KAYE SCHOLER LLP | INVESTMENT FUNDS GROUP

Cash Solicitation Rule Does Not Apply to Investment Funds

The staff of the Securities and Exchange Commission (the "SEC") issued a no-action letter on July 15, 2008, clarifying that Rule 206(4)-3 of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), known as the "cash solicitation rule," does not apply to a registered investment adviser's cash payment to a person solely to compensate that person for soliciting investors or prospective investors for an investment pool[1] managed by the adviser.

Section 206(4) of the Advisers Act makes it unlawful for any investment adviser to engage in any act, practice or course of business that is fraudulent, deceptive or manipulative, and authorizes the SEC by rules and regulations to define and prescribe means reasonably designed to prevent such acts, practices and courses of business. Rule 206(4)-3 under the Advisers Act makes it unlawful for any investment adviser required to be registered under the Advisers Act to pay a cash fee, directly or indirectly, to a solicitor "with respect to solicitation activities" unless the payments are made in compliance with conditions set forth therein. The SEC intended for Rule 206(4)-3 to address the conflicts of interest inherent in certain cash solicitation arrangements.

While a literal reading of Rule 206(4)-3 could view it as applying to cash payments made by advisers to others to compensate them for soliciting investors for investment pools managed by the advisers, the staff believes that the SEC did not intend for the Rule to apply to those payments. First, the SEC releases proposing and adopting Rule 206(4)-3[2] did not contain any statements suggesting that the Rule would apply to cash payments by advisers to others solely to compensate them for soliciting investors for investment pools managed by the advisers. Second, the Rule is designed to apply to solicitations and referrals in which the solicited or referred persons may ultimately enter into investment advisory contracts with the investment adviser,[3] 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 suggests that the Rule was intended to apply to solicitations and referrals in which the solicited or referred persons may ultimately enter into investment advisory contracts with the adviser.

Furthermore, the *Goldstein* decision[4] supports a narrow interpretation of the Rule. In *Goldstein*, the court stated that, for purposes of Section 206 of the Advisers Act, investors in a pooled investment vehicle are not "clients" of the investment adviser of the pool. Similarly, the SEC staff believes that references to "client" and "prospective client" in Rule 206(4)-3 should not be interpreted to include investors or prospective investors in investment pools.

Whether a registered investment adviser's cash payment to a person is being made solely to compensate that person for soliciting or referring investors or prospective investors to invest in investment pools managed by the adviser will depend upon all of the facts and circumstances of the particular case. In the SEC staff's view, the most pertinent factors generally will include the nature of the arrangement between the soliciting/referring person and the adviser, the nature of the relationship between the adviser and the solicited/referred person, and the purpose of the adviser's cash payment to such person.

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[1] As used in the SEC no-action letter, the term "investment pool" is an investment company, as defined by the Investment Company Act of 1940, as amended (the "Company Act"), or a company that would be an investment company, but for an exclusion from the definition of investment company under Section 3(c) of the Company Act.

[2] *See* Requirements Governing Payments of Cash Referral Fees by Investment Advisers, Inv. Adv. Act. Rel. No. 615 (Feb. 2, 1978); and Requirements Governing Payments of Cash Referral Fees by Investment Advisers, Inv. Adv. Act. Rel. No. 688 (Jul. 12, 1979).

[3] For example, subsection (a)(2)(iii)(B) of Rule 206(4)-3 requires that the adviser must receive certain acknowledgements from the client, "*prior to, or at the time of, entering into any written or oral investment advisory contract with such client* …"

[4] *See Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).

For example, the Rule would not appear to apply to an adviser's cash payment to a referring/soliciting person, where the adviser manages or seeks to manage only investment pools and is not seeking to enter into investment advisory relationships with other persons, and the payment compensates the referring person solely for referring persons to invest in the pools managed by the adviser. However, the Rule would seem to apply if the adviser manages or seeks to manage investment pools and individual accounts, and is seeking to enter into investment advisory relationships with other persons, and its cash payments compensate the referring person for referring investors as prospective advisory clients.

If Rule 206(4)-3 does not apply to an investment adviser, it follows that the referring person would not be required by the Rule to provide the investor or the prospective investor with either the written agreement specified in Rule 206(4)(a)(1)(iii) under the Advisers Act or the investment adviser's written disclosure statement specified in Rule 204-3 under the Advisers Act. Importantly, even if Rule 206(4)-3 does not apply to a particular situation, the soliciting/referring person may generally be required by Section 206 of the Advisers Act to disclose to the investor or prospective investor material facts relating to conflicts of interests. Depending upon the circumstances, a soliciting/referring person may be "advising others ... as to the advisability of investing in ... securities" within the meaning of Section 202(a)(11) of the Advisers Act, and thus may be an investment adviser subject to Section 206 of the Advisers Act.[5]

The SEC did not address whether a person's receipt of cash compensation from an investment 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 Section 3(a)(4) of the Securities Exchange Act of 1934, as amended.

The SEC no-action letter is available online at:
http://www.sec.gov/divisions/investment/noaction/2008/mayerbrown071508-206.htm

[5] As interpreted by the courts and the SEC, Section 206 of the Advisers Act requires investment advisers to disclose to clients and prospective clients material facts relating to conflicts of interest.

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