A Bird in the Hand – Navigating the Client Intake Process

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Introduction

In many ways, prospective clients and investors are the lifeblood of an advisory firm. The prospect of attracting new business and the opportunity to grow the firm can significantly drive decision-making. However, the zeal with which an adviser undertakes the solicitation process can potentially obscure the hazards that exist along the way. Indeed, a considerable amount of forethought is required for an adviser to safely execute its strategy and achieve its business development goals. To assist with this pre-planning, this article highlights a number of key considerations for advisers before reaching out to potential prospects.

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Marketing

Advisers often spend time preparing marketing materials designed to grab a new client's attention. The use of any flipbook, past performance calculations, offering memoranda, or other marketing material must comply with the Investment Advisers Act of 1940. All information provided to prospects must be fair and balanced and cannot contain any untrue statement of material fact or otherwise be false or misleading. For example, displaying performance information without explaining the key assumptions, conditions, risks and methods of calculation may render the presentation fraudulent. Presenting information on expected returns, liquidity or the risk of the investment must be handled with particular vigilance. The adviser also must take care not to include any prohibited testimonials or display information in a way that would be perceived as cherry picking or overstating the adviser's credentials or experience. The information provided to prospects should be understandable and linked to the marketed product. For example, presenting information on a successful fixed income strategy may not be defensible in marketing materials relating to a real estate fund.

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The adviser also should ensure that its materials are appropriately vetted before being disseminated to prospects. This likely would include review by the adviser's compliance or legal function to ensure the materials comply with applicable law and there are no material misstatements or omissions therein. Compliance or legal should ensure that the materials disclose any relevant conflicts of interest and the steps the adviser takes to mitigate them. The business team also should review the materials to ensure they are consistent with the adviser's general messaging and strategy and fairly and accurately reflect the adviser's business.

It is important for an adviser to be mindful of its recordkeeping requirements in connection with its marketing efforts. Advisers must maintain marketing materials, including investment performance calculations and the back-up substantiating the calculations and other factual statements in the adviser's advertising documents. These supporting materials must be preserved in the adviser's systems for at least five years from the adviser's last day of use. This means that an adviser that cites its 2015 performance during 2018 must keep its work papers and other calculations from 2015 until 2023.

Marketing on a Global Basis

The penalties for improperly soliciting prospects can be severe, including potential monetary fines, suspension of licenses and, in certain cases, criminal sanctions. As such, soliciting prospects across jurisdictions can be a veritable minefield of regulatory issues. In these cases, a

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prospect's domicile is pertinent because the activities that trigger "marketing" requirements often vary by jurisdiction. In a number of jurisdictions, an adviser may need to provide certain filings with a local regulator before engaging in marketing activities. The process for registration can be time intensive and costly. An adviser also may need to engage local counsel to help complete the registration process, and certain jurisdictions may require the appointment of a depositary or paying agent, which entails even more cost and burden. Thus, it is important for an adviser to keep close tabs on roadshow and meeting schedules in order to make appropriate registrations well in advance of marketing.

An adviser also should consider the specifics of the local marketing rules in the applicable jurisdiction, including the requirements for meetings and the approved distribution methods for relevant materials, such as offering memoranda and subscription documentation. Activities such as telephoning or emailing into a jurisdiction or sending materials to an address in that jurisdiction may be considered conduct occurring within that jurisdiction, and may therefore subject the adviser to local requirements.

In some jurisdictions, "reverse solicitation" (*i.e.,* where a prospect invests on his or her "own initiative") provides a potential means of engaging a prospect without triggering local marketing requirements. However, the use of reverse solicitations can raise thorny issues. The validity of a reverse solicitation generally will depend on local practices, and may necessitate advice from local counsel. Given that valid reverse solicitations generally do not implicate local marketing requirements, they are often scrutinized – because they may be viewed as a way to circumvent the law. A best practice may be to involve the legal or compliance department in assessing the validity of all potential reverse solicitations and ensuring that appropriate documentation exists. Certain jurisdictions also permit "pre-marketing" as a way to meet with prospects to gauge interest without subjecting the adviser to marketing requirements. Depending on the jurisdiction, activities constituting pre-marketing may be somewhat restrictive (*e.g.,* marketing materials should not relate or refer to an existing fund or enable a prospect to make a commitment of investing in a particular fund).

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Controlling Information Flows

Often a prospect will request additional information from an adviser before the prospect invests. This may take the form of a due diligence questionnaire or other questions or requests. If the investment opportunity involves an offering of securities, the adviser will need to take care in responding to these requests to ensure that it is not creating a dissymmetry with respect to material information between the requesting and other investors. This is because all investors should have access to all material information necessary to make their investment decisions. In the event that a prospect inquires about information that arguably would be material to an investment decision, the adviser should consider whether that information should be provided to all other prospects as well.

Additionally, advisers would be well advised to have one internal repository to oversee any requests for additional information from prospects. This will ensure the consistency and accuracy of any additional data and will facilitate centralized materiality determinations, as appropriate. The adviser's compliance or legal function should be involved in this review to ensure that any new materials are fair and balanced and comply with the advertising and other guidance under relevant securities laws. The compliance or legal function also can oversee the retention of any such materials for recordkeeping purposes under the Advisers Act.

Prospect Screening and Verification

Suitability. With respect to certain investment products, prospects generally must meet certain suitability requirements that vary by jurisdiction. In the United States, to comply with applicable private placement rules, investment-fund prospects generally will be "accredited investors" under the Securities Act of 1933, and may be "qualified purchasers" under the Investment Company Act of 1940. Other jurisdictions have similar requirements (*e.g.,* investors in Europe generally must be "professional investors," which generally requires a certain level of wealth or investment experience, expertise and knowledge). Before discussing relevant products with such prospects, an adviser generally must form a reasonable belief that the prospect satisfies such suitability criteria. In many cases, an adviser can do so by soliciting written confirmation of the applicable status via a written questionnaire or certification letter.

Anti-Money Laundering. As evidenced by its 2018 exam priorities, the Securities and Exchange Commission (SEC) staff continues to focus on anti-money laundering (AML) programs. Further, in connection with increased regulatory concerns with respect to the sources of funds used in investments and other activities, AML or AML-like screening is an important consideration in engaging prospects. Notwithstanding a potential lack of mandated AML requirements, an

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adviser's customer screening practices may include certain related protocols to conduct appropriate diligence, including:

- checking the prospect's name, as well as names of associated parties, against various global blacklists;
- conducting expanded due diligence on "senior foreign political figures" or "politically exposed persons";
- conducting expanded due diligence on prospects from countries appearing on certain lists of jurisdictions considered high risk for money-laundering; and
- checking prospects against global adverse media databases.

Understanding the Prospect

Before taking on a new client or investor, an adviser should conduct its own fact finding to ensure that it has enough information to make investment recommendations. This would include an understanding of the prospect's current financial situation and its investment objectives, risk tolerance and investment horizon. This information should be documented so that there is a clear understanding of the adviser's mandate.

Once onboarded, the adviser should periodically check with the client to ensure that the client's investment desires and mandate have not changed, particularly if it is aware of an event that potentially would alter the client's approach. For instance, the sale of a family business by a client may cause it to rethink its investment goals or risk appetite. An adviser also should examine the client's portfolio from time to time, and no less than annually, to ensure that the securities in the account are consistent with the client's stated investment mandate.

Privacy Considerations

In today's climate, privacy concerns often are top of mind for advisers. The scope of these issues often depends on the location of the adviser and/or its prospects. In the United States, registered advisers are subject to Regulation S-P, which generally governs the disclosure and safekeeping of nonpublic personally identifiable information (*e.g.,* names, addresses, social security numbers, etc.). Among other things, Regulation S-P requires an adviser to provide each prospect with an initial privacy notice no later than upon establishing an adviser-client relationship. The notice must describe the adviser's privacy policies and allow the client to opt out of certain disclosures with respect to its personal information. Although not mandatory, the SEC has adopted a model privacy notice, the use of which provides advisers with a safe harbor for compliance with the applicable privacy notice content requirements. In terms of delivery to prospects, an adviser may include the initial privacy notice in its advisory contract or distribute it as part of the diligence materials in a data room or online diligence site. In addition to heeding these federal requirements, advisers also should consider that various states (including Massachusetts and California) have adopted privacy laws that may apply to advisers with prospects who reside in those states.

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Additional considerations arise if prospects reside abroad. In certain cases, there are significant differences between United States privacy and data protection laws and the laws in other countries. To this end, certain non-U.S. jurisdictions have adopted comprehensive rules that apply to personal data "processing" activities. One such law is the European Union General Data Protection Regulation (GDPR), which requires that companies adhere to certain data protection principles with respect to the personal data of EEA residents. The GDPR notice requirements are significantly more robust than corresponding requirements in the United States – requiring a company to include information such as (i) the legal bases for processing the person's data, (ii) the retention periods, and (iii) the individual's rights with respect to his or her data. Adhering to these requirements is critical because, technically, an adviser cannot collect or otherwise use the person's data unless it has first provided such notification.

FATCA and CRS

In dealing with prospects, advisers also may need to consider the operational impact of the Foreign Account Tax Compliance Act (FATCA) and OECD Common Reporting Standard (CRS) rules. FATCA refers to tax regulations that are intended to detect, prevent and deter tax evasion by U.S. persons investing through offshore investment vehicles. The OECD developed the CRS rules for the automatic exchange of FATCA-like financial account information amongst OECD member states. Among other things, compliance with FATCA and CRS requires advisers to obtain and review appropriate due diligence information with respect to certain prospective investors. Such diligence information may include documentation related to an investor's tax status, as well as information collected for AML purposes (*e.g.,* passports, articles of incorporation). In addition to diligence requirements, each of these tax rules entails potential reporting to tax authorities with respect to investors. Consequently, it may be prudent to inform prospects as to the broad requirements related to these rules, while also urging the prospects to consult their own tax advisors regarding all aspects of the

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rules as they affect the prospect's particular circumstances.

Working with Third-Party Intermediaries

A potential trap for the unwary involves using third-party intermediaries, such as solicitors or finders, in the marketing process. The Advisers Act requires advisers to provide certain disclosures to clients and prospective clients contacted via a third-party "solicitor". State securities regulators also may impose registration and other solicitation requirements to the extent prospects are solicited within a particular jurisdiction, and these may be more restrictive than the Advisers Act requirements. An adviser should conduct due diligence on any third-party intermediary that assists in the marketing process, to ensure that the intermediary would be a good emissary of the adviser, will provide all of the relevant documentation to a prospect and has complied with all applicable legal requirements. This is particularly important if an adviser is using a broker or a finder to locate new prospects. In these cases, an adviser must ensure that the broker or finder is appropriately registered and should include in its engagement letter with the broker representations that the entity will maintain its registration during the life of the engagement. The SEC has pursued enforcement actions against registered investment advisers for aiding and abetting an unregistered finder's violation of the broker-dealer registration requirements.[1]

Conclusion

One article cannot adequately capture all of the potential stumbling blocks that exist in connection with obtaining new clients and investors. The critical point is that soliciting prospects should be a strategic process. In the planning stage, it may require input from a number of different stakeholders outside of the marketing professionals. Here, the compliance or legal function can play a key role in identifying the challenges and helping to steer the business in the right direction. By devoting the appropriate time and effort on the front end, an adviser can proceed with confidence and clear eyes.

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[1] See *e.g.*, In the Matter of Ranieri Partners & Donald W. Phillips, Investment Advisers Act Release No. 3563 (March 8, 2013).

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