STATE OF CALIFORNIA
BUSINESS, TRANSPORTATION AND HOUSING AGENCY
DEPARTMENT OF CORPORATIONS

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DATE May 25, 1993

RELEASE No. 80-C
(Revised)

APPLICABILITY OF THE CORPORATE SECURITIES LAW OF 1968 TO PERSONS ENGAGED IN BUSINESS AS "FINANCIAL PLANNERS"

This release, as revised, discusses the definition of "investment adviser" under the California Corporate Securities Law of 1968 (the "Law"), and regulations adopted by the Commissioner of Corporations setting forth additional fiduciary responsibility standards for investment advisers.

Definition of Investment Adviser

The definition of "investment adviser" found at Section 25009 of the Corporations Code provides that any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities are investment advisers required to be licensed in this state. Certain classes of persons such as banks, trust companies or savings associations are excluded from the definition of investment adviser. Certain other classes of persons such as attorneys at law, accountants, engineers, teachers, and broker-dealers are excluded from the definition only when the investment advisory services they offer are solely incidental to the practice of their profession. This exclusion does not apply, however, when one advertises or otherwise holds oneself out as engaging in another business such as financial planning. In this case, an investment adviser's license must first be obtained. The exclusion for broker-dealers would not apply to a broker-dealer, or associated person of a broker-dealer, acting within the scope of the business of a broker-dealer, if the person receives any special compensation for providing investment advisory services.

Persons licensed by the Departments of Insurance and Real Estate, tax preparers and persons generally holding themselves out as "financial planners", have no exclusion from the definition of investment adviser under the Law and may not make recommendations with respect to securities without first obtaining an investment adviser's license.

Agents employed by licensed broker-dealers and associated persons employed by licensed investment advisers effecting transactions in securities or giving investment advice, respectively, in the context of providing financial planning for clients must comply with the appropriate notification and disclosure provisions of the Law and Commissioner's Rules, unless the agent or associated person comes within a specific statutory or regulatory exemption.

The definition of "investment adviser" found under the Law, above, has as its source the federal law definition found in the Investment Advisers Act of 1940. Accordingly, the Commissioner of Corporations may look to Securities and Exchange Commission Release IA-1092 (17 CFR 276.1092), among other things, to aid in the interpretation of the definition of "investment adviser" as well as other provisions of the Law. (SEC Release IA-1092 issued October 8, 1987 superseded SEC Release IA-770 issued August 13, 1981.)

The Commissioner of Corporations has previously concluded that a financial planner providing clients with a financial plan which, among other things, sets forth areas in which a client could plan his finances as well as explaining characteristics of various forms of investment, including tax shelter real estate limited partnerships, but who does not make specific financial or investment recommendations unless a client wishes to implement the plan, is an investment adviser subject to the licensing requirements of the Law. Comm. Op. 74/61C. Also, see: Comm. Ops. 72/80C and 75/25C.

The Securities and Exchange Commission, in Release IA-1092, states that a person who provides advice, or issues or promulgates reports or analyses, which concern securities, but which do not relate to specific securities, generally is an investment adviser, assuming the services are performed as part of a business and for compensation.

In construing the "in the business" element of the definition of investment adviser under this release, the Securities and Exchange Commission states that the giving of advice need not constitute the principal business activity or any particular portion of the business activities of a person in order for the person to be an investment adviser. The giving of advice need only be done on such a basis that it constitutes a business activity occurring with some regularity. The frequency of the activity is a factor but is not determinative. The release also considers relevant, receiving any separate or additional compensation that represents a clearly definable charge for providing advice about securities, regardless of whether the compensation is separate from or included within any overall compensation, or receiving transaction-based compensation if the client implements the investment advice.

The "for compensation" element of the definition of "investment adviser" is satisfied by the receipt, or expected receipt, of any economic benefit, whether in the form of an advisory fee, commissions, or any other fee relating to the services rendered. It is not necessary that an adviser's compensation be paid directly by the person receiving investment advisory services, but only that the investment adviser receive compensation from some source for his services. The Securities Exchange Commission, in Release IA-1092, states that a person providing a variety of services to a client, including investment advisory services, for which the person receives any economic benefit, for example, by receipt of a single fee or commissions upon the sale to the client of insurance products or investments, would be performing such advisory services "for compensation."

Fiduciary Responsibility

The Commissioner emphasizes that the duty of an investment adviser to his client is that of a fiduciary. Subdivision (d) of Section 25235 of the Corporations Code provides that it is unlawful for any investment adviser, directly or indirectly, to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. In Release IA-1092, the Securities and Exchange Commission states that the duty of an investment adviser to refrain from fraudulent conduct includes an obligation to disclose material facts to clients whenever the failure to do so would defraud or operate as a fraud or deceit upon any client or prospective client. The investment adviser's duty to disclose material facts is particularly pertinent whenever the investment adviser is in a situation involving a conflict, or potential conflict of interest with a client. An investment adviser is under a duty to disclose fully the nature and extent of any interest the investment adviser has in such recommendation, including compensation which would be received should a client act on the recommendation. Accordingly, if an investment adviser, his employer or an affiliate will receive fees or other compensation from the sale of securities or other products or services recommended to a client (including, but not limited to, the sale of insurance and real estate), or otherwise have a conflict of interest, an investment adviser must disclose in writing such fees, compensation and conflicts at the time of entering into a contract for, or otherwise arranging for the provision of, the delivery of a financial plan.

Since the Securities and Exchange Commission published Investment Advisers Act Release No. 770 (August 13, 1981), the Securities and Exchange Commission and the North American Securities Administrators Association have worked together to promote more uniform regulation of investment advisers under federal and state securities law.

In December of 1985, the Commissioner adopted Rule 260.235.2 requiring an investment adviser or an associated person of an investment adviser to deliver to a financial planning client a notice in writing containing information relating to the financial planning activities. A companion rule, Rule 260.216.4.1, was adopted with respect to broker-dealer and agent financial planning activities. Rule 260.235.2 requires an investment adviser to disclose to a financial planning client: whether the investment adviser or affiliate will receive commissions, fees or other compensation from the sale of securities or other products or services recommended in the financial plan or otherwise has a conflict of interest; and that the client is under no obligation to act on the investment adviser's recommendations, but if the client chooses to act on any recommendation the client is under no obligation to effect the transaction through the investment adviser or an affiliate.

Effective June 11, 1992, the Commissioner adopted several new regulations to conform the California investment adviser regulations under the Corporate Securities Law of 1968 to the regulations drafted by the Securities and Exchange Commission and the North American Securities Administrators Association.

Specifically, the Commissioner adopted Rule 260.235.3 to specify that a licensed investment adviser or a person licensed as a broker-dealer (together "persons") controlling, controlled by or under common control with, a licensed investment adviser shall be deemed to be in compliance with Section 25235(c) of the Law in effecting agency cross transactions for an advisory client, if: (1) the advisory client has executed a written consent prospectively authorizing the person to effect agency cross transactions, provided that the written consent is obtained after full written disclosures, as specified; (2) the person sends to each client a written confirmation containing specified information, including the nature and time of the transaction and the source and amount of any other remuneration received or to be received by the person; (3) the person sends to each client, at least annually, a written disclosure statement identifying the total number of transactions during the period since the date of the last statement and the total amount of all commissions or other remunerations received or to be received; (4) each written disclosure or confirmation includes a conspicuous statement that the written consent may be revoked at any time by written notice; and (5) no transaction is effected in which the same person or an affiliate recommended the transaction to both any seller and any purchaser.

The Commissioner also adopted Rule 260.235.4 to provide that it shall constitute a fraudulent, deceptive or manipulative act, practice or course of business within the meaning of Section 25235 of the Law for any investment adviser to fail to disclose to any client or prospective client all material facts regarding: (1) a

financial condition of the adviser that is reasonably likely to impair the ability of the adviser to meet contractual commitments to clients if the adviser has discretionary authority, custody of funds or securities, or requires prepayment of advisory fees; and (2) a legal or disciplinary event that is material to the evaluation of the adviser's integrity or ability to meet contractual commitments to clients. The rule specifies legal and disciplinary events that create a rebuttable presumption that they are material to the evaluation. Compliance with the rule does not relieve the investment adviser from other disclosure requirements under the Law.

Finally, the Commissioner adopted Rule 260.238 to specify certain activities that do not promote "fair, equitable or ethical principles" as that phrase is used in Section 25238 of the Law. Included in these activities are: (1) recommending to a client the purchase, sale or exchange of a security without reasonable grounds to believe that the recommendation is suitable; (2) placing an order to purchase or sell a security, without authority to do so; (3) exercising discretionary power in placing an order to purchase or sell securities without first obtaining discretionary authority, unless the discretionary power relates solely to the price at which, or time when, an order involving a definite amount of a specified security shall be executed, or both; (4) inducing excessive trading in a client's account; (5) borrowing money or securities from a client, unless certain conditions are met; (6) loaning money to a client, unless certain conditions are met; (7) making certain misrepresentations to a client, as specified; (8) charging unreasonable advisory fees; (9) failing to disclose conflicts of interest; (10) guaranteeing that a specific result will be achieved; and (11) entering into, extending or renewing an investment contract, unless such contract is in writing and discloses the services to be provided and the fees that will be charged.

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