

REQUIREMENTS GOVERNING PAYMENTS OF CASH REFERRAL FEES BY INVESTMENT ADVISERS

SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISORS ACT OF 1940

Release No. 615

February 2, 1978

TEXT:

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rules.

SUMMARY: The purpose of this document is to solicit public comments on the advisability of issuing a rule under the Investment Advisers Act of 1940 ("Act") which would prohibit cash payments by investment advisers to persons who solicit clients for the adviser. As an alternative to a complete prohibition on such payments, the Commission is also soliciting public comments on a proposed rule under the Act which would set forth clear guidelines concerning when and under what circumstances an investment adviser can make a cash payment to a person who has solicited clients for the adviser. Because the Commission regularly receives inquiries concerning the applicability of the federal securities laws to the use of cash referral fees as a method of soliciting clients, the Commission believes a rule setting forth the applicability of the Act to such payments is appropriate.

DATES: Comments must be received on or before March 31, 1978.

ADDRESSES: Interested persons should submit their views and comments in triplicate to George A. Fitzsimmons, secretary, Securities and Exchange Commission, 500 North Capitol Street, Washington, D.C. 20549. All submissions will be made available for public inspection at the Commission's Public Reference Section, Room 6101, 1100 L Street, N.W., Washington, D.C. 20005 and should refer to File No. S7-735.

FOR FURTHER INFORMATION CONTACT:

Michael Berenson, Esq., Office of the Chief Counsel, Division of Investment Management, Securities and Exchange Commission 500 North Capitol Street, Washington, D.C. 20549 (202-376-8053).

SUPPLEMENTARY INFORMATION:

The Commission regularly receives interpretive requests concerning the applicability of the Investment Advisers Act of 1940 [15 U.S.C. 80b-1 et seq.] ("Act") to arrangements pursuant to which an investment adviser compensates another person for recommending clients to the investment adviser. In view of the frequency of such requests, the Commission believes that it would be more efficient for both the Commission and the investment advisory industry for the Commission to adopt a rule which specifically addresses the applicability of the Act to the payment of such fees.

Because of the inherent conflicts of interest which can be present in arrangements pursuant to which an individual receives compensation, even on a fully disclosed basis, for referring someone to an investment adviser, one possible resolution of the question would be a rule adopted pursuant to Section 206(4) of the Act [15 U.S.C. 80b-6(4)] which contained a prohibition, either complete or subject to specified exceptions, on the payment of referral fees of any kind or in any manner to a solicitor who is not and employee of the investment adviser. Section 206(4) of the Act authorizes the Commission to define, and prescribe means reasonable designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative. Because referral arrangements are fraught with possible abuses inconsistent with the fiduciary relationships which frequently exist in the investment

advisory industry, the Commission believes that such a prohibition may be a means reasonably designed to prevent fraudulent practices. The Commission specifically invites public comments on the advisability of such a rule and comments on what its effects would be on the investment advisory industry as it currently operates.

If, after considering the public comments received in response to this release, the Commission concludes that a complete prohibition on the payment of referral fees is appropriate, it will consider the need to adopt a rule reflecting such decision.

An alternative resolution would be to permit such payments, but only under narrowly circumscribed conditions. Accordingly, the Commission is also soliciting public comments on a proposal to adopt Rule 206-(4)-3 [17 CFR 275.206(4)-3] (the "Rule") and new paragraph (k) of Rule 204-2 [17 CFR 275.204-2(k)] under the Act which would set forth when and in what circumstances an investment adviser can make a cash payment to someone who solicits clients for the investment adviser.

Provisions of the Proposed Rule

Paragraph (a) of the Rule makes it unlawful for an investment adviser to pay a cash referral fee except in one of three circumstances. The first is a payment to an employee of the investment adviser who either is primarily engaged in performing duties relating to the investment advisory business of the investment adviser or is someone clearly identified as a sales representative for the investment advisory services of the investment adviser. In these circumstances, the prospective client should be aware of the solicitor's natural predilection to recommend his own employer and knowledge of the existence of a compensation arrangement would not, the Commission believes, affect the prospective client's evaluation of the employee's recommendation. However, this exception would not be available to an employee who is not primarily engaged in activities relating to his employer's advisory business or who is not identified as a sales representative, for example, a registered representative who recommends advisory services furnished by the broker-dealer -- investment adviser firm with which he is associated. While, of course, a prospective client would expect that a registered representative would have a natural bias toward recommending all of his employer's services, the prospective client would not necessarily realize that the registered representative was being additionally compensated for his solicitation activities.

The Rule also provides that it is not unlawful for a cash referral fee to be paid in connection with solicitation of clients for an investment adviser who provides:

- (a) written materials or oral statements which are not individually tailored;
- (b) statistical information which does not comment on the investment merits of particular securities; or
- (c) a combination of the two foregoing services.

The advisory services which could be offered pursuant to this exception are of an impersonal nature. The Commission believes that sales of such services will frequently be made by individuals who are clearly identifiable as salesmen and that prospective clients would normally be aware that such salesmen are compensated on a commission basis.

Those investment advisers whose referral arrangements do not fall into either of the two categories described above will be required to adhere to a series of conditions. These conditions govern who can receive a referral fee, the timing and nature of the disclosures the solicitor must make to prospective clients, the investment adviser's responsibilities with respect to the solicitor's activities and the investment adviser's continuing responsibilities under the Rule.

Because it would be inappropriate for an investment adviser to be permitted to employ indirectly, as a solicitor, someone whom it might not be able to hire as an employee, the Rule prohibits payment of a

referral fee to someone who is the subject of a Commission order barring or suspending the right of such person to be associated with an investment adviser or who has engaged in any of the conduct set forth in Section 203(e) of the Act [15 U.S.C. 80b-3(e)] or been the subject of the type of injunction described in Section 203(e)(3) of the Act and therefore could be the subject of a Commission order barring or suspending the right of such person to be associated with an investment adviser. n1

n1 However, since a finding that a person has engaged in the conduct specified in this section only authorizes and does not require the Commission to bar such person from being associated with a registered investment adviser, the Commission would entertain, and be prepared to grant in appropriate circumstances, requests for permission to employ as a solicitor a person who is subject to a statutory bar.

During the course of the solicitation, the prospective client must receive a written document containing the information set forth in paragraph (b) of the proposed Rule. These disclosures consist, for the most part, of basic information relating to the solicitation, such as the name of the solicitor and the investment adviser on whose behalf he is working, the nature of the relationship between the investment adviser and the solicitor and a description of the compensation to be paid to the solicitor. While these requirements and their rationales should be easily understandable, particular attention should be given to the content of and the intent behind the requirements of paragraph (b)(7).

The Commission believes that a prospective client should know whether he will be compelled to pay a specific charge, similar to a sales load, or a higher advisory fee because a solicitor recommended him to the investment adviser. Accordingly, if the prospective client will be required to pay a specific charge in addition to the advisory fee to compensate the investment adviser for the cost of obtaining his account or will be required to pay a higher advisory fee than other clients with similar sized accounts receiving similar services and such charge or differential is due to the existence of a referral arrangement, paragraph (b)(7) requires that the disclosure statement set forth the amount of the additional charge or advisory fee increment.

One of the major obligations which an investment adviser who uses solicitors will have to bear is a duty to supervise the solicitation activities of these individuals as though they were the investment adviser's own employees. Although an investment adviser may not be able to exercise as much direct control over a solicitor as it could over its own employees, the Commission believes that the contractual relationships between the two parties can be structured so that the investment adviser can effectively supervise the solicitor's solicitation activities. Furthermore, the problems of supervising a solicitor who is operating in an area geographically remote from the investment adviser would not seem to be appreciably greater than those attendant to supervising a branch office's activities. In addition, because payment of referral fees is not an essential feature of operating an advisory service, an investment adviser who does not believe he can adequately supervise the solicitation activities of his solicitors presumably can decide to rely on other methods of obtaining new clients.

Certain staff interpretive positions concerning the applicability of the Act to referral arrangements have stated that a solicitor must either himself be a registered investment adviser or be an associated person of an investment adviser. n2 In light of an investment adviser's responsibility to supervise his solicitors, it is the Commission's opinion that a solicitor who engages in solicitation activities in accordance with the provisions of the Rule will be, at least with respect to these activities, an associated person of an investment adviser and therefore would not be required to register under the Act individually solely as a result of these activities.

n2 As relevant, Section 202(a)(17) of the Act [15 U.S.C. 80b-2(a) (17)] defines an "associated person" to include "any partner, officer, or director of such investment adviser (or any person performing similar functions), or any person directly or indirectly controlling or controlled by such investment adviser, including any employee"

If an investment advisory relationship which was initiated as a result of a solicitor's activities continues beyond the initial contract period or one year, whichever is less, and additional referral fees are to be paid, the investment adviser must furnish the client a new disclosure statement prior to the

commencement of each additional period. In addition to the information contained in the initial disclosure statement, this new statement must describe all compensation the solicitor received during the preceding contract period for his solicitation of the client to whom the disclosure is being made. The Commission believes that having this information available each time the client must decide whether to renew an advisory relationship will enable the client to make this decision fully cognizant of the circumstances which originally brought him to the adviser.

Before entering into an advisory relationship with a client who has been recommended by a solicitor, the investment adviser must have a reasonable basis for believing that the client has been provided the required disclosure statement in a form the prospective client can understand and must receive from the client a written acknowledgment that he has received the disclosure statement. The investment adviser must retain in accordance with the provisions of proposed paragraph (k) of Rule 204-2 a copy of these acknowledgments, a written agreement with each of its solicitors in which the solicitor undertakes to act consistent with the Rule, and all documents and correspondence relating to its solicitation arrangements.

A solicitor who has a pre-existing relationship with the prospective client, e.g., a registered representative of a broker-dealer, may, depending on the nature of his relationship with his client, have fiduciary obligations to such client which require him to make a reasonable attempt to find the investment adviser best suited to the particular client. So that it is clear that this obligation continues to exist even if the solicitor complies with all provisions of the Rule, paragraph (d) of the Rule expressly provides that the standards set forth in the Rule are not intended to relieve any solicitor of any fiduciary or other obligation applicable to such person in connection with the solicitation activities covered by the Rule.

It may be difficult for investment advisers who direct their client's brokerage transactions to particular broker-dealers as compensation for client referrals to disclose to their prospective clients meaningfully and in a manner which can be evaluated the existence of such arrangements. In addition, investment advisers and broker-dealers have statutory and common law obligations to their clients which may preclude their participating in an arrangement which, among other things, might require an investment adviser to direct a client's transactions to a particular broker-dealer, irrespective of the broker-dealer's ability to execute the transaction competently and at an appropriate cost. Therefore, in certain circumstances, it may be a fraudulent course of business, within the meaning of Section 206(2) of the Act [15 U.S.C. 80b-6(2)], for an investment adviser to use client commission dollars for this purposeⁿ³ and this rule proposal only addresses the applicability of the Act to those investment advisers who make cash payments to individuals who solicit clients for them. The Commission is in the process of reviewing its position with respect to various uses of client commission dollars which in the past have been common in the securities industry, but are now prohibited. When the review is completed, the Commission will consider whether it is appropriate to amend this rule so that it explicitly addresses the applicability of the Act to investment advisers who use directed brokerage as compensation for client referrals. However, the Commission wishes to emphasize that nothing which is stated in this release or this rule proposal should be taken as an expression of its views on the question of whether directed brokerage can be used in this manner.ⁿ⁴

ⁿ³ Cf. in the Matter of Consumer Investor Planning Corporation, Securities Exchange Act Release No. 8542, (February 20, 1969).

ⁿ⁴ This release and rule proposal should also not be taken as an expression of the Commission's views on any potentially related questions, such as the use of the assets of a registered investment company to bear expenses associated with the distribution of its shares or the rules the Commission has proposed pursuant to Section 11(a) [15 U.S.C. 78k(a)] of the Securities Exchange Act of 1934 [15 U.S.C. 78a et seq.] relating to trading by members of exchanges, brokers, and dealers.

Authority

Rule 206(4)-3 and paragraph (k) of Rule 204-2 would be adopted pursuant to the authority contained in Sections 204, 206(4), and 211(a) of the Act [15 U.S.C. 80b-4, 80b-6(4) and 80b-11(a)].

I. It is proposed to amend Part 275 of Chapter II of Title 17 of the Code of Federal Regulations by adding new § 275.206(4)-3 as follows:

§ 275.206(4)-3 Cash payments for client solicitations.

(a) It shall constitute a fraudulent, deceptive, or manipulative act, practice or course of business within the meaning of Section 206(4) of the Act for any registered investment adviser to pay a cash fee to a person who solicits or recommends any client for or to the investment adviser unless such payment (1) is made to an employee of the investment adviser who is primarily engaged in performing duties relating to the investment advisory business of the investment adviser or is clearly identified as a sales representative for the investment advisory services of the investment adviser; (2) is made with respect to the solicitation or recommendation of clients for or to an investment adviser who furnishes such clients only (i) written materials or oral statements which do not purport to meet the objectives or needs of the specific clients, or (ii) statistical information containing no expressions of opinions as to the investment merits of particular securities, or (iii) any combination of the foregoing services; or (3) is made pursuant to an arrangement which complies with the following:

(i) the recipient of such fee (a "solicitor") is not a person who is the subject of a Commission order barring or suspending the right of such person to be associated with an investment adviser or a person who has engaged in any of the conduct set forth in Section 203(e) of the Act or been the subject of the type of injunction set forth in Section 203(e)(3) of the Act which could allow such person to be the subject of an order issued by the Commission barring or suspending the right of such person to be associated with an investment adviser;

(ii) The investment adviser supervises the solicitation activities of the solicitor as if the solicitor were one of its own employees;

(iii)(A) The investment adviser has a reasonable basis for believing that the client has received from the solicitor during the course of the solicitation or recommendation a written disclosure document containing the information required by paragraph (b) of this section and that the client is capable of evaluating the information set forth in the disclosure document; and (B) the investment adviser receives from the client prior to the inception of the advisory relationship with the investment adviser a written acknowledgment of receipt of the disclosure document;

Note The investment adviser shall retain a copy of each such acknowledgment, as well as the acknowledgments referred to in paragraph (iv) below, as part of the records required to be kept by Rule 204-2(k) under the Act.

(iv) If additional fees are to be paid by the investment adviser to the solicitor with respect to an advisory relationship with a client obtained as a result of a solicitation or recommendation by the solicitor which has continued beyond the period covered in the initial advisory agreement or one year, whichever is less, the investment adviser must furnish the client in writing prior to the commencement of each additional period or year, whichever is less, a new current disclosure document containing the information required by paragraph (b) of this section and the investment adviser shall receive from the client a written acknowledgment of receipt of the disclosure document.

(b) The written disclosure document required by this rule shall contain the following information:

(1) The name of the solicitor.

(2) The name of the investment adviser.

(3) The nature of the relationship between the solicitor and the investment adviser.

(4) A statement that the solicitor has a financial interest in the selection of the investment adviser.

(5) The terms of such financial interest, including a description of the compensation paid or to be paid to the solicitor.

(6) A statement as to whether such compensation is to be paid on a one-time or a continuing basis in respect of such client.

(7) The amount, if any, for the cost of obtaining his account the client will be charge in addition to the advisory fee, and/or the differential, if any, among clients with respect to the amount or level of advisory fees charged by the investment adviser if such differential is attributable to the existence of any arrangement pursuant to which the investment adviser has agreed to compensate the solicitor for soliciting or recommending clients for or to the investment adviser.

(8) If, pursuant to the provisions of paragraph (a)(3)(iv) of this section, such statement is delivered in respect of any additional period of such advisory relationship, a statement describing the nature and amount of all compensation received by the solicitor in the immediately preceding period for his solicitation of such client as a client.

(c) An investment adviser shall enter into, and retain as part of the records required to be kept by Rule 204-2(k) under the Act, a written agreement with each of its solicitors in which the solicitor accepts the investment adviser's supervision with respect to his solicitation activities and undertakes to act consistently with the provisions of this section.

(d) Nothing in this section shall be deemed to relieve any solicitor of any fiduciary or other obligation to which such solicitor is subject under law with respect to recommending an investment adviser best suited to any of his clients.

II. It is proposed to amend Part 275 of Chapter II of Title 17 of the Code of Federal Regulations by adding new paragraph (k) to § 204-2 as follows:

§ 275.204-2 Books and records to be maintained by investment advisers.

(a) Every investment adviser who makes use of the mails or of any means or instrumentality of interstate commerce in connection with his or its business as an investment adviser (other than one specifically exempted from registration pursuant to section 203(b) of the Act) shall make and keep true, accurate and current the following books and records relating to his investment advisory business:

* * *

(k) If an investment adviser subject to paragraph (a) of this section utilizes a solicitor pursuant to an arrangement of the type contemplated by paragraph (a)(3) of Rule 206(4)-3 under the Act, the records required to be made and kept under paragraph (a) of this section shall include true, accurate and current copies of all agreements relating to such arrangement, all documents and correspondence delivered by the solicitor in connection with such arrangement, all required acknowledgments, and full and complete records of all transactions effected pursuant thereto.

Public Comment

Persons wishing to make written comments should file three copies thereof with George A. Fitzsimmons, Secretary, Securities and Exchange Commission, Room 892, 500 North Capitol Street, Washington, D.C. 20549 not later than March 31, 1978. In filing such submissions, commentators should make reference to Commission File No. S7-735. Copies of all submissions will be available for public inspection in the Commission's Public Reference Section, Room 6101, 1100 L Street, N.W., Washington, D.C. 20005.

By the Commission.