CORE COMPLIANCE & LEGAL SERVICES, INC.
SOLUTIONS FOR TODAY'S BUSINESS

Risk Management Update
January 2012

PRACTICAL TIPS FOR RIA SERVICE AGREEMENTS: MAKING SURE YOUR CLIENTS ARE HAPPY AND YOU ARE PROTECTED

It is a new year and with that comes a renewed spirit to protect your business by considering high-profile regulations such as the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). One of the best ways to commence this process is to review and where necessary, update your advisory contracts to reflect not only new regulatory requirements, but also clarifying terms to set expectations with your clientele. If you have not done so recently, check to ensure that your agreements are carefully updated to reflect your current business practices and ensure that it is written in plain English so that your clients are able to clearly understand what each provision within the contract means. The purpose of this month's Risk Management Update is to provide helpful information and practical tips on how to review your advisory agreement so that it is customized to your practice. This is not intended to provide legal advice, but rather, a reference for you to consider and further discuss with counsel, as needed.

Generally, most large registered investment advisers develop their advisory agreements with the help of qualified and experienced legal counsel. For mid- to smaller-size advisers, you may have initially developed your own agreements or requested assistance from a qualified professional. Yet in both cases, often times such agreements are not updated or reviewed with regular frequency. Consequently, it is important to consider the following:

1. Do I have essential contractual provisions addressing roles, responsibilities, assignments and limitation of liabilities?
2. Does my contract include the latest ERISA Disclosures?
3. Have I considered notice provisions, standard contract clauses and electronic delivery of documents to my clientele?

This month CCLS will address essential contractual provisions. Next month, we will consider ERISA disclosures, notice provisions, standard clauses and electronic delivery options.

ESSENTIAL CONTRACTUAL PROVISIONS

Advisory contracts are governed by Rule 204-(5) of the Investment Advisers Act of 1940, as amended ("Advisers Act"). While advisers are not required to have a written agreement, it is prudent to have one in order ensure there is a meeting of the minds prior to commencing advisory services. Each contract needs to contain certain standard clauses about the qualifications of the adviser, the services being provided to the client and expectations for the relationship. The contract should also consider how to limit liabilities, such as through a memorialized dispute resolution process.

Representations and Qualification of the Adviser
Typically in this section the adviser will represent and warrant that it is registered either the U.S. Securities and Exchange Commission or applicable states as an "Investment Adviser" as that term is defined in the Investment Advisers Act of 1940, as amended, or pursuant to state statutes. In addition, the adviser should represent that it is qualified to act as an investment adviser for the client per the laws of the state in which the client is resident as of the effective date of the contract. Disclose that if this status changes the adviser will provide timely notification.

Advisory Services
The description of your advisory services is one of the most important sections of your agreement. Client disputes generally arise because of expectations that were not set at the on-set of the client relationship. A detailed, well-written description of your advisory services will help minimize these occurrences by setting forth your explicit role and responsibilities as the adviser and mutually set forth what you may need from the client (such as detailed discussion of investment goals, risk levels and income needs prior to commencing services). Be sure to customize your agreement to match the description of your advisory protocols as set forth in your Form ADV Part 2A, which should complement the client agreement.

Assignments
While some advisory contracts may be binding upon and inure to successors, assigns, heirs and personal representatives, the rights and obligations of the parties are not generally assignable. For example, if there is a direct or indirect transfer of an investment advisory contract by an adviser, or a material change in firm organization and structure, then consent must be obtained from the client in order for the adviser to continue providing advisory services. In order to further clarify this point operationally, be sure that your advisory contract provides that if an assignment is attempted without such consent, the transfer will be void and that furthermore, an assignment can take place if it does not result in a change of the adviser's actual control or management within the meaning of Rule 202(1)(1)-1 . However, in the case of an adviser organized as a partnership, the client agreement must provide that the adviser will provide notice for a change in any of its membership.[1]

Limiting Liability
In order to limit an adviser's liability, typically three key sections are included, but are not limited to, the following in advisory agreements: (1) Limitations of Liability (*i.e.,* setting forth that the adviser is not liable to the client for any incidental or consequential damages due to, for example, loss of profit); (2) Indemnification (regarding material breach by the other party pursuant to the terms of the contract); and (3) Dispute Resolution provisions (such as by arbitration). The most commonly used method is dispute resolution, which is discussed in detail, below.

Dispute Resolution
Dispute resolution clauses determine the options a non-breaching party has to enforce a contract against a breaching party. There are two types of dispute resolution: Litigation and Alternative

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[1] *See generally* "General Information: Regulation of Investment Advisers," *available at* http://www.sec.gov/divisions/investment/iaregulation/memoia.htm.

Dispute Resolution. In the absence of a clause otherwise, the default resolution method is litigation. Both have their strategic strengths and weaknesses.

Litigation. Litigation is the process of adjudicating a civil suit in a court of law. The major downside of litigation is that it is very costly and may take months or even years to resolve. Because the stakes involved in filing a civil suit are very high, litigation also acts as both a deterrent to keep parties from filing nuisance complaints.

Alternative Dispute Resolution (ADR). ADR is not mandatory for advisory businesses. However, most advisers do prefer ADR to litigation dispute resolution due to the associated costs. The two most common forms of ADR are mediation and arbitration.

***Mediation*.** Mediation is process for resolving disputes between two or more parties through a neutral third party mediator. The mediator typically facilitates an equitable settlement after hearing from both sides after informally hearing the merits of the case. Mediation is cost effective, private and, assuming settlement is reached and signed by both parties, binding.[2]

***Arbitration*.** Arbitration involves an informal hearing of the dispute by a neutral third party(-ies) (the "Arbitrator(s)"). Unlike Mediation, the decisions rendered by the Arbitrator are binding (unless agreed to be non-binding by both parties in the agreement). The decision is based on the merits of the case after an informal hearing of evidence, and there is a high bar to appeal the decision given by an Arbitrator.[3]

The advantages to arbitration are that it is heard on the merits of the case before an experienced panel, whose decision is binding, which makes this a cost-effective process. Further, parties can modify an Arbitration clause by incorporating a mandatory negotiation period. The negotiation period takes place in the initial weeks after a dispute is raised. During this time, both parties must meet to try and settle the issue through good-faith negotiations prior to commencing arbitration.

***Practical Tip*:** The most widely used Arbitration service is the American Arbitration Association.[4] They offer a national service, a wide range of Arbitrators to choose from and are considered to be very reputable. They also may be considerably more expensive compared to their regional counterparts. JAMS Mediation and Arbitration offers perhaps a more cost effective option, with equally qualified individuals, but typically, a more limited service area.[5]

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[2] *See generally* "Major Arbitration and Mediation Rules and ADR Programs," *available at* http://www.adr.org/commercial_arbitration (Last visited on January 13, 2012).
[3] Id.
[4] *See* "About American Arbitration Association," *available at* http://www.adr.org/about_aaa (Last Visited on January 13, 2012).
[5] *See* "ADR Spectrum: Mediation, Arbitration," *available at* http://www.jamsadr.com/adr-spectrum/ (Last Visited on January 13, 2012).

CONCLUSION

For your own protection and to ensure there is a "meeting of the minds" prior to commencing advisory services, it is important to develop and / or enhance your existing advisory contracts. This will help to set expectations and optimize your ability to service advisory accounts while minimizing your exposure to liability.

Next month we will delve further into investment advisory agreement considerations with a discussion on *new* ERISA requirements, as well as notice provisions, standard contract clauses and electronic delivery of documents.

For more information on service agreements, or to learn about how CCLS may be of assistance, please do not hesitate to contact us at (619) 278-0020.

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