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SEC Lifts "Cash Solicitation Rule" for Private Fund Referrals

The SEC staff has issued a no-action letter formally reversing its long-held position that Rule 206(4)-3, the Cash Solicitation Rule, applies to investor referrals for private fund investments. More specifically, the no-action letter states that the rule "does not apply to an investment adviser's cash payment to a person solely to compensate that person for soliciting investors to invest in [a private fund relying on any exclusion under Section 3(c) of the Investment Company Act] managed by the adviser." A copy of the no-action letter can be found here.

The Cash Solicitation Rule, adopted by the SEC in 1979, requires a registered adviser to comply with certain requirements when making cash payments in return for client referrals. Among other conditions, a registered adviser making cash payments to a third-party solicitor must have a written agreement with the solicitor requiring that the solicitor, at the time of any paid solicitation activities, provide the client with both a current copy of the adviser's Form ADV Part II and a separate written disclosure document. The separate written disclosure document must contain certain disclosures, including a statement that the solicitor will be compensated by the adviser and the specific terms of the compensation arrangement.

The SEC staff had previously issued no-action letters suggesting that the Cash Solicitation Rule applies equally to referrals involving clients for separate accounts and referrals involving investors in private funds. *See, e.g., Dana Investment Advisors, Inc.*, SEC No-Action Letter (Oct. 12, 1994). In the past few years, however, senior SEC staff members have suggested that the rule would no longer be viewed as applying to referrals involving private fund investors. The latest letter confirms the SEC staff's new position.

In providing the relief, the no-action letter cites a number of reasons for the staff's new position, including that (1) neither the rule nor the adopting release reference payments to persons who solicit investors for private funds; (2) the rule refers to solicitations and referrals that may result in clients entering into advisory contracts with the investment adviser and that private fund investors typically do not enter into advisory contracts with the fund's adviser; and (3) the rule uses the terms "client" and "prospective client,"

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but not the term "investor." The letter also notes that the Federal Appeals Court decision in *Goldstein v. SEC* supports the conclusion that the rule generally does not apply to cash payments to persons soliciting investors to invest in private funds (noting that the *Goldstein* opinion indicated that investors in private funds are not "clients" of the fund's adviser).

The no-action letter, however, leaves open certain areas for further consideration, including the following:

1. *Advisers with hedge funds and separate accounts.* The no-action letter provides relief solely to solicitations for private fund investors. The rule may still apply, however, where an adviser manages both private funds and separate accounts. Whether the rule applies in such cases will depend on the facts and circumstances, including whether (i) the adviser is seeking to enter into investment advisory relationships with other persons; and (ii) the adviser's cash payment, under the adviser's arrangement with the solicitor, compensates the solicitor for referring other persons as prospective advisory clients. An adviser who manages only private funds would not have this concern.

2. *General disclosure obligations*. A private fund adviser remains subject to Section 206 and Rule 206(4)-8 under the Advisers Act and has a general obligation to disclose to investors and prospective investors material facts relating to conflicts of interest. Accordingly, a private fund adviser making cash payments to solicitors in return for investor referrals should disclose this fact, including the conflict of interest the arrangement presents. A private fund adviser could satisfy this obligation through disclosure in a fund's private placement memorandum and the adviser's Form ADV Part II.

3. *Status of solicitors as "brokers."* A solicitor being compensated for referring investors may be considered a "broker" under Section 3(a)(4) of the Exchange Act. The no-action letter, however, states that the requesting letter did not ask, and the no-action does not address, whether a person's receipt of cash compensation from an investment adviser of a private fund for referring investors or prospective investors would result in the solicitor being considered a broker.

4. *Status of solicitors as "advisers" and related disclosure obligations*. A solicitor may be acting as an adviser if the solicitor is advising others as to the advisability of investing in securities. If so, the solicitor may be subject to Section 206 of the Advisers Act and have a duty to disclose to its clients and prospective clients material facts relating to conflicts of interest, including its receipt of compensation for making referrals.

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