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IN THIS ISSUE



# Referral Arrangements and Referral Fees: What You Should Consider

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## I. Introduction

Any person in marketing or sales will tell you that the best way to advertise is, and always has been, by word of mouth. Despite technological advances and access to social media, individuals rely on those they know and trust when determining where to go for the services they need. Recognizing this, investment advisors often form strategic relationships with other professionals. These relationships span a wide range of formality. At the informal end, the advisor may simply meet with other professionals to make them aware and keep them up to date on the advisor's services and capabilities. At the other end of the range, the advisor may pay other professionals fees for referrals.

Between mere "awareness" discussions and "for-fee" referral agreements lie many variations. This article first focuses on the compliance requirements for advisors paying referral fees and then looks at other considerations for referral arrangements, including non-cash compensation.

## II. Regulations Governing Payment of Referral Fees

Referral fee arrangements typically involve the investment advisor 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 who may not have otherwise been found, it also creates a potential conflict of interest as a result of the financial incentives for the party referring those prospects to the advisor. Accordingly, the Securities and Exchange Commission ("SEC") has promulgated certain rules governing these relationships under the Investment Advisers Act of 1940 (the "Advisers Act"), as have the states and other regulatory bodies.

Rule 206(4)-3 of the Advisers Act (commonly referred to as "The Cash Solicitation Rule"; hereinafter, the "Rule") governs referral arrangements of investment advisors registered with the SEC.[1]

Pursuant to the Rule, a federally registered investment advisor is prohibited from paying a cash fee directly or indirectly to a solicitor with respect to solicitation activities, unless certain conditions are observed.[2] The conditions required by the Rule include the following:

- **The investment advisor must register.** While the Rule applies to all investment advisors "required to be registered [with the SEC] pursuant to section 203" of the Advisers Act, in order to participate in a referral fee program the advisor must be registered with the SEC or state.
- **Only qualified solicitors.** In an effort to reduce the chance of fraud, the Rule specifies that referral relationships are valid only when entered into by an advisor and a qualified solicitor; i.e., one who meets the definition of solicitor and is in good standing. 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 solicitor is considered disqualified, and therefore ineligible to receive a cash fee, when he or she: (i) is subject to an order issued by the SEC under Section 203(f) (willful violations of the Securities Act) or 203(e)(4) (permanent or temporary disbarment); or (ii) 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) of the Advisers Act.

- **Written agreement.** All fees paid to a solicitor must be paid pursuant to a written agreement with the investment advisor. There are no exceptions to this requirement. The written agreement should describe the activities the solicitor will engage in for the advisor, specify the compensation to be received, and confirm that the solicitor must 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 advisor's disclosure brochure along with the solicitor's disclosure statement, which provides information related to the referral fee arrangement.[3] In accordance with the Rule, before or at the time of entering into an advisory contract with that prospect, the advisor must receive from such client a signed and dated acknowledgment of receipt of the solicitor disclosure statement and its brochure.
- **Due diligence on the solicitor.** When working with third-party solicitors, the investment advisor 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.
- **Recordkeeping.** In accordance with Advisers Act Rule 204-2(a)(10) and (15), the investment advisor 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.

## III. Other Considerations

While the Rule provides a foundation for building a referral program, it is only the beginning. Facts and circumstances of the solicitor arrangement may necessitate that other issues be considered, including SEC "no-action" letters, state law, and those rules utilized by governing bodies of other professionals.

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### A. Independent Contractor, or Affiliated Party Status

The above guidelines may slightly vary depending on whether the solicitor is considered an employee or an outside independent contractor who may or may not be registered with another investment advisor. Typically, those solicitors who are independent contractors registered with the advisor will be considered employees, analogous to the "pay to play" rule,[4] through which the SEC broadly interpreted the term "employee" to include "independent contractors" acting on behalf of an investment advisor,[5] depending on the facts of a given situation. Under these circumstances, the independent contractor is required to reveal to the client his or her "employee" relationship with the advisor only when making a referral.

On the other hand, as further discussed below, independent contractors not registered with the advisor may be subject to more stringent rules governing solicitors, including the requirement to have any solicitor arrangement entered into be pursuant to a selling agreement (in the case of solicitors who are registered with another broker-dealer or investment advisor), to provide a written disclosure statement to the client, and to attain the client's written attestation of having received the disclosure statement and the advisor's brochures.

### B. State Registration Requirements for Solicitors

According to the Rule, a solicitor does not necessarily need to be registered as an investment advisor so long as the activities of the solicitor are limited solely to making the referral on behalf of the advisor. This occurs, for example, when a referral is made by simply providing the advisor's business card without further marketing or discussion of the advisor's services. While several states have adopted the SEC's approach to regulating solicitor referral arrangements, other states have opted to adopt more stringent guidelines that go beyond those of the SEC's requirements. For instance, California and Texas[6] (among other states) require third-party solicitors to be registered as investment advisor 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 involved only in providing impersonal advice.

### C. 'Investment Pool' Exception

The SEC has clarified its position on whether the Rule applies to arrangements involving referrals for pooled investment vehicles, such as private fund investments. In the *Mayer Brown, LLP* SEC Staff No-Action Letter dated July 15, 2008, the SEC stated that the Rule does not apply to those referral fees paid solely to compensate solicitors for referring investors to investment pools managed by the advisor. However, the SEC failed to clarify what conditions are required to meet the "solely" standard described[7] or whether such referrals would cause the solicitor to be considered a "broker" under the Securities and Exchange Act of 1934 ("Exchange Act").[8] As such, specific clauses in the written agreement, as well as disclosures made to the client, should be carefully drafted.

### D. Non-Cash Compensation

Only "cash fee" arrangements are covered by Rule 206(4)-3. This naturally raises the question: Are non-cash solicitation arrangements acceptable, and if so, what governs these types of relationships? Unfortunately, the answer is not as clear as the question. There is no explicit prohibition on the payment of non-cash consideration to a solicitor. But the SEC has suggested that non-cash compensation, such as directed brokerage, may violate the general antifraud provisions of the Advisers Act if the advisor fails to disclose or inadequately discloses the arrangement.[9] Disclosure of less direct "compensation," such as a reciprocal expectation of referrals to the solicitor by the advisor, has not been addressed, but should certainly be considered. Advisors should consult with their compliance officers and legal counsel about the structure and disclosure of any non-cash referral arrangement.

### E. Referral Arrangements With Other Professionals

Investment advisors will often wish to develop a professional network to which they can refer their clients. Under these circumstances, it is very common to develop a referral fee arrangement that is mutually beneficial for all within the network. Some of the most common pairings include investment advisors with certified public accountants ("CPAs"), attorneys, and broker-dealers ("BDs").

**1. CPA Firms**

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. There are restrictions to such arrangements, however—for instance, prohibiting such fees when the CPA also performs attest services for the same client.[10] Notably, although the adherence to the AICPA standards rests with the CPA, risks can fall to the advisor when the CPA is providing anything other than impersonal advice.

Instances in which the CPA is deemed to be an investment advisor due to the nature of services[11] provided to the client may require the solicitor to register in the state as an investment advisor.[12]

It should also be noted that while several states have adopted the AICPA's model rule on referral arrangements, some states have additional regulations that must be followed. These rules are normally found in the state's accountancy laws and/or its code of ethics and should be reviewed before engaging in this type of relationship.

**2. Attorneys**

Utilizing attorneys for client referrals creates a unique situation that is controlled more at the state level than by the SEC. In most states, this arrangement is believed to create serious conflicts and limitations in regard to the attorney's ability to represent the client. Consequently, depending on the jurisdiction, some attorneys may be prohibited from receiving a cash fee for referrals in those states. There are, however, certain states that may provide for exceptions and allow for this type of referral arrangement, depending on the circumstances and pursuant to specified disclosures and agreements.[13] Before entering into such arrangements, it is prudent for attorneys to check with their state bar rules to confirm the standards that apply to this type of referral relationship.

**3. BD Firms**

Unlike CPAs (who, when acting as solicitors, and depending on the arrangement and jurisdictional requirements, may be required to register as investment advisors), a broker-dealer registered with the SEC under the Securities and Exchange Act of 1934 ("Exchange Act") is excluded from having to register if the solicitation is: (i) solely incidental[14] to the conduct of the broker-dealer's business and (ii) the broker-dealer does not receive any "special compensation"[15] for the solicitation.[16] Furthermore, states are barred from forcing broker-dealers to register as investment advisors pursuant to section 203A(b)(1)(ii) of the Advisers Act, which states in pertinent part that states are disallowed from requiring registration of any person who is "not registered . . . because that person is excepted from the definition of an investment adviser under section 202(a)(11)."[17] Because broker-dealers are included in those persons excepted from the definition of investment advisor, states may not require registration.

It should be noted, however, that such a relationship still imposes a significant conflict of interest on the advisor in these situations. As such, the advisor is still obligated to disclose to clients material information regarding this conflict.[18]

### F. Marketing and Promotional Materials

Depending on whether the advisor enters into a referral arrangement whereby the solicitor is promoting the advisor, another important consideration may be the types of marketing and promotional materials a solicitor may use with potential clients.

> Within the solicitor's agreement, advisors should consider prohibiting the solicitor from self-producing and/or using any materials related to the advisor's service without the express written consent of the advisor.

Since the solicitor is acting on the advisor's behalf, the advisor is ultimately responsible for the messaging that the solicitor is relaying about the advisor's products and services. Consequently, most advisors may opt to control the marketing materials that are disseminated by solicitors by restricting the solicitor to using only compliance-approved materials as provided by the advisor.[19]

### G. Other Considerations for the Written Solicitor's Agreement

As mentioned above, all solicitor relationships must be governed by a written agreement between the investment advisor and the solicitor. While the Rule requires certain language to be included, it is prudent to consider other items that may prevent complications in the future. For instance, the advisor may wish for the solicitor to provide a list of the solicited prospects within 10 days of solicitation. In addition, the advisor may wish to include arbitration provisions to govern disputes concerning fees or parts of the written agreement and define the scope of permissible solicitation activities.

## IV. Conclusion: Risk Management Factors to Weigh When Entering Into Solicitor Arrangements

Before entering into any solicitor arrangement, it is important to weigh the following risks associated with this business arrangement and to mitigate such risks wherever possible. 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. Be clear about the scope of the arrangement and each side's (the advisor's and the solicitor's) expectations, including any compensation. Will cash referral fees be paid? If not, is there some other form of compensation?
2. Conduct thorough due diligence of the solicitor. Start by performing a background check. Create a checklist for yourself of those services you will require of the solicitor and any state or professional regulations that need to be considered. Ensure that the solicitor is reputable and contact industry references.
3. Provide the most recent copy of your client brochure to the solicitor as well as a Form ADV Part 2 delivery log format. Provide guidance on the respective delivery and maintenance of each and advise that these books and records are required for the advisor.
4. Review Item 14 of Form ADV Part 2A and update as needed to reflect new solicitor arrangements and any conflicts related to that arrangement (e.g., compensation arrangements with affiliated companies).
5. When solicitation activities occur, consult applicable state regulations, which contain guidance regarding disclosures and licensure requirements for the firm and its solicitors.
6. Develop a supervisory system for all solicitor arrangements. Oversee the solicitor's marketing referral efforts on behalf of the advisor. Ensure that clear guidance is provided on what the solicitor can and cannot say and restrict the solicitor's use of any materials that have not been provided for and/or approved by the advisor.

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

[2] Advisors should note that the SEC is considering whether to "harmonize" the current differing treatment of advisors' use of "solicitors" (as discussed in this article) and broker-dealers' use of "finders." See "Duties of Brokers, Dealers, and Investment Advisers," Release No. 34-69013, IA-3558 (March 1, 2013), p. 59.

[3] The separate written disclosure document must contain the following information: (i) the name of the solicitor; (ii) the name of the investment advisor; (iii) the nature of the relationship between the solicitor and the investment advisor; (iv) a statement that the solicitor will be compensated by the investment advisor 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 differential attributable to such a solicitor arrangement.

[4] Rule 206(4)-5 of the Advisers Act.

[5] See Interpretive Release No. IA-1000, at II.C.3

[6] For more information, see Texas State Securities Board, http://www.ssb.state.tx.us/.

[7] Terrance J. O'Malley, *Investment Adviser's Legal and Compliance Guide* (2–14), 2010.

[8] Patricia C. Foster, "The Carefully Contracted Strategic Alliance," *Charles Schwab Services,* Vol. 19, No. 1, Jan. 2010.

[9] Terrance J. O'Malley, *Investment Adviser's Legal and Compliance Guide* (2–14), 2010. See also Thomas P. Lemke and Gerald T. Lins, *Regulation of Investment Advisers,* 2010, §2.188.

[10] Professional Advisors Alliance, "FAQ's for CPA's," http://www.professionaladvisorsalliance.com/paa/pages/misc/faqs.html.

[11] 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.

[12] Wesley G. Nissen and Milton K. Buckingham, "New Investment Adviser Requirements of the Dodd-Frank Act: What CPAs Should Know," *Journal of Accountancy*, Jan. 2011, http://www.journalofaccountancy.com/Issues/2011/Jan/20103194.htm.

[13] For example, California, Georgia, and Minnesota (among others) may provide exceptions that generally permit attorneys to receive a cash fee for client referral arrangements under certain circumstances and subject to applicable state regulations.

[14] Legal Information Institute, Cornell University Law School, April 19, 2005, http://www.law.cornell.edu/cfr/text/17/275.202(a)(11)-1.

[15] Generally, to avoid receiving "special compensation," a broker or dealer relying on this exclusion must receive only commissions, markups, and markdowns.

[16] Staff of the Investment Adviser Regulation Office, Division of Investment Management, U.S. Securities and Exchange Commission, "Regulation of Investment Advisers by the U.S. Securities and Exchange Commission," March 2013, http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf.

[17] The University of Cincinnati College of Law, Securities Lawyer's Deskbook, http://taft.law.uc.edu/CCL/InvAdvAct/sec203a.html.

[18] Steven W. Stone, "Marketing and Referral Arrangements From the Investment Adviser's Perspective," Institute for International Research, The Compliance Forum for Registered Investment Advisers and Hedge Fund Managers, June 2001, http://www.morganlewis.com/pubs/6F99F2DF-5215-4F89-A7CAF9427EB3DE5C_Publication.pdf.

[19] Rules governing advisors' advertising are found in sections 206 and 206(4)(1) of the Advisers Act, in various SEC "No-Action" Letters and enforcement actions, and within state regulations.


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