

# SEC STAFF CONFIRMS THAT HEDGE FUND SOLICITORS ARE NOT SUBJECT TO THE CASH SOLICITATION RULE

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*SEC'S NO-ACTION LETTER IS STRAIGHTFORWARD, BUT A FEW FACETS AND SOME PRACTICAL IMPLICATIONS WARRANT DISCUSSION.*

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As had long been expected, the Securities and Exchange Commission (SEC) staff confirmed on July 15, 2008, that the SEC's cash solicitation rule, Rule 206(4)-3 ("Rule") under the Investment Advisers Act of 1940 ("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.<sup>1</sup> The Rule specifically 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 Rule came under greater focus after the Washington, D.C. Circuit Court's ruling in *Goldstein*<sup>2</sup> that hedge fund investors are not clients for purposes of the Advisers Act.

## DISCUSSION AND ANALYSIS

The no-action letter is straightforward, but a few facets and some practical implications warrant discussion. 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, the 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 potential liability for wrongdoing by a solicitor. While cynics may say that it is surprising

that the 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 arrangements with other intermediaries promoting securities, such as broker-dealers acting as placement agents. Accordingly, and in contrast to the Rule's requirements, an adviser is not required to (1) have agreements with hedge fund solicitors (or ensure that the solicitors are not subject to a statutory disqualification), (2) make certain that they provide appropriate disclosure of the receipt of compensation, or (3) 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 also would help to limit an adviser's potential aiding and abetting liability. In this connection, it will remain prudent for advisers to obtain representations and warranties from solicitors, including to the effect that they:

1 Are not subject to a statutory disqualification.

2 Will not refer pension plan clients or investors for which they are fiduciaries.

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

<sup>2</sup> *Goldstein v. SEC*, 451 F.3d 873 (CA-D.C., 2006).

3 Will not solicit state, municipal, or other government accounts for which they have had prior employment.

4 Will make appropriate disclosure to prospective investors about the arrangements and their receipt of compensation.<sup>3</sup>

This last point—receipt of compensation—is important, and many advisers have private placement memorandum (PPM) disclosure of this concept to backstop this issue. It is recommended 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 typically must do to mitigate aiding and abetting liability.

However, firms may want to consider establishing policies and procedures to address any red flags involving hedge fund solicitors to prevent any concerns about 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.<sup>4</sup> This, however, 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.

#### STATE LAW

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.

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<sup>3</sup> 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, with regard to bro-

ker-dealers, Securities Exchange Act of 1934, Rule 10b-10.

<sup>4</sup> Morgan Lewis's Investment Management Practice includes a brief discussion on that is-

sue in our Hedge Fund Deskbook, [www.morganlewis.com/pubs/2007HedgeFundDeskbookExcerpt1.pdf](http://www.morganlewis.com/pubs/2007HedgeFundDeskbookExcerpt1.pdf)