investment pools managed by the advisers.
- Second, the Rule is designed so as to clearly apply to solicitations and referrals in which the solicited or referred persons might ultimately enter into investment advisory contracts with the investment adviser yet investors in investment pools (as such) do not typically enter into investment advisory contracts with the investment advisers of the pools.
- Third, the Rule's use of the terms "client" and "prospective client," rather than "investor" or "prospective investor," also strongly suggests that the Rule was intended to apply to solicitations and referrals in which the solicited or referred persons might ultimately enter into investment advisory contracts with the investment adviser.

Importantly, the SEC staff noted that its view as to whether an adviser's payment to a referrer is being made solely to compensate the referrer for the solicitation of fund investors, will depend upon the facts and circumstances of the particular case with the most pertinent facts and circumstances generally being 1) the nature of the arrangement between the soliciting/referring person and the adviser, 2) the nature of the relationship between the adviser and the solicited/referred person, and 3) the purpose of the adviser's cash payment to the soliciting/referring person.

Implications of the Letter

The Letter is useful as a public affirmation of informal staff advice that has been informally expressed for several years. Nevertheless, advisers and referrers should be cautious in interpreting the views stated in the Letter as generally sanctioning the use and compensation of referrers to solicit fund investments for several reasons:

- **Registration of Referrer Under the Advisers Act**. The Letter notes that a referrer may be subject to registration if the person is "advising others" as to the advisability of investing in securities. In addition, the referrer may be subject to registration as an "investment adviser representative" under state laws.
- **Advisers Who Also Provide Advisory Services**. The Letter appears to make a distinction with respect to advisers who provide advisory services in addition to managing a fund. It states that the Rule would apply if the facts show that the adviser's payment

compensates the referrer for referring persons as prospective advisory clients of the adviser rather than where the adviser manages only investment pools and the payment is solely for soliciting investments in a fund.

- **Application of Section 206 of the Advisers Act**. The Letter cautions that, even if the Rule does not apply to a particular situation, the referrer may be required by Section 206 of the Advisers Act to disclose to the investor or prospective investor material facts relating to conflicts of interest.

- **Additional Cautionary Note**. It is important to note that a footnote in the Letter states that the SEC does not address whether a person's receipt of compensation from an adviser of an investment pool for soliciting or referring investors or prospective investors to invest in the pool would result in the person being considered a "broker" under the Securities Exchange Act of 1934. Fund interests are securities as defined in federal and state securities laws. Both the federal and state securities laws generally provide that persons who are in the business of "effecting transactions in securities" for the account of others must be registered as brokers. Individuals who assist issuers or brokers to offer securities must generally be registered as agents. Where a referrer is being compensated in the form of commissions or other payments that are contingent on investors' purchases of securities, it is highly likely that the SEC staff would regard the referrer as "effecting transactions in securities" for the account of others and therefore subject the referrer to registration as a broker. Although it may be possible for a referrer to argue that he is merely acting as a "finder," securities regulators take a very narrow view of when a person engaged in finder activities is not subject to registration as a broker. The failure of a person who is acting as a broker to be registered as such can result in criminal prosecution and fines, bar and other administrative or enforcement proceedings and civil liability. The danger of a referrer's being treated by regulators as a broker has always existed and the Letter in no way diminishes that hazard.

For more information about the Letter, please feel free to contact your Butzel attorney, the authors listed below, other attorneys of the Investment Management Practice Group, or the attorneys of our Tax Strategies & Resolutions Practice Group.

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Footnotes

[1] See, Mayer Brown, SEC No-Action Letter (July 15, 2008).

[2] The Rule defines a "solicitor" as "any person who, directly or indirectly, solicits any client for, or refers any client to, an investment adviser."

[3] Those conditions include a written agreement between the adviser and the solicitor which requires the solicitor to provide the client with both a current copy of the adviser's Form ADV Part II and a separate written disclosure document, the absence of certain disqualifying circumstances with respect to the solicitor and certain restrictions and conditions on the nature of the advice given by the solicitor.

[4] See, Dana Investment Advisers, Inc., SEC No-Action Letter, 1994 WL 718968 (Oct. 12, 1994).

[5] 451 F.3d 873 (D.C. Cir. 2006).
