



1991

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Recommended Citation

Gray, John A. (1991) "Accountants' Obligations under Maryland's New Investment Adviser Law," *University of Baltimore Law Forum*: Vol. 22 : No. 2 , Article 3.

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Accountants' Obligations Under Maryland's New Investment Adviser Law

By John A. Gray

I. Introduction

In the spring of 1989, the Maryland General Assembly significantly amended the Maryland Securities Act¹ by enacting investment adviser provisions.² Certain portions of the amendments, including anti-fraud and disclosure provisions, were made effective July 1, 1989, and the remainder of the amendments, those primarily dealing with registration-related matters, became effective October 1, 1990. The Maryland Securities Commissioner (the Commissioner) adopted regulations to implement both the provisions effective in 1989 and 1990.³

Accountants nationally, as well as in Maryland, took a special interest in the proposed investment adviser legislation. The statute would apply to all accountants (certified, or not) whether located in Maryland or not, who provide investment advisory/financial planning services to persons in Maryland.⁴ Further, in recent years, Maryland has taken an aggressive lead in the regulation of financial planners with requirements beyond those of the federal Investment Advisor Act of 1940 - becoming a state whose statutory provisions and regulations are likely to be emulated by other states in the continuing absence of any federal developments. Starting in 1989, the Maryland accounting professional organization successfully lobbied for an amendment⁵ to the proposed legislation, over the opposition of other professional groups and the Securities Division.⁶ Three years later, the Mary-

land General Assembly repealed the so-called "accountants' exemption."

The repeal of the "accountants' exemption" raises the question of how accountants providing financial planning services are covered by the investment adviser legislation and regulations adopted pursuant to it. This question has a twofold significance. Individual accountants need to know whether they have statutory obligations, and if so, what they must do to comply. In addition, because accountants are a major source of financial planning services, the public needs to know to what extent it is protected under the new legislation in its dealings with accountants acting as investment advisers and/or financial planners.

Initially, it is important to distinguish between the applicability of the provisions to accountants who are not certified public accountants ("CPAs") and to those who are CPAs. By regulation, the Commissioner has defined "accountant" as used in the Maryland Securities Act (the Act) to mean "any person who is licensed by and in good standing with the Maryland State Board of Public Accountancy . . . or its equivalent licensing and regulatory agency in any state."⁸ The effect of this regulation is that all non-certified accountants providing investment advisory and financial planning services in Maryland are subject to all investment adviser provisions. The one exception to this generalization is that a non-certified accountant may enjoy

the benefit of an exemption from the registration requirement under either the "investment/insurance company" exemption⁹ or the "de minimis" exemption,¹⁰ because these two exemptions are available to "any person" who qualifies.¹¹ In contrast, individual CPAs may qualify either for the "incidental practice" exclusion from the "investment adviser" definition or for one or more of the two exemptions from the registration provisions. The question accordingly is not whether the Act covers accountants providing financial planning services, but to what extent it covers an individual accountant who provides investment advisory/financial planning services, and, more specifically, an individual CPA who does so.

For purposes of this discussion, the Act can be understood to apply to three groups of accountants: (1) those who must comply with all its provisions, (2) those who have a registration exemption, and (3) those who have benefit of the "incidental practice" exclusion from the Act's definition of "investment adviser."

II. Accountants Who Must Register

The Act requires persons acting and/or holding themselves out as financial planners and investment advisers¹² to register¹³ with the Commissioner, unless they enjoy the benefit of either a statutory exclusion from the definition of investment adviser¹⁴ or a registration exemption.¹⁵

The statutory definition of "in-

vestment adviser" has two components: the "traditional" or "federal" investment adviser component, and the recently enacted financial planner component. A person is brought within the definition by being covered by either one or both components.

The "traditional" investment adviser component has been a part of the Act since 1962 and mirrors the definition of investment adviser at section 202(a)(11) of the federal Investment Advisers Act of 1940. Section 11-101(f)(1) of the Maryland Act states:

'Investment adviser' means a person who, for compensation: (i) 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, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities;

In applying this component, the Maryland Securities Division has adopted the interpretations and applications of the federal Securities and Exchange Commission (SEC),¹⁶ as is required by the Act itself.¹⁷ On the basis of SEC releases and no-action letters discussing the elements of this component and their applicability, an investment adviser is anyone who, for compensation, is in the business of providing securities related advice.¹⁸

The second component of the Maryland definition expands the traditional federal definition to include any person who, for compensation:

(1) provides or offers to provide, directly or indirectly, financial and investment counseling or advice, on a group or individual basis; (2) gathers information relating to investments, establishes financial goals and objectives, processes and analyzes the information gathered, and recommends a

financial plan; or (3) holds himself out as an investment adviser in any way, including indicating by advertisement, card, or letterhead, or in any other manner indicates that he is a financial or investment 'planner,' 'counselor,' or 'consultant,' or any other similar type of adviser or consultant.¹⁹

This additional component of the Maryland definition authorizes the Commissioner to regulate a broader spectrum of persons not covered by the federal Investment Adviser Act. Theoretically, the federal definition does not encompass financial planners and others who provide non-securities related investment advisory and financial planning services. Practically, the "securities-related advice" requirement of the federal definition has created a loophole which numerous financial planners attempt to slip through despite SEC efforts to clarify the federal Act's applicability to financial planners and others.²⁰ Maryland's additional "financial planner" component closes this loophole by statutorily including all those who provide financial planning services or hold themselves out as financial planners or as similar types of advisers or consultants. Consequently, while all those covered under the federal Act's definition are simultaneously covered under the Maryland Act's definition, the converse is not true.

Thus, any individual CPA whose activities meet the elements of either of Maryland's two definitional components must register and is subject to all the Act's provisions unless he or she qualifies for the one of two registration exemptions available or for the "incidental practice" exclusion.

III. Accountants Exempt Only From Registration Requirements²¹

There are two ways in which an accountant, whether or not a CPA, whose activities otherwise bring him within the statutory definition may

qualify for an exemption but only from the registration related requirements. A registration exemption is available to any person (1) who provides investment advisory and/or financial planning services exclusively to insurance companies or investment companies,²² or (2) who is an out-of-state adviser and/or planner with statutorily defined "institutional clients" of five or fewer clients in any twelve month period.²³

IV. Accountants Excluded From the Definition

An individual CPA qualifies for the "incidental practice" exclusion from the statutory definition of investment adviser if he can establish that he or she meets three conjunctive requirements: (1) that the investment advisory services provided are connected with and reasonably related to the other professional services rendered, (2) that the fee charged for the investment advisory services is based on the same factors as those used to determine the fee for the other professional services, and (3) that he does not hold himself out to the public as an investment adviser.²⁴ The Maryland General Assembly has codified the three conjunctive "incidental practice" criteria traditionally used by the SEC staff to determine an exclusion under the federal Investment Advisers Act of 1940.

Any CPA who holds himself out as an investment adviser and/or financial planner does not have the benefit of the solely incidental exclusion. The SEC position is that one holds himself out to the public whenever one uses the term "investment adviser" or similar term (including titles such as Certified Financial Planner ("CFP"), Chartered Financial Consultant ("ChFC"), or Accredited Personal Financial Specialist ("APFS")) on a business card or stationary or in a telephone, business, or building directory, or when one lets it be known generally by advertisement, publication of an article or word of mouth that he or she

is available to provide investment advice and/or financial planning services.²⁵ The Maryland Securities Commissioner, however, by regulation, has ruled that a certified public accountant or CPA firm is not deemed to "hold out" as an investment adviser if the CPA limits his or her holding out as an investment adviser to the following and does not in any other manner hold out as an investment adviser. The CPA is allowed to enumerate financial or investment planning, counseling, consulting, or similar types of advising or consulting as a service of the practice of the CPA (1) in brochures or similar materials used for internal client purposes only, and (2) under the heading or caption "Certified Public Accountant(s)" in a classified telephone book advertisement or listing, or in a directory of professional services, provided that such services are enumerated among the other services that are offered by the CPA.²⁶ However, a CPA who uses the Maryland Rule in his or her practice should be aware that he or she may be violating the federal Investor Advisers Act based on the SEC Rule.

It is critical to note the scope of the "incidental practice" exclusion. While the effect of this exclusion is to eliminate the requirement to comply with the statute's "investment adviser" provisions, particularly all registration related requirements, it does not exclude coverage under those provisions that expressly apply to "any person." For example, section 11-302(a) makes it unlawful for "any person" while acting as a financial planner to commit fraud, to engage in any dishonest or unethical practices as the Commissioner has defined by rule, and to engage in any cross-agency transaction without prior written disclosure to the client and the client's consent. Section 11-302(c) likewise makes it unlawful for "any person" in the solicitation or in dealings with advisory clients to make any untrue statement of a material fact, or to omit a material fact necessary in order to make the

statement, in the light of the circumstances under which they are made, not misleading.

Accountants who are not excluded from the statutory definition of investment adviser and who do not qualify for an exemption must comply with all registration related provisions. This group includes all non-certified accountants who do not qualify for either the "insurance/investment company" registration exemption or the "de minimis" registration exemption, and those CPAs who do not qualify for either the "incidental practice" exclusion or one of the two registration exemptions. Registration-related provisions fit into one of three categories. Most are identical with both SEC and Uniform Securities Act regulations.

The Act authorizes the Commissioner to establish by rule or order the qualifications²⁷ for those who are required to register. One of the primary legislative purposes in passing investment adviser legislation was to protect clients of financial planners from losses due to incompetence, as well as from those due to conflicts of interest and fraudulent misconduct. Accordingly, no one will be allowed to practice as an investment adviser or financial planner in Maryland without demonstrating the pre-determined competency level established by the Commissioner in Investment Adviser Regulation 13. No one may register as an investment adviser or investment adviser representative unless he or she (1) has passed the Series 65 examination, as administered by the National Association of Securities Dealers ("NASD"), with a score of seventy percent or better, or (2) alternatively has earned one of the credentials designated by the Commissioner,²⁸ or (3) has obtained a waiver from the Commissioner based on a demonstration of relevant factors.

V. Application Process Requirements - Initial²⁹ and Renewal³⁰

Applicants who have met the eligibility requirements must file with the

Division the required information and forms along with the required fee.³¹ Applicants for initial registration as an investment adviser have to file federal Form AD, an appropriately initialed and manually signed copy of the Division's Certification Form, evidence of compliance with the Regulation 13 examination requirement, and the \$300 fee. Those who intend to have custody of or discretionary authority over client funds or securities must also file certification that they are bonded as required or alternatively have the required tangible assets or net worth.³²

All registrations automatically expire on December 31 of each year. Investment advisers applying for renewal need not refile any documents already filed unless there has been a material development requiring an update. The renewal application requires filing federal Form AD-S, amendments as required by section 11-411 (d) of the Act, and the renewal fee.

The initial application for investment adviser representatives³³ includes the registration Form U-4, a certification that the applicant has complied with or is exempt from the examination requirement, and the \$50 fee. Renewal requires an updated Form U-4 and the renewal fee.

Registrants must comply with, (1) record keeping requirements³⁴ subject to on-site inspection,³⁵ (2) additional disclosure to actual and prospective clients,³⁶ (3) reporting requirements to the Division,³⁷ and (4) surety or net worth requirements when there is custody of client funds or securities.

VI. Sanctions

Failure to register, even if in good faith and inadvertently, is a violation for which the Division may initiate administrative³⁸ and/or civil proceedings³⁹ and for which clients have a statutory private cause of action.⁴⁰ A client must bring suit within two years from discovery and no later than three years after the rendering of the invest-

ment advisory service.⁴¹ Statutory remedies include rescission, damages with interest, costs, and reasonable attorney fees.⁴² The CPA claiming benefit of the "solely incidental" exclusion or one or more of the two registration exemptions has the burden of establishing his claim.⁴³

A violation of any of the "any person" provisions may subject the person to administrative⁴⁴ and/or civil proceedings⁴⁵ by the Commissioner, including fines up to \$5,000 per violation, and to criminal proceedings by either the Criminal Investigation Division of the Office of the Attorney General or by a local State's Attorney.⁴⁶ The Act also provides the same generous private cause of action against another person acting as an investment adviser if he knowingly commits fraud in the solicitation of or in dealings with advisory clients, or if he employs any device, scheme, or artifice to defraud or engages in any act, practice, or course of business which operates or would operate as a fraud or deceit.

VII. Conclusion

Accountants who provide securities related advice and/or financial planning services should not assume that the investment adviser provisions in the Maryland Securities Act do not apply to them. For example, the "any person" provision of section 11-302(c), which makes it unlawful for any person to knowingly commit fraud in soliciting or in dealings with advisory clients, covers all accountants, CPAs and non-CPAs, who for any consideration, direct or indirect, provide investment advisory services, regardless of whether they have the benefit of an exclusion or exemption.

Non-CPAs are subject to the Act because only CPAs by definition may have benefit of the "solely incidental" exclusion, but non-CPAs still may qualify for either the "investment/insurance company" registration exemption or the "de minimis" registration exemption.

Individual CPAs may not have to comply with the registration related requirements by qualifying for either the "solely incidental" exclusion or one of the two registration exemptions. Individual CPAs who do not hold themselves out to the public as investment advisers and whose performance of investment advisory services is solely incidental to the performance of accounting services do not have to comply with "investment adviser" provisions including the requirement to register. Those individual CPAs who do not qualify for the "incidental practice" exclusion may qualify for one of the two registration exemptions but remain subject to all other provisions of the Act. Individual CPAs who do not qualify for either the "incidental practice" exclusion or one of the two registration exemptions must register.

The individual has the burden of establishing that he has met the requirements of the exclusion or an exemption. Therefore, each individual CPA who provides investment advisory and/or financial planning services should examine his practice to determine in which of the three groups his practice locates him and, correspondingly, the extent to which he is regulated.

Endnotes

¹Md. Code Ann., Corps. & Ass'ns § 11 (1992).

²House Bill 712, Laws of Maryland, 1989, Ch. 805.

³Code of Maryland Regulations 02.02.05.01-18 (hereinafter "COMAR, Investment Adviser Regulation").

⁴Md. Code Ann., Corps. & Ass'ns § 11-801(a)(2) (1992). The Act makes relevant sections applicable to anyone who offers or provides investment advisory services if (1) the contract is executed in the state, presumably by either party, or (2) the services are rendered in the state (including, for example, advice mailed, or faxed or phoned into and received by the client in the state), or (3) any action instrumental in effecting prohibited conduct is taken in the state, whether or not either party is then present in the state.

⁵The purpose of the amendment proposed by the accounting interests was to make it possible, under certain circumstances, for certified public accountants (CPAs) licensed by the Maryland State Board of Public Accountancy to be free of the Act's investment adviser registration related provisions.

⁶75 Op. Att'y Gen. 7 n.9 (Md. 1990) ("The amendment was opposed by the Securities Division; brokers and dealers, see letter from Ira Cooke to Delegate Casper R. Taylor, Jr. (Feb. 28, 1989); and all organized financial planner organizations, see memorandum to committee members from Dennis M. Gurtz (Feb. 24, 1989).").

⁷See House of Delegates Bill 1249 (1992), amending the Maryland Securities Act to delete § 11-401(b)(4).

⁸COMAR, Investment Adviser Regulation, *supra* note 3 at 02.02.05.01(B)(1).

⁹Md. Code Ann., Corps. & Ass'ns § 11-401(b)(2) (1992).

¹⁰Md. Code Ann., Corps. & Ass'ns § 11-401(b)(3) (1992).

¹¹See *infra* notes 23-25 and accompanying text.

¹²Hereinafter, the term "investment adviser" will be used to refer to those persons who engage in investment advisory activities as defined under the Maryland Act. The Maryland Act definition includes both those persons who provide securities related advice and financial planners regardless of whether they provide securities related advice. See *infra* notes 16-23 and accompanying text.

¹³Md. Code Ann., Corps. & Ass'ns § 11-401(b)(1) (1992).

¹⁴Md. Code Ann., Corps. & Ass'ns § 11-101(f)(2) (1992) (providing six statutory exclusions).

¹⁵Md. Code Ann., Corps. & Ass'ns § 11-401(b) (1992) (providing two exemptions from registration: the "investment/insurance company" exemption and the "de minimis" exemption).

¹⁶See COMAR, Investment Adviser Regulation, *supra* note 3 at 02.02.05.01(B)(3).

¹⁷Md. Code Ann., Corps. & Ass'ns § 11-804 (1992) (instructing the Maryland Securities Division to "coordinate the [Act's] interpretation and administration . . . with the related federal regulation").

¹⁸See SEC IA Interpretive Releases 770 and 1092. The SEC staff has developed a three-pronged analysis to determine the applicability of the federal statutory definition. The three prongs are: (1) whether

the advice provided is securities related, (2) whether it is provided, directly or indirectly, for compensation, and (3) whether it is provided as a regular part of one's business.

¹⁹Md. Code Ann., Corps. & Ass'ns § 11-101(f)(1)(ii) (1992).

²⁰See SEC IA Interpretive Releases 770 and 1092.

²¹Md. Code Ann., Corps. & Ass'ns § 11-401(b)(2)-(4) (1992). Unlike the incidental practice exclusion which the Maryland legislature has expressly limited to the members of five designated groups as defined by the Commissioner, the two registration exemptions are available to "any person" who meets their respective requirements.

²²*Id.* § 11-401(b)(2).

²³*Id.* § 11-401(b)(3).

²⁴*Id.* § 11-101(f)(2)(iii). This section provides that:

'Investment adviser' does not include: . . . (iii) A lawyer, certified public accountant, engineer, insurance agent or broker, or teacher whose performance of these services is solely incidental to the practice of his profession, provided that the performance of such services is not solely incidental unless: (1) The investment advisory services rendered are connected with and reasonably related to the other professional services rendered; (2) The fee charged for the investment advisory services is based on the

same factors as those used to determine the fee for other professional services; and (3) The lawyer, certified public accountant, engineer, insurance agent or broker, or teacher does not hold out as an investment adviser.

²⁵See SEC No-Action Letters: R. Bate, June 29, 1988; Alan P. Woodruff, August 20, 1987; American Capital Financial Services, April 29, 1985; Richard W. Blantz, January 25, 1985; Dale M. Mueller, February 20, 1984; Peter Jacobs, February 7, 1979.

²⁶COMAR, Investment Adviser Regulation, *supra* note 3 at 02.02.05.20 (containing exemption for accountants).

²⁷Md. Code Ann., Corps. & Ass'ns § 11-412(a)(9), (c) (1992).

²⁸These include Certified Financial Planner (CFP), Chartered Financial Consultant (ChFC), and Accredited Personal Financial Specialist (APFS).

²⁹Md. Code Ann., Corps. & Ass'ns § 11-405 (1992).

³⁰*Id.* § 11-406.

³¹*Id.* § 11-407.

³²COMAR, Investment Adviser Regulation, *supra* note 3 at 02.02.05.14.

³³Md. Code Ann., Corps. & Ass'ns § 11-101(g)(1) (1992) (defining "investment adviser representative" or "representative" to mean: ". . . any partner, officer, director of (or a person occupying a similar status or performing similar functions) or other individual employed by or associated with an investment adviser, except

clerical or ministerial personnel, who: (i) Makes any recommendations or otherwise renders advice regarding securities to clients; (ii) Manages accounts or portfolios of clients; (iii) Determines which recommendation or advice regarding securities should be given with respect to a particular client account; (iv) Solicits, offers or negotiates for the sale of or sells investment advisory services; (v) Directly supervises employees who perform any of the foregoing . . .").

³⁴Md. Code Ann., Corps. & Ass'ns § 11-411(a) (1992).

³⁵*Id.* § 11-411(e).

³⁶*Id.* § 11-411(b).

³⁷*Id.* § 11-411(c).

³⁸*Id.* § 11-701.1.

³⁹*Id.* § 11-702.

⁴⁰*Id.* § 11-703(a)(3).

⁴¹*Id.* § 11-703(f)(3).

⁴²*Id.* § 11-701(b)(4)(i).

⁴³*Id.* § 11-604.

⁴⁴*Id.* § 11-701.1.

⁴⁵*Id.* § 11-702.

⁴⁶*Id.* § 11-705.

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