

SEC Staff Confirms that Hedge Fund Solicitors Are Not Subject to the Cash Solicitation Rule

July 22, 2008

What This Means

As had long been expected, Securities and Exchange Commission (SEC) staff confirmed a few days ago that the SEC's cash solicitation rule, Rule 206(4)-3 (the Rule) under the Investment Advisers Act of 1940 (the Advisers Act), does not apply to a registered adviser's cash payment to a person solely to compensate that person for soliciting investors or prospective investors for, or referring investors or prospective investors to, hedge funds and other pooled investment vehicles.¹ The Rule prohibits a registered investment adviser from directly or indirectly paying a cash fee to a person who solicits on the adviser's behalf, unless the solicitor is not subject to a court order or administrative sanction, and the fee is paid pursuant to a written agreement to which the adviser is a party.

Past SEC staff precedent had muddied the waters on this issue. The issue came under greater focus after the Washington, D.C. Circuit Court's ruling in *Goldstein*² that hedge fund investors are not clients for purposes of the Advisers Act.

Discussion and Analysis

Although the no-action letter is straightforward, we would like to point out a few facets and practical implications.

- **First**, the letter suggests that investment advisers' arrangements with hedge fund solicitors do not raise the antifraud issues that prompted SEC regulation of ordinary cash solicitation arrangements under the Advisers Act. Although there could be potential aiding and abetting liability for an adviser for the acts of a solicitor (a point not made in the letter), the letter pins antifraud concerns under the Advisers Act on the solicitor, not the adviser engaging the solicitor.

Specifically, SEC staff points out that because solicitors operating outside of the Rule might be deemed investment advisers (and, because they are operating outside of the Rule, are not deemed associated persons of the adviser hiring them), they could be potentially liable for nondisclosure of conflicts such as the receipt of solicitation fees for the promotion of hedge funds.

- **Second**, the letter suggests that an adviser engaging a solicitor to promote its hedge funds does not need to adhere to the procedural requirements of the Rule—for example, to mitigate against potential liability for wrongdoing by a solicitor. While cynics may say it is surprising that SEC staff passed up an opportunity to impose duties on advisers in this context, the SEC staff's restraint appropriately ensures that an adviser's arrangements with hedge fund solicitors are treated no differently than an adviser's

¹ Mayer Brown LLP, SEC No-Action Letter (July 15, 2008).

² *Goldstein v. SEC*, NO. 04-1434 (D.C. Cir. June 23, 2006).

arrangements with other intermediaries promoting securities, such as broker-dealers acting as placement agents.

Accordingly, and in contrast to the requirements of the Rule, an adviser is **not** required to have agreements with hedge fund solicitors, or to ensure the solicitors are not subject to a statutory disqualification, to ensure that they provide appropriate disclosure of the receipt of compensation, or to supervise them as if they were associated persons of the adviser.

- **Third**, the letter does not mean that advisers should strip out provisions related to the Rule in their hedge fund solicitation agreements. As the letter rightly points out, some solicitation arrangements may contemplate or evolve into solicitations for separate accounts, which would be subject to the Rule (and for which provision would have to be made in advance of any solicitations).

Maintaining documentation and related internal controls for solicitation arrangements would also help to limit an adviser's potential aiding and abetting liability. In this connection, we think it will remain prudent for advisers to obtain representations and warranties from solicitors, including to the effect that they:

- (i) Are not subject to a statutory disqualification
- (ii) Will not refer pension plan clients or investors for which they are fiduciaries
- (iii) Will not solicit state, municipal, or other governmental accounts for which they have had prior employment
- (iv) Will make appropriate disclosure to prospective investors about the arrangements and their receipt of compensation.³

This last point—on receipt of compensation—is important, and many advisers have private placement memorandum (PPM) disclosure of this concept to backstop this issue. We recommend that advisers consider discarding any procedures that require supervision of hedge fund solicitors as associated persons because this goes beyond both the strict requirements of the law and what firms would typically be required to do in order to mitigate aiding and abetting liability. However, firms may wish to consider establishing policies and procedures to address any red flags involving hedge fund solicitors in order to prevent any concerns regarding potential aiding and abetting liability.

- **Fourth**, the letter notes but does not address the lingering issue of whether hedge fund solicitors are required to register as broker-dealers. Morgan Lewis's Investment Management Practice includes a brief discussion on that issue in our *Hedge Fund Deskbook*.⁴ But this continues to be an issue for which there is a gap between practice in some quarters and a strict reading of both the federal and state law relating to the registration of broker-dealers.

On the subject of state law, the letter and the *Goldstein* decision may help advisers assess whether hedge fund solicitors are investment advisers or investment adviser representatives under state law. At last count, some 38 states had treated third-party solicitors as either investment advisers or investment adviser representatives subject to licensing. The applicability of these requirements to hedge fund solicitors has not been clear.

Morgan Lewis Can Help

All told, the application of this Rule signals a long-awaited and welcome form of clarification and progress.

If you have any questions regarding this important legal development and how it applies to your company, please contact any of the following Morgan Lewis attorneys:

³ Aside from Rule 206(4)-3 and any fiduciary duties, disclosure obligations for solicitors may arise under Securities Act of 1933 Sections 17(a) and (b) and, in the case of broker-dealers, Securities Exchange Act of 1934 Rule 10b-10.

⁴ <http://www.morganlewis.com/pubs/2007HedgeFundDeskbookExcerpt1.pdf>

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