

SEC ISSUES RISK ALERT ON CASH SOLICITATION RULE

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U.S. Investment Management Alert

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The Securities and Exchange Commission's ("SEC") Office of Compliance Inspections and Examinations ("OCIE") released a Risk Alert on October 31, 2018 identifying the most frequent deficiencies that OCIE staff (the "Staff") has cited relating to Rule 206(4)-3 (the "Cash Solicitation Rule") under the Investment Advisers Act of 1940.

SEC-registered investment advisers are generally prohibited from paying a cash fee, directly or indirectly, to any person who solicits clients for the adviser (a "solicitor") unless the arrangement complies with the conditions of the Cash Solicitation Rule. The Cash Solicitation Rule requires the cash fee be paid to a solicitor pursuant to a written solicitation agreement. [1] A solicitor cannot be a person subject to certain disqualifications specified in the Cash Solicitation Rule. If a solicitor is not associated with the adviser, [2] the Cash Solicitation Rule imposes additional requirements, including:

1. the solicitation agreement must contain specified provisions (e.g., a description of the solicitation activities and compensation to be received);
2. the third-party solicitor must provide the prospective client, at the time of any solicitation activities, with both a copy of the adviser's Form ADV Part 2 (the "brochure") and a separate written disclosure document (the "solicitor disclosure document") that highlights the solicitor's financial interest;
3. the adviser must receive from the client, before or at the time of entering into any written or oral agreement with the client, a signed and dated client acknowledgment of the client's receipt of the adviser's brochure and the solicitor disclosure document; and
4. the adviser must make a bona fide effort to ascertain whether the solicitor complied with the solicitation agreement and have a reasonable basis for believing the solicitor has so complied.

In the Risk Alert, the Staff identified the following most frequent deficiencies (among others) in arrangements covered by the Cash Solicitation Rule: [3]

- Solicitor disclosure documents: Third-party solicitors either did not provide, or provided inadequate solicitor disclosure documents to prospective clients. The Staff found solicitor disclosure documents that failed to disclose the nature of the relationship, including any affiliation, between the solicitor and adviser; contain the terms of the compensation arrangement between the adviser and solicitor; or specify the actual compensation terms of the solicitation agreement or additional solicitation cost the client will be charged in addition to the advisory fee.

- Client acknowledgements: Advisers failed to timely receive a signed and dated client acknowledgement of receipt of the adviser's brochure and the solicitor disclosure document. The Staff observed that some client acknowledgments were undated or dated after clients had entered into an investment advisory contract.
- Solicitation agreements: Advisers paid cash fees to a solicitor without a solicitation agreement in effect or pursuant to an agreement that did not contain certain required provisions such as an undertaking by the solicitor to perform its duties under the solicitation agreement in a manner consistent with the instructions of the adviser; a description of the solicitor's activities and compensation; or a requirement that the solicitor provide clients and prospective clients with a copy of the adviser's brochure and the solicitor disclosure document.
- Bona fide efforts to ascertain solicitor compliance: Advisers did not make a bona fide effort to ascertain whether third-party solicitors complied with solicitation agreements and appeared to not have a reasonable basis for believing that the third-party solicitors so complied.

In addition to the deficiencies relating to the Cash Solicitation Rule, the Staff observed similar conflicts that may implicate other provisions of the Advisers Act such as an adviser's fiduciary duty under Sections 206(1) and 206(2). For example, the Staff observed that some advisers that were recommending service providers to clients in exchange for client referrals without full and fair disclosure of the conflicts of interest.

THE TAKEAWAY

In light of the deficiencies identified in the Risk Alert, advisers should carefully review the adequacy and effectiveness of their policies and procedures, and client disclosures, relating to the Cash Solicitation Rule and client referrals. This includes, but is not limited to, a review of the adviser's solicitation agreements, Form ADV Part 2A brochure, and solicitor disclosure documents, as well as an inventory of all client acknowledgements. In addition, advisers should consider taking a more proactive approach in the supervision of solicitors' activities to ensure compliance with the Cash Solicitation Rule.

NOTES

[1] The investment adviser shall retain a copy of each written agreement as a part of the records required to be kept under Rule 204-2(a)(10).

[2] A solicitor may be associated with the adviser when (1) the solicitor is 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 or (2) the cash fee is paid with respect to solicitation activities for the provision of impersonal advisory services only.

[3] This Risk Alert does not address all deficiencies or weaknesses related to the Cash Solicitation Rule that have been identified by the Staff.

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