



## Legal Risk Management Tip February 2013

### **REFERRAL FEES AND REFERRAL ARRANGEMENTS: WHAT YOU SHOULD CONSIDER**

Ask any person in marketing or sales and they will tell you that the best way to advertise is, and always has been, by word of mouth. Despite technology advances and access to social media, individuals still rely on those that they know and trust when determining where to go for the services they need. Recognizing this, investment advisers often form strategic relationships with other professionals by setting up referral programs in order to help promote and grow their respective businesses. These arrangements typically involve the investment adviser paying a fee to an individual, or business, in return for the referral of potential clients. Some arrangements condition the payment of the referral fee upon the engagement of the potential client; others merely pay a fixed amount based on the ongoing referral of prospective clients. While these relationships allow for access to potential clients that may not have otherwise been found, it also creates a conflict of interest due to the financial motivation of the party referring those clients to the adviser. As such, these relationships are regulated under the Investment Advisers Act of 1940 (the “Advisers Act”), as well as by various regulatory bodies and state laws.

#### **Regulations Governing Payment of Referral Fees**

Rule 206(4)-3 of the Advisers Act (commonly referred to as “The Cash Solicitation Rule”) governs referral arrangements of investment advisers registered with the Securities and Exchange Commission.<sup>1</sup> Pursuant to the Rule, a federally registered investment adviser is prohibited from paying a cash fee, directly or indirectly, to a solicitor with respect to solicitation activities, unless certain conditions are observed. The conditions required by the Rule include the following:

- **Registered and in Good Standing** – A pre-requisite for the payment of a referral fee is that the adviser must be registered as required under the Advisers Act, and such payment cannot be made to a solicitor who is subject to an order issued by the Commission under Sections 203(f) or 203(e)(4) or has been convicted of a felony or misdemeanor within the last 10 years involving false reporting, bribery, perjury, burglary and other activities as specified within Section 203(e)(2)(A)-(d).
- **Only Qualified Solicitors** – In an effort to reduce the chance of fraud, the Rule specifies that referral relationships are only valid when entered into by an adviser and a qualified solicitor. For purposes of the Rule, a “solicitor” includes “any person who, directly or indirectly, solicits clients for, or refers any client to, an investment adviser.” A list of those solicitors deemed to be disqualified can be found in Section (a)(1)(ii) of the Rule.

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<sup>1</sup> Rule 206(4)-3 does not apply to the payments by an adviser to solicit investments in a pooled investment vehicle, such as a hedge fund, sponsored by the adviser. *See Mayer Brown, LLP*, SEC Staff No-Action Letter (July 15, 2008).

- Written Agreement – All fees being issued to a solicitor must be paid pursuant to a written agreement whereby the investment adviser is a party to that agreement. There are no exceptions to this requirement. The written agreement should describe the activities the solicitor will engage in for the adviser, the compensation to be received and an undertaking for the solicitor to act in conformance with the provisions of the Advisers Act.

Written Disclosure Statement - Typically, for third-party solicitors, the written agreement requires them to furnish to the prospective client at the time of the solicitation a current copy of the adviser's disclosure brochure along with the solicitor's disclosure statement, which provides information related to the referral fee arrangement.<sup>2</sup> Prior to or at the time of entering into an advisory contract with that prospect, the adviser then must receive from such client a signed and dated acknowledgment of receipt of the solicitor disclosure statement as well as its brochure in accordance with Rule 204-3.

- Recordkeeping – In accordance with Rule 204-2(a)(10) and (15) of the Advisers Act, the investment adviser must retain a copy of each written agreement entered into with a solicitor as well as a copy of the solicitor's written disclosure document.
- Due Diligence of the Solicitor - The investment adviser must make a bona fide effort to determine whether the solicitor has complied with the written agreement, and must have a reasonable basis for believing that the solicitor has done so.

## **Other Considerations**

While the Rule provides a starting point for building a referral program, it is only the beginning. Facts and circumstances to the solicitor arrangement will necessitate other regulations to be considered, including state law and those rules utilized by governing bodies of other professionals.

### 1. State Registration Requirements for Solicitors

Whereas several states have adopted the SEC's approach to regulating solicitor referral arrangements, other states have opted to adopt their own guidelines that go beyond those of the SEC. For instance, California and Texas<sup>3</sup> require third-party solicitors to be registered as investment adviser representatives with the state. While this may be a limited registration (*i.e.*, no examinations are required), filing with the state regulators is still necessary even when the solicitor is only involved in providing impersonal advice.

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<sup>2</sup> The separate written disclosure document must contain the following information: (i) the name of the solicitor; (ii) the name of the investment adviser; (iii) the nature of the relationship between the solicitor and the investment adviser; (iv) a statement that the solicitor will be compensated by the investment adviser for the referral; (v) the terms of such compensation arrangement including a description of the fees paid or to be paid to the solicitor; and (vi) the additional amount that will be charged to the investment advisory fee and the deferential attributable to such a solicitor arrangement.

<sup>3</sup> For more information, please see <http://www.riabiz.com/a/12025002/where-riabiz-should-draw-the-line-in-rewarding-clients-for-referrals>.

## 2. Referral Arrangements with CPA Firms

Oftentimes investment advisers will wish to develop a professional network to refer their clients to. Under these circumstances, it is very common to develop a referral fee arrangement that is mutually beneficial for all within the network. One of the most common pairings includes investment advisers with Certified Public Accountants (“CPAs”).

Under Rule 503(c) of the American Institute of Certified Public Accountants (“AICPA”) standards, “any member who accepts a referral fee for recommending or referring any service of a CPA to any person or entity or who pays a referral fee to obtain a client shall disclose such acceptance or payment to the client.” Consequently, here again pursuant to AICPA standards, the referral must be disclosed to the client at the time the referral is made. Notably, the adherence to the AICPA standards rests with the CPA. However, risks can fall to the adviser where the CPA is providing other than impersonal advisement.

Where the CPA is deemed to be an investment adviser due to the nature of services<sup>4</sup> provided to the client, the solicitor will be required to register in the state as an investment adviser.<sup>5</sup> Additionally, some states (including California) require some “nexus” of activity<sup>6</sup> between the duties being performed by the CPA and those services received by the client from the adviser.<sup>7</sup> There are also additional disclosures<sup>8</sup> required by the CPA in the written agreement with the client.<sup>9</sup>

### **Risk Management Tips to Consider When Entering Into a Referral Arrangement**

When you decide that a referral arrangement is right for your business, it is important to consider the risks and mitigate each accordingly. The following provides several considerations of potential safeguards to consider when devising a referral program. This list is not comprehensive, and facts unique to each particular situation will warrant additional consideration.

1. Conduct thorough due diligence of the solicitor. Create a checklist for yourself of those services that you will require of the solicitor and any state or professional regulations that need be considered. Ask for references and conduct a background check.
2. Provide the most recent copy of your client brochure to the solicitor, and provide guidance on how the solicitor should maintain a Form ADV Part 2 delivery log, which is part of the adviser’s books and records.

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<sup>4</sup> CPAs are exempt from registration only to the extent that a CPA engages in activities that are “solely incidental to the practice of his profession” (Advisers Act, section 202(a)(11)(B)) or “customary and usual,” such as accounting and tax services.

<sup>5</sup> <http://www.journalofaccountancy.com/Issues/2011/Jan/20103194.htm>.

<sup>6</sup> For instance, if the CPA performs the taxes for the referred client, it can satisfy this “nexus” of activity by commenting on the tax implications of those investments recommended by the adviser.

<sup>7</sup> Section 5061 of the California Accountancy Act.

<sup>8</sup> These additional disclosures are similar as those required by the Advisers Act for third-party solicitors as described in footnote 3.

<sup>9</sup> Section 5061 of the California Accountancy Act.

3. Review Item 11 of Form ADV Part 2A and update as needed to reflect new solicitor arrangements and the inherent conflicts that lie therein; and don't forget to consider compensation arrangements with affiliated companies.
4. Consult state regulations, which may contain guidance regarding disclosures and licensure requirements for the firm and its solicitors.
5. Oversee the solicitor's marketing referral efforts on behalf of the adviser. Ensure that clear guidance is provided on what the solicitor can and cannot say and restrict the solicitor's use of using any materials that have not been provided or approved by the adviser.

For more information on these and other considerations, please contact us at [info@jackolg.com](mailto:info@jackolg.com), or (619) 298-2880. Also, please visit our website at [www.jackolg.com](http://www.jackolg.com).

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