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informed on accounting law matters

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PURSUING FINANCIAL SERVICE OPPORTUNITIES: AVOIDING REGULATORY AND OTHER DANGERS

The Changing Face of the Accounting Profession

More and more small- and medium-sized accounting firms are forming new business entities to provide an array of business and personal financial services, including investment advisory services, insurance-related services, and services involving the purchase and sale of securities. There are a number of reasons why new business opportunities are attracting the attention of growing numbers of accountants. First, accounting professionals have evolved into the position of being their clients' most trusted business advisers. Rather than render advisory services on a casual (and often uncompensated) basis, CPAs have begun to treat such activities as professional services, applying the same standards of competence and diligence to these activities as they have traditionally applied to their attest services.

Second, the current wave of acquisitions of medium-sized accounting practices by consolidators (such as American Express Tax and Business Services, Century Business Services, CenterPrise Advisors, Inc., and HRB Business Advisors) has underscored the value of the accountant/client relationship and the economic potential in providing accounting firm clients with diverse business and personal products and services. At the same time, many accountants believe that in order to maintain their current client relationships against the threat of competition from accounting firm consolidators, they must be able to meet the full panoply of their clients' needs for high-quality professional business and financial services.

Moreover, it has become increasingly apparent to the accounting profession that increased profitability is more easily achieved by expanding the scope of services provided to existing clients than by seeking new clients for traditional accounting services. Thus, whereas accountants may have been willing to refer their clients to other financial services providers for nonaccounting services in the past, the current competitive environment makes such referrals both undesirable and dangerous.

A third reason underlying the accounting profession's movement into financial services is that the regulatory bodies within the accounting profession are in the process of relaxing long-standing restrictions on non-CPA ownership of accounting firms, commissions and referral fees, and contingent fee arrangements. Heretofore, these restrictions significantly limited the ability of CPAs to operate effectively in other businesses, particularly those that traditionally used contingent compensation arrangements. The status of the reform of such regulatory restrictions in New York State and elsewhere is discussed in Section I.

Finally, the opportunity to expand into new business services may appear especially attractive to the small- and medium-sized firms, which, under the current legal climate, must perform attest and other accounting services on a near zero-defect basis. This fact has made it increasingly difficult for the smaller practice units to compete with the Big Five and large regional firms, which have the resources to develop the requisite expertise in specific business industries and to maintain technical staffs to keep abreast of the increasingly complex professional standards applicable to the performance of attest services.

While providing investment advisory and other financial services (especially in the current bull market) at first may appear to be lower risk opportunities, there are significant hidden dangers awaiting practitioners who unwarily venture into these areas. The first danger is presented by the complex regulatory and licensure requirements imposed upon providers of financial services. The regulatory requirements relating to investment advisory services, insurance-related services and securities-related services are discussed in Section II.

In venturing into the financial services area, accounting

firms are confronted with several options:

- furnish such services through their existing firms;
- enter into joint venture with persons who may already possess the necessary registrations and/or licenses to provide regulated services; or
- refer their clients to established providers of such services under arrangements that will permit the firm to share in the compensation for the services provided to its clients.

These and related considerations are discussed in Section III.

Finally, it is indeed dangerous to embark upon any new business venture without devoting adequate attention to risk management issues, which are discussed in Section IV. Thus, we conclude this article with a discussion of risk management issues to be considered by accounting professionals who plan to provide financial services.

I. Relaxation of Regulations Affecting the Accounting Profession

Regulators of the accounting profession, in an effort to assure the independence and integrity of the profession, particularly when performing attest services, have historically prohibited the use of commissions and referral fees and contingent fee arrangements. In addition, almost every state still prohibits CPAs from practicing in an entity owned even in part by non-CPAs.

Largely in response to the expansion of the profession's services into new areas, the American Institute of Certified Public Accountants ("AICPA") and the National Association of State Boards of Accountancy ("NASBA") reached agreement to relax these long-standing prohibitions. The AICPA/NASBA accord is embodied in a new Uniform Accountancy Act ("UAA"), which covers a broad range of regulatory issues in addition to reforms relating to compensation restrictions. Essentially, the UAA permits CPAs to receive commissions and referral fees with respect to nonattest clients and permits contingent fee arrangements to be used with respect to all clients for which the CPA does not perform attest services, so long as

the engagement does not involve the preparation of an original income tax return. The AICPA/NASBA accord, however, does not by itself enable CPA firms to avail themselves of these types of arrangements, which in many instances may be appropriate and desirable in the delivery of new business services such as financial services.

Thus, before these arrangements can be used, the State Board of Accountancy and State Society of CPAs in the states in which the involved CPAs are licensed must first adopt the reforms in practice structure and fee arrangements promulgated by the AICPA/NASBA. At present, approximately one-half of the states have adopted the fee reforms contained in the UAA; few, if any, states have adopted the proposal to permit non-CPA firm ownership. See Exhibit A attached at the end of this article, for a table showing which states have adopted the UAA commission and contingent fee rules.

The UAA provision has been adopted by the New York State Board of Regents, albeit in a modified version. Unlike the UAA provision, the current Regents' rule prohibits the receipt of commissions, referral fees, and contingent fees with respect to any client for which the CPA performs tax preparation services as well as attest services. Thus, the Regents' rule relaxes the prohibitions against such fees only to a very minor extent. However, since the definition of the practice of accounting is limited under New York State law essentially to attest services (see New York Education Law, § 7401), the State Education Department (which administers the accounting law in New York) last year acknowledged that it does not have the authority to impose these prohibitions with respect to clients for which a CPA provides no attest services.

Since reaching this conclusion in September 1998, the State Education Department has drafted legislation, which has been submitted to the state legislature, broadening the definition of the practice of accounting and thereby enabling the Board of Regents to regulate accountants performing nonattest services such as:

- keeping books, making trial balances, and preparing statements and reports as part of bookkeeping operations;

- providing financial advisory services or preparing

personal financial or investment plans or providing to clients products or services of others in implementation of personal financial or investment plans; and

- providing management advisory services.

In an apparent attempt to attract the support of the accounting profession for its proposed legislation, the State Education Department has also included in its bill a provision that would specifically enable CPAs to provide accounting services as employees of non-CPA owned business entities, such as American Express Tax and Business Services and other consolidators. The Education Department's proposed legislation has not gained the support of the accounting profession or the state legislature. Indeed, the New York State Society of CPAs has drafted and submitted to the legislature its own UAA proposal, which would retain the current limited definition of the practice of accounting and permit the payment of commissions and referral fees and the use of contingent fee arrangements in connection with the performance of nonattest services. The legislation would also permit non-CPA ownership of CPA firms, provided that "a majority of the ownership of the firm in terms of equity interest and voting rights of all partners, members or shareholders, belongs to individuals who are licensed or otherwise authorized by law to practice public accounting."

It is expected that the state legislature may act to adopt the State Society's proposed legislation as early as the end of this year. Thus, it appears likely that many long-standing obstacles to the performance of a wide variety of new business services by accounting firms is about to be, in part, removed. It is partly in anticipation of the relaxation of these regulatory prohibitions that many accounting firms have begun preparations for offering a wide array of new financial services.

II. Regulatory Considerations for Specific Financial Services

The expected removal of prohibitions or obstacles imposed by state regulators on the accounting profession does not mean that the performance of financial services is without any regulatory implications. Indeed, many of the new services that accountants are contemplating offering – particularly, investment advisory services, securities

brokerage services, and insurance-related services – are themselves regulated under state and/or federal law.

A. Investment Advisers. In October 1996, Congress eliminated federal registration of investment advisers that hold under $25 million of assets under management. Such advisers (or advisory firms) are now regulated solely by the states. Today, all states except Colorado, Iowa and Wyoming have some form of regulation covering investment advisers, a term generally defined to include persons and entities in the business of offering advice regarding investments in securities for compensation. Investment advisory firms that have more than $25 million under management are now exclusively registered with the Securities and Exchange Commission ("SEC") as registered investment advisers ("RIAs").

Although there are currently no educational requirements imposed under state or federal law upon investment advisers, a number of states do require investment advisers to take qualifying tests, such as the Series 65 examination. In addition, both state and federal laws require that all firms (as well as individuals) that come within the definition of an investment adviser must register with the SEC or state regulatory agency and comply with their rules. A notable exception to this requirement applies to attorneys and CPAs who render investment advice which is *solely incidental* to their practice of their respective professions. This exception, however, is very narrowly construed by regulatory authorities, which consider personal financial planning services *not* to be "in connection with the rendering of accounting services." (See 17 CFR 276.1092.) Thus, any firm that offers investment advice as a separate service is likely to be required to register.

The definition of an investment adviser under New York law is:

> any person who, for compensation, engages in the business of advising members of the public, either directly or indirectly or through publications or writings within or from the State of New York, as to the value of securities or as to the advisability of investing in, purchasing, or selling or holding securities, or who, for compensation and as a part of a regular business issues or promulgates analyses or reports concerning securities to members of the

public within or from the State of New York.

The applicable code provisions contain exemptions from registration as an investment adviser for, among others: (i) accountants (and certain other professionals) whose performance of investment advisory services is solely incidental to the practice of such profession; and (ii) investment advisers with fewer than 15 clients in the State of New York.

An investment adviser proposing to do business in New York may file a voluntary notification form with the Department of Law. All investment advisers with more than 40 clients in the State of New York, including those who previously filed voluntary notification forms, must apply to register as investment advisers by completing and filing investment advisory statements (Form NY-ADV) with the Department of Law. The statement requires information concerning, among other things: (i) the identity and background of officers, directors, principals, partners, and other persons responsible for overall determination of the adviser's investment policy; (ii) the procedures under which advisory recommendations or ratings are formulated, together with the identity of the persons participating in such decision-making procedures; (iii) whether the adviser issues periodic publications on a subscription basis or special reports or analyses; (iv) the general method of securities analysis employed; (v) the principal sources of information for the adviser's research; (vi) the method for verifying or testing the accuracy of externally provided information and data; and (vii) the adviser's schedule of fees and charges. The investment adviser is also required to provide a balance sheet dated within 90 days of its application.

The applicable law in New York (and in most other states) also requires an investment adviser to file with the Department of Law copies of all investment advisory literature provided to clients or prospective clients as well as copies of any advertisements, general notices, circulars, form letters, or other advertising communications prior to their dissemination. An investment adviser is also required annually to send a statement to their clients notifying such clients that they may obtain from the adviser a copy of its investment advisory statement and all exhibits thereto.

In addition to registering with the applicable regulatory agency, in most instances, an investment adviser must file

an annual report disclosing a wide variety of matters. For those advisers registered with the SEC, the annual disclosures include: (a) the financial condition of the firm; (b) the amount and types customer assets under the firm's management; (c) the amount and types of customer assets in the custody of the firm; (d) the terms under which the firm offers its services; and (e) the names of those employees of the firm who provide investment advisory services (see 17 CFR 276.1000). In addition, in some jurisdictions investment advisers may be required to disclose material customer claims made against them.

In most jurisdictions, including New York, one of the duties of an investment adviser is to maintain a wide variety of business records, including a complete list of all cash receipts and disbursements as well as auxiliary ledgers reflecting the assets, liabilities, reserves, capital, income, and expenses of each advisory client.

Typically, investment advisers also must comply with a variety of client disclosure requirements. For example, investment advisers are required to disclose the basis for their fees, who prepared any research reports provided to their customers, any conflicts of interest the firm may have with respect to recommended investments, how and where client assets in the possession of the firm are held, the financial condition of the firm, the names of all persons having an ownership interest in the firm and any changes in the firm's ownership, and any disciplinary proceedings and court actions that have been instituted against the firm or any of its key employees. In addition, investment advisers are often restricted as to the types of disclosures that they can make to their clients and prospective clients. In this regard, they are usually not allowed to use testimonials regarding the quality of their services (although they are permitted to disclose their track records if this information has been recorded and is verifiable). They may not, however, provide selective data regarding their track records.

Most state investment adviser statutes also tend to limit the types of compensation that an investment adviser may charge. For example, although investment advisers may charge a percentage of the assets under their management, they may not base their fees on the level of return they generate unless they manage in excess of $500,000 for the client. Even then, such arrangements are generally prohibited unless the incentive compensation arrangement

includes unrealized losses in the compensation base and the compensation arrangement is fully disclosed to the client.

Most states, including New York, have modeled their investment adviser regulations after the federal regulatory scheme administered by the SEC. Accordingly, the investment adviser regulations described above are very similar to those adopted in other states. Registration as an investment adviser and as an investment advisory representative is generally required on both firm and individual levels, respectively, with the more pervasive requirements being applied at the firm level. This means that a group of CPAs wishing to offer investment advisory services can do so either by establishing their own registered investment advisory firm or by having their members associate with an established investment advisory firm.

Because both state and federal regulations of investment advisers apply on a firm-wide basis (*i.e.*, to all activities engaged in by the regulated firm, irrespective of whether they are strictly undertaken in connection with providing investment advisory services), it is generally prudent to organize an investment advisory firm as a separate legal entity even though it may be owned by or have common ownership with a CPA firm. In this way, the firm will not have to make public disclosures regarding its overall activities.

B. Securities Brokers/Dealers. While most CPA firms probably will not wish to engage in retail securities business in competition with Merrill Lynch or Charles Schwab, they may wish to assist clients in buying or selling their businesses and to be paid a commission (or finder's fee) for their services. Such activities, if conducted on a routine or frequent basis, may place a firm in the securities business. In order to engage in the business of buying and/or selling securities for others, a person or entity must register as a broker/dealer with state *and* federal securities regulators, and the employees of such broker/dealer actually engaged in securities transactions must be licensed as registered representatives or agents of the broker/dealer. As in the case of insurance and real estate sales, licensure is required in every state in which the entity is deemed to be engaged in the business of buying and selling securities for others. In the State of New York, engaging in any such transactions requires

registration. Moreover, merely holding oneself out as conducting a securities business is likely to be sufficient to require registration. Therefore, CPA firms should be careful not to mention securities transactions in their promotional literature unless they are prepared to seek licensure as brokers/dealers.

For the purposes of these statutes, a firm conducts business where its office is located *or* where its customers are located. Accordingly, if an entity engages in securities transactions with New Jersey residents out of its New York office, it would be required to become licensed in both New Jersey and New York.

Under New York law, a "broker" is defined as:

> any person, firm, association or corporation, other than a dealer, engaged in the business of effecting transactions in securities for the account of others within or from this state, but does not include a bank.

A "dealer" under New York law is:

> any person, firm, association or corporation engaged in the business of buying or selling securities from or to the public within or from this state for his or its own account, through a broker or otherwise, except a bank, but does not include any person, firm, association or corporation in so far as he or it buys or sells securities for his or its bona fide investment account, either individually or in some fiduciary capacity.

Although there are several exceptions to the definitions of "broker" and "dealer," the primary exceptions are for persons engaged in the business of selling or purchasing "any security or securities to, from or through any bank, dealer or broker, or to or from any syndicate, corporation or group formed for the specific purpose of acquiring such securities for resale to the public directly or through other syndicates or groups."

In addition, in New York, employees of a broker or dealer who meet the definition of "salesman" must file a registration statement with the Department of Law. For the purposes of the registration requirement, a salesman is defined as any person "employed by a broker or dealer…

for the purpose of representing such broker or dealer in the sale or purchase of securities to or from the public within or from this state."

In order to register as a broker or dealer in New York, an entity must file a registration statement with the Department of Law every four years, file a "state notice" with the Department of State, and also pay fees in connection with filing the registration statements. The application must cover a wide variety of information regarding the entity's operations and qualifications and business history, including information regarding its owners and managers and each employee who is to effect securities sales. Also to be included in the application is financial information regarding the applicant.

Of particular concern to the state and federal regulators is whether the applicant will be holding any customer funds. The Department of Law is authorized to impose minimum capital requirements, and those requirements will vary depending upon whether the applicant will hold customer funds. The Department of Law also has the power to require that applicants be tested, and all supervisory employees of a broker/dealer entity are required to pass the NASD principal's exam.

Like investment advisers, agents of a broker/dealer must pass an examination which covers, among other things, regulations pertaining to securities transactions. Although these examinations are not difficult, they do require applicants to become acquainted with the regulatory requirements for executing securities transactions as well as the NASD Rules of Fair Practice. Licensure as a broker/dealer requires that at least one managerial employee pass the "principal's exam," which includes questions relating to the net capital regulations that are applicable to all registered broker/dealers.

Registered broker/dealers also must comply with the rules and regulations adopted by the Attorney General which require special filings for those broker/dealers who are not members of the NASD. In addition to these rules, New York's securities law (the "Martin Act") contains general anti-fraud and deception rules which parallel those in the Securities Exchange Act.

While CPA firms are accustomed to supervising their professional staffs, broker/dealer regulations mandate the

supervision of all persons who engage in securities transactions in order to assure compliance with all applicable state, federal, and NASD rules. This supervision must include not only the review of the terms of all transactions effected for customers and the broker/dealer, but also monitoring the activities of the individual representatives to assure that they are not making false representations in the course of their activities.

Unlike investment advisers, broker/dealers must register both with the SEC and with regulatory authorities in all states in which they conduct business. Accordingly, the regulatory burden is not inconsequential, and most broker/dealers maintain extensive staffs to assure that they remain in compliance with the laws of all jurisdictions in which they operate. A CPA firm can avoid much of this burden by having one or more of its partners and employees become associated with a broker/dealer licensed in those states in which the firm has securities clients. While this tactic may result in sharing commissions with the selected broker/dealer, unless the firm will be engaging in extensive securities transactions, it is likely to be more economical.

C. Insurance Services. Under Section 2102 of the New York Insurance Law, no person, firm, association, or corporation shall act as an insurance agent (or as an insurance broker) without having the authority to do so by virtue of a license issued by the Superintendent of Insurance. The sale of insurance is regulated by every state, and similar laws are found in every jurisdiction. These regulations pertain to the types of insurance that may be sold, the terms of the policies, which companies may offer insurance products, and the licensure of insurance agencies and their sales employees.

While there is no prohibition against acting as an insurance consultant without the authority provided by a license, the New York Insurance Law prohibits an insurance consultant from holding itself out as such without first obtaining an insurance consultant license. See Section 2102(a)(1), (b)(1). Although the Insurance Law does not define the term "insurance consultant," it should be assumed that the law refers to the act of offering advice, counsel, opinion, or services regarding the benefits, advantages, or disadvantages of insurance contracts not otherwise encompassed within the meaning

of insurance agent or insurance broker. The New York Insurance Law exempts from the licensing requirement imposed upon insurance consultants certain professionals, such as certified public accountants, who:

> provide information, recommendations, advice or services in their professional capacity, if neither they nor their employer receive any compensation directly or indirectly on account of insurance, bond, annuity or pension contract that results in whole or part from such information, recommendation, advice or services.

Section 2102(b)(1)(4)(B).

Moreover, unless licensed as an insurance agent, no person, firm, association or corporation shall receive any money, fee, commission or thing of value for examining, appraising, reviewing, or evaluating any insurance policy or shall make recommendations or give advice with regard to such matters. An exception to this provision applies to certified public accountants who provide such information, recommendations, advice, or services in their professional capacity, provided they receive no direct or indirect compensation on account of any insurance contract that results from such conduct. This narrow exception will not apply to the fee-generating enterprise under consideration here.

An insurance agent is defined in Section 2101(a) of the New York Insurance Law as:

> any authorized or acknowledged agent of an insurer or fraternal benefit society, and any sub-agent or other representative of such an agent, who acts as such in the solicitation of, negotiation for, or procurement or making of, an insurance or annuity contract, other than as a licensed broker.

It should also be noted that the New York Insurance Law also requires licensure for an insurance broker (*i.e.*, any person or entity who, for compensation, commission, or other thing of value, acts or aids an insured in soliciting, negotiating, or procuring the making of an insurance contract). As in the case of securities brokers/dealers, the requirements for licensure of insurance brokers are more rigorous than for licensure of insurance agents, including completion of a course of study and one year of recent,

About Vedder Price

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The Vedder Accounting Law Group

Vedder Price features one of the nation's premier accounting law practices, which has served as defense counsel in more than 150 suits against CPA firms. It currently represents in excess of 125 accounting firms in addition to advising the New York State Society of CPAs and several insurance companies offering accountants' professional liability insurance.

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regular employment in the insurance field.

In order to obtain the requisite license from the Superintendent of Insurance, the prospective agent must: (i) complete a written application containing certain information prescribed by the Superintendent; (ii) submit a certificate of appointment by the insurer or fraternal benefit society stating that it has satisfied itself that the applicant is trustworthy and competent to act as such an insurance agent and that the insurer or society will appoint the applicant as its agent if the license is issued; and (iii) pass a written competency test administered by the Superintendent. In order to qualify to take the written examination, an applicant is required to successfully complete a course or courses approved by the Superintendent covering the principal branches of insurance as to which the applicant seeks a license. An agent is permitted to sell only the particular insurance products specified in the license and only for the insurer on behalf of whom the license is issued.

If a CPA firm intends to serve as an insurance broker, rather than as an insurance agent, the Insurance Law imposes licensing requirements on brokers similar to the above-described requirements for licensure of agents.

III. How to Structure New Business Entities

The first step in structuring the performance of financial services is to consider whether the services should be performed: (i) by the existing accounting firm; (ii) by association with an existing entity which is already licensed to perform the services; or (iii) by forming a separate entity or entities to perform the service or services.

Associating with a licensed service provider may help the accounting firm avoid having to comply with complex regulatory and licencing requirements (assuming that the licensee alone performs the services). Such associations, however, do exact a heavy payment by generally restricting the accounting firm's involvement in the management of the operation and precluding it from ensuring the quality of the services delivered to its clients.

While an accounting firm can avoid the disadvantages associated with affiliating with an existing licensee by providing the services itself, there are circumstances that

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make such an arrangement undesirable. In order to be able to provide quality business services in areas outside traditional accounting practice, most accounting firms will need to attract individuals who possess the expertise required for the effective delivery of services. Many such individuals, however, demand some form of ownership interest in the venture as a condition of association. Even though non-CPA ownership of accounting firms will likely soon be permitted under certain conditions, offering an ownership interest in the existing firm to non-CPAs may be undesirable for a number of reasons. For example, the often delicate balance many firms have achieved (through great effort, no less) in management structure and firm operation may be strained or upset by the admittance of non-CPA owners. Similarly, existing compensation structures are not always appropriate for some of the new business ventures.

Thus, in most instances, accounting firms will want to create a separate entity to provide the new services. Once a decision is made to do so, careful consideration must be given to which form of business organization is best suited to the new venture. An important objective in structuring any business entity is to limit the owners' vicarious liability for the errors and misconduct of the entity and/or the co-owners. Accordingly, most firms will wisely choose to operate the new venture or ventures as some form of limited liability entity. In New York, as in most jurisdictions, state law offers a wide variety of forms for organizing a limited liability business entity such as a business corporation, professional corporation, limited partnership, limited liability partnership, and limited liability company. Unlike most states, New York law also provides for the establishment of "related limited liability partnerships," which are expressly designed for professional entities that are associated with limited liability partnerships.

Since professional corporations and limited liability partnerships are limited in use to entities composed solely of professionals, these forms of business organization will likely not be available for many new business operations because, in most cases, the entity providing new business services will, by necessity, include among its owners non-CPAs who possess the needed expertise to carry on the business operations.

Similarly, the traditional corporate form, although offering

protection to owners from vicarious liability, presents obstacles to achieving the attractive pass-through tax treatment. In order to achieve such treatment, a business corporation must comply with the limitations imposed on S corporations. Limited partnerships are generally an undesirable form in which to carry on new business services because of the requisite division in such entities between ownership and management.

Thus, in most instances the preferred form of business organization will be the limited liability company ("LLC"), which provides owners with protection from vicarious liability, favorable pass-through tax treatment, and virtually limitless flexibility in fashioning management, profit and loss sharing arrangements, and other matters. The flexibility of the LLC form of business operation permits the entity to be structured to meet the particular needs of the venture in question.

Those firms seeking to perform a variety of new business services may also choose to form separate entities for each such service. The formation of separate entities offers the advantage of limiting the application of regulatory and reporting requirements to a smaller and specialized entity rather than to a larger, multi-purpose firm. In addition, providing the services through separate entities permits the allocation of rewards based on the performance of each constituent service entity.

In structuring entities to carry on new business ventures, careful consideration should also be paid to additional matters, such as the protection of the firm's client relationships through the use of noncompete and other appropriate restrictive covenants. In addition, it may be advisable to provide for a trial period for any individual or entity through which the services are performed. A trial period enables the parties to gauge the "fit" and likely success of the venture before committing to a lengthy term of association. Similarly, buy-out, termination, and other exit provisions must be carefully negotiated and drafted. Additional issues peculiar to the type of service performed can and should be addressed in the operating and associated start-up agreements. For these reasons, it is advisable to seek experienced and competent legal counsel to assist in the formation of the business entity and in the negotiation of the various start-up agreements.

IV. Risk Management Measures

Risk management is extremely important when pursuing new business opportunities, particularly ones which are highly regulated such as the financial services discussed herein. It would be a terrible mistake to ignore the lessons of risk management learned in the conduct of an accounting practice when embarking upon these new business endeavors. Many accountants use a number of valuable risk management tools in connection with their accounting practices which can also work well when performing any other business services.

A. Engagement Letters and Client Disclosures. The primary tool is the engagement letter, which specifies the scope of the services to be performed and the respective rights and obligations of the provider and recipient of the services. Engagement letters are an important means for limiting liability exposure since they help preclude the disappointed client from making fanciful claims after the fact regarding the nature of the services which the service provider undertook to perform. In fact, under both New York State and federal regulatory schemes, it is mandatory to have written agreements with all investment advisory clients.

With respect to financial advisory services, it is also important to use investment questionnaires in order to memorialize such crucial matters as the client's investment objectives and preference and tolerance for investment risk. It is also prudent to consider what written disclosures should be made to the client, particularly when performing investment advisory services. In many instances, written disclosures are mandated by applicable regulation. Regardless of whether it is legally required, it may be advisable to provide disclosure of matters such as the basis for the firm's compensation and limitations on investment advice.

B. Operating Procedures. Another risk management tool is the adoption of appropriate internal procedures to assure that staff members perform the services with due care. Of course, once the procedures are adopted and circulated, some mechanism is needed to assure that the procedures are followed by staff members. Such procedures should cover such matters as client acceptance and continuation, including what types of clients are deemed undesirable, who should make the determination, and the mechanics of gathering and reviewing the requisite information regarding clients. Internal procedures should also address

which individuals should be authorized to recommend or effect transactions for clients, what data should be recorded and how, and who should review such activities, and the scope of that review. In addition, firms should establish a mechanism for periodically deciding what types of transactions entail an unacceptable level of risk for the firm and its clients. Firm internal procedures should also encompass staff training and operating procedures to assure that the quality of services being provided not only does not breed liability claims but also does not diminish the firm's reputation in the community. Operating procedures should include appropriate checklists to assure full compliance with legal requirements and the firm's internal procedures as well as uniformity of action.

C. Insurance. Some of the new services being offered by accounting firms involve a high risk of liability claims. For this reason, adequate insurance coverage is an important factor in the firm's risk management arsenal. This is particularly important since many clients expect that their accounting firm will operate under the highest ethical and fiduciary standards. Accordingly, these clients are likely to be particularly motivated to seek legal redress when they believe that their trusted accountants have provided them with erroneous investment advice or advice motivated by self-interest.

The first consideration is whether the firm's existing accountants' liability policy will cover the new service or services which are to be performed. For example, most professional liability insurers have long considered investment advice to be outside the practice of accountancy and have disclaimed liability for claims based upon the sale of securities or advice to purchase specific securities. More recently, however, a number of insurers have begun to cover financial planning services, provided the services do not include advice regarding the purchase of specific securities. In most cases, this minimal coverage afforded by such policies will not afford adequate liability protection because the providing of financial advisory services will likely include the recommendation of specific securities or other investments.

At least two professional liability insurers have begun to include coverage for claims arising out of investment advisory services under their accountants' liability policies. This coverage is being offered on a largely

experimental basis, as insurance underwriters rightly consider investment advice to be a high risk activity, especially for accountants whose activities are governed by strict requirements for professional diligence, objectivity, and fiduciary duty.

Even if it is determined that an existing policy covers the contemplated new services, CPA firms should consider whether the limits of liability under their policies are adequate, given the additional exposure which the performance of additional services presents. In addition, if financial services are being provided by a separate entity, it will be necessary under the terms of most policies to obtain an endorsement to the policy naming that entity as an additional insured.

If the firm's existing liability policy does not cover the new services, an assessment of the degree of risk posed by the performance of the new service or services must be made, and, where the risk is significant, liability insurance coverage should be obtained.

V. Conclusion

While providing financial services may be a good way to enhance firm profitability, such activity requires compliance with a broad spectrum of regulation, with the result that it cannot be undertaken on a casual basis. Accordingly, firms wishing to pursue these activities must carefully assess the amount of business they are likely to generate by providing financial services, and whether that business justifies the costs of complying with the applicable regulations and establishing and maintaining appropriate loss prevention systems.

If you have any questions about the information contained in this *Accounting Law Bulletin*, please contact Dan L. Goldwasser (212/407-7710) or any other Vedder Price attorney with whom you have worked.

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