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Hedge Fund Law Report
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Marketing

Five Ways to Avoid Common Violations of the Cash Solicitation Rule Identified in OCIE's Recent Risk Alert

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By Robin L. Barton, *Hedge Fund Law Report*

Rule 206(4)-3 (the Cash Solicitation Rule) of the Investment Advisers Act of 1940 (Advisers Act) bars investment advisers that are required to be registered under the Advisers Act from paying a cash fee – directly or indirectly – to any person who solicits clients for the adviser unless the arrangement complies with certain conditions. For example, the cash fee must be paid pursuant to a written solicitation agreement to which the adviser is a party.

The SEC Office of Compliance Inspections and Examinations (OCIE) recently issued a National Exam Program Risk Alert that discusses the most frequent compliance issues related to the Cash Solicitation Rule identified in deficiency letters from adviser examinations completed in the past three years. Although prior SEC guidance has stated that the Cash Solicitation Rule does not apply to the solicitation of investors for a private fund, the rule does apply to the solicitation of separately managed account clients. Thus, fund managers that use solicitors for referrals of clients for separate accounts should understand the Risk Alert and review their policies and procedures accordingly.

This article analyzes OCIE's findings and provides guidance from a former SEC lawyer on how investment advisers can avoid the identified violations. For coverage of other OCIE Risk Alerts, see "How to Avoid the Eight Best Execution Compliance Issues in OCIE's Latest Risk Alert" (Aug. 30, 2018); "OCIE Risk Alert Warns of Six Most Frequent Fee and Expense Compliance Issues" (May 3, 2018); and "Risk Alert Highlights Six Most Frequent Advertising Rule Compliance Issues" (Oct. 19, 2017).

The Cash Solicitation Rule

The Cash Solicitation Rule generally prohibits the direct or indirect payment of a cash fee by a SEC-registered investment adviser to a "solicitor" – that is, any person who, directly or indirectly, solicits any client for, or refers any client to, an investment adviser – for "solicitation activities" unless the arrangement meets certain conditions.

There are additional requirements for "third-party solicitors" – *i.e.*, when the solicitor is not a partner, officer, director or employee of the adviser or of an entity that controls, is controlled by or is under common control with the adviser. The Risk Alert generally includes observations relating to an adviser's use of third-party solicitors subject to the broader requirements of the Cash Solicitation Rule.

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Under the rule, an investment adviser may only pay a cash fee to a third-party solicitor if:

1. the solicitor is not a person subject to certain statutory disqualifications;
2. the cash fee is paid pursuant to a written solicitation agreement that contains specified provisions, including a description of the solicitation activities and compensation to be received; an undertaking by the solicitor to perform his or her duties in accordance with the adviser's instructions and the Advisers Act; and a requirement that, at the time of any solicitation activities for which compensation is paid or to be paid, the solicitor provides the prospective client with a current copy of the adviser's brochure or Part 2A of its Form ADV, as well as a separate, written disclosure document containing required information that highlights the solicitor's financial interest in the client's choice of an adviser (solicitor disclosure document);
3. prior to or at the time the client enters into an investment advisory contract with the adviser, the adviser receives from the client a signed and dated acknowledgement of receipt of the adviser's brochure or Part 2A of its Form ADV and the solicitor disclosure document (client acknowledgement); and
4. the adviser makes a bona fide effort to ascertain whether the solicitor has complied with the solicitation agreement and has a reasonable basis for believing that the solicitor has complied.

According to the 2008 Mayer Brown no-action letter, the Cash Solicitation Rule does not apply to payments to a solicitor or placement agent who is only soliciting investors for pooled investment vehicles, such as hedge funds, but remains applicable in the context of solicitations of clients in connection with offering them separately managed accounts. See "Finally, Some Good News for Private Fund Placement Agents" (Nov. 12, 2008); and "SEC Issues No-Action Letter Suggesting Hedge Fund Advisers Are Exempt From Cash Solicitation Arrangement Disclosure Requirements" (Aug. 1, 2008).

Cash Solicitation Rule Compliance Issues

The compliance issues identified in the Risk Alert by OCIE fall into four categories.

1) Solicitor Disclosure Documents

According to the Risk Alert, OCIE staff observed advisers whose third-party solicitors either did not provide solicitor disclosure documents to prospective clients or provided solicitor disclosure documents that did not contain all the information required by the Cash Solicitation Rule. For example, staff observed solicitor disclosure documents that did not:

- disclose the nature of the relationship between the solicitor and the adviser, including any affiliation;
- contain the terms of the compensation arrangement between the adviser and the solicitor;
- specify the actual compensation terms agreed to in the solicitation agreement and instead used vague or hypothetical terms to describe the solicitor's compensation; or
- specify the additional solicitation cost the solicited client will be charged in addition to the advisory fee.

2) Client Acknowledgements

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OCIE staff also observed advisers that did not timely receive signed and dated client acknowledgements of receipt of the advisers' brochures and the solicitor disclosure documents. Moreover, staff observed advisers that received client acknowledgements, but those acknowledgements were undated or dated after the clients had entered into investment advisory contracts.

"From what I gather in reading the Risk Alert, what might be happening is that advisers forget to ensure they receive the client acknowledgements from third-party solicitors," said Stacey Song, partner at Fried Frank and former Senior Counsel in the Private Funds Branch of the Division of Investment Management at the SEC. "During the onboarding process, they may realize the client acknowledgement is missing and then ask the client to sign one, either backdating it or leaving it undated. I think the Risk Alert is getting at those types of situations."

3) Solicitation Agreements

In addition, OCIE staff observed advisers that paid cash fees to solicitors without solicitation agreements in effect or pursuant to agreements that did not contain certain specific provisions. For example, staff observed solicitation agreements with third-party solicitors that did not:

- contain any undertaking by the solicitor to perform its duties under the solicitation agreement in a manner consistent with the instructions of the adviser;
- describe the solicitor's activities and the compensation to be paid; or
- oblige solicitors to provide clients (including prospective clients) with a current copy of the adviser brochure and the solicitor disclosure document.

4) Bona Fide Efforts to Ascertain Solicitor Compliance

Finally, OCIE staff observed advisers that did not make bona fide efforts to ascertain whether third-party solicitors complied with solicitation agreements and that did not appear to have reasonable bases for believing that the third-party solicitors so complied. For example, staff observed advisers that were unable to describe any efforts they took to confirm compliance with solicitation agreements.

Application to Private Fund Managers

"For private fund advisers, the first thing to do is determine whether the Cash Solicitation Rule applies to them," advised Song. "If a fund manager only advises private funds and is not looking for separate account clients, then the rule would not apply." In other words, the rule only applies in those instances when a private fund manager is paying a third party to solicit separately managed account clients – not investors for a fund, she explained.

Song observed that although some private fund advisers have both a private fund business and a separate account business, other advisers have just a few separate accounts for their large relationships that are intended for co-investment opportunities or excess capacities. She remarked, "These advisers are not really looking to open up separate accounts as one of their main business lines."

As a result, Song said she has seen advisers that do not have a specific separate account business enter into placement agreements that include representations that, for purposes of the Cash Solicitation Rule and in accordance with the Mayer Brown no-action letter, the solicitation

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activities of the solicitor will be limited to soliciting only investors and prospective investors for the fund.

See "A Roadmap for Advisers to Comply With Marketing and Advertising Regulations (Part Two of Two)" (Aug. 10, 2017); and "The Transformation of Third-Party Hedge Fund Marketer Contracts and Compensation" (May 3, 2012).

How to Avoid These Issues

"The release of the Risk Alert is a warning that the SEC and OCIE are focusing on the Cash Solicitation Rule and violations of it," noted Song. "So, it is a good time for investment advisers subject to the rule to review their policies and procedures as to the rule." Specifically, she said she recommends that advisers take the following steps to ensure compliance with the Cash Solicitation Rule.

1) Perform Thorough Due Diligence on Third-Party Solicitors

"To start, investment advisers should be hiring good solicitors," advised Song. "For example, advisers should perform due diligence on solicitors to ensure there are no statutory disqualifications or complaints. In addition, if an adviser is talking to a solicitor and gets the feeling that the solicitor is sketchy, then it should not engage that solicitor."

Song recommended conducting the same type of due diligence that an adviser would conduct when hiring its own employees, especially given that the SEC views third-party solicitors as associated persons of the adviser – at least with respect to solicitation activities. Bottom line: if an adviser would not hire someone as an employee, the adviser should not hire that person as its solicitor, she concluded.

See "The Importance of Exercising Due Diligence When Hiring Auditors and Other Vendors" (Jun. 21, 2018); and "How Fund Managers Can Develop an Effective Third-Party Management Program" (Sep. 21, 2017).

2) Use the Onboarding Process to Review Solicitor Compliance

The SEC's release on the adoption of the Cash Solicitation Rule notes that what would constitute "a bona fide effort" to ensure that third-party solicitors are complying with solicitation agreements depends on the circumstances. In general, however, a bona fide effort would – at a minimum – involve "making inquiries of some or all clients referred by the solicitor in order to ascertain whether the solicitor has made improper representations or has otherwise violated the agreement with the investment adviser."

According to Song, the best way to fulfill the minimal bona fide effort requirement is to use the onboarding process for new clients to check that the solicitor has complied with the requirements of the Cash Solicitation Rule, as well as the solicitation agreement. For example, she said an adviser can include in the client agreement a representation that the client acknowledges that it was solicited by the solicitor and that it received a copy of the adviser's brochure and the solicitor disclosure document.

Song also recommends obtaining a signed verification letter from the solicitor in which the solicitor represents that it has complied with the Cash Solicitation Rule and the solicitation agreement. The solicitor should submit that letter on an annual basis, she added.

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3) Review Key Documents

In light of the Risk Alert, Song advised investment advisers to review certain key documents, including:

- existing solicitation agreements;
- solicitor disclosure documents; and
- client acknowledgements.

This review should ensure that the adviser has the necessary documents and that those documents comply with the requirements of the Cash Solicitation Rule, including that they contain the required provisions. "One step that investment advisers can take is to attach the solicitor disclosure document as an exhibit to the solicitation agreement," recommended Song. "That way, when they are reviewing the agreement to ensure it contains all the required provisions, they can also review the disclosure document as well."

In addition, Song suggested that investment advisers review their Forms ADV to ensure they are properly disclosing their solicitation arrangements. Part 1 and Part 2 of Form ADV specifically require advisers to disclose "client referral" arrangements. "Even though the form refers to 'client' referrals – as opposed to investor referrals – a lot of private fund advisers use that section to disclose any investor placement agreements," she explained. Thus, advisers should review their Forms ADV to see if they need to update their disclosures as to both client and investor referral arrangements.

See "Application of Brochure Delivery and Public Filing Requirements of New Form ADV to Offshore and Domestic Hedge Fund Managers" (Apr. 1, 2011).

4) Review Policies and Procedures

The release of a Risk Alert is always a good time for investment advisers to review their applicable policies and procedures, noted Song. Thus, advisers should review their policies and procedures related to the Cash Solicitation Rule and ensure that they cover all of the rule's requirements.

For example, Song recommended that advisers review their recordkeeping practices to ensure they are receiving signed and dated client acknowledgements in a timely manner from any solicitors they use. In addition, the legal department should ensure that the marketing department knows that all solicitation agreements must be reviewed by legal, she added.

5) Provide Refresher Training

Investment advisers should provide adequate training to all relevant employees on the Cash Solicitation Rule and their related policies and procedures. With the release of the Risk Alert, it is appropriate to consider providing refresher training on the rule and its requirements, said Song. "It is toward the end of the year when compliance officers are looking to conduct their annual reviews and are thinking about their next trainings," she observed. "The Cash Solicitation Rule is something that they should put on the list of topics to review in training."

See "High- and Low-Tech Innovations for Fund Managers to Overcome Compliance Training's Drawbacks" (Feb. 1, 2018).

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The Future of the Rule

On April 12, 2018, in a panel discussion on program priorities at the National Compliance Outreach Seminar for Investment Companies and Investment Advisers,[1] Paul Cellupica, Deputy Director of the SEC Division of Investment Management, said that revision to investment adviser marketing and solicitation rules – including the Cash Solicitation Rule specifically – is on the medium- to long-term agenda.

According to Reginfo.gov,[2] the rules regarding marketing communications and practices under the Advisers Act, including the Cash Solicitation Rule, are still on the SEC's Reg Flex agenda, with an April 2019 target date for proposed amendments.

See "SEC's Reg Flex Agenda Promotes Transparency While Adding Potential Compliance Burdens" (Mar. 15, 2018).

As to the kinds of changes the SEC might propose to the Cash Solicitation Rule, Song opined that one obvious area to address is cash payments. "Who makes cash payments nowadays?" she asked. Song noted that the Risk Alert hints at this in the section that discusses advisers' recommending service providers to clients in exchange for client referrals and the implications of that practice under an adviser's fiduciary duty. "In that situation, there isn't a cash payment, but there is a tit-for-tat. So, I can see the SEC considering whether 'cash' should include non-cash compensation as well," she said.

In addition, Song pointed out that there are numerous no-action letters that the SEC might propose codifying in the Cash Solicitation Rule. For example, there are a number of no-action letters (see, *e.g.*, the Citigroup Inc. no-action letter, as well as the Emanuel J. Friedman and EJF Capital LLC no-action letter) in which the SEC staff said that they would not recommend enforcement action even if a solicitor has a statutory disqualification if, among other things, the investment adviser and solicitor otherwise comply with the Cash Solicitation Rule and the solicitor discloses its statutory disqualification for 10 years. The SEC might also ask for comments on whether the Mayer Brown no-action letter should be incorporated into the rule, added Song.

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[1] A recording of the National Compliance Outreach Seminar for Investment Company and Investment Advisers is available on the SEC's website here: https://www.sec.gov/video/webcast-archive-player.shtml?document_id=041218ccoiciapart1.

[2] See https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201810&RIN=3235-AM08.

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