



12 Things You Need to Know about Adviser Referral Arrangements and the Cash Solicitation Rule

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OCIE recently issued a [Risk Alert](#) on common exam deficiencies in complying with the Cash Solicitation Rule, [Rule 206\(4\)-3](#), of the Advisers Act. It is not surprising that OCIE decided to highlight referral arrangements, since this is an area fraught with regulatory risk. So in addition to OCIE's insights, we've included some other traps for the unwary.

OCIE reviewed deficiency letters from the past three years and cited four common mistakes:

1. Disclosure Documents Failure: Advisers make two common errors. The first is a failure to provide the disclosures required under Rule 206(4)-3 to clients. The second is providing incomplete disclosures. Disclosure documents must:

- Describe the relationship between the solicitor and adviser, including any affiliation.
- Describe the terms of the compensation arrangement and specify how much the solicitor is going to be paid.
- Describe whether the client will pay any additional cost as a result of the solicitation.

Here is an example of the required disclosure for an unaffiliated solicitor:

Jane Smith, an investment adviser representative of Archaic Asset Management ("Ms. Smith" or "Solicitor"), has entered into an agreement with Basic Capital Management ("Basic" or "Adviser"), a registered investment adviser, where Basic has agreed to pay Ms. Smith a fee in exchange for introducing potential advisory clients to Basic. Ms. Smith is not an employee or otherwise affiliated with Basic.

Basic has agreed to pay Ms. Smith a fee for these solicitation services. The fee is [__ %] of the investment management fee paid to Basic. Basic pays this fee to Ms. Smith out of its investment management fee. This means that you do not pay any additional fees as a result of Ms. Smith's solicitation services.

Enclosed is a copy of the Basic's current Form ADV Part 2A. This document contains important disclosure about Basic's investment management services, fees and conflicts of interest. This document must be provided to any client or prospective client before establishing a relationship with Basic.

Please sign and date your receipt of this disclosure and Basic's Form ADV in the spaces indicated below.

2. Failure to Have Acknowledgements from Solicited Clients. Another common mistake is the failure by advisers to have a signed and dated document from the client acknowledging receipt of (1) the adviser's Form ADV Part 2A brochure, and (2) the disclosure regarding the solicitation arrangement. The signed and dated disclosure acknowledgment should be received BEFORE the client signs the advisory agreement. I recommend that firms include a provision in their solicitation agreements that the solicitor cannot get paid until the signed disclosure documents are received by the advisory firm.

3. No Agreement or Inadequate Agreement. OCIE also found that advisers paid fees to solicitors without a written agreement, or using an agreement that did not contain the provisions required by the rule.

A solicitation agreement must contain the following:

- A description of the solicitation activities and the compensation to be paid;
- A statement that solicitor will perform his or her duties "in a manner consistent with the instructions of the investment adviser" and the Adviser Act; and
- An agreement that the solicitor will give the solicited client a copy of the investment adviser's Form ADV Part 2A (the brochure) at the time of the solicitation and a disclosure document that describes the terms of the solicitation agreement, including the compensation.

I recommend attaching the required disclosure to the solicitation agreement and instructing the solicitor to download the Form ADV Part 2A from the SEC's website to ensure that the document is up to date. I have also attached Hardin Compliance's [form for reviewing solicitor's agreements](#).

4. Failure to Check if Solicitor is Complying with the Agreement. Another common deficiency is the failure of an adviser to follow up to determine whether the solicitor is complying with the terms of the solicitation agreement. This follow-up is also required under the Rule 206(4)-3, which says that the adviser should make a *bona fide* effort to find out whether the solicitor has complied with the solicitation agreement, **and** have a reasonable basis for believing that the solicitor has complied with the agreement. In the [proposing release for the rule](#) (IA Release No. 688) issued in 1979, the SEC said the question of what constitutes a *bona fide* effort would "depend upon the circumstances. In general, however, it would seem that such a bona fide effort would, at a minimum, involve making inquiries of some or all clients referred by the solicitor in order to ascertain whether the solicitor has made improper representations or has otherwise violated the agreement with the investment adviser."

Interestingly, OCIE did not reference this release and simply stated that advisers "were unable to describe any efforts they took to confirm compliance with solicitation agreements." In my experience, advisers do not ask clients about their experiences with solicitors. A simple method for getting client feedback would be to require a firm's Investment Adviser Representatives to discuss the solicitation arrangement with a newly-referred client and then note any feedback in the firm's client relationship management system. Advisory firms could require that solicitors certify annually that they are complying with the terms of the agreement. [Click here](#) for a sample certification.

Advisers should also take action to ensure that solicitors know what is expected of them. Provide the solicitors with training on their responsibilities, including delivery of the Form ADV Part 2A and the disclosure document. Advisers should provide solicitors with approved marketing materials and guidance on what they are permitted to say to prospective clients. As further protection, the solicitation agreement should include a requirement that the solicitor can only use marketing materials approved by the adviser.

Other Traps for the Unwary

In addition to the Risk Alert, we've pulled together a hit list of common issues faced by investment advisers when entering into referral arrangements.

5. Registration as an IAR is Required to Receive Referral Fees in Most States. Advisers considering whether to hire an unregistered solicitor should first check state law. In many states, the act of recommending an investment adviser is considered providing investment advice, so a person receiving a solicitation fee has to register as an investment adviser representative.

The solicitor bears the legal risk of referring business to an investment adviser for a fee. To avoid any legal complications, I recommend that the solicitation agreement include a representation from the solicitor that his or her activities comply with state and federal law. Here is an example:

The Solicitor maintains or will obtain any SEC and state registrations that may be appropriate or required in connection with the solicitation services provided under this agreement or has been advised by counsel that it is exempt or excluded from registration.

6. CPAs and Attorneys Can be Restricted from Receiving Referral Fees. Advisory firms often seek to partner with other "centers of influence" such as CPA and law firms. CPAs and attorneys are excluded from the definition of investment adviser under federal and state securities law, as long as any investment advice that they give is "solely incidental" to the practice of their profession. (See [Section 202\(a\)\(11\)](#) of the Investment Advisers Act.) Whether the accountant or lawyer crosses the "solely incidental" line in providing advisory services is a question of fact. Whether a CPA or lawyer qualifies for the exemption under the Advisers Act depends on whether the professional:

- a. holds himself out to the public as an investment adviser or financial planner,
- b. has a fee structure for investment advisory services that is different from the schedule for other professional services, and
- c. provides advice regarding investments that is not in connection with or reasonably related to the professional services rendered as an accountant.

So the bottom line is that the accountant or lawyer has to determine whether to register as an RIA or IAR based on its business model.

There are also issues of state law. Some states view the receipt of referral fees by accountants and lawyers as a conflict of interest. Most states allow accountants to receive referral fees under certain circumstances (which include disclosure of the arrangement to the client), but a few do not. Generally accountants that provide services that require independence cannot receive commissions or referral fees. These services include:

- Audit, review or agreed-upon-procedures of a financial statement,
- Examination of prospective financial information, or
- Compilation of a financial statement if the compilation report does not disclose a lack of independence between the client and the licensee.

In some states, ethics rules regarding attorneys are even more prohibitive. For example, the state bars of [New York](#), [Maine](#), [Texas](#), and [Pennsylvania](#) prohibit attorneys from receiving cash referral fees from investment advisers. Other states allow referral arrangements, but limit the circumstances and require disclosures.

7. Disqualifications and due diligence. Before entering into a referral agreement, advisers should conduct a background check on the potential solicitor. The Cash Solicitation Rule (Rule 206(4)-3) prohibits the payment of cash referral fees to anyone:

- Who 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
- Who has been convicted of a felony or misdemeanor within the last ten years involving false reporting, bribery, perjury, burglary, and other activities as specified within [Section 203\(e\)\(2\)\(A\)-\(D\) of the Advisers Act](#).

Advisers should also require that the solicitor represent that they are not subject to any of these disqualifications in the solicitation agreement. Legal considerations aside, advisers that want to protect their reputation will not want to hire solicitors that have black marks on their regulatory records.

8. Only CASH is allowed. The cash solicitation rule is essentially a safe harbor, and only permits the payment of cash for referrals. There is no rule specifically prohibiting non-cash consideration, but I would advise discussing with legal counsel. At a minimum, advisers providing non-cash compensation for referrals should disclose this practice in Form ADV Part 2A.

9. Update your Form ADV to include solicitors: Advisers should include disclosure of referral arrangements in Items 5 B.(6) and 8.H of Form ADV Part 1A and Item 14 of Form ADV Part 2A, including a discussion of conflicts related to that arrangement.

10. Restrictions on Paying Solicitors of Governmental Entities. Advisers seeking governmental clients should also be aware of the restrictions imposed by the “Pay to Pay Rule” ([Rule 206\(4\)-5 of the Advisers Act](#)). This rule prohibits advisers from paying third-party solicitors unless they are “regulated persons” subject to pay-to-play restrictions on political contributions. “Regulated persons” include broker-dealers and SEC-registered investment advisers that are also subject to pay-to-play restrictions.

11. Lobbyist Registration. Investment advisers that work (or want to work) with state retirement systems should also be aware of state lobbying laws. Many states have adopted lobbying laws that define “lobbying” to include activities related to contracting with a governmental entity to provide investment management services. This law may require firms, their employees and representatives, including solicitors, to register as lobbyists before pitching advisory services to state retirement plans. For example, [in Ohio](#), a “Lobbyist” is a person or entity whose main purpose on a “regular and substantial basis” is to influence the state retirement system’s decisions by direct communications with board members, investment officials or any employee whose position involves substantial and material exercise of investment discretion. Similarly, [in California](#), persons serving as placement agents before

the State's retirement systems - including the California Public Employees' Retirement System and the California State Teachers' Retirement System - must register as lobbyists, with certain exemptions. Some states, such as New York and Pennsylvania, even ban the use of third-party placement agents in connection with public retirement systems.

The lobbyist registration laws vary from state to state, so if your firm actively solicits state retirement plans for their investment advisory business, I recommend that you consult with counsel on the applicability of lobbying laws. Some local governments also require lobbyist registration, so it is important to review local laws to determine whether registration as a lobbyist and lobbyist employer is required. K&L Gates produced an excellent Investment Management Alert on this topic. Check it out [here](#).

12. Exclusion for Private Fund Referrals. The Cash Solicitation Rule does not apply to private fund referrals. In the [Mayer Brown No-Action Letter](#) issued by the SEC in 2008, the SEC staff stated that the Cash Referral Fee Rule generally does not apply to an investment adviser's cash payment to a person solely to compensate that person for soliciting or referring investors or prospective investors to an investment pool managed by the adviser. But private fund managers should be aware that the rule may still apply if the manager manages both private funds and separate accounts. As with so many SEC pronouncements, however, determining whether the rule applies depends on the facts.

Finally, a solicitor compensated for referring investors in a private fund could be deemed a "broker" under Section 3(a)(4) of the Securities Exchange Act of 1934. Again, whether a solicitor has crossed the regulatory threshold into acting as a broker depends on the facts and circumstances. In an administration proceedings against [Ranieri Partners LLC and Donald W. Phillips](#), and [William M. Stephens](#), the SEC found that an unregistered consultant who solicited clients for private funds crossed that line by providing potential investors with fund documents and discussing the funds' investment strategy. The consultant was also paid a percentage of the commitment investors he solicited. The combination of these activities, and the fund manager's complicity, resulted in the fund manager paying a penalty of \$375,000 and the consultant being barred from the securities industry.

Referral agreements may result in more business, but advisers should understand that these arrangements carry additional compliance burdens. Before inking that first deal, make sure you have a process in place for performing due diligence on the solicitors, training them on their responsibilities, providing them with the required disclosure documents, and following up to ensure they meet their obligations. And don't forget to update your Form ADV to disclose these arrangements.