Solicitation and Referral of Advisory Clients

By David J. Baum, Partner, Alston & Bird LLP*

Investment advisers often use affiliated persons or third parties to market their services and solicit potential clients to generate new business. While solicitation arrangements are a common tool in the industry for marketing investment advisory services, considerable attention has been paid by regulators to the compensation that is received in exchange for client referrals and the inherent conflicts of interest that exist in such relationships. In fact, as recently as October 31, 2018, the SEC’s Office of Compliance Inspections and Examinations (“OCIE”) issued a National Exam Program Risk Alert that highlighted the most frequent compliance issues related to solicitation arrangements found in adviser examinations completed in the three years prior (the “Risk Alert”). Accordingly, when entering into solicitation arrangements, it is important to understand the requirements under, and be cognizant of the anomalies that exist between, federal and state law.

I. Federal Law

A. Cash Solicitation Arrangements: Rule 206(4)-3

The SEC has long held the view that arrangements in which advisers compensate individuals for the solicitation of new investment advisory clients raise serious questions under the anti-fraud provisions of Section 206 of the Investment Advisers Act of 1940, as amended (the “Advisers Act”). In response to these concerns, and to clarify when cash fees may be paid for solicitation services, the SEC adopted Rule 206(4)-3 to alert potential clients to the conflicts of interest that exist when a person solicits clients for, or refers clients to, an adviser in return for cash compensation. Specifically, Rule 206(4)-3 allows advisers to make cash payments to persons who solicit clients on their behalf if the following conditions are met:

(i) the adviser is registered under the Advisers Act;
(ii) the solicitor is not subject to a statutory disqualification;
(iii) cash referral fees are only paid pursuant to a written agreement to which the adviser is a party; and
(iv) the adviser makes certain disclosures depending upon the nature of the relationship between it and the solicitor.

The first three conditions are common to all cash solicitation arrangements. With respect to the second condition, Rule 206(4)-3 prohibits payment of cash referral fees to solicitors who are subject to statutory disqualification because of certain violative conduct under Section 203 of the Advisers Act. The SEC, however, has liberalized this restriction by permitting the payment of referral fees despite the existence of violative conduct if disclosure of the existence and nature of the infraction is made in a separate written disclosure document at least 48 hours before the potential client enters into the advisory agreement, or at the time of solicitation if the client has the right to terminate the advisory contract within five days.

The contents of the written agreement and the disclosure obligations vary depending upon the identity of the solicitor and the services performed. As discussed below, Rule 206(4)-3 sets forth three types of arrangements in which cash referral fees are permitted.

1. Impersonal Advisory Services

Cash referral fees may be paid in arrangements involving the solicitation of clients strictly for the provision of impersonal advisory services. “Impersonal advisory services” include: (i) written materials or oral state-

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ments that do not purport to meet the objectives or needs of the specific client, (ii) statistical information containing no expressions of opinions as to the investment merits of particular securities, or (iii) any combination of the foregoing services. In these kinds of arrangements, there are no formal requirements regarding the contents of the solicitation agreement. Advisers must simply ensure that an agreement exists memorializing the relationship.

2. Affiliated Solicitors

Cash referral fees may also be paid by an adviser to affiliated solicitors. Affiliated solicitors include (i) partners, officers, directors or employees of the adviser, or (ii) partners, officers, directors or employees of a person which controls, is controlled by, or is under common control with the adviser. No-action relief granted by the SEC staff has indicated that a company may also receive cash referral fees directly from its affiliated adviser. The requirements of Rule 206(4)-3 apply to each affiliated solicitor separately.

Affiliated solicitors must enter into a contract with the adviser but, as with arrangements regarding the solicitation of impersonal advisory services, there are no requirements regarding the contents of such agreements. Affiliated solicitors must also disclose the nature of their relationship with the adviser to a potential client at the point of solicitation. Where the solicitor is associated with an affiliated company rather than the adviser directly, the solicitor must disclose to the client the nature of the relationship between his, her or its employer and the adviser.

3. Third-Party Solicitors

The most burdensome requirements under Rule 206(4)-3 pertain to arrangements with third-party solicitors who are neither affiliated with the adviser nor solicit clients strictly for impersonal advisory services. Under the rule, advisers may only provide compensation to third-party solicitors pursuant to a written agreement setting forth:

(i) the nature of the solicitation activities and the compensation to be received;
(ii) an undertaking by the solicitor to perform his, her or its duties under the agreement in a manner consistent with the instructions of the adviser and the provisions of the Advisers Act and the rules thereunder; and
(iii) a requirement that the solicitor, at the time of any solicitation activities, must provide the client with a current copy of the adviser’s written disclosure statement required by Rule 204-3 and a separate written disclosure document.

The required written disclosure document must provide: (i) the name of the solicitor; (ii) the name of the adviser; (iii) the nature of the relationship between the solicitor and the adviser; (iv) a statement that the solicitor will be compensated for his, her or its solicitation services and the terms of such compensation arrangement; (v) the terms of such compensation arrangement, including a description of the compensation paid or to be paid to the solicitor; and (vi) the amount, if any, for the cost of obtaining his, her or its account the client will be charged in addition to the advisory fee, and the differential, if any, among clients with respect to the advisory fees charged if the differential is attributable to cash compensation pursuant to a solicitation agreement.

In addition to the disclosure requirements imposed on third-party solicitors, the adviser must receive from each client referred by a third-party solicitor, no later than the inception of the advisory relationship, a signed and dated acknowledgment of his or her receipt of (i) the adviser’s written disclosure statement, and (ii) the solicitor’s written disclosure document. The adviser must also make a bona fide effort to ascertain whether the solicitor is in compliance with the agreement, and have a reasonable basis for concluding the solicitor has complied, in order to pay any referral fees.

B. Non-Cash Solicitation Arrangements

Solicitation arrangements involving non-cash referral fees are generally restricted by the anti-fraud provisions of Section 206 of the Advisers Act. Although the SEC has not specifically prohibited the payment of non-cash referral fees, it noted in the adopting release for Rule 206(4)-3 that the intent behind the rule is to employ appropriate regulatory safeguards to protect investors and discourage the use of “other, possibly undisclosed, methods of compensation, such as directed brokerage.” While cash referral fees are permitted if provided in compliance with Rule 206(4)-3, “non-cash” referral fees would likely undergo intense scrutiny by the SEC absent full disclosure of the arrangement. Accordingly, at a minimum, advisers engaging in such arrangements should disclose the arrangements in their Form ADV Part 2A brochure. Additionally, in determining whether to permit certain forms of non-cash referral fees, the SEC staff has indicated that it may consider: (i) the type of compensation; (ii) the frequency of the referrals; (iii) whether the solicitor actually recommends the adviser; and (iv) whether the adviser and solicitor comply with any requirements of Rule 206(4)-3.

If non-cash referral fees paid to a solicitor are found to be impermissible payments, the SEC has indicated that, contingent upon the facts and circumstances involved, such compensation may be deemed to render the solicitor “engaged in the business of advising others,” thus requiring the solicitor to register with the SEC as an investment adviser.

II. State Law Considerations

Individual states have the ability to prescribe licensing requirements for investment adviser representatives. Continued from page 15
(“IARs”) doing business in their state. As such, some states include individuals who engage in the solicitation of investment advisory clients in their definition of “investment adviser representative.” While Section 203A(b) of the Advisers Act preempts state regulation of “supervised persons” of SEC-registered advisers, it does permit states to require licensing of an investment adviser representative with a place of business in the state. To determine whether a solicitor is subject to a state’s IAR registration requirements, the following questions must be asked:

(i) Does the state definition of “investment adviser representative” include “soliciting for the sale of investment advisory services”?
(ii) Is the solicitor a “supervised person” of the adviser?

In regards to the first prong of the test noted above, the vast majority of states include solicitors in the definition of “investment adviser representative.” For the minority of states that do not include solicitors in the definition of “investment adviser representative,” solicitors who maintain a place of business in these states would not be required to register as an IAR.

If a state’s definition of “investment adviser representative” includes solicitors, it should next be determined whether the solicitor is a “supervised person” under the Advisers Act and thus potentially exempt from any state registration requirements. Pursuant to Section 202(a)(25) of the Advisers Act, a “supervised person” is defined as either: (i) any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser; or (ii) other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser. Generally, third-party solicitors do not provide advice on behalf of the adviser and would not be supervised persons. Therefore, states are permitted to require these third-party solicitors to register as IARs regardless of their place of business.

In addition, several states define the term “investment adviser” to include entities that solicit for the sale of investment advisory services. Accordingly, under this broader definition, simply soliciting clients on behalf of an adviser may be sufficient to subject an entity to a state’s investment adviser registration requirements.

III. OCIE Risk Alert and Best Practices to Avoid Compliance Pitfalls

OCIE’s Risk Alert highlighted the deficiencies its staff most frequently identified in relation to solicitation arrangements. These deficiencies, which fall into four categories, can easily be avoided with adherence to proper compliance procedures. Those compliance issues noted in the Risk Alert and ways to avoid them are discussed below.

A. Solicitation Agreements

In the Risk Alert, OCIE’s staff saw instances of advisers paying cash to solicitors either without a written agreement in effect or pursuant to an agreement that did not contain all of the provisions required under Rule 206(4)-3. Advisers should ensure that, for each of their solicitation arrangements, they have in place a written agreement that complies with the requirements of Rule 206(4)-3 discussed above.

B. Solicitor Disclosure Document

OCIE’s staff also noted that in many cases, third-party solicitors did not provide the required solicitor disclosure documents to prospective clients or provided documents that did not contain all of the required disclosures.

To avoid this compliance pitfall, advisers should ensure that the solicitor, when providing the required solicitor disclosure document, and the adviser’s Form ADV Part 2A brochure. Additionally, advisers should review the solicitor disclosure document to ensure that it satisfies the requirements of Rule 206(4)-3 and consider adding it as an exhibit to the solicitation agreement. The solicitation agreement should also require that the solicitor, when providing the Form ADV Part 2A brochure, download the brochure from the Investment Adviser Public Disclosure website to ensure that they are providing the most up-to-date version. Advisers should also consider adding a provision to the solicitation agreement making payment conditioned on the provision of the adviser’s brochure to any prospective client.

C. Client Acknowledgements

OCIE’s staff further observed that advisers often did not timely receive signed and dated client acknowledgements of receipt of the adviser’s Form ADV Part 2A brochure or received acknowledgements that were undated or dated after the client had entered into an advisory agreement with the adviser.

In addition to ensuring that solicitors are trained on their responsibilities under Rule 206(4)-3, including on the need to obtain and provide to the adviser properly completed client acknowledgements, advisers should consider adding receipt of such acknowledgement as part of the client onboarding process. Additionally, advisers should consider adding a provision to their solicitation agreements requiring receipt by the adviser of a timely and properly completed acknowledgement as a condition to payment of referral fees.

D. Efforts to Ascertain Solicitor Compliance

OCIE staff also took note of instances where advisers had not made efforts to determine whether third-party solicitors had complied with the requirements of the solicitation agreements and did not appear to have a reasonable basis for believing that solicitors had complied.

To demonstrate a bona fide effort...
at ascertaining compliance by solicitors with the requirements applicable to solicitation arrangements, advisers should, at a minimum, have solicitors certify at least annually that they are complying with the requirements of Rule 206(4)-3 and the terms of the solicitation agreement. Additionally, advisers should set up a procedure to inquire of new clients during the onboarding process about the solicitation arrangement and the actions of the solicitor. In addition to adding to the client agreement an acknowledgement that the client has been solicited by a solicitor and that the client has received copies of the solicitor’s disclosure document and the adviser’s Form ADV Part 2A brochure, the adviser should speak directly with each client referred by the solicitor to ensure that there have been no violations of the established referral program.

**IV. Other Best Practices**

Advisers should review their compliance policies and procedures to ensure that they address all of the requirements of Rule 206(4)-3, as well as review their recordkeeping practices to ensure that they are receiving and maintaining all required records. Additionally, advisers should set up a procedure to inquire of new clients during the onboarding process about the solicitation arrangement and the actions of the solicitor. In addition to adding to the client agreement an acknowledgement that the client has been solicited by a solicitor and that the client has received copies of the solicitor’s disclosure document and the adviser’s Form ADV Part 2A brochure, the adviser should speak directly with each client referred by the solicitor to ensure that there have been no violations of the established referral program.

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While solicitation agreements can drastically increase an adviser’s exposure to potential clients, failure to comply with federal and state requirements can negate any potential benefit that can be reaped by this marketing tool. Accordingly, it is essential that advisers entering into solicitation arrangements ensure that comprehensive procedures are in place to ensure compliance with the requirements of Rule 206(4)-3, appropriate training of solicitors is implemented and accurate books and records are maintained.

* The SEC has stated it plans to amend the cash solicitation rule, and a proposed amendment is expected within 12 months of appearing in the SEC’s May 2019 regulatory agenda, or by May 2020.

* David J. Baum is a Partner in the Investment Management, Trading and Markets Group at Alston & Bird LLP in Washington, DC. Mr. Baum can be reached at David.Baum@alston.com or (202) 239-3346.