

# Utah Division of Securities

## Guidance on Educational Companies and Proprietary Trading Firms

### July 30, 2014



The Utah Division of Securities (“Division”) has received a number of inquiries regarding business models that provide some or all of the following services:

- Training courses and/or mentorship programs to teach individuals how to trade securities, including but not limited to stocks, options and forex.
- Prop trading opportunities whereby individuals who receive company training can trade the company’s funds through membership or subscription.
- Auto-trading or mirror trading services whereby individuals can pay for trading signals that are automatically executed in client accounts.

While the particulars vary widely from company to company, the Division offers the following guidance on educational services and unregistered proprietary trading firms.

### **EDUCATION vs. ADVICE**

Many companies offer educational services, including mentoring services, whereby clients are taught how to trade securities and other financial instruments without being required to license as investment advisers. However, the narrow distinction between investment advisers and educational companies is largely based on the nature of the services offered and the compensation arrangements for such services.

An investment adviser is defined under §61-1-13(1)(q)(i) of the Utah Uniform Securities Act (“Act”) as: “a person who: (A) 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 (B) for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.”

In terms of services, for a company to be considered strictly educational, the content of its curriculum must be sufficiently general in scope and limited in application. When curriculum is narrowly tailored to a singular investment strategy, the instruction may be deemed investment advice. In particular, companies that teach individuals to use specific algorithms, select indicators, or certain trading signals—often sold as a uniquely successful system created by the company founder or licensed exclusively to the company—are, in effect, providing recommendations on when to buy and sell (market timing advice) or issuing reports or analyses (how to interpret the algorithm, indicators, or trading signals). In any case, if the company does not provide sufficient breadth in its curriculum, the education may be considered advice.

Moreover, if the application of educational content involves the live entry of transactions in a client's own account (or the company's account as discussed below), the "education" offered may be considered non-discretionary or discretionary management, insofar as the client acts in concert with their instructors. Educational companies that offer ongoing training (often through mentorship or coaching programs) or actionable trading information (whether used directly by the recipient or through auto-trading or mirror trading platforms) may also be rendering investment advice through such communication.

In terms of compensation, if a company charges fees based on a percentage of assets or based on performance, those compensation structures denote an advisory relationship between the company and clients. However, even fixed fees or hourly fees may be considered advisory compensation if the nature of the services includes the direct or indirect rendering of investment advice (e.g. discretionary or non-discretionary portfolio management, auto-trading, mirrored trading, issuing trading signals or recommendations, etc.).

If an educational company is determined to be acting as an investment adviser, it is required to license under §61-1-3 of the Act and becomes subject to oversight by the Division or the Securities and Exchange Commission ("SEC"), depending on the level of assets under management, among other factors.

## **MARKETING CONCERNS**

Various marketing practices employed by educational companies also present some noteworthy concerns for the Division.

Acquiring new clients often creates an incentive for educational companies to highlight or only report favorable returns resulting from their training. Selective performance reporting—a practice known as "cherry picking"—would be deemed a dishonest and unethical business practice for licensed investment advisers, but securities regulators may consider such practices to be securities fraud<sup>1</sup> regardless of licensing status. In addition to performance reporting, many educational companies employ testimonials, touting credentials, and sales puffery in sales materials that would be also deemed dishonest and unethical for a licensed investment adviser to use and possibly securities fraud.

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<sup>1</sup> In 2008, the SEC filed civil fraud charges against Linda Woolf and David Gengler, former speakers for "Teach Me to Trade" securities trading workshops, and their related companies, for false and misleading statements in televised infomercials and investor workshops (see: <http://www.sec.gov/litigation/litreleases/2008/lr20486.htm>).

In 2009, the SEC filed civil fraud charges against Investools Inc., Michael J. Drew and Eben D. Miller for misleading and false advertising about their trading success and prospective success for those who attended their training workshops (see: <http://www.sec.gov/litigation/litreleases/2009/lr21331.htm>).

In 2011, the SEC filed civil fraud charges against Long Term-Short Term, Inc., (dba BetterTrades) and Freddie Rick for its instructors making false claims about their trading success and touting the success of the company founder (see: <http://www.sec.gov/litigation/litreleases/2011/lr22133.htm>).

Separate from sales materials, the Division also has concerns when educational companies use aggressive sales practices, namely free-meal seminars and multi-level marketing, to attract new clients. While such practices may not violate securities laws inherently, the Division has found numerous violations within free-meal seminars and consistently issues warnings about these events. With multi-level marketing, the licensing concerns for educational companies may extend down the organization, as soliciting advisory services requires licensing as an investment adviser representative.<sup>2</sup>

Ultimately, securities laws seek to protect investors through required disclosures and regulation of sales materials used by licensed entities. Legitimate educational companies may not require licensing, but the lack of oversight raises concerns about the sales materials and practices of these companies.

## **PROP TRADING**

A growing concern has been the proliferation of companies purporting to be proprietary trading firms (or “prop trading firms”). Traditional prop trading firms have been internal departments, divisions, or subsidiaries of broker-dealers or other financial institutions that manage the firm’s trading accounts, often in a principal capacity. In other words, prop trading is the in-house trading conducted by institutions.

However, many companies are claiming to operate as prop trading firms when their business model is clearly different. Many of these prop trading firms require investors to pay large fees (e.g. educational course fees, enrollment fees, membership fees, technology fees, deposits) that range from hundreds to thousands of dollars for the access to trade the company’s money, use its software or information, and retain a portion of the profits earned. The attraction is clear: learn to trade, hone your skills with the company’s money, and keep some of your profits. However, such prop trading firms present a myriad of regulatory concerns.

### ***Firm Licensing***

First and foremost, the Division requires prop trading firms to license as broker-dealers. The Act defines broker-dealers as: “...a person engaged in the business of effecting transactions in securities for the account of others or for the person’s own account.”<sup>3</sup>

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<sup>2</sup> §61-1-13(1)(r)(i) of the Act defines an investment adviser representative as: “...a partner, officer, director of, or a person occupying a similar status or performing similar functions, or other individual, except clerical or ministerial personnel, who (A)(I) is employed by or associated with an investment adviser who is licensed or required to be licensed under this chapter; or (II) has a place of business located in this state and is employed by or associated with a federal covered adviser; and (B) does any of the following: (I) makes a recommendation or otherwise renders advice regarding securities; (II) manages accounts or portfolios of clients; (III) determines which recommendation or advice regarding securities should be given; (IV) solicits, offers, or negotiates for the sale of or sells investment advisory services; or (V) supervises employees who perform any of the acts described in this Subsection (1)(r)(i)(B).

<sup>3</sup> §61-1-13(1)(c)(i) of the Act.

Many prop trading firms erroneously believe that so long as the firm only trades its own account, it does not meet the definition of broker-dealer or is somehow exempt from licensing requirements. The Act's definition clearly includes such activity, and the Act offers no exemptions for prop trading firms, which are required to license under §61-1-3 of the Act. Recently, the SEC also indicated that it may consider "a rule to clarify the status of unregistered active proprietary traders" and would make them subject to SEC rules as dealers.<sup>4</sup>

### ***Capital Raising***

A secondary regulatory concern is the source of the prop trading firm's capital. Where traditional prop trading firms manage the institutional assets of the firm, the Division has concerns that non-institutional prop trading firms may engage in corporate finance activities, thereby triggering notice-filing or registration requirements.

If the "trainees" of the prop trading firm invest monies, directly or indirectly, the trainees should become principals in the firm, but, in any case, the prop trading firm would be considered an issuer and its account would be considered a pooled investment vehicle requiring proper registration, notice filing, or exemption under §61-1-7 of the Act.

If the prop trading firm has relied on capital from other investors (not trainees), the nature of these investors (i.e. whether they are accredited investors) would determine whether the prop trading firm could rely on an exemption under §61-1-7 of the Act and which exemption may be available.

If the prop trading firm relies exclusively on its principal's capital (not trainees), the Division would likely have no corporate finance concerns so long as the principals remain active participants in the business and not passive investors (i.e. they are engaged in day-to-day management of the company).

### ***Traders and Licensing***

Prop trading firms may also expose their trainees to the liability of acting as unlicensed agents or investment adviser representatives. As prop trading firms should be licensed as broker-dealers, their traders should be licensed as agents.<sup>5</sup> Evaluated independently, however, individuals receiving compensation (typically a percentage of profits) for managing a securities portfolio for the company would require the individual to license as an investment adviser representative. The Division cautions individuals seeking either educational services or employment as a prop trader that they may be acting as unlicensed agents or investment adviser representatives in violation of §61-1-3 of the Act.

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<sup>4</sup> SEC Chair Mary Jo White, "Enhancing Our Equity Market Structure." Speech, Sandler O'Neill & Partners, L.P. Global Exchange and Brokerage Conference, New York, NY, 5 June 2014.  
<http://www.sec.gov/News/Speech/Detail/Speech/1370542004312#.U865XPldUuc>

<sup>5</sup> §61-1-13(1)(b)(i) of the Act defines an agent as: "...an individual other than a broker-dealer who represents a broker-dealer or issuer in effecting or attempting to effect purchases or sales of securities."

## ***Products & Fees***

Investors should be wary of the fine print with these unregistered prop traders. In addition to the various types of fees charged, the Division has found many prop trading firms often impose conditions and restrictions on the dollar amount their prop traders are authorized to trade.

In some instances, the prop trader is required to deposit funds to cover any losses incurred and loses access when losses exceed the deposited amount. When deposits are required from the prop trader, the Division does not consider these companies to be true prop trading firms and would likely consider the deposits as investments in the company, subjecting the company to corporate finance rules (see the *Capital Raising* section above).

In other instances, the rules for gaining access (or higher levels of access) to the firm's assets are engineered to prevent such access. Often this is a means to continue charging different types of recurring fees or selling additional educational services. Sometimes the prop trading aspect of the educational business is used merely as a marketing tool, particularly when used in conjunction with multi-level marketing models.

As with all investments, investors should carefully review the contractual arrangements to ensure they understand the fee structure, the conditions for access, and the licensing requirements for both the firm and the individuals.

## **CONTACT THE DIVISION**

While the Division cannot provide business or legal advice, and nothing herein should be construed as such, Division staff can assist in providing guidance for investors and companies seeking to remain compliant with securities laws and regulations. For additional information, please feel free to contact the Division at (801) 530-6600.