BEFORE THE DEPARTMENT OF
CORPORATIONS STATE OF
CALIFORNIA

In the Matter of: THE CALIFORNIA CORPORATIONS COMMISSIONER, Complainant, v. FIDUCIARY INVESTMENTS, INC.; RICHARD ALBERT COX, individually and doing business as RICHARD COX FIDUCIARY SERVICES; and BARBARA BAILEY COX, Respondents.	OAH NO. 2011100520

PROPOSED DECISION REGARDING DESIST AND REFRAIN ORDERS

Karl S. Engeman, Administrative Law Judge, Office of Administrative Hearings, State of California, heard this matter on November 2 and 3, and December 13, 2011, in Sacramento, California.

Erik Brunkal and Timothy LeBas, Senior Corporations Counsel, represented complainant.

John C. Schaller, Attorney at Law, represented all of the respondents. Richard Albert Cox and Barbara Bailey Cox were present during the administrative hearing.

Because of statutory time limits applicable to respondents' appeal of the Commissioner's Desist and Refrain Orders, the hearing was limited to the validity of such orders with the understanding that further hearing dates will be arranged, if necessary, to address claims for ancillary relief including administrative penalties. The administrative hearing concluded on November 3, 2011, and the parties agreed to submit simultaneous written briefs on or before November 14, 2011. Post hearing briefs from both sides were received on November 14, 2011. Complainant's brief was marked exhibit 26 and made a part of the record, and respondents' brief was marked exhibit F and made a part of the record. The matter was submitted on November 14, 2011, for a Proposed Decision on the

Desist and Refrain Orders. On November 18, 2011, the Administrative Law Judge ordered the matter reopened for the receipt of additional evidence relating to Richard Cox's activities as a trustee, based on the legal authorities reviewed and the need for greater detail with which to decide this matter. The parties agreed to appear on December 13, 2011, and evidence and oral argument were received. Respondents were permitted to file a final brief in response to a document submitted by counsel for complainants on December 13, 2011. Respondents' brief was received on December 15, 2011, marked exhibit I and made a part of the record. The matter was submitted on December 15, 2011.

FACTUAL FINDINGS

1. On September 28, 2011, complainant Preston DuFauchard, California Corporations Commissioner, filed the Statement in Support of (1) Orders Levying Administrative Penalties Pursuant to Corporations Code Section 25252; (2) Claim for Ancillary Relief Pursuant to Corporations Code Section 25254; and (3) Desist and Refrain Orders. Effective September 28, 2011, the Commissioner ordered respondents to desist and refrain from offering or selling any security in the State of California, including but not limited to shares of stock, by means of any written or oral communication which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. This desist and refrain order was based upon the Commissioner's determination that securities in the form of stock offered in Fiduciary Investments, Inc. were subject to qualification and were being offered or sold in California without first being qualified pursuant to section 25110 of the Corporate Securities Law of 1968.

2. The Commissioner further ordered that respondent Richard Albert Cox, individually, and doing business as Richard Cox Fiduciary Services, desist and refrain from effecting any transactions in securities as a broker-dealer, or inducing or attempting to induce the purchase or sale of any security, in this state, and/or engaging in investment adviser activities unless and until certification has been made under law or unless exempt. This desist and refrain order was based upon the Commissioner's determination that Richard Albert Cox, individually, and doing business as Richard Cox Fiduciary Services, effected transactions as a broker-dealer and engaged in investment adviser activities without securing from the Commissioner a certificate authorizing him to act in either capacity, in violation of sections 25210 and 25230 of the Corporate Securities Law of 1968.

3. Respondents filed timely Notices of Defense.

4. On August 6, 2002, respondents Richard and Barbara Cox (husband and wife) formed Fiduciary Investments, Inc., with Richard Cox as Director and Chief Executive Officer and Barbara Cox as Director and Secretary. Richard and Barbara Cox purchased one share of stock each for $50. The remaining 2,000 shares were purchased for cash by six trusts of which Richard Cox, individually, or doing business as Richard Cox Fiduciary Services, was trustee. The total capitalization for the corporation was $100,100.00. Richard

Cox formed the corporation as a vehicle to invest trust proceeds in single family residences to enhance the diversification of assets held by each of the trusts. He regarded the purchase of rental real estate as a good investment at the time because of favorable market rents relative to the purchase price of such properties, expected appreciation and tax benefits for depreciation and other expenses against other trust income. Richard Cox felt the trust assets were too small to participate in real estate investment trusts and general partnerships and his goal was to limit their participation to ten per cent or less of total assets.

5 On or about January 4, 2002, respondent Fiduciary Investments, Inc. filed a Notice of Issuance of Securities with the Department of Corporations, reflecting the initial shareholders as Richard and Barbara Cox and the six trusts with trust shares ranging from 200 to 600, and trust purchase prices ranging from $10,000 to $30,000. Fiduciary Investments, Inc. asserted that the notice was pursuant to Corporations Code section 25102, subdivision (h), for issuance subject to qualification under Corporations Code section 25110, unless exempted. Residential properties were purchased by Fiduciary Investments, Inc. and rented through a real estate management company. After the initial sale of common stock and up until March of 2009, Fiduciary Investments, Inc. sold additional shares to purchase additional real estate. The sales were to Richard Cox as trustee of various trusts, and the total number of trust "purchasers" was approximately 21. On or about December 3, 2008, Richard Cox, using his eBay name style Turdel and Fundt, also purchased approximately 145 shares of stock for approximately $14,835 to cover short term cash flow problems. On March 10, 2009, he sold the shares back to Fiduciary Investments, Inc. for $8,469, an approximately $6,000 loss. After the initial capitalization of the corporation, Richard Cox priced the shares purchased or sold based on an annual appraisal of all of the real estate owned by the corporation. The annual appraisal took place on August 23 of each year and was performed by the real estate broker managing the properties. Share prices at the time of a purchase or sale were based on the last appraisal.

6. With the decline in real estate values, Fiduciary Investments, Inc. began liquidating the rental properties until just one property with two houses remained unsold. As properties were sold, the corporation "redeemed" the stock based on the last appraisal and credited the trusts with the proceeds as a return of capital. In or about March of 2009, all of the shares except for the two held by Richard and Barbara Cox were transferred to two trusts of which Richard Cox was trustee. Fiduciary Investments, Inc. sold shares to Richard Cox as trustee for the two trusts for $178, 498. Fiduciary Investments, Inc. was dissolved on or about October 3, 2011, with distribution of the remaining real estate to the trusts which had been the last two shareholders other than Richard and Barbara Cox. These two trusts continue to hold title to the remaining property known as the "Portola property."

7. Richard Cox was registered by the Department of Corporations as an investment adviser for approximately 15 years. On June 24, 2009, the registration was summarily revoked for non-payment of renewal fees. Richard Cox decided not to renew his registration because, in his opinion, he was no longer acting as an investment adviser.

8. Since in or about 1998, Richard Cox has acted as a professional fiduciary serving as a trustee, guardian, conservator, and personal representative. With the creation of the professional fiduciary license under the jurisdiction of the California Department of Consumer Affairs on July 1, 2008, respondent applied for a professional fiduciary license and became licensed as such on August 4, 2008. As of December 13, 2011, there were 593 professional fiduciaries licensed by the California Professional Fiduciaries Bureau. Respondent Richard Cox is familiar with the community of professional fiduciaries and he knows of none who is a licensed investment adviser.

9. Richard Cox has served as a trustee for approximately 200 trusts since the year 2000. Of the initial appointments, those ordered by probate courts accounted for approximately 60 percent. Over time, some of these no longer required active court monitoring. Approximately 85 percent of the trusts for which Richard Cox has served as trustee are special needs trusts. The life beneficiary is typically someone who is disabled and receiving government benefits. The trustee may purchase items needed by the beneficiary, but may not distribute income to him or her. The distribution of income or the involvement by the beneficiary in the management of trust assets will jeopardize the receipt of the government benefits. Upon the death of the special needs life beneficiary, the government agencies which have provided benefits are reimbursed from the trust with any remaining assets paid to the remainder beneficiaries. By law, Richard Cox is required to account to the life beneficiaries or their representatives. These reports, which include investments, are made following the period of time to which they relate. There is no requirement that the trustee account to remainder beneficiaries. As a matter of practice, respondent Richard Cox reports to beneficiaries on a semi-annual basis. Respondent Richard Cox and Richard Cox Fiduciary Services typically charge a fee for the performance of trustee responsibilities and associated liabilities (3/4 of one percent in 2008), plus a fee for investment management of liquid assets (another ¾ of one percent in 2008.) The fees are in accordance with California Probate Code standards.

10. As of December 13, 2011, Richard Cox had 32 professional fiduciary appointments. He is the special administrator, or personal representative, for two estates and was appointed as such after the previously named administrators resigned in his favor as their successor. Of the remaining appointments, approximately two-thirds are special needs trusts. Richard Cox gained expertise in this area working with two attorneys in the Bay Area specializing in special needs trusts and has garnered additional appointments through other attorneys familiar with his reputation as a special needs trustee. Approximately 80 per cent of these special needs trusts required a trustee's bond initially, but many no longer require the bond because the trust assets have been reduced below the amount of the bonds initially posted. Richard Cox's remaining appointments are individual irrevocable trusts for which he is typically appointed as successor trustee when the named trusted is unable or unwilling to serve. Richard Cox is appointed trustee at the request of the beneficiaries and the appointments may or may not be filed with the appropriate probate court. Any beneficiary may petition the court for relief, or the answer to questions about a trustee's activities, regardless of whether the trust is actively supervised by the probate court. A beneficiary may seek to replace the trustee. As an example, at the time of the last day of administrative

hearing, respondent Richard Cox had been temporarily removed as trustee of the Russell Decedents' Trust, one of the two trusts holding title to the Portola property. This court based its order on a petition filed in probate court by one of the beneficiaries alleging improprieties by Richard Cox's activities as trustee in the sale of Fiduciary Investments, Inc. stock to the trust. A hearing to determine whether Richard Cox should be permanently removed is pending.

LEGAL CONCLUSIONS

Sale of Unqualified Securities

1. The first ground for the issuance of a Desist and Refrain Order was the Commissioner's determination that the offering and sale of shares in Fiduciary Investments, Inc. constituted the unlawful offer and sale of unqualified securities pursuant to section 25110 of the Corporate Securities Law of 1968. Corporations Code section 25110[1] reads:

> It is unlawful for any person to offer or sell in this state any security in an issuer transaction (other than in a transaction subject to Section 25120), whether or not by or through underwriters, unless such sale has been qualified under Section 25111, 25112 or 25113 (and no order under Section 25140 or subdivision (a) of Section 25143 is in effect with respect to such qualification) or unless such security or transaction is exempted or not subject to qualification under Chapter 1 (commencing with Section 25100) of this part. The offer or sale of such a security in a manner that varies or differs from, exceeds the scope of, or fails to conform with either a material term or material condition of qualification of the offering as set forth in the permit or qualification order, or a material representation as to the manner of offering which is set forth in the application for qualification, shall be an unqualified offer or sale.

2. Respondents do not dispute that the shares were securities, nor do they dispute that the securities were not "qualified." Rather, they assert that the initial offering was exempt from qualification pursuant to section 25102, subdivision (h), and subsequent sales were exempt pursuant to subdivision (f) of the same section. Section 25102 reads, in pertinent part:

> The following transactions are exempted from the provisions of Section 25110:

[1] All subsequent statutory references are to the Corporations Code, unless otherwise stated.

(f) Any offer or sale of any security in a transaction (other than an offer or sale to a pension or profit-sharing trust of the issuer) that meets each of the following criteria:

(1) Sales of the security are not made to more than 35 persons, including persons not in this state.

(2) All purchasers either have a preexisting personal or business relationship with the offeror or any of its partners, officers, directors or controlling persons, or managers (as appointed or elected by the members) if the offeror is a limited liability company, or by reason of their business or financial experience or the business or financial experience of their professional advisers who are unaffiliated with and who are not compensated by the issuer or any affiliate or selling agent of the issuer, directly or indirectly, could be reasonably assumed to have the capacity to protect their own interests in connection with the transaction.

(3) Each purchaser represents that the purchaser is purchasing for the purchaser's own account (or a trust account if the purchaser is a trustee) and not with a view to or for sale in connection with any distribution of the security.

(4) The offer and sale of the security is not accomplished by the publication of any advertisement. The number of purchasers referred to above is exclusive of any described in subdivision (i), any officer, director, or affiliate of the issuer, or manager (as appointed or elected by the members) if the issuer is a limited liability company, and any other purchaser who the commissioner designates by rule. For purposes of this section, a husband and wife (together with any custodian or trustee acting for the account of their minor children) are counted as one person and a partnership, corporation, or other organization that was not specifically formed for the purpose of purchasing the security offered in reliance upon this exemption, is counted as one person. The commissioner may by rule require the issuer to file a notice of transactions under this subdivision.

The failure to file the notice or the failure to file the notice within the time specified by the rule of the commissioner shall not affect the availability of this exemption. An issuer who fails to file the notice as provided by rule of the commissioner shall, within 15 business days after discovery of the failure to file the notice or after demand by the commissioner, whichever occurs

first, file the notice and pay to the commissioner a fee equal to the fee payable had the transaction been qualified under Section 25110.

(h) Any offer or sale of voting common stock by a corporation incorporated in any state if, immediately after the proposed sale and issuance, there will be only one class of stock of the corporation outstanding that is owned beneficially by no more than 35 persons, provided all of the following requirements have been met:

(1) The offer and sale of the stock is not accompanied by the publication of any advertisement, and no selling expenses have been given, paid, or incurred in connection therewith.

(2) The consideration to be received by the issuer for the stock to be issued consists of any of the following:

(A) Only assets (which may include cash) of an existing business enterprise transferred to the issuer upon its initial organization, of which all of the persons who are to receive the stock to be issued pursuant to this exemption were owners during, and the enterprise was operated for, a period of not less than one year immediately preceding the proposed issuance, and the ownership of the enterprise immediately prior to the proposed issuance was in the same proportions as the shares of stock are to be issued.

(B) Only cash or cancellation of indebtedness for money borrowed, or both, upon the initial organization of the issuer, provided all of the stock is issued for the same price per share.

(C) Only cash, provided the sale is approved in writing by each of the existing shareholders and the purchaser or purchasers are existing shareholders.

(D) In a case where after the proposed issuance there will be only one owner of the stock of the issuer, only any legal consideration.

(3) No promotional consideration has been given, paid, or incurred in connection with the issuance. Promotional consideration means any consideration paid directly or indirectly to a person who, acting alone or in conjunction with one or more other persons, takes the initiative in founding and

organizing the business or enterprise of an issuer for services rendered in connection with the founding or organizing.

(4) A notice in a form prescribed by rule of the commissioner, signed by an active member of the State Bar of California, is filed with or mailed for filing to the commissioner not later than 10 business days after receipt of consideration for the securities by the issuer. That notice shall contain an opinion of the member of the State Bar of California that the exemption provided by this subdivision is available for the offer and sale of the securities. The failure to file the notice as required by this subdivision and the rules of the commissioner shall not affect the availability of this exemption. An issuer who fails to file the notice within the time specified by this subdivision shall, within 15 business days after discovery of the failure to file the notice or after demand by the commissioner, whichever occurs first, file the notice and pay to the commissioner a fee equal to the fee payable had the transaction been qualified under Section 25110. The notice, except when filed on behalf of a California corporation, shall be accompanied by an irrevocable consent, in the form that the commissioner by rule prescribes, appointing the commissioner or his or her successor in office to be the issuer's attorney to receive service of any lawful process in any noncriminal suit, action, or proceeding against it or its successor that arises under this law or any rule or order hereunder after the consent has been filed, with the same force and validity as if served personally on the issuer. An issuer on whose behalf a consent has been filed in connection with a previous qualification or exemption from qualification under this law (or application for a permit under any prior law if the application or notice under this law states that the consent is still effective) need not file another. Service may be made by leaving a copy of the process in the office of the commissioner, but it is not effective unless (A) the plaintiff, who may be the commissioner in a suit, action, or proceeding instituted by him or her, forthwith sends notice of the service and a copy of the process by registered or certified mail to the defendant or respondent at its last address on file with the commissioner, and (B) the plaintiff's affidavit of compliance with this section is filed in the case on or before the return day of the process, if any, or within the further time as the court allows.

> (5) Each purchaser represents that the purchaser is purchasing for the purchaser's own account, or a trust account if the purchaser is a trustee, and not with a view to or for sale in connection with any distribution of the stock.
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> For the purposes of this subdivision, all securities held by a husband and wife, whether or not jointly, shall be considered to be owned by one person, and all securities held by a corporation that has issued stock pursuant to this exemption shall be considered to be held by the shareholders to whom it has issued the stock.
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> All stock issued by a corporation pursuant to this subdivision as it existed prior to the effective date of the amendments to this section made during the 1996 portion of the 1995-96 Regular Session that required the issuer to have stamped or printed prominently on the face of the stock certificate a legend in a form prescribed by rule of the commissioner restricting transfer of the stock in a manner provided for by that rule shall not be subject to the transfer restriction legend requirement and, by operation of law, the corporation is authorized to remove that transfer restriction legend from the certificates of those shares of stock issued by the corporation pursuant to this subdivision as it existed prior to the effective date of the amendments to this section made during the 1996 portion of the 1995-96 Regular Session.

3. Section 25163 imposes on respondents the burden of establishing an exemption from the requirements of section 25110. Counsel for complainant argued that respondents have failed to establish exemptions under either subdivision (f) or (h) of section 25102. Counsel for complainant asserted that the "purchasers" were the trust beneficiaries, not respondent Richard Cox in his capacity as trustee. Thus, to establish a subdivision (f) exemption, Richard Cox must have had a "preexisting personal or business relationship" with the beneficiaries or establish that they were sufficiently sophisticated investors to protect their own interests. Respondent Richard Cox countered that he was the purchaser in his capacity as trustee, and he was therefore essentially selling shares of the corporate stock (which he and his wife managed) to himself.

Subparagraph (f) Exemption

4. The Commissioner has promulgated regulations implementing and interpreting subdivision (f) of section 25102. California Code of Regulations, title 10 (Regulation), section 260.102.12, applies to the subdivision (f). The word "purchaser" is defined as "a person who acquires a beneficial ownership of the security, whether individually or in joint ownership." The phrase "beneficial ownership" is not defined in the regulations, but

complainant noted that the definition of that phrase as used in subdivision (h) of section 25102 is defined by Regulation section 260.102.5 and suggested that the same definition should be adopted. Regulation section 260.102.5 provides that "securities held by a trustee shall be considered to be owned beneficially by each of the beneficiaries, present, future, and contingent of the trust" (excluding future and contingent beneficiaries related by blood or marriage). This language of the regulation makes clear that it was promulgated to interpret the phrase as used in the first paragraph of subdivision (h) of section 25102 requiring the stock to be "owned beneficially by no more than 35 persons." By contrast, a subdivision (f) exemption applies if sales of stock "are not made to more than 35 persons." More importantly, another criterion for the exemption in subparagraph (3) of subdivision (f) reads: "Each purchaser represents that the purchaser is purchasing for the purchaser's own account (or a trust account if the purchaser is a trustee) and not with a view to or for sale in connection with any distribution of the security."[2] Subparagraph (5) of subdivision (h) of section 25102 includes identical language, although the reference to a trust account is not in parentheses. Therefore, while the regulations create some ambiguity regarding the meaning of the term "purchaser" in subdivision (f), as least for purposes of counting the offerees or purchasers, the Legislature regards a trustee as the purchaser as reflected in the language quoted above.

5. Assuming respondent Richard Cox was the purchaser, all of the criteria for a section 25102 exemption were established by respondents. The sales were made to trustee Richard Cox and to Richard and Barbara Cox, individually, so there were less than 35 purchasers even if one counts each of the trusts who eventually bought shares.[3] The second requirement was met because the sale of shares was made by Fiduciary Services, Inc. managed by Richard Cox to Richard Cox as trustee, and the required preexisting personal or business relationship or demonstrated business acumen on the part of the purchaser is not applicable. Complainant characterized this situation as a "silly contortion of law" and a "legal impossibility." However, corporate officers and directors who purchase shares in their own companies are in the same situation.

6. Even if one were to adopt complainant's argument that the purchasers were the trust beneficiaries, respondent Richard Cox had a "personal and business relationship" with them of the strongest sort. He had a legally imposed fiduciary duty to them to manage their assets in a reasonably prudent manner. Regulation section 260.102.12, subsection (d)(1), provides that preexisting personal or business relationship includes "any relationship consisting of personal or business contacts of a nature and duration such as would enable a reasonably prudent purchaser to be aware of the character, business acumen and general business and financial circumstances of the person with whom such relationship exists." This test is intended to protect investors by placing on the offeror the burden of establishing that the nature and

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[2] Parentheses in original.

[3] Richard and Barbara Cox are excluded from the count as officers and directors of the issuer in accordance with subparagraph (4) of subdivision (f) of section 25102.

duration of the relationship is one that would enable a reasonably prudent investor to assess the general business and financial circumstances of the issuer. (*People v. Simon* (1995) 9 Cal.4th 493, 503 at footnote 8.) Richard Cox was appointed as a trustee based on his reputation as a professional fiduciary, including his demonstrated expertise in managing trust assets. This is not a situation in which Richard Cox sold securities to members of the general public or casual acquaintances. In closing arguments, counsel for complainant focused on the obvious inability of special needs beneficiaries to manage trust assets, but the exemption in subparagraph (2) of subdivision (f) includes not only sales to sophisticated investors who can take care of themselves, but also sales by those whose character and business reputation are known to purchasers by reason of a preexisting personal or business relationship. This part of the exemption obviously does not require that the purchaser demonstrate such business acumen.

7. Richard Cox, as trustee, purchased the shares for the trust accounts and not in contemplation of a sale "in connection with any distribution of the security." That additional shares were sold to other trusts over the years to purchase more rental property, and shares were ultimately redeemed and sold to the two remaining trusts, does not negate the intent to purchase the shares for the trustee's account and not for resale. The sales of shares in Fiduciary Investments, Inc. were not accomplished by the publication of any advertisement.

Subparagraph (h) Exemption

8. The sales of shares in Fiduciary Investments, Inc. may have qualified for the exemption in subdivision (h) of 25102, but respondents did not establish that the total number of beneficiaries of the trusts, excluding relatives and spouses, did not exceed 35 immediately after the sales of shares of voting common stock. There was no publication of the offer or sale and no selling expenses were incurred, consideration was cash only, no promotional consideration was paid or incurred, the required attorney notice was submitted, and trustee Richard Cox purchased the shares for the trust accounts and not for resale.

9. The sale of shares in Fiduciary Investments, Inc. by respondents was exempt pursuant to section 25102, subdivision (f). Therefore, there is no valid basis for a Desist and Refrain Order based on allegations that respondents sold unqualified securities.

Whether Respondents Were Broker-Dealers or Investment Advisers

10. The second ground for a Desist and Refrain Order was the Commissioner's determination that respondent Richard Cox, individually and doing business as Richard Cox Fiduciary Services, effected transactions as a broker-dealer and engaged in investment adviser activities without being authorized by the Commissioner to act in either capacity. These contentions will be addressed separately.

Broker- Dealer Contention

11. Section 25004 defines a "broker-dealer" and reads:

(a) "Broker-dealer" means any person engaged in the business of effecting transactions in securities in this state for the account of others or for his own account. "Broker-dealer" also includes a person engaged in the regular business of issuing or guaranteeing options with regard to securities not of his own issue. "Broker-dealer" does not include any of the following:

(1) Any other issuer.

(2) An agent, when an employee of a broker-dealer or issuer.

(3) A bank, trust company, or savings and loan association.

(4) Any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business.

(5) A person who has no place of business in this state if he effects transactions in this state exclusively with (A) the issuers of the securities involved in the transactions or (B) other broker-dealers.

(6) A broker licensed by the Real Estate Commissioner of this state when engaged in transactions in securities exempted by subdivision (f) or (p) of Section 25100 or in securities the issuance of which is subject to authorization by the Real Estate Commissioner of this state or in transactions exempted by subdivision (e) of Section 25102.

(7) An exchange certified by the Commissioner of Corporations pursuant to this section when it is issuing or guaranteeing options. The commissioner may by order certify an exchange under this section upon such conditions as he by rule or order deems appropriate, and upon notice and opportunity to be heard he may suspend or revoke such certification, if he finds such certification, suspension, or revocation to be in the public interest and necessary and appropriate for the protection of investors.

(b) For purposes of this section, an agent is an employee of a broker-dealer under paragraph (2) of subdivision (a) when the agent is employed by or associated with the broker-dealer under all of the following conditions:

(1) The agent is subject to the supervision and control of the broker-dealer.

(2) The agent performs under the name, authority, and marketing policies of the broker-dealer.

(3) The agent discloses to investors the identity of the broker- dealer.

(4) The agent is reported pursuant to subdivision (c) of Section 25210 and the rules adopted thereunder.

12. Respondent Richard Cox argued that he is not engaged in the business of effecting transactions in securities in this state for the account of others or for his own account. He also maintained that he is exempt pursuant to subparagraphs (1), (3) and (4) of subparagraph (a). Counsel for complainant argued that by purchasing and selling Fiduciary Investments, Inc. shares on behalf of the trusts for which he served as trustee, respondent Richard Cox effected transactions in securities for others. Counsel for complainant asserted respondent Richard Cox has not met his burden of establishing that any exemption applies.

13. Respondent's Richard Cox's activities do not fall within the definition of a broker-dealer, and even if they do, he is exempt. Respondent did not "engage in the business of effecting transactions in securities" when he invested trust funds in Fiduciary Investments, Inc. His business was that of a professional fiduciary, charged with the obligation to invest trust assets in diverse areas including securities. He was compensated for his management of trust assets, not for the purchase and sale of securities as an incidental part of is trustee responsibilities. Further, if respondent Richard Cox's activities did fall within the general definition of a broker-dealer, he would be exempt under subparagraph (4) of subdivision (a). That subparagraph exempts any "person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business." Respondent Richard Cox bought and sold securities for his own accounts, as trustee, in his professional fiduciary capacity as such. As noted, he was not in the "business" of buying and selling securities, but did so as one part of his fiduciary responsibilities. The other exemptions raised by respondent Richard Cox do not apply. He was not an "issuer" when he purchased securities from Fiduciary Investments, Inc. He was not a trust company (corporation) licensed by the California Department of Financial Institutions pursuant to Financial Code section 350.

Investment Adviser

14. Section 25230 defines an investment adviser as follows:

(a) 'Investment adviser' means 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, or who, for compensation and as a part of a regular business, publishes analyses or reports concerning securities. 'Investment adviser' does not include (1) a bank, trust company or savings and loan association; (2) an attorney at law, accountant, engineer or teacher whose performance of these services is solely incidental to the practice of his or her profession; (3) an associated person of an investment adviser; (4) a broker-dealer or agent of a broker-dealer whose performance of these services is solely incidental to the conduct of the business of a broker-dealer and who receives no special compensation for them; or (5) a publisher of any bona fide newspaper, news magazine or business or financial publication of general, regular and paid circulation and the agents and servants thereof, but this paragraph (5) does not exclude any such person who engages in any other activity which would constitute that person an investment adviser within the meaning of this section.
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> (b) 'Investment adviser' also includes any person who uses the title 'financial planner' and who, for compensation, engages in the business, whether principally or as part of another 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, publishes analyses or reports concerning securities. This subdivision does not apply to: (1) a bank, trust company, or savings and loan association; (2) an attorney at law, accountant, engineer, or teacher whose performance of these services is solely incidental to the practice of his or her profession, so long as these individuals do not use the title "financial planner;" (3) an associated person of an investment adviser where the investment adviser is licensed or exempt from licensure under this law; (4) an agent of a broker-dealer where the broker-dealer is licensed or exempt from licensure under this law, so long as (A) the performance of these services by the agent is solely incidental to the conduct of the business of the broker-dealer, and (B) the agent receives no special compensation for the performance of these services; or (5) a publisher set forth in paragraph (5) of subdivision (a), so long as the publisher or the agents and servants of the publisher are not engaged in any other activity which would constitute that person an investment adviser within the meaning of this section.

15. Complainant established, and respondent Richard Cox does not dispute, that respondent Richard Cox's investment adviser license lapsed and was revoked June 24, 2009. Counsel for complainant view respondent Richard Cox's trustee' fees based in part on the value of the trust assets administered as compensation for "advising" beneficiaries (whom complainant characterizes as "clients") about the value and advisability of investing in

securities. Counsel for complainant point to the letter accompanying the required trustee annual report that respondent typically sent to trust beneficiaries or their representatives commenting on his investment strategies and the performance of the trust portfolios when compared to standard market indexes. However, respondent was not "advising" anyone regarding the value of securities or strategies for investing. The letters accompanied the annual reports that respondent Richard Cox was required to send to beneficiaries reflecting the investment decisions he had *already* made. He did not consult with beneficiaries about such decisions, and consultation with the special need trust beneficiaries would have jeopardized the viability of such trusts and the government benefits received by the beneficiaries.

16. Counsel for complainant point out that the California Corporations Commissioner often looks to federal securities laws and the interpretations of the Security and Exchange Commission (S.E.C.) and its staff for interpretation of the California Securities Law in the absence of relevant California law. Section 202 (a) (11) (F) of the federal Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(11)) defines an investment adviser as "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 or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities." Excluded are lawyers, accountants, engineers and teachers whose performance of these services is "solely incidental to the practice of [their professions]." Clearly, the federal definition is substantially similar to that embodied in California law. Unfortunately, interpretation of the federal law is not so clear.

17. The S.E.C. issued its own opinion in *"In the Matter of Augustus P. Loring, Jr."* (11 S.E.C 885; July 20, 1942), shortly after the enactment of the Investment Advisers Act. The Commission opined that :

> An individual who is primarily engaged in the business of acting as a professional trustee under judicial appointment, appointments under trust indentures or pursuant to powers of attorney, who derives most of his income from acting as trustee under judicial appointments and under irrevocable trust indentures, who manages and administers personal property and real property in addition to the supervision of securities and who does not hold himself out as giving advice to others as to securities, held, not an investment adviser within the meaning of Section 202(a)(11) of the Investment Advisers Act of 1940.

18. The Commission, in the recitation of facts underlying the opinion, noted that most of Mr. Loring's business consisted of acting as a court fiduciary, i.e., trustee, guardian, conservator, or executor under wills or other instruments filed with and under supervision of the courts. As such, he was required to give a bond and account to the courts for their approval. His compensation, when under court supervision, was in accordance with that permitted by the courts. As trustee, he held legal title to the personal and real property

administered in the trust. His obligations as trustee exceeded supervision of investments. The recited facts are obviously very similar to those involved in this matter.

19. In *Selzer v. Bank of Bermuda Ltd*., (D.C. N.Y.1974) 385 F.Supp.415, a federal District Court, citing *Loring*, held that a trustee is not an investment adviser. The court adopted the reasoning advanced by respondents in this matter, that the trustee is the legal owner of the trust corpus, while the beneficiary is the equitable owner. The trustee does not advise the trust corpus to take action; rather, he acts himself as principal. The court concluded that while there may be public policy reasons for holding trustees to the standards of the Investment Advisers Act, the common sense meaning of the word "adviser" does not compel that interpretation. The District Court rejected the S.E.C. staff opinion in *Brewer-Burner Associates, Inc.* in which the Commission's Division of Investment Management determined that a Panamanian trustee of Panamanian trusts to be set up by American investors to invest in Mexican government and other securities would be an investment adviser within the meaning of the Act.

20. On July 22, 1976, the Commission's Division of Investment Management Regulations issued a "No Action Letter" regarding Philip Eiseman ((Fed. Sec. L. Rep. p. 80, 914). The Division offered that Mr. Eiseman's work as a professional trustee with discretionary authority over investments constituted the provision of advisory services to the trusts for compensation and for the benefit of beneficiaries of the trusts. The Commission's staff asserted that the *Loring* opinion applied only to Mr. Loring and that the Commission's opinon was based on specific facts and circumstances including that most of Mr. Loring's business consisted of judicial appointments as a trustee by which he acted as a court fiduciary subject to court supervision.

21. In a January 31, 1983 "No Action Letter" regarding Joseph J. Nameth (Fed. Sec. L.Rep.1983), the Commission's Division of Investment Management wrote that one who, for compensation, is engaged in investment management with the discretionary power to buy and sell securities is an investment adviser even if the business is operated through the medium of trusts. Compensation included the fee for administration of the trusts, and no separate fee for investment advice was necessary to meet the definition of an investment adviser. According to the Division, *Loring* was limited to persons whose business was mostly acting as a court-appointed fiduciary, and as such, required to give a bond upon acceptance of each trust in an amount sufficient to protect the trust assets and required to account to the courts. The Division also stated that it disagreed with the *Selzer* decision affecting a "private trust," in which the court, according to the Division, was of the mistaken impression that it was the Commission's position that at trustee was not an investment adviser within the meaning of the Investment Act. The *Nameth* facts involved the creation of a number or inter vivos revocable trusts, revocable at will by the settlors. The trustee was to be given actual title to all property placed held in the trusts. The trustee was to have broad discretionary power to invest, and not limited to conservative investments, and the settlors would be able to elect what types of instruments the trustee could use.

22. In *Abrahamson v. Fleschner* (2nd Cir. 1975), 568 F.2d 862, the United States Court of Appeal for the Second Circuit was faced with the question whether a private action for fraud could be implied from the federal Investment Adviser Act of 1940. The answer depended, in the first instance, on whether the defendants were "investment advisers" under the Act. As noted above, the definition of an investment adviser under federal law is substantially the same as the first sentence of subparagraph (a) of Corporations Code section 25230 cited above. The *Abrahamson* facts involved a limited partnership established by the general partners for investments. The general partners controlled the manner in which the partnership funds were invested. The partnership agreement provided that their compensation was 20 percent of the net profits and capital gains each fiscal year plus a salary of $25,000. The general partners issued a brief monthly report to the limited partners showing the percentage gain or loss of partnership assets and a comparison to the Standard and Poors 500 Stock Average. The monthly reports also included a statement of investment policy. General partner representations regarding investment policy, i.e. "low risk stance" and "a most conservative posture," formed the basis for plaintiff limited partners' allegations of fraud after learning that the defendant general partners had invested heavily in high-risk securities. The federal Investment Adviser Act makes it unlawful for investment advisers to defraud clients or prospective clients. The general partners also sent limited partners a certified yearly financial report. Limited partners could withdraw any or all of their fund balances at the end of each fiscal year with 30 or 60 days' notice depending on the time of year.

23. The Second Circuit Court of Appeal held that the general partners were investment advisers. They received substantial compensation for management of the limited partners' investments. The remaining question under the federal statute was whether the general partners were engaged in the business of advising "others" with respect to investments. The court held that they were on two grounds. First, the monthly reports provided investment advice to limited partners. The general partner income depended upon the size of the investment pool and limited partners necessarily relied upon the monthly reports to decide whether to withdraw their funds from the partnership. Second, the general partner activities met the plain language of the statute defining an investment adviser. The Court recited legislative history (including an S.E.C. report) relating to the Investment Adviser Act of 1940 and later amendments reflecting its remedial purpose to curb abuses revealed by the stock market crash of 1929.[4] The Court concluded that from the start, the Act was designed to regulate those who exercise control over purchases and sales with client funds, as this is the method by which they "advise" clients. (*Abrahamson*, at p. 871.)

24. On January 6, 1995, in an unpublished opinion (1995 U.S. Dist. LEXIS 22352), the United States District Court for the Eastern District of Michigan, Southern Division, decided *S.E.C. v. Smith*.[5] The action by the S.E.C. was very similar to this matter.

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[4] The S.E.C. submitted an Amicus Curiae brief to the Court at the Court's invitation.

[5] A California state court (and presumably the California Corporations Commissioner) may rely upon unpublished federal District Court decisions as persuasive and not precedential. (*Olinick v. BMG Entertainment* (2006) 138 Cal. App.4th 1286, 1301.)

The Commission alleged that Smith had acted as an unregistered investment adviser (under the federal Advisers Act), had failed to provide adequate safeguards for client funds, did not maintain required books and records, failed to furnish disclosure documents, and failed to include a required non-assignability clause in client contracts. The Commission sought a permanent injunction and civil penalties. Smith contended that he was not an investment adviser. The facts in *Smith* are quite similar to those in *Abrahamson*, except that Smith held the investor funds in a "living" trust established by him and for which he served as trustee. Smith discussed clients' investment goals with them when opening a new account and included the goals in an account management agreement that clients signed. The agreement granted Smith exclusive and discretionary control of the funds invested by clients. The agreement was revocable by either party upon 30 days- notice. Smith issued statements to clients on either a monthly or quarterly basis. From time to time, Smith encouraged clients towards certain investments. Smith's fees were calculated monthly based on one-half of one percent of the month ending value of the client's assets. The District Court ruled that Smith was an investment adviser and granted the relief sought by the Commission including the issuance of an injunction. The Court relied upon the *Abrahamson* decision and rejected Smith's assertion that his activities fell within the *Loring* exception. The District Court distinguished *Loring*, noting that Loring's business consisted mainly of acting as a court fiduciary under wills and instruments filed with and under court supervision. The Court pointed out that none of Smith's business was performed under court supervision and all of it was performed under powers of attorney. The Court noted that the *Abrahamson* holdings applied to Smith because, like the general partners in *Abrahamson*, Smith sent clients investment performance reports and clients had the ability to withdraw money based on the reports. Smith, the court noted, went beyond the general partners as he encouraged clients to have him invest their money in particular types of investments.

25. From these authorities, several principles may be gleaned which are helpful to the resolution of this matter. First, the regulation of investment advisers is remedial, designed by Congress (and presumably California) to curb abuses by those whose business depends on advising others regarding investments in securities. As remedial legislation, the federal law has generally been interpreted in an expansive manner, resolving ambiguities regarding coverage of the act in favor of inclusion, for the benefit of investors. Thus, the *manner* in which client assets are held has not been a significant determining factor in deciding whether one has acted as an investment adviser. The management of trust assets, at least those in which the settlors retain the power to revoke the trust, may subject a trustee to regulation. There is also no requirement that the adviser *consult* with investors on a regular basis about investment decisions. Investment advisers include those who have exclusive discretionary power to manage investments, at least so long as the investors have the ability to withdraw funds. Also, the formula by which the investor is compensated has not been a major issue in deciding whether one manages investments "for compensation."

26. The one exception to coverage, carved out by the S.E.C. (as opposed to its enforcement staff), has been the investment in securities in the context of a trustee's administration of trust assets under court direction and with the safeguards inherent in such assignments. While the Commission's *Loring* opinion is nearly as old as the federal

Investment Adviser Act of 1940 itself, it has never been vitiated by the Commission and even the later opinion letters by the Commission's staff have sought to distinguish the *Loring* facts from those in cases in which the staff has concluded that the activities were those of an investment adviser. The District Court in *Selzer* relied upon *Loring* when concluding that a trustee is not an investment adviser, although the court's rationale based on the manner in which the trustee held assets as the principal, may no longer be viable. The more enduring rationale, enunciated in *Loring*, and at least implicitly recognized in the opinion letters of the Commission's enforcement staff, is the oversight of court created or sanctioned trusts by the courts with strict accountability provisions and bonding requirements for trustees to protect beneficiaries.

27. California has taken an additional regulatory step. In 2007, the California Legislature enacted the Professional Fiduciaries Act, Business and Professions Code section 6500 et seq., effective January 1, 2009. The Act requires that conservators and guardians for more than two persons and trustees and those acting under specified powers of attorneys for more than three persons or families must be licensed as professional fiduciaries by the California Department of Consumer Affairs. It is notable that investment advisers registered with the Department of Corporations are exempt so long as their sole business is investment advice. Concurrent changes were also made to the California Probate Code which now prohibit the court's appointment of a person to carry out the duties of a professional fiduciary without having a license to do so or an exemption.[6] The Act created the Professional Fiduciary Bureau within the Department of Consumer Affairs whose powers include the ability to discipline a licensee for misconduct including "fraud, dishonesty, corruption, willful violation of duty, gross negligence, or incompetence in practice, or unprofessional conduct in, or related to, the practice of a professional fiduciary." (Business and Professions Code section, 6584, subparagraph (d).) The Department of Consumer Affairs has promulgated regulations to interpret and implement the statutory provisions relating to professional fiduciaries, e.g., California Code of Regulations, title 16, section 4476, requiring licensees to avoid conflicts of interest.

28. Respondents Richard Cox and Richard Cox, doing business as Richard Cox Fiduciary Services, were not acting as investment advisers and this ground for the issuance of a Desist and Refrain Order cannot be affirmed.[7] The *Abrahamson* court reached the opposite conclusion in its interpretation of very similar language in the federal Investment

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[6] This prohibition was effective July 1, 2008.

[7] Respondents suggested during closing oral arguments on December 13, 2011, that this issue may be moot because respondent Richard Cox was licensed as an investment adviser until June 24, 2009, which would encompass virtually all of the purchases and sales of Fiduciary Investment, Inc. stock. However, complainant's position is that respondents' did not comply with applicable investment adviser regulatory requirements, and management of trust investments and the annual reports that respondent Richard Cox continues to provide beneficiaries require respondents to be licensed as investment advisers. Thus, the matter is not moot.

Adviser Act of 1940. As noted above, the case involved a limited partnership established for the express purpose of managing investments, and the court's analysis included that the activities of the general partners fit within the *plain language* of the federal statute. In contrast, respondents' activities do not fit within the plain language of section 25230. Respondents were not engaged "in the business of advising others… as to the value of securities or as to the advisability of investing in, purchasing or selling securities." Nor were they publishing analyses or reports concerning securities "as part of a regular business." Although respondents cannot technically qualify under the "trust company" express exemption, as professional fiduciaries, 2009, the newly created that is their business. The professional fiduciary responsibilities include the management of trust assets, including securities, but unlike the situations in which courts and the S.E.C. have determined that persons or entities were acting as investment activities, those with "beneficial ownership" did not place the assets in the hands of respondents to manage investments while retaining the power to withdraw all or part of the trust assets depending on the performance of the trustee. Moreover, the *Loring* exception, accepted by the S.E.C. and courts, is primarily justified by the supervision inherent in court monitored trusts. Whether court supervision is active or passive, all of the trusts managed by respondents are subject to court oversight. Many initially required a bond to protect the beneficiaries, although most of the special needs trusts no longer include such a requirement because of the diminution of trust assets paid out for the benefit of the special needs life beneficiary. And, as noted, California has added another layer of consumer protection by requiring all professional fiduciaries to be licensed and subject to discipline for violations of professional standards including those dealing with conflicts of interest.

29. None of the three grounds for the issuance of a Desist and Refrain Order was established by counsel for complainant. Thus, the Desist and Refrain Orders previously issued should be dissolved. Each of the grounds presented complex legal issues and sub-issues and applicable law is anything but clear. The thrust of complainant's case was the underlying premise that the trust beneficiaries are unprotected from alleged self -dealing and fraud by respondents unless respondents' investment decisions are regulated by the Commissioner for the benefit of the beneficiaries. However, respondents have not been acting in a regulatory vacuum as each of the trusts for which respondent Richard Cox and Richard Cox Fiduciary Services serves as trustee is subject to the supervision of California probate courts with the power to address claims of inappropriate conduct and to provide relief. One probate court recently did so with the temporary removal of respondent Richard Cox as trustee for the Russell Decedents' Trust. As of 2009, the newly created Professional Fiduciary Bureau of the California Department of Consumer Affairs licenses and regulates professional fiduciaries including respondents Richard Cox and Richard Cox Fiduciary Services. The Legislature by statute, and the Department by rule, have established standards of conduct including prohibitions against fraud and self-dealing the violation of which may result in the revocation of the professional fiduciaries license. The position taken by counsel for complainant in this matter would require that virtually *all* trustees of court supervised trusts who invest in securities be licensed as investment advisers, a more expansive interpretation of applicable law than the S.E.C. on whose decisions complainant has historically relied.

ORDER

The Desist and Refrain Orders issued by the Commissioner of Corporations against respondents based on allegations of unlawful sale of unqualified securities and unauthorized activities as a broker-dealer and investment adviser are dissolved.

Dated: January 11, 2012

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KARL S. ENGEMAN
Administrative Law Judge
Office of Administrative Hearings