ALSTON+BIRD LLP

Securities Law Advisory

July 28, 2008

SEC Staff Issues Letter Exempting Investment Pools from Cash Solicitation Rule

On July 15, 2008, the staff of the Securities and Exchange Commission (SEC) issued an interpretive letter explaining that Rule 206(4)-3 (the "Rule") under the Investment Advisers Act of 1940 (the "Act") generally does not apply to a registered investment adviser that makes cash payments to a person as compensation for the solicitation of investors in an investment pool, such as a hedge fund or private equity fund, managed by the adviser.[1]

Rule 206(4)-3: The Cash Solicitation Rule

The Rule prevents registered investment advisers from paying cash for "solicitation activities" unless the payment satisfies the conditions set forth in the Rule. Specifically, a registered adviser making cash payments to a third-party solicitor must, among other conditions, enter into a written agreement with such solicitor requiring them to provide prospective clients with both a copy of the adviser's written disclosure statement required by Rule 204-3 (usually Part II of Form ADV) and a separate written disclosure document containing, among other things, a statement that the solicitor will be compensated by the adviser and the terms of the compensation arrangement. The conditions of the Rule are intended to address the inherent conflicts of interest in situations where a person is being compensated for referring the services of an adviser and, therefore, may not make such recommendation entirely upon the merits of the services to be provided.

Interpretative Letter

Examining both the plain text of the Rule and the legislative history relating to its initial adoption, the SEC staff concluded in its interpretative letter that the Rule may not apply to the solicitation of potential private fund investors. The SEC staff noted that neither the proposing nor the adopting release specifically addressed whether it was the intent of the drafters to include this type of situation. While the lack of reference to investment pools in the adopting and proposing releases was not dispositive, the SEC staff recognized that the Rule, on its face, clearly applied only to instances in which a client would ultimately enter into an advisory contract with the adviser. As investors in investment pools do not enter into contracts with the advisers to such pools directly, the SEC staff felt that the Rule did not intend to

[1] Mayer Brown LLP (July 15, 2008).

cover solicitations for such products. The SEC staff also focused upon the terminology used in the Rule to describe the solicited party. It stated that the Rule's use of the term "client" rather than "investor" provided additional support for the fact that solicitations for such pools were not intended to be captured by the Rule. This view is further supported by the *Goldstein* decision, in which the D.C. Circuit court held that investors are not "clients" of the investment pool's adviser.[2]

The SEC staff noted, however, that the applicability of the Rule would depend upon all of the facts and circumstances surrounding the relationship between the parties, the purpose of the adviser's cash payment to the soliciting person, and the nature of the adviser's business. For instance, situations where an adviser only advises investment pools, and does not engage the referring party to solicit potential investment advisory clients in addition to investors in the investment pool, would likely not be covered by the Rule. On the other hand, if an adviser manages private pools and individual accounts and uses a solicitor to solicit both private pool investors and advisory clients, the Rule may apply.

Section 206 Obligations: Anti-Fraud

Repeating previous oral statements, the SEC staff noted that, even if Rule 206(4)-3 does not apply, advisers are still bound by the anti-fraud obligations imposed by the Act and, pursuant to Section 206 of the Act, a solicitor may still be required to disclose to an investor or prospective investor all potential conflicts of interest inherent in the referral arrangement.

Potential Applicability of Broker-Dealer Regulations

Because no-action relief was specifically requested from the Division of Investment Management and not from any other division, the letter did not address whether solicitors for investment pools could be considered broker-dealers under Section 3(a)(4) of the Securities Exchange Act of 1934. This question would need to be addressed by the Divison of Trading and Markets.

---

2 Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

David J. Baum
202.756.3346
david.baum@alston.com

Paul D. Hourigan
202.756.3155
paul.hourigan@alston.com

Joshua Andersen
202.756.3355
josh.andersen@alston.com

Matthew W. Mamak
212.210.1256
matthew.mamak@alston.com

Mark F. Costley
202.756.5593
mark.costley@alston.com

Kristin P. Manzano
704.444.1332
kris.manzano@alston.com

Charles F. Glorioso, Jr.
212.210.9508
charles.glorioso@alston.com

Andrea L. Parisi
212.210.9580
andrea.parisi@alston.com

Aaron M. Gonzales
202.756.3370
aaron.gonzales@alston.com

Alexis I. Rieger
212.210.9571
alexis.rieger@alston.com

Omar Idilby
212.210.9525
omar.idilby@alston.com

Timothy P. Selby
212.210.9494
tim.selby@alston.com

Jennifer D. Lawrence
704.444.1337
jennifer.lawrence@alston.com

Margaret A. Sheehan
202.756.3305
margaret.sheehan@alston.com

If you would like to receive future *Securities Law Advisories* electronically, please forward your contact information including your e-mail address to **securities.advisory@alston.com**. Be sure to put "***subscribe***" in the subject line.

ALSTON+BIRD LLP

www.alston.com

Atlanta: One Atlantic Center • 1201 West Peachtree Street • Atlanta, Georgia, USA, 30309-3424 • 404.881.7000 • Fax: 404.881.7777
Charlotte: Bank of America Plaza • 101 South Tryon Street, Suite 4000 • Charlotte, North Carolina, USA, 28280-4000 • 704.444.1000 • Fax: 704.444.1111
Dallas: 2200 Ross Avenue • Chase Tower • Suite 3601 • Dallas, Texas, USA, 75201 • 214.922.3400 • Fax: 214.922.3899
New York: 90 Park Avenue • New York, New York, USA, 10016-1387 • 212.210.9400 • Fax: 212.210.9444
Research Triangle: 3201 Beechleaf Court, Suite 600 • Raleigh, North Carolina, USA, 27604-1062 • 919.862.2200 • Fax: 919.862.2260
Washington, DC: The Atlantic Building • 950 F Street, NW • Washington, DC, USA, 20004-1404 • 202.756.3300 • Fax: 202.756.3333