

Division of Investment Management: Staff Legal Bulletin No. 11

Applicability of the Advisers Act to Financial Advisors of Municipal Securities Issuers

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Summary: This staff legal bulletin states the views of the Division of Investment Management (the "Division") on the applicability of the Investment Advisers Act of 1940 (the "Advisers Act") to financial advisors of issuers of municipal securities. The bulletin clarifies the circumstances under which financial advisors (a) may be investment advisers, and (b) may give advice to issuers of municipal securities regarding the investment of offering proceeds without being deemed to be investment advisers.

Supplementary Information: The statements in this legal bulletin represent the views of the staff of the Division of Investment Management. The Office of Municipal Securities provided substantial assistance in the preparation of this bulletin and concurs with the views expressed herein. This bulletin is not a rule, regulation or statement of the Securities and Exchange Commission. Further, the Commission has neither approved nor disapproved the contents of this bulletin.

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I. Background

Financial advisors to issuers of municipal securities¹ ("municipal issuers" or "municipal bond issuers") typically provide a range of services concerning the structuring, timing and issuance of bonds.² Among other things, they may assist in preparing bond-related documents and in selecting, and negotiating with, underwriters. When providing these services, financial advisors also may provide advice concerning the investment of the proceeds of the bond offerings. Under certain circumstances, a financial advisor that provides such advice will be an investment adviser subject to the Advisers Act.

The Division has taken the position that a financial advisor would not be an investment adviser if it advises its municipal clients to invest the proceeds of a bond offering that are temporarily idle pending their project use ("temporarily idle bond proceeds") in securities. The Division's no-action position was subject to two conditions: that the financial advisor would provide such advice (a) only upon the occasional request of a financial advisory client and (b) for no compensation.³

Two recent enforcement actions underscore the limited scope of the Division's no-action position. In one enforcement action, In the Matter of O'Brien Partners, the Commission found that a financial advisor acted as an investment adviser by advising municipal clients to invest their bond offering proceeds in securities, including repurchase agreements and guaranteed investment contracts ("GICs"), and by receiving compensation for providing that advice.⁴ In another enforcement action, In the Matter of Rauscher Pierce Refsnes, Inc., the Commission found that a financial advisor acted as an investment adviser by advising its client to invest bond offering proceeds in securities, including a forward supply contract and a GIC, and by receiving compensation for providing that advice.⁵

We understand that the two recent enforcement actions against the financial advisors have created substantial concern among financial advisors to municipal issuers about the status of financial advisors under the Advisers Act.⁶ The Division is publishing this staff legal bulletin to provide financial advisors and their counsel with further guidance on this subject.

II. Discussion

The Advisers Act applies to persons who are "investment advisers," a term defined in Section 202(a)(11) to include:

any person who, for compensation, engages in the business of advising others . . . 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

Thus, whether a person is an investment adviser depends on whether the person:

- (a) provides advice, or issues reports or analyses, regarding securities or as to the advisability of investing in, purchasing, or selling securities ("investment advice");
- (b) provides such services for compensation; and
- (c) is in the business of providing such services.⁷

If a financial advisor satisfies each of the three elements of the definition of "investment adviser" - that is, if it provides investment advice for compensation and is "in the business" of providing investment advice - it generally will be an investment adviser unless it is entitled to rely on one of the exclusions from the definition of investment adviser in the Advisers Act.⁸ The Division construes the three elements of the definition of "investment adviser" broadly. A person who makes recommendations about specific securities or who simply provides advice concerning the relative advantages and disadvantages of investing in securities in general is providing investment advice and satisfies the first element.⁹ A person who is compensated for a variety of services that include investment advice is receiving compensation for providing investment advice and satisfies the second element.¹⁰ Finally, even if a person's investment advisory activities are not its sole or even principal business activity, the person will be "in the business" of providing investment advice, and satisfy the third element, if the person:

- (a) holds itself out as an investment adviser or as one who provides investment advice;
- (b) receives 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 receives transaction-based compensation if the client implements the advice; or
- (c) on anything other than rare, isolated and non-periodic instances, provides specific investment advice, including a recommendation or analysis about specific securities or specific categories of securities.¹¹

A. Advice Regarding Municipal Financings

Financial advisors typically (a) provide advice to municipalities about the advisability of issuing (i.e., selling) their securities, (b) are engaged in the business of providing those services and (c) provide those services for compensation. As a result, they technically satisfy all three elements of the definition of investment adviser. The Division believes,

however, that Congress generally did not intend to apply the Advisers Act to any person who merely advises issuers concerning the structuring of their financings.¹² Hence, we would not consider a financial advisor to be an investment adviser if it limits its activities to providing advice as to whether and how a municipality should issue debt securities, including advice with respect to the structuring, timing and terms concerning such issue or issues.

B. Advice Regarding the Investment of Proceeds from Municipal Financings

1. The Investment Advice and Compensation Elements

Some financial advisors may provide specific investment advice to clients regarding the investment of the proceeds of their municipal bond offerings in non-government securities.¹³ These financial advisors generally would satisfy two of the three elements of the definition of investment adviser because their advice is clearly advice or analyses concerning securities,¹⁴ and because they receive compensation for providing such advice.¹⁵ Whether these financial advisors fall within the definition of "investment adviser" under the Advisers Act, however, will depend on the remaining element of the definition of investment adviser, that is, whether they are "in the business" of providing investment advice.

2. The "In the Business" Element

Whether a person is "in the business" of providing investment advice depends upon all of the relevant facts and circumstances.¹⁶ As noted above, the Division previously has stated that a person is "in the business" of providing investment advice if it:

- (a) holds itself out as an investment adviser or as one who provides investment advice;
- (b) receives 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 receives transaction-based compensation if the client implements the advice; or
- (c) on anything other than rare, isolated and non-periodic instances, provides specific investment advice, including a recommendation or analysis about specific securities or specific categories of securities.¹⁷

(a) Holding Out

There are various ways in which a financial advisor may hold itself out as an investment adviser ("hold itself out"). For example, a financial advisor could hold itself out as an investment adviser by: advertising its investment advisory services; referring to itself as an "investment adviser;" maintaining a listing as an investment adviser in a telephone, business, building or other directory; using letterhead indicating any investment advisory activity; or letting it be known, through word of mouth or otherwise, that it is willing to provide investment advisory services.¹⁸

A financial advisor also may hold itself out through its contractual relationships with its clients. For example, a financial advisor would be holding itself out as an investment adviser to its clients, and therefore would satisfy the "in the business" element, if its financial advisory contracts with those clients specifically contemplate that the financial advisor will advise municipal issuers about investing the proceeds of bond offerings in non-government securities.

(b) Separate, Additional or Transaction-Based Compensation

As previously noted, compensation is an element of the statutory definition of investment adviser, and is satisfied by the receipt of "any economic benefit."¹⁹ For purposes of determining whether a person has satisfied the "in the business" element, however, the Division focuses more specifically on whether the compensation is received for providing advice about securities.²⁰

We have stated that a person generally is "in the business" of providing investment advice if it

receives 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 receives transaction-based compensation if the client implements the advice.²¹

Under this standard, a financial advisor would be "in the business" of providing investment advice if it:

- (a) charged its financial advisory clients for investment advice separately from its financial advisory fee;
- (b) received any compensation that represented a "clearly definable" charge for providing advice about securities, regardless of whether that compensation is separate from or included in any overall compensation; or
- (c) received transaction-based compensation if the client implemented the advice.

Further, the compensation received by the financial advisor need not be paid by the client; it could be paid by a third party.

(c) On Anything Other Than Rare, Isolated and Non-Periodic Instances

Municipal bond issuers typically invest the proceeds from bond offerings pending their use in municipal projects. Financial advisors that advise municipal issuers regarding the structuring of their financings are sometimes also requested to provide investment advice regarding the investment of some or all of the temporarily idle bond proceeds. The Division stated in the Financial Planner Release that a person would be "in the business" of providing investment advice if it provides specific investment advice "on anything other than rare, isolated and non-periodic instances."²²

The Division has twice given no-action assurances to financial advisors that proposed to provide advice regarding the investment of temporarily idle bond proceeds in non-government securities. In *Dominion Resources*, the Division took the position that a financial advisor that, at the issuer's request, and for no additional compensation, advises its client from time to time regarding the investment of temporarily idle bond proceeds is not subject to the Advisers Act.²³ The Division took a similar position in 1991.²⁴ Some financial advisors reportedly have understood the Division's position to mean that financial advisors may regularly provide investment advice regarding the investment of temporarily idle bond proceeds without being investment advisers.²⁵ These financial advisors misunderstand the Division's position.

A financial advisor that provides specific advice about the investment of temporarily idle bond proceeds routinely or "with some regularity"²⁶ is "in the business" of providing investment advice and therefore is an investment adviser under the Advisers Act. A financial

advisor that provides such advice on "rare, isolated and non-periodic instances," that is, only as an occasional accommodation to clients, however, will not be deemed to be "in the business" of providing investment advice, and thus will not be deemed to be an investment adviser, provided that it receives no separate, additional or transaction-based compensation for performing such services and does not hold itself out as an investment adviser. The determination as to whether a financial advisor only occasionally gives specific advice about investing temporarily idle bond proceeds, in other words, whether such investment advice is only incidental to the financial advisor's business, depends on all of the facts and circumstances. For example, we believe that a financial advisor should consider the number of times that it has provided such advice during the past 12 months. A financial advisor that has provided investment advice several times during this period would likely be deemed to be an investment adviser, whether the advice was provided to a single client multiple times or to several clients a single time each.²⁷

3. Money Market Funds

Most of the positions in this bulletin concerning the applicability of the Advisers Act to financial planners are derived from staff pronouncements made before the tremendous growth in money market funds. Since those staff pronouncements were made, the use of money market funds has grown substantially.²⁸ This development, together with the nature of such funds, affects our analysis of the applicability of the Advisers Act to financial advisors who give advice about money market funds to financial advisory clients solely as an incident to their financial advisory relationship with those clients.

Money market funds are highly regulated by the Commission. Our rules require them to be very liquid, and limit their investments to high quality, short-term instruments.²⁹ Given the liquidity and relative safety of principal of money market funds, many investors use them as a substitute for a checking account or a place for temporarily idle funds. Interests in a money market fund are securities. Under our previous statements, therefore, a financial advisor giving advice to its financial advisory clients about investing proceeds of a bond offering in a money market fund would be subject to the Advisers Act unless (a) it did not receive separate, additional or transaction-based compensation for providing advice about money market funds, and (b) it provided advice about money market funds only on rare or isolated occasions, or provided very general advice about money market funds (for example, that money market funds in general may provide acceptable investment alternatives for temporarily idle bond proceeds).

In light of the nature of money market funds and the purposes for which they are used, however, we believe that a financial advisor that is providing financial advisory services to a client also may advise that client about investments in specific money market funds without being "in the business" of providing investment advice, and thus not be subject to the Advisers Act, if:

- (a) the advice about the money market funds is solely incidental to the financial advisory services that the financial advisor provides to its financial advisory client;
- (b) the financial advisor receives no separate, additional or transaction-based compensation for the advice about the money market funds;
- (c) the financial advisor does not hold itself out as an investment adviser; and
- (d) the financial advisor does not have discretionary authority over the assets of its financial advisory client that are invested in the money market funds.

III. Conclusion

Financial advisors can conduct their business without being subject to the Advisers Act if they limit their advisory activities to advising municipal issuers as to the structuring of their financings. Financial advisors' activities, however, may cause them to be investment advisers subject to the Advisers Act. A financial advisor may not routinely provide advice for compensation regarding the investment of assets, including the investment of temporarily idle bond proceeds, in non-government securities without being deemed to be an investment adviser. Generally, however, a financial advisor would not be an investment adviser if it does not give such advice on a regular basis, as discussed above, receives no separate or additional compensation for such advice (and receives no transaction-based compensation if the client implements the advice), and does not hold itself out as an investment adviser.

In addition, a financial advisor that provides advice to a municipal issuer regarding the structuring of its financing also may advise that client to invest bond proceeds in specific money market funds without being deemed an investment adviser, provided that: the advice given is solely incidental to the financial advisor's business; the financial advisor receives no separate, additional or transaction-based compensation for providing this investment advice; the financial advisor does not hold itself out as an investment adviser; and the financial advisor has no discretionary authority over the assets of the municipal issuer that are invested in the money market funds.

Footnotes

1 See Section 3(a)(29) of the Securities Exchange Act of 1934 (the "Exchange Act") (definition of "municipal security").

2 The term "financial advisor" is not defined in the federal securities laws. But see Rule G-23(b) of the Rules of the Municipal Securities Rulemaking Board (defining "financial advisory relationship"). For purposes of this bulletin, a financial advisor is anyone who, for compensation, advises a municipal issuer regarding the structuring, timing and issuance of bonds.

3 See Division of Investment Management no-action letter, The Knight Group (available Nov. 13, 1991); Division of Market Regulation and Division of Investment Management no-action letter, Dominion Resources, Inc. (available Aug. 22, 1985). Earlier this year, the Division of Market Regulation withdrew the no-action position that it took in the 1985 Dominion Resources letter. See Division of Market Regulation letter, Dominion Resources, Inc. (available March 7, 2000). The Division of Market Regulation's action does not affect the no-action position that the Division of Investment Management took in the 1985 letter. This staff legal bulletin does not address the status of financial advisors as broker-dealers under the Exchange Act.

4 In the Matter of O'Brien Partners, Inc., Advisers Act Release No. 1772 (Oct. 27, 1998) ("O'Brien Partners"). The Commission found that O'Brien Partners violated Section 206(2) of the Advisers Act by advising municipalities to invest their bond offering proceeds in securities without disclosing to the municipalities that O'Brien Partners was receiving a portion of the commissions paid to the brokers that O'Brien Partners had selected or recommended. The Commission also found that O'Brien Partners violated Sections 17(a)(2) and (3) of the Securities Act of 1933 (the "Securities Act"), Sections 204 and 207 of the Advisers Act, and Rules 204-2 and 204-3 thereunder. *Id.*

5 In the Matter of Rauscher Pierce Refsnes, Inc., et al., Advisers Act Release No. 1863 (April 6, 2000) ("Rauscher Administrative Proceeding"). The Commission found that Rauscher violated Sections 206(1), (2) and (3) of the Advisers Act, as well as Sections 17(a)(2) and (3) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder by, among other things, selling securities to the State of Arizona at prices that incorporated undisclosed, excessive markups. In connection with settling the administrative proceeding, the Commission moved to dismiss an injunctive action that it had instituted against Rauscher in federal court and in which the Commission had alleged the same misconduct. See "SEC Settles Yield Burning Case Against Dain Rauscher, Inc.," Litigation Release No. 16505 (April 6, 2000); *Securities and Exchange Commission v. Rauscher Pierce Refsnes, Inc.* ("Rauscher injunctive action"), 17 F. Supp. 2d 985 (D. Ariz. 1998), dismissed pursuant to settlement, April 6, 2000.

In both O'Brien Partners and Rauscher, the financial advisors also were registered investment advisers. O'Brien Partners, at Section III.A.; Rauscher Administrative Proceeding, at Section II.A. The defendants in the Rauscher injunctive action argued that the court should dismiss the allegations of Advisers Act violations because Rauscher had not acted as an investment adviser, even though it was a registered investment adviser. The court disagreed, finding that the Commission had properly alleged that Rauscher had acted as an investment adviser in connection with the transactions at issue. 17 F. Supp. 2d at 1002 (denying motion to dismiss for failure to state a claim). See also Rauscher Administrative Proceeding, at

n.2 ("Rauscher acted as an investment adviser . . . in connection with the [1992] offering because, for compensation, Rauscher was in the business of advising [the State of Arizona] as to the advisability of investing in, purchasing, or selling securities") (emphasis added); O'Brien Partners, at Section III.D.1 (O'Brien Partners acted as an investment adviser . . . for purposes of the Advisers Act . . .") (emphasis added). We note that a financial advisor's status as a registered investment adviser may be relevant to whether it is "in the business" of providing investment advice, but it is not necessarily determinative.

6 See, for example, "O'Brien Partners Settles SEC Investment Adviser Fraud Case," *The Bond Buyer* (Oct. 28, 1998); "FAs May Become Investment Advisers If They Push GICs for Refunding Escrows," *The Bond Buyer* (Sept. 18, 1998) (discussing the Rauscher injunctive action). See also Panel IV of the First Annual Municipal Market Roundtable (Oct. 14, 1999, transcript available on SEC website: www.sec.gov/offices/munisec/round/panel4.htm).

7 See *Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons who Provide Investment Advisory Services as a Component of Other Financial Services*, Advisers Act Release No. 1092 (Oct. 8, 1987) ("Financial Planner Release"). The Financial Planner Release used the term "financial planner" to refer to persons who typically provide advice to individuals or families regarding the management of their financial resources based on their particular needs; that term should not be confused with the use of the term "financial advisor" in this staff legal bulletin. See *supra* n.2.

8 See Sections 202(a)(11)(A) through (F) of the Advisers Act. Financial advisors traditionally have relied upon (a) the government-securities exclusion (Section 202(a)(11)(E)) or (b) the broker-dealer exclusion (Section 202(a)(11)(C)) when advising municipal bond issuers to invest temporarily idle bond offering proceeds.

The government-securities exclusion excludes from the definition of investment adviser "any person whose advice, analyses or reports relate to no securities other than securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States . . ." *Id.* Subsection (E). Thus, a financial advisor is not an investment adviser if its investment advice is limited to Treasury and other U.S. government securities as described in the Advisers Act. See, e.g., *Rauscher Administrative Proceeding*, at n.2 ("Because Rauscher's advice was not limited to Treasury securities or other government securities as described in Section 202(a)(11)(E), that provision did not operate to exclude Rauscher from the definition of investment adviser."). See also Division of Investment Management no-action letter, J.Y. Barry Arbitrage Management Inc. (available Oct. 18, 1989) (person who advises others on investments in reverse repurchase agreements may not be able to rely on the exclusion from the definition of investment adviser in Section 202(a)(11)(E)).

The broker-dealer exclusion excludes from the definition of investment adviser "any broker or dealer whose performance of such services [i.e., providing investment advice] is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor." *Id.* Subsection (C). See also *Rauscher*, 17 F. Supp. 2d at 1003 (holding for purposes of motion to dismiss that, based on the Commission's allegations that Rauscher's advice regarding which securities should constitute the escrow was central to the services being provided, Rauscher's advice was not solely incidental to its broker-dealer business).

9 Financial Planner Release, *supra* n. 7, at Section II.A.1.

10 *Id.* at Section II.A.3. The compensation element is satisfied by the receipt of "any economic benefit." *Id.* See also n.15, *infra*.

11 Financial Planner Release, *supra* n. 7, at Section II.A.2. Each of the three factors in the "in the business" element is discussed in greater detail below in Section II.B.2 of this bulletin.

12 See Division of Investment Management no-action letter, *The Arkad Company* (available March 19, 1992); Division of Investment Management no-action letter, *Magnuson, McHugh & Co.* (available Nov. 13, 1989); Division of Investment Management no-action letter, *Bruce H. Gemmel* (available July 14, 1976). See also L. Loss & J. Seligman, *Securities Regulation*, at 3345-46 (1991 ed.) ("[T]here is nothing to indicate that Congress intended that the Advisers Act should regulate investment banking functions.").

13 Some financial advisors may provide investment advice, whether general or specific, to their financial advisory clients on a regular basis for compensation, in addition to advice concerning the structuring of bond offerings. These financial advisors generally would satisfy each of the elements of the definition of investment adviser.

14 See, for example, *O'Brien Partners*, at Section III.D.1 ("O'Brien Partners acted as an investment adviser to [certain municipal governments] for purposes of the Advisers Act because it rendered advice to those clients concerning their investment of bond proceeds in [non-government] securities, including repurchase agreements and GICs . . .").

15 As stated above, we construe the compensation element of Section 202(a)(11) broadly. See n. 10, *supra*, and accompanying text. See also Division of Investment Management no-action letter, *Russell H. Smith* (available May 2, 1996) (the compensation element would be satisfied "even if a person receives compensation on a totally voluntary basis"). The compensation need not come from the financial advisor's client. In *O'Brien Partners*, for example, the compensation to the financial advisor sometimes took the form of undisclosed payments by brokers that received bond offering proceeds to invest. *O'Brien Partners*, at Section III.D.1. Similarly, the undisclosed markups that Rauscher charged on the sale of escrow securities and the separate fee that it charged for acting as co-broker for the purchase and sale of a GIC, see *Rauscher Administrative Proceeding*, at Sections II.B., E. and F., satisfied the compensation element of Section 202(a)(11).

16 Financial Planner Release, *supra* n. 7, at Section II.A.2.

17 *Id.*

18 Division of Investment Management no-action letter, DZP Associates (available Nov. 19, 1976).

19 See n. 10, *supra*, and accompanying text.

20 Compare the Financial Planner Release's discussion of compensation as part of the "in the business" element, at Section II.A.2, with its discussion of compensation as an element of the definition of investment adviser, at Section II.A.3.

21 *Id.* at Section II.A.2.

22 Financial Planner Release, *supra* n. 7, at Section II.A.2. For these purposes, "specific investment advice" includes "a recommendation, analysis or report about specific securities or specific categories of securities." *Id.* In the context of a financial planner, it also includes a recommendation that a client allocate certain percentages of its assets to "life insurance, high yielding bonds, and mutual funds or particular types of mutual funds such as growth stock funds or money market funds." *Id.* However, "specific investment advice" does not include "advice limited to a general recommendation to allocate assets in securities, life insurance, and tangible assets." *Id.* We discuss money market funds in Section II.B.3. of this bulletin.

23 See Dominion Resources, *supra* n. 3. For purposes of this staff legal bulletin, we are treating Dominion Resources as if it were a financial advisor, although it identified itself as a public utility holding company that sought to advise both corporate and governmental clients regarding the issuance of securities.

24 See The Knight Group, *supra* n.3 (citing Dominion Resources and granting no-action relief without expressing any legal conclusions on the issues presented).

25 Neither of the financial advisors in the two recent enforcement actions could rely on the Division's position in The Knight Group or Dominion Resources letters. Rauscher could not do so for two reasons. First, its advice did not concern investing temporarily idle bond proceeds. See Rauscher, 17 F. Supp. 2d at 1004 (the Commission alleged that there were "no idle proceeds to give advice on because the plan from the beginning was to invest the proceeds from the offering in United States Treasury securities, a GIC, and a forward supply contract") (ruling, on a motion to dismiss, that Rauscher could not rely on the Knight Group or Dominion Resources letters). Second, Rauscher received transaction-based compensation for providing investment advice. See Rauscher Administrative Proceeding, at Section III. & n.2. O'Brien Partners could not rely on the Division's position in the letters because it received separate and transaction-based compensation for its investment advice concerning the investment of temporarily idle bond proceeds in non-government securities. See O'Brien Partners, at Section III.D.1.

26 See Financial Planner Release, *supra* n. 7, at Section II.A.2.

27 For example, the Commission found that O'Brien Partners acted as an investment adviser to some of its financial advisory clients, finding that the relationship was expressly stated in the agreements with certain financial advisory clients and implicitly understood in O'Brien Partners' course of conduct with others. See O'Brien Partners, at Section III.D.1.

28 In 1987, assets in U.S. money market funds totaled approximately \$316 billion. In 1999, assets in U.S. money market funds totaled approximately \$1.613 trillion. Investment Company Institute, Mutual Fund Fact Book (2000 ed.) at 69.

29 See Rule 2a-7(b)(2) under the Investment Company Act of 1940 (requiring money market funds to comply with limitations regarding portfolio maturity, quality and diversification).