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SEC UPDATE

By Seth Davis, Timothy Silva, and Gretchen Passe Roin

OCIE Risk Alert on Cash Solicitation Rule

On October 31, 2018, the Securities and Exchange Commission's (SEC) Office of Compliance Inspections and Examinations (OCIE) released a new Risk Alert regarding compliance deficiencies observed in connection with Rule 206(4)-3 (Cash Solicitation Rule) under the Investment Advisers Act of 1940, as amended (Advisers Act).¹ The purpose of the Cash Solicitation Rule is to notify prospective advisory clients that the person recommending the adviser (that is, the solicitor) has a financial incentive to make the referral. The Cash Solicitation Rule prohibits SEC-registered advisers from compensating affiliated or third-party solicitors in cash for referring or soliciting persons to become advisory clients of the investment adviser unless the solicitation arrangement satisfies a number of conditions.

The Cash Solicitation Rule at a Glance

The Cash Solicitation Rule imposes four conditions, three of which are identical among all third-party and affiliated cash solicitation arrangements:

1. The investment adviser must be properly registered under the Advisers Act;
 2. The solicitor cannot be subject to a statutory disqualification (for example, certain disciplinary events); and
 3. The cash fee must be paid pursuant to a written agreement with the investment adviser (referred to as the solicitation agreement).²
- The fourth condition, which relates to the disclosure required to be provided by the solicitor, varies depending on whether the solicitor is affiliated with the investment adviser.
- If the solicitor is affiliated (that is, a partner, officer, director, or employee of the investment adviser or of an entity that controls, is controlled by, or is under common control with, the investment adviser), then the solicitor must disclose its affiliation to the client or prospective client at the time of the solicitation or referral for advisory services.
 - If the solicitor is not affiliated (a third-party solicitor), then the solicitor must provide written disclosures, at the time of any solicitation activity that is or will be compensated, by delivering a current copy of the adviser's ADV brochure and an additional written disclosure document that contains detailed information about the solicitor's compensation and resulting financial

interest in the client's choice of an investment adviser. The investment adviser is responsible for:

- ensuring the written solicitation agreement requires the third-party solicitor to deliver these disclosures and to perform his or her duties in a manner consistent with investment adviser's instructions and with the Advisers Act;³
- obtaining, prior to entering an advisory contract, a signed and dated acknowledgment from the client of its receipt of the adviser's brochure and solicitor's disclosure document; and
- making a bona fide effort to ascertain whether the third-party solicitor has complied with the solicitation agreement and having a reasonable basis for believing that the third-party solicitor is in compliance.⁴

OCIE's Findings

While the Risk Alert did not address all the weaknesses the OCIE Staff observed, it did set forth the most frequent deficiencies identified in third-party solicitation arrangements under the Cash Solicitation Rule, including:

- *Solicitation Agreements.* Investment advisers used solicitors without a solicitation agreement in place, or with a solicitation agreement missing the required terms, such as the obligation for the third-party solicitor to provide clients, including prospective clients, with a current copy of the investment adviser's brochure and the solicitor's disclosure document.
- *Client Acknowledgements.* Investment advisers did not obtain client acknowledgements of receipt of the adviser's brochure and the third-party solicitor's disclosure document, or obtained acknowledgements that were deficient

due to the fact that they were either undated or dated after the clients had entered into an investment advisory contract.

- *Bona Fide Efforts.* Investment advisers did not make bona fide efforts to determine whether third-party solicitors complied with their solicitation agreements and appeared to not have a reasonable basis for believing that the third-party solicitors did comply with the solicitation agreements.
- *Disclosure Documents.* Third-party solicitors did not provide the necessary disclosure documents to prospective clients, or provided disclosure documents missing required information, such as the terms of the compensation paid to the third-party solicitor.

Takeaways and Additional Considerations

OCIE's Risk Alert focuses on ensuring technical compliance with the Cash Solicitation Rule. Thus, investment advisers utilizing solicitors, particularly third-party solicitors, should review their policies and procedures, as well as their actual practices and documentation, for compliance with each element of the Cash Solicitation Rule and associated recordkeeping requirements in Rule 204-2(a) under the Advisers Act. This is a good opportunity to go back to the text of the rule and ensure that each condition is being satisfied and documented.

Advisers can also consider streamlining operations to facilitate compliance. For instance, investment advisers can facilitate receipt of the clients' written acknowledgement of the disclosure documents *no later than* entering the advisory contract by including the acknowledgement with the client's advisory contract to be signed and dated contemporaneously.

Advisers can also avoid pitfalls by following the spirit of the Cash Solicitation Rule when engaging

persons to solicit investors for a fund managed, as opposed to advisory clients. The SEC takes the position that the Cash Solicitation Rule does not apply to advisers when compensating persons solely for the solicitation of investors in an investment fund (whether registered or not) managed by the investment adviser.⁵ However, many solicitation arrangements are silent on whether the prospect invests through a fund or advisory account, and some solicitation arrangements may require payments for a managed account relationship established many years following a prospective investor's initial fund investment. Thus, investment advisers should consider incorporating the full requirements of the Cash Solicitation Rule into any solicitation agreement that provides for the possibility of the adviser paying a solicitor for a future managed account relationship. Even solicitation agreements that are clearly limited to fund referrals benefit from consulting the Cash Solicitation Rule for guidance on the appropriate timeline and specificity of disclosures and oversight of solicitors.

Engaging a solicitor also raises compliance considerations for an investment adviser other than the Cash Solicitation Rule. An investment adviser should require the solicitor to represent that it is in compliance with all applicable state and federal securities law registration and licensing requirements. This is especially important for solicitors who are compensated on a transaction-by-transaction basis for the sale of interests in a fund and could be deemed a "broker" under the Securities Exchange Act of 1934, which in some cases could result in the potential right of rescission by investors solicited by unregistered brokers.⁶ Investment advisers whose clients include state and local government entities should be careful not to trigger prohibitions on receiving fees from such clients imposed by Rule 206(4)-5 of the Advisers Act (the "pay-to-play" rule). The restrictions on political contributions in the rule extends to most third-party solicitors unless they

are "regulated persons" that are themselves subject to pay-to-play restrictions on political contributions (for example, a registered broker-dealer). Therefore, an adviser's solicitation agreement should require that the solicitor maintain "regulated person" status. Finally, because a solicitor in a private placement is a "covered person" under Rule 506(d) of Regulation D under the Securities Act of 1933, an investment adviser engaging a solicitor to assist with a private placement of fund interests should obtain "bad actor" representations from the solicitor in the solicitation agreement and periodically refresh those representations.

If cognizant of the technical requirements of the rule and these additional considerations, investment advisers should be able to navigate cash solicitation arrangements while avoiding the common deficiencies identified in OCIE's Risk Alert as well as other potential pitfalls.

Mr. Silva and **Ms. Roin** are Partners, and **Mr. Davis** is a senior associate, at WilmerHale LLP.

NOTES

- ¹ The full Risk Alert can be found at <https://www.sec.gov/files/OCIE%20Risk%20Alert%20-%20Cash%20Solicitation.pdf>.
- ² Rule 204-2(a)(10) under the Advisers Act further requires that a copy of the solicitation agreement be retained by the investment adviser for its records.
- ³ The solicitation agreement also must outline the solicitation activities to be performed by the third-party solicitor on the investment adviser's behalf and the compensation to be received by the third-party solicitor.
- ⁴ What constitutes a "bona fide effort" to oversee a third-party solicitor depends on the facts and circumstances, but the SEC recommends that an investment adviser should, at the very least, inquire into some or all of the clients referred by a third-party solicitor to determine whether the third-party solicitor has made

improper representations or otherwise violated the solicitation agreement. See Inv. Adv. Act. Rel. No. 688 (July 12, 1979).

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

⁶ A Few Observations in the Private Fund Space, (April 5, 2013), available at <https://www.sec.gov/news/speech/2013-spch040513dwghtm>.

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