



# NATIONAL EXAM PROGRAM

## RISK ALERT

By the Office of Compliance Inspections and Examinations\*

October 31, 2018

### Investment Adviser Compliance Issues Related to the Cash Solicitation Rule

**Key Takeaway:**  
Advisers should review their practices and policies to ensure compliance with the Cash Solicitation Rule.

#### I. Introduction

The Office of Compliance Inspections and Examinations (“OCIE”) is issuing this Risk Alert to provide investment advisers, investors and other market participants with information concerning the most common deficiencies the staff has cited relating to Rule 206(4)-3 (the “Cash Solicitation Rule”) under the Investment Advisers Act of 1940 (the “Advisers Act”).<sup>1</sup> This Risk Alert includes observations by OCIE staff and is intended to assist investment advisers in identifying potential issues and adopting and implementing effective compliance programs.<sup>2</sup>

In general, investment advisers required to be registered under the Advisers Act (“advisers”) are 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 a number of conditions.<sup>3</sup> Among other things, the cash fee must be paid pursuant to a written agreement to which the adviser is a party (the “solicitation agreement”).<sup>4</sup> The solicitor may not be a person subject to certain disqualifications specified in the Cash Solicitation Rule.

There are additional requirements 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 (a “third-party solicitor”).<sup>5</sup> The Cash Solicitation Rule imposes the

\* The views expressed herein are those of the staff of OCIE. The Securities and Exchange Commission (the “SEC” or the “Commission”) has expressed no view on the contents of this Risk Alert. This document was prepared by OCIE staff and is not legal advice.

<sup>1</sup> This Risk Alert reflects issues identified during a review of deficiency letters from investment adviser examinations completed during the past three years.

<sup>2</sup> The SEC has brought enforcement actions charging advisers with violations of the Cash Solicitation Rule. *See, e.g., In the Matter of Essex Fin. Servs., Inc.*, Advisers Act Rel. No. 4603 (Jan. 9, 2017) (settled order) (finding that adviser violated the Cash Solicitation Rule by paying a cash fee to a solicitor despite knowing that the solicited clients had not received the necessary disclosures).

<sup>3</sup> Advisers Act Rule 206(4)-3.

<sup>4</sup> A copy of the solicitation agreement must be retained by the adviser under Advisers Act Rule 204-2(a)(15).

<sup>5</sup> Advisers are subject to narrower requirements under the Cash Solicitation Rule 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

following additional requirements when an adviser uses a third-party solicitor:

- (1) the solicitation agreement must contain certain specified provisions (e.g., a description of the solicitation activities and compensation to be received);
- (2) the solicitation agreement must require that, at the time of any solicitation activities, the solicitor provide the prospective client with a copy of (a) the adviser's brochure pursuant to Advisers Act Rule 204-3 ("adviser brochure") and (b) a separate, written disclosure document containing required information that highlights the solicitor's financial interest in the client's choice of an adviser (the "solicitor disclosure document");
- (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 acknowledgment that the client received the adviser brochure and the solicitor disclosure document ("client acknowledgement"); and
- (4) the adviser must make a bona fide effort to ascertain whether the solicitor has complied with the solicitation agreement, and must have a reasonable basis for believing that the solicitor has so complied.<sup>6</sup>

## II. Most Frequent Compliance Issues Related to the Cash Solicitation Rule

Below are some of the most frequent deficiencies that OCIE staff has identified pertaining to the Cash Solicitation Rule.<sup>7</sup>

- *Solicitor disclosure documents.* OCIE staff observed advisers whose third-party solicitors 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, including any affiliation, between the solicitor and the adviser.
  - 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.

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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. Advisers Act Rule 206(4)-3(a)(2)(i)-(ii). This 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.

<sup>6</sup> Advisers Act Rule 206(4)-3(a)(2)(iii).

<sup>7</sup> This Risk Alert does not address all deficiencies or weaknesses related to the Cash Solicitation Rule that have been identified by OCIE staff.

- Specify the additional solicitation cost the solicited client will be charged in addition to the advisory fee.
- *Client acknowledgements.* OCIE staff observed advisers that did not timely receive a signed and dated client acknowledgement of receipt of the adviser brochure and the solicitor disclosure document.<sup>8</sup> Staff also observed advisers that received client acknowledgements, but such client acknowledgements were undated or dated after the clients had entered into an investment advisory contract.
- *Solicitation agreements.* OCIE staff observed advisers that paid cash fees to a solicitor without a solicitation agreement in effect or pursuant to an agreement that did not contain certain specific provisions.<sup>9</sup> For example, staff observed solicitation agreements with third-party solicitors that did not:
  - Contain an 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.
  - Oblige solicitors to provide clients (including prospective clients) with a current copy of the adviser brochure and the solicitor disclosure document.
- *Bona fide efforts to ascertain solicitor compliance.* OCIE staff observed advisers that 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.<sup>10</sup> For example, staff observed advisers that were unable to describe any efforts they took to confirm compliance with solicitation agreements.

OCIE also observed advisers with 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, OCIE observed advisers that recommended service providers to clients in exchange for client referrals without full and fair disclosure of the conflicts of interest.

### III. Conclusion

The examinations within the scope of this review resulted in a range of actions. In response to the staff’s observations, some advisers elected to amend their disclosure documents and solicitation agreements, revise their compliance policies and procedures, or otherwise change their practices regarding the Cash Solicitation Rule.

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<sup>8</sup> Advisers Act Rule 206(4)-3(a)(2)(iii)(B).

<sup>9</sup> Advisers Act Rule 206(4)-3(a)(2)(iii)(A).

<sup>10</sup> Advisers Act Rule 206(4)-3(a)(2)(iii)(C).

In sharing the information in this Risk Alert, OCIE encourages advisers to review their practices, policies, and procedures in these areas and to promote improvements in adviser compliance programs.

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*This Risk Alert is intended to highlight for firms risks and issues that OCIE staff has identified. In addition, this Risk Alert describes risks that firms may consider to (i) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.*

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