

Opinion 536
May 2001
Tex. Comm. on Professional Ethics, Op. 536, V. 64 Tex. B.J. 7 (2001)

QUESTION PRESENTED

May a lawyer receive referral or solicitation fees from an investment adviser for referring a client to the investment adviser?

STATEMENT OF FACTS

An investment advisory firm (“Investment Adviser”) that is registered under the U.S. Investment Advisers Act of 1940 (“Advisers Act”) and the Texas Securities Act of 1957 (“Texas Act”) and qualified to provide investment advisory services in Texas under the Texas Act proposes to enter into an arrangement with a lawyer concerning an investment advisory program (the “Program”) provided by the Investment Adviser. Under the Program, the Investment Adviser will pay the lawyer a referral or solicitation fee for referring clients to the Investment Adviser. The referral fee will be a percentage of the fees paid by the client to the Investment Adviser for investment advisory services throughout the period that the client’s funds are invested.

The lawyer’s involvement in the Program is proposed to be limited to (i) providing clients with materials describing the Program, (ii) introducing the client to the Investment Adviser’s registered personnel and attending meetings at which the Investment Adviser’s personnel will explain the Program to the client and assist the client in choosing the investment advisory services that best fit the client’s investment advisory needs, and (iii) receiving copies of periodic investment advisory statements so that the lawyer may monitor the client’s involvement in the Program. It is assumed for the purposes of this opinion that the participating lawyer and the Investment Adviser comply with all legal requirements under the Advisers Act and the Texas Act and with all other legal requirements applicable to a relationship of this nature.

We have been advised in the opinion request that the Securities and Exchange Commission has taken the position that the person providing solicitation services for a fee (in this situation the lawyer) is not required to register as an Investment Adviser under the Advisers Act if certain conditions are met, including the requirement that the solicitation fee is paid pursuant to a written agreement which: a) describes the solicitor’s activities and compensation; b) contains the solicitor’s undertaking to perform those duties consistent with the Investment Adviser’s instructions; and c) requires the solicitor, at the time of the solicitation, to provide the client with a copy of the Investment Adviser’s disclosure document, and a separate written disclosure document that sets forth certain information about the Investment Adviser, the solicitor and the arrangement. Accordingly, the arrangement between the Investment Adviser and lawyer, including the solicitation fees to be received by the lawyer, is disclosed to the client prior to his entering into the Program and the client acknowledges receipt of such information.

DISCUSSION

The referral fee arrangement described above raises conflict of interest issues under the Texas Disciplinary Rules of Professional Conduct (the “Rules”), as discussed below.

Rule 1.06(b)(2) provides that:

“(b)In other situations and except to the extent permitted by paragraph (c), a lawyer shall not represent a person if the representation of that person:

...

(2) reasonably appears to be or become adversely limited by the lawyer’s or law firm’s responsibilities to another client or to a third person or by the lawyer’s or law firm’s own interests.”

Since the lawyer will receive fees from the Investment Adviser for recommending the Investment Adviser to the lawyer’s client, the lawyer might advise the client to choose one approach to investing if there were no fee arrangement with the Investment Adviser, while the lawyer might be swayed by the promise of a solicitor’s fee to give different advice in order to receive a fee. Comment 4 to Rule 1.06 cautions that loyalty to a client is impaired in any situation when a lawyer may not be able to consider, recommend or carry out an appropriate course of action for a client because of the lawyer’s own interests.

The obligation to provide independent advice to each client is an essential element of a lawyer’s relationship with the client that is reinforced by Rule 2.01, which provides:

“In advising or otherwise representing a client, a lawyer shall exercise independent professional judgment and render candid advice.”

In this regard, the facts indicate that the lawyer will sign an agreement with the Investment Adviser undertaking to perform his duties consistent with the Investment Adviser’s instructions. And following the lawyer’s initial counseling of the client that results in a referral to the Investment Adviser, if the client agrees to participate in the Program the lawyer thereafter receives from the Investment Adviser copies of periodic investment advisory statements related to the client’s investments so that the lawyer may monitor the client’s involvement in the Program. A client cannot reasonably expect to receive independent professional judgment from his lawyer when such lawyer is contractually obligated to perform his duties consistent with the Investment Adviser’s instructions, and his monitoring of the client’s involvement in the Program results in additional solicitation or referral fees to the lawyer .

This referral arrangement constitutes a conflict of interest under Rule 1.06(b)(2) because the lawyer’s representation reasonably appears to be adversely limited by the lawyer’s own financial interests and by his obligations to a third person, the Investment Adviser.

Before accepting or continuing a representation that involves a conflict of interest under Rule 1.06(b), the lawyer must satisfy the requirements of Rule 1.06(c), which provides:

“(c)A lawyer may represent a client in the circumstances described in (b) if:

(1) the lawyer reasonably believes the representation of each client will not be materially affected; and

(2) each affected or potentially affected client consents to such representation after full disclosure of the existence, nature, implications, and possible adverse consequences of the common representation and the advantages involved, if any.”

Under this Rule, the lawyer must first reasonably determine whether the arrangement with the Investment Adviser will materially affect the lawyer's representation of the client. Comment 5 to Rule 1.06 notes that:

“[A] lawyer's need for income should not lead the lawyer to undertake matters that cannot be handled competently and at a reasonable fee. . . . If the probity of a lawyer's own conduct in a transaction is in question, it may be difficult for the lawyer to give a client detached advice.”

With respect to determining whether a client can provide effective consent to a conflict of interest, Comment 7 to Rule 1.06 cautions that:

“[W]hen a disinterested lawyer would conclude that the client should not agree to the representation under the circumstances, the lawyer involved should not ask for such agreement or provide representation on the basis of the client's consent.”

It is the opinion of the Committee that the standards of Rule 1.06(c) cannot be met under these circumstances. Because the client's participation in the Program could continue for a substantial period of time and the lawyer has contractual obligations to the Investment Adviser, the lawyer could not reasonably believe that this arrangement with an Investment Adviser would not materially affect his representation of the client. For example, the on-going fee arrangement to the lawyer from the Investment Adviser would create a financial inducement for the lawyer to avoid a critical appraisal of the Investment Adviser's on-going services that might lead to a recommendation that the client terminate such advisory services. Moreover, the inherent uncertainties involved in an lawyer monitoring his client's involvement in the Program over a period of time would make it impossible for the lawyer to provide full disclosure of the implications and possible adverse consequences resulting from the representation.

CONCLUSION

A lawyer's receipt from an Investment Adviser of solicitation fees that continue while the lawyer's client continues to receive services from the Investment Adviser violates Rule 1.06(b)(2) because the lawyer's representation of the client would be adversely limited by the lawyer's own financial interests and his obligations to the Investment Adviser. Under these circumstances the lawyer could not satisfy the requirements of Rule 1.06(c).