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Blue Sky Regulation

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1 Blue Sky Regulation About the Author

About the Author

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1 Blue Sky Regulation General Editor (1994-2002)

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1 Blue Sky Regulation Acknowledgments

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Robert N. Rapp



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What's New

1 Blue Sky Regulation Scope

Scope

HIGHLIGHTS

Release 92 August 2010

This release contains updates to:

Chapter 7, Exempt Securities

Indiana State Guide

South Carolina State Guide

In this Release Chapter Seven--"Exempt Securities"--has been substantially rewritten, and State Guides for Indiana and South Carolina have been updated to reflect the adoption in those states of the 2002 Uniform Securities Act. These states now join Georgia, Hawaii, Idaho, Iowa, Kansas, Maine, Michigan, Minnesota, Missouri, Oklahoma, South Dakota, and the U.S. Virgin Islands in adopting the 2002 Uniform Act, which is designed to bring state securities regulation fully into line with the National Securities Market Improvements Act of 1996 (NSMIA). That is also the theme of newly rewritten Chapter Seven, which focuses on the array of security exemptions from registration requirements of Blue Sky laws in the post-NSMIA world.

The operation, and indeed the relevance, of certain security exemptions in Blue Sky laws have been directly affected by NSMIA, which established classes of federal "covered securities" that are no longer subject to state registration or qualification requirements without regard to any state exemption. NSMIA includes as federal covered securities those exempt as a matter of federal law under various parts of Section 3 of the Securities Act of 1933, several of which overlap with common exemptions in Blue Sky laws. Other than in states which have moved to the 2002 Uniform Securities Act as the model for their securities laws, states continue with the array of exemptions that is largely based on the original Uniform Securities Act, and which today in many instances have only nuanced applications by reason of the scope of federal exemptions. States preserved the full array of security exemptions because in some instances they may be broader than the counterpart federal exemption. Newly rewritten Chapter Seven addresses the continued vitality of various state exemptions and their meaningful application after NSMIA.

1 Blue Sky Regulation Scope

Chapter Seven also now fully integrates the 2002 Uniform Securities Act into the broader construct of state securities laws still based on the original Uniform Act, and those in Non-Uniform Act states. Another important new element of the chapter is the integration of the State Guides which now comprise Volumes Three and Four of the Treatise. The State Guides were added to the Treatise in its Second Edition, and today, on an on-going basis, address security exemptions uniquely in the context of an individual state Blue Sky law, thus eliminating the former charting of exemptions in Chapter Seven. The State Guides also allow for attention to special purpose or other unique exemptions adopted in particular states. Full attention is given in the text of Chapter Seven, however, to the common Blue Sky security exemptions and the extent of their continuing application. "World class securities" have also been added to the security exemption mix. And overall, there is expanded attention in Chapter Seven to administrative authority over security exemptions, with the focus on enforcement-related powers.

As Indiana and South Carolina have joined the increasing number of states adopting the 2002 Uniform Securities Act, the trend to modernization of Blue Sky laws continues. In an era of major financial regulatory reform, the investor protection role of state securities regulation will be carried out in a new regulatory environment. Modernization of Blue Sky laws will be essential to the continued achievement of the historic investor protection objectives of state securities regulation. The South Carolina Uniform Securities Act of 2005 (which became effective January 1, 2006), and the Indiana Uniform Securities Act (which became effective July 1, 2008), are two examples of continuing modernization initiatives designed to assure that robust state regulation will remain an essential part of the national market regulatory construct. Their updated State Guides also feature recent additions to the selected enforcement topics.



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CHAPTER 1 Introduction To Blue Sky Regulation

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§ 1.syn Synopsis to Chapter 1: Introduction To Blue Sky Regulation

§ 1.01 The Role of State Securities Regulation

§ 1.02 The Historical Development of Blue Sky Laws

[1] The Early Laws

[2] The Blue Sky Cases of 1917

[3] Dual State/Federal Regulation

[4] The National Securities Markets Improvement Act of 1996 ("NSMIA")

[5] The Securities Litigation Uniform Standards Act of 1998

§ 1.03 The Uniform Securities Act(s)

§ 1.04 The Blueprint for Regulatory Reform and the Future of Blue Sky Regulation



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CHAPTER 1 Introduction To Blue Sky Regulation

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§ 1.01 The Role of State Securities Regulation

State securities regulation has been part of the American legal landscape since the early days of the Twentieth Century. Kansas is credited with adoption of the first "Blue Sky Law" in 1911. There were earlier statutes in some states that touched upon aspects of the offer and sale of stock or other securities in certain contexts, but as a product of the surging agrarian Populism movement the Kansas statute was the first general securities law. By providing for registration of securities and licensing of securities salespersons, Kansas established the key elements of regulation that would form the core of legislation in nearly all states to follow, and which would eventually be embodied in the first Uniform Securities Act promulgated in 1956.

From the beginning, state securities regulation was paternalistic. While the entire scheme of federal securities regulation that came two decades later is grounded in the generation and dissemination of information upon which informed investor decision--making is possible, the premise of state regulation has always been to protect the public from fraud and insubstantial or speculative offerings.ⁿ¹ State authority is thus interposed between issuers, intermediaries and the investing public to assure that what is presented for consideration by potential purchasers is sound in the first place, and that the people involved in the selling process are of good repute. Although much has changed over the years in the extent to which state administrators carry out that mission, and in their authority to do so, it remains constant that state securities laws operate to protect those who are unable to protect themselves, to assure to the greatest extent possible that those central to the process of creating and distributing securities are of the highest integrity, and to police against fraud.

Blue Sky laws today, with some variations and degrees of emphasis, involve three principal elements of regulation, all of which are considered in detail throughout this Treatise. They are:

(1) *Securities Registration*. Unless exempted, excluded by definition, or outside the scope of state authority by reason of federal preemption,ⁿ² every security offered or proposed to be offered in a state is, almost universally, subject to registration under Blue Sky laws. The process is in many cases streamlined and uniform, but the fundamental requirement is for submission of registration materials and approval by the state administrator prior to offering the security. An early element of state authority in this process was "merit" review, in which state administrators reviewed the terms and aspects of securities against qualitative fairness standards to determine their soundness and make judgments whether to permit the offering. Over time a number of states abandoned direct merit regulation of securities offerings, and others significantly altered the extent to which it would be applicable. The trend away from full scale

merit review of offerings reflected increasing recognition that its protection was simply not needed in some settings, or that the goal of investor protection was accomplished through other means. With substantial federal preemption of the merit review authority of the states in 1996, the traditional role of Blue Sky laws in securities offerings became even more circumscribed.

Nevertheless, merit review remains a part of the regulatory process in a significant number of states. Today, it is largely facilitated by application of uniform "guidelines" developed by the North American Securities Administrators Association (NASAA) for particular types securities or offerings, or to address common items of concern in offerings generally. There are also cooperative efforts and programs among states to make the process efficient in circumstances involving multi-state offerings.

Whether or not merit review is applicable in a particular state,ⁿ³ registration requirements remain in place, all of which mandate some form of registration statement or submission to the administrator, and all of which involve a mechanical process of approval or determination of effectiveness as a condition to offering a security in the state.ⁿ⁴ To be sure, by largely tracking the array of exempt securities and transactions contained in the Securities Act of 1933, and as implemented through SEC Regulations, securities offerings in many circumstances will not be subject to compliance with registration provisions of Blue Sky laws, or will involve only minimal notice filing requirements. Still, the registration element of state securities regulation remains in place, and is of central importance in settings in which the historic role of Blue Sky laws to protect against insubstantial or fraudulent investment schemes is accomplished.ⁿ⁵

In considering the registration element of Blue Sky laws, careful attention must be given to key definitions of "security" and "offer" or "sale" that are a part of each state law. The very broad definitions of these terms define the scope of state regulatory authority, and in particular the application of registration requirements. In the wake of NSMIA, which preempted state authority to regulate most securities offerings that are national in character, state securities administrators now more than ever focus attention on the application of registration requirements to the local or regionalized offer and sale of unconventional classes of securities, such as those falling under the heading of "investment contracts," or to debt instruments, or participations in other "investment" oriented enterprises or programs. Every such security is subject to registration requirements under state laws, and the failure to do so subjects issuers and intermediaries to enforcement actions as well as potential civil and criminal liability.

(2) *Intermediary Regulation.* The licensing of investment intermediaries has always been a part of state securities regulation. Broker-dealers, agents or salespersons, and today investment advisers and their representatives, must (subject to some de minimis exceptions) be licensed in each of the states in which they do business.ⁿ⁶ Although broker-dealers and large investment advisers may be "registered" as such with the U.S. Securities and Exchange Commission under provisions of the federal securities laws, there is no federal licensing involved. This function has always been reserved to the states, and remains so in the wake of other federal preemption of state authority in the area. Licensing of intermediaries by the states involves qualitative assessments of business and personal repute, and assessments of the competency or fitness of an individual to engage in securities activities. Securities broker-dealer firms are commonly governed by financial responsibility and business conduct rules set by the SEC and the self-regulatory organizations to which the firm belong. Thus, while states, both by statute and administratively, establish qualifications for licensing, they are more often satisfied by meeting requirements externally established. Individuals likewise satisfy state competence requirements by passing one or more uniform examinations applicable either to securities or investment advisory activities. The greater focus by state administrators in the initial licensing process for an intermediary is on background, and a determination of character and fitness to engage in the business.

Intermediary regulation is an on-going process under Blue Sky laws. Licenses are generally subject to annual renewal, and regulated firms and investment advisers are subject to periodic inspection. Through access to centralized databases, state administrators review current reporting of complaints, proceedings or disciplinary actions involving licensed individuals and firms, and may act administratively at any point to initiate suspension or revocation proceedings. Blue Sky laws also contain reporting and bookkeeping requirements for intermediaries, all subject to review as part of the

1-1 Blue Sky Regulation § 1.01

renewal and on-going inspection processes, and they may also impose bonding or other financial responsibility requirements that impact particular intermediaries.ⁿ⁷ State administrators are likewise increasingly active in policing conduct of individuals "away" from broker-dealer or advisory firms with which they are associated, and in both assessing and enforcing accountability for *supervision* by intermediaries over those who engage in securities activities in the state.

Although the historic role of state securities regulation in the securities registration context has changed with the times and as a matter of federal preemption, in the area of intermediaries it remains true to its mission of investor protection by policing the conduct of those firms and individuals who are central to the offer and sale of securities, and through licensing, focusing on their integrity. In the wake of NSMIA and federal preemption, intermediary regulation is today the central aspect of Blue Sky laws because it remains an avenue by which administrators may indirectly control the quality of what is offered for sale by directly regulating the quality of persons who carry it out, and policing them in the process. This is particularly true when coupled with the third principal element of state securities regulation--antifraud and enforcement--discussed below.

(3) *Antifraud and Enforcement.* Above all, state securities regulation is aimed at preventing and redressing fraudulent and abusive practices. Blue Sky laws empower administrators to act in a variety of ways to deal with fraud and fraudulent practices. Merit review in the securities registration process is in several states expressly geared to a determination whether the terms of a particular security or offering are such that the offering would tend to work a fraud on purchasers, and administrative power to suspend or revoke the effectiveness of an offering are likewise keyed to such determinations. Antifraud enforcement authority of the states was expressly preserved by NSMIA, regardless of whether regulatory authority over an offering is otherwise preempted.ⁿ⁸ Likewise, states retain full authority to act against fraud by intermediaries.ⁿ⁹

Overall, Blue Sky laws typically premise antifraud enforcement authority either by defining violations or setting out prohibited practices in terms akin to federal provisions, as exemplified in Michigan:

It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly:

- (1) To employ any device, scheme, or artifice to defraud.
- (2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading.
- (3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.ⁿ¹⁰

The extent to which protection against fraudulent practices is a paramount goal of Blue Sky laws is no better evidenced than by New York's "Martin" Act,ⁿ¹¹ which, but for relatively simple filing provisions covering securities offerings and qualification requirements for intermediaries, is essentially a fraud statute. As its main thrust, the New York law grants broad authority to the Attorney General to investigate and require, or take, other actions whenever it appears in connection with any security transaction or investment advice that any person: "[s]hall have employed, or employs, or is about to employ any device, scheme or artifice to defraud or for obtaining money or property by means of any false pretense, representation or promise...".ⁿ¹² Actual prohibited conduct under the New York law is also almost entirely defined in antifraud terms. New York is unique in its nearly singular focus on fraud, yet it clearly illustrates the importance of the antifraud mission in state securities regulation generally.

The arsenal of enforcement weapons available to state administrators in dealing with fraud varies, but most often includes authority to issue cease-and-desist orders; to bring injunctive actions seeking the full range of equitable and ancillary remedies;ⁿ¹³ to impose civil money penalties; and to make criminal referrals. These remedies are supported by considerable investigative powers,ⁿ¹⁴ and the power of state administrators is construed broadly in order to protect the investing public.

New York's Martin Act notwithstanding, Blue Sky laws today incorporate all three key elements of regulation discussed above. In large measure, this is a result of the adoption, in whole or part, of the 1956 Uniform Securities Act by some thirty-seven states, or the 1985 Revised Uniform Securities Act in a handful of others. Today an entirely new 2002 version of the Uniform Securities Act is available, and has been adopted in several states. The Uniform Acts, discussed further in *section 1.03 below*, apply the full range of state regulatory authority in the securities registration, intermediary licensing and antifraud enforcement contexts. Non-Uniform Act states likewise combine all three elements. All states have been impacted by NSMIA. However, the end result of the preemption of state authority where NSMIA covered securities are involved is the reorientation of Blue Sky regulation to investor protection against myriad schemes, scams and abusive practices that is wholly consistent with the historic mission of the laws and the exercise of police power of the states. The role of state securities regulation today to protect against insubstantial and fraudulent investment schemes, and to police the activities of intermediaries who would promote them has never been better defined, and the power of state administrators has never been more focused since the early days of the Twentieth Century. State securities administrators today direct their resources efficiently and effectively within jurisdictional limitsⁿ¹⁵ to interdict the offer and sale of a vast range of unregistered securities that still "have no more basis than so many feet of blue sky," and to assure to the greatest extent possible that the people who offer, promote and advise or arrange investments meet licensing criteria based on competence and integrity.

The necessary perspective for understanding the role of state securities regulation today is found in its historical development from the early laws through evolution of the dual federal/state system of securities regulation and ultimately the redefinition of the state and federal roles in NSMIA. This development is explored in *section 1.02 below*.

FOOTNOTES:

(n1)Footnote 1. The term "blue sky law" itself is an expression of the goal of the states to protect the investing public from fraud and insubstantial speculative securities offerings "which have no more basis than so many feet of blue sky" *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550, 37 S.Ct. 217, 220, 61 L. Ed. 480 (1917) ("The name that is given to the law indicates the evil at which it is aimed; that is, to use the language of a cited case, 'speculative schemes which have no more basis than so many feet of blue sky;' or, as stated by counsel in another case, 'to stop the sale of stock in fly-by-night concerns, visionary oil wells, distant gold mines, and other like fraudulent exploitations.' "); See also *SEC v. Steadman*, 798 F. Supp. 733, 738 (D.D.C. 1991) ("[S]tates may exercise their police power to protect the public against speculative schemes which have no more basis than so many feet of 'blue sky' ").

(n2)Footnote 2. The National Securities Markets Improvement Act of 1996 ("NSMIA"), 110 Stat. 3416 (1996), brought fundamental changes in the dual system of federal and state securities regulation in the United States. NSMIA created defined classes of "covered securities," over which state regulatory authority was preempted. The particular impact of NSMIA in the offering context, as well as its application in other areas of state regulatory authority is discussed further in *section 1.02[4], below* , and is addressed throughout the Treatise.

(n3)Footnote 3. The full scope of merit review in state securities regulation today, with particular consideration of the impact of NSMIA, is discussed in Chapter 6, *below*.

(n4)Footnote 4. The mechanics of registration under state Blue Sky laws are presented in Chapter 5, *below* .

(n5)Footnote 5. See *Technomedical Labs v. Utah Sec. Div.*, 744 P.2d 320, 324-325 (Utah Ct. App. 1987) (State has a valid public interest in stopping the issuance of public shares in an offering that does not comply with disclosure requirements that are a part of registration).

(n6)Footnote 6. There are some variations among the states in the scope and application of intermediary licensing requirements, although most states have elaborate mechanisms for application and licensing. In practice, much of the mechanical process has been automated through the development of the Central Registration Depository ("CRD") and the Investment Adviser Registration Depository ("IARD"), both operated by the National Association of Securities Dealers, Inc. (NASD). The state licensing process for intermediaries is considered in detail in Chapter 11, *below*.

(n7)Footnote 7. As discussed in Chapter 11, *below*, after NSMIA the authority of states to impose bookkeeping and financial responsibility requirements on intermediaries has been limited so as to assure uniformity. States are not, however, precluded from imposing such requirements, and they remain a part of many Blue Sky laws.

(n8)Footnote 8. Section 18(c)(1) of the Securities Act of 1933, 15 U.S.C. § 77r(c)(1), added as part of NSMIA, provides:

Consistent with this section, the securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions.

(n9)Footnote 9. Section 18(c)(1) of the Securities Act of 1933, 15 U.S.C. § 77r(c)(1).

Where NSMIA "covered" securities are involved, drawing the line between what fraud-based enforcement authority is preserved and what constitutes impermissible regulation may not be an easy task. Preservation of fraud authority in the offering context is discussed in Chapter 5, and in the enforcement setting in Chapter 14, *below*.

(n10)Footnote 10. *Mich. Comp. Laws § 451.501 [101]*.

(n11)Footnote 11. N.Y. Gen. Bus. Law, Ch. 20, Art. 23-A.

(n12)Footnote 12. N.Y. Gen. Bus. Law, Ch. 20, Art. 23-A, § 352.1.

(n13)Footnote 13. In some instances the scope of remedies available to administrators includes the authority to make a claim for money damages on behalf of defrauded investors, *see, e.g., Colo. Rev. Stat. § 11-51-602*. In *Feigin v. Alexa Group, Ltd.*, 19 P.3d 23 (Colo. 2001) (*en banc*), the Colorado Supreme Court rejected an attempt by investors to intervene in an action brought by the Colorado Commissioner of Securities seeking such relief. The Court concluded, among other things, that the Commissioner, who is charged by the legislature with representing investors' interests and protecting them against fraud, adequately represented the investors' interests in being compensated for their losses.

(n14)Footnote 14. Enforcement authority and investigative powers are discussed in detail in Chapter 14, *below*.

(n15)Footnote 15. Jurisdictional limits of Blue Sky regulatory authority present particular challenges in the age of the Internet, and the simplicity with which investment promoters may reach a limitless audience from virtually anywhere. This and other important considerations in determining the scope of state regulatory authority are discussed in detail in Chapter 4 (State Jurisdiction) and Chapter 12 (Blue Sky Laws and the Internet), *below*.



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CHAPTER 1 Introduction To Blue Sky Regulation

1-1 Blue Sky Regulation § 1.02

§ 1.02 The Historical Development of Blue Sky Laws

[1] The Early Laws

Blue Sky laws and their antecedents may represent the earliest form of consumer protection legislation in the history of the nation. Although the first comprehensive general securities law was enacted in Kansas in 1911, forms of state securities regulation actually appeared much earlier. In 1852, for example, Massachusetts enacted legislation that prohibited any railroad company from building its road until it had filed a certificate with the state that "responsible parties" had subscribed to all of its stock, and that at least 20% of the par value of each share had actually been paid into the treasury of the company.ⁿ¹ Investor protection through requirements on the escrow and use of proceedings of an offering would become common elements of state securities laws in the next century.

In the early part of the Twentieth Century state regulation of securities issued by public utilities was introduced, and during the same period at least two states, Connecticut,ⁿ² and Nevadaⁿ³ adopted laws aimed at regulating offers of securities of mining companies. Connecticut prohibited such offerings unless a certificate was filed with the Secretary of State showing financial condition, location and plans of properties and other information regarding the particular project. A few years later the state made the offer and sale of shares of oil or mining companies conditional on administrative approval.ⁿ⁴ Other early statutes that touched upon securities appeared in California, Missouri and Rhode Island.ⁿ⁵ The states, of course, had always regulated corporate affairs, including mergers, sales of assets, capital structure and other aspects of corporation law that touched upon the issuance of stock.ⁿ⁶ Kansas, however, adopted the first general securities law in 1911.

The Kansas Blue Sky lawⁿ⁷ provided for registration of securities and licensing of securities salespersons. No security covered by the act could be sold in the state unless a "permit" was issued. Standards for issuing permits were included, and investigative authority established. With the passage of the Kansas statute, full scale securities regulation among the states took hold. Indeed, a perceived proliferation of "blue sky" schemes, especially those originating in eastern financial centers that preyed upon the agrarian West and Midwest, ignited the spread of state securities laws throughout the Midwest, West and the South. The early laws were quite restrictive, allowing few exemptions from registration requirements, and establishing broad enforcement powers for administrators. By 1913 twenty-three more states had enacted securities laws, and within a decade after the Kansas law virtually all states had passed laws governing the sale of securities. The impetus was a subject of this U.S. Supreme Court commentary in 1917:

[T]he judgment [regarding the expediency of official investigations into the soundness, good faith

1-1 Blue Sky Regulation § 1.02

and prospects of companies] is for the state to make, and in the belief of evils and the necessity for their remedy the state has determined that the business of dealing in securities shall have administrative supervision, and twenty-six states have expressed like judgments.ⁿ⁸

The quoted passage communicates the impetus for state securities regulation but also suggests the constitutional challenge to the exercise of state authority that was inevitable. The extent to which the states could exercise police power to regulate the offer and sale of securities and the business of dealing in them led to a series of cases in 1917 in which the U.S. Supreme Court validated state securities laws under both the *Fourteenth Amendment* and the Commerce Clause of the U.S. Constitution.

[2] The Blue Sky Cases of 1917

In early challenges to the constitutional validity of state securities laws, lower federal courts in Iowa, Michigan, Ohio and West Virginia held Blue Sky laws unconstitutional on grounds that they impermissibly burdened interstate commerce, and violated the *Due Process Clause of the Fourteenth Amendment*.ⁿ⁹ The latter challenge focused on the licensing power of states under their Blue Sky laws, and particularly the power to revoke or refuse to renew the license of an intermediary on grounds such as those included in the Ohio statute that the licensee is of "bad business repute." Such power, it was argued, was exercised without any standard or guide, and left room for purely personal or arbitrary determinations.

On the broader issue of authority, states had long been denied the power to regulate interstate commerce directly, or discriminatorily, or to take steps that had unjustified consequences in other states. Nevertheless, the police power of states was also firmly established, and in a trilogy of cases decided by the United States Supreme Court in 1917, the broad authority of state administrators to regulate trade in securities was held to be within both that police power and the confines of the Due Process Clause.ⁿ¹⁰ As to any asserted burden on commerce, the Supreme Court observed:

[W]e think that the statute under review is within the power of the state. It burdens honest business, it is true, but burdens it only that, under its forms, dishonest business may not be done. This manifestly cannot be accomplished by mere declaration; there must be conditions imposed and provision made for their performance.ⁿ¹¹

The fact that Blue Sky regulation applied only to sales of securities and licensing of persons who deal in them within the borders of a state mitigated any Commerce Clause concerns. The Court declared:

The provisions of law, it will be observed, apply to dispositions of securities within the state, and while information of those issued in other states and foreign countries is required to be filed ... they are only affected by the requirement of a license of one who deals in them within the state. Upon their transportation into the state there is no impediment, no regulation of them or interference with them after they get there. There is the exaction only that he who disposes of them there shall be licensed to do so, and this only that they may not appear in false character and impose an appearance of a value which they may not possess, and this certainly is only an indirect burden upon them as objects of interstate commerce, if they may be regarded as such. It is a police regulation strictly, not affecting them until there is an attempt to make disposition of them within the state. To give them more immunity than this is to give them more immunity than more tangible articles are given, they having no exemption from regulations the purpose of which is to prevent fraud and deception. Such regulations affect interstate commerce in them only incidentally.ⁿ¹²

As for concern that state licensing authority could be exercised arbitrarily, the Supreme Court was satisfied that state laws provided for judicial review of administrators' decisions, and that a safeguard against abuse was thus created.ⁿ¹³

With the Blue Sky Cases of 1917 the way was prepared for widespread enactment of Blue Sky laws, with only occasional, and largely unsuccessful,ⁿ¹⁴ challenges to particular provisions. Blue Sky laws have been seen as regulating evenhandedly, as effectuating legitimate state interests, and as having only incidental effects on interstate commerce.ⁿ¹⁵ The premise, however, was ultimately challenged as Blue Sky laws were amended to include anti-takeover provisions or other provisions involving direct intervention in corporate affairs. These undertakings, crafted by state legislatures as a response to a rising tide of hostile takeovers, sought to bring within the administrative authority of state securities regulators the power to subject takeover bids directed to security holders to administrative review of fairness, and to empower administrators to block tender offers from proceeding. Jurisdiction to adopt and enforce such provisions was variously based on the presence of substantial assets of a target company within the state, or incorporation of the target company in the state. They renewed Commerce Clause concerns by reason of the authority conferred on state administrators effectively to regulate transactions conducted across state lines and in some cases wholly outside a state.

In *Edgar v. MITE Corp.*,ⁿ¹⁶ the U.S. Supreme Court struck down the Illinois Business Takeover Act, adopted as part of the state's Blue Sky law, as an unconstitutional burden on interstate commerce. As with many such provisions adopted at the time, the Illinois law imposed several requirements upon a tender offeror prior to communicating any offer to shareholders. Requirements included advance notification and submission of materials, to be followed by a fairness hearing in which the state administrator could determine whether the offer should be permitted to proceed. The Court held that the provision gave the state power to block an interstate tender offer, and to exercise authority wholly outside the state by imposing requirements having the power to block transactions based only on the fact that a target company had substantial assets within the state.

Generations of state anti-takeover laws evolved, and are discussed further in considering the scope of state jurisdiction under Blue Sky laws in Chapter Three of this Treatise. In the history of Blue Sky laws, however, the constitutional debate over such laws both at their inception and again in the MITE line of cases has well illustrated that the single constant in setting the limits of authority has been a clearly identifiable need for investor protection. The firmly established power of states to act for the protection of investors within the state is subject to degrees of preemption as a consequence of the evolution of national and global capital markets. Yet the essential role of Blue Sky laws to intercede for investors in the protection against fraud and abuse continues unabated, as it has throughout development of the entire state/federal dual system of securities regulation that is discussed further below.

[3] Dual State/Federal Regulation

All of securities regulation is oriented around three areas of intended protection: (a) the *distribution* of securities, that is, the creation of a security and the process by which it is placed into the hands of the investing public; (b) *trading* in securities; and finally (c) *holding* securities, that is, the setting in which investors are neither purchasing nor selling securities, but are rather impacted by what issuers or others do, or are faced with decisions relating to appurtenant rights such as voting. From the earliest days securities laws in the United States have thus had as their main concern abuses involving:

- (1) The lack of fair and honest dealing in securities transactions;
- (2) Irresponsible, high pressure selling practices and denigration of the trading markets; and
- (3) The unavailability of adequate information on which a potential investor could make an informed investment decision.

Against this backdrop a strong motivating concern was also the fact that traditional legal and equitable remedies were insufficient either to prevent such abuses or provide meaningful redress if it occurred.

1-1 Blue Sky Regulation § 1.02

Blue Sky laws responded to these concerns with regulation by intercession. Whether in the registration of securities, or in the licensing process for intermediaries, state securities administrators put themselves between an investor and the offer or sale of a security in order to receive information and make a determination on substantive fraud or fairness grounds what may be offered for consideration by an investor, and who may be involved in offering it. Thereafter, on those same grounds, administrators were empowered to suspend or halt the process altogether. Yet as capital markets evolved on a national basis, and abuses became evident in a national market context that culminated with the stock market crash of 1929, limitations on the power of state regulators to govern national markets also became evident. Blue Sky regulation, however effective, was parochial in the face of needed regulation of the distribution, trading and holding of securities on a national scale. Blue Sky laws did virtually nothing for example to address trading market abuses that had become a major concern in the wake of the stock market crash.¹⁷ Congress thus entered the field of securities regulation with enactment of the Securities Act of 1933, followed soon thereafter with the Securities Exchange Act of 1934 with its particular focus on market regulation and the mechanisms for assuring a continuous flow of information to markets and the investing public.

From inception, the federal securities laws involved a premise very different from Blue Sky laws. Congress chose to establish a regulatory scheme based on full disclosure to investors--to create a process by which structured information is created and disseminated, to assure an opportunity to assess that information in an atmosphere free of pressure, and to create an antifraud remedy in the event information provided in the process is false or misleading. This is the focus of the Securities Act of 1933 and its provisions for registration of securities, and for the content and use of the prospectus, in the distribution process. Congress eschewed the notion of administrative intercession in the offer and sale of securities that was central to the state approach in favor of a system designed to assure the creation and dissemination of material information upon which the investing public could make its own judgments.

The *Blue Sky Cases* of 1917 and their progeny nevertheless cemented the continuing role of state securities regulation as a full partner with federal regulation, and in the enactment of the federal securities laws Congress expressly preserved state Blue Sky laws and authority. This allowed for the dual federal/state regulatory system that remained fully in place until NSMIA in 1996. The historic paternalistic role of the states in the distribution of securities gradually diminished through the widespread adoption of exemptions based on realistic assessments of the extent to which the Blue Sky model for regulation was actually needed in certain circumstances, and with an eye to evolving national markets and the need for uniformity among the states. The move away from merit regulation likewise gained momentum as Blue Sky laws and regulations were re-engineered to more closely coordinate with federal mechanisms, and the need for protection in many settings was perceived as lessened.

The federal securities laws also introduced self-regulation into the mix of intermediary regulation. Congress established a system of regulating the securities industry through statutorily mandated self-regulatory organizations functioning under the oversight authority of the Securities and Exchange Commission. Every national securities exchange registered under the Securities Exchange Act of 1934, along with securities broker-dealers who are members of the Financial Industry Regulatory Authority (FINRA), which was formerly the National Association of Securities Dealers, Inc. (NASD), is thus charged with responsibility to adopt and enforce rules governing the conduct of members. The structure of requirements is such that by law nearly every broker-dealer must be a member of either an exchange or FINRA, and thus be subject qualification requirements and conduct rules. Although it remained possible after enactment of the federal securities laws for a broker-dealer to be engaged in purely intrastate activities, and to avoid application of these mandates, states responded with coordinate requirements so as to close any self-regulatory loophole, and now generally mandate FINRA membership as a condition to licensing as a broker-dealer.¹⁸

Licensing remains a prime component of Blue Sky laws even in the wake of NSMIA. Although by effectively mandating membership in a self-regulatory organization the federal securities laws indirectly impose qualitative standards on those who would engage in the securities business, there is no federal license involved. This is province of the states, which exercise the authority today true to the historic mission of Blue Sky laws. States have also added investment advisers and investment adviser representatives to the scope of licensing authority, subjecting at least the

latter to the same kind of competence and qualitative standards that control the licensing process for broker-dealers and securities salespersons. The state role in regard to investment advisers and their representatives is put in sharp focus by the fact that there is today no self-regulatory organization to which such intermediaries must belong, and thus no set of industry standards and conduct rules by which they are bound, and for which there is any oversight enforcement authority.

[4] The National Securities Markets Improvement Act of 1996 ("NSMIA")

With the enactment of NSMIA in 1996 the dual system of federal/state securities regulation was altered to clearly define the lines of regulatory authority in the context of a national securities market. NSMIA is most often described only in terms of preempting state authority under Blue Sky laws. As introduced above and discussed throughout this Treatise, NSMIA did preempt certain state authority to regulate securities offerings and transactions that are national in character, and prescribe some limits in other areas of securities regulation. However, NSMIA is more accurately described as realigning state and federal roles. As legislative history makes clear, NSMIA has as its objective to:

[f]urther advance the development of national securities markets and eliminate the costs and burdens of duplicative and unnecessary regulation by, as a general rule, designating the Federal government as the exclusive regulator of national offerings of securities. State governments generally retain authority to regulate small, regional, or intrastate securities offerings, and to bring actions pursuant to state laws and regulations prohibiting fraud and deceit, including broker-dealer sales practices abuses.ⁿ¹⁹

NSMIA addressed administrative inefficiencies in the dual federal/state regulatory system for registration of securities by preempting state authority to exercise registration (and any merit review) authority over the distribution of securities falling within the NSMIA defined class of "covered securities." NSMIA covered securities include:

- (1) Securities listed or authorized to be listed on the New York Stock Exchange, the American Stock Exchange, the National Market System tier of the Nasdaq Stock Market, or that are listed or authorized for listing on any other national securities exchange that the Securities and Exchange determines has listing standards substantially similar to those listed.
- (2) Securities that are equal in seniority, or that are senior to, the securities described in (1) above;
- (3) Securities issued by an investment company registered under the Investment Company Act of 1940, thus encompassing all mutual fund shares distributed on any significant scale;
- (4) Securities offered and sold to persons who meet criteria established by the Securities and Exchange Commission rule as a "qualified purchaser." The SEC definition of "qualified purchaser" tracks that of "accredited investor" as used in connection with other transactional exemptions under the Securities Act of 1933 and various regulations;
- (5) Securities offered and sold in reliance on several other exemptions, either for securities or transactions, under the Securities Act of 1933 if certain issuer qualifications are met.ⁿ²⁰

Congress concluded that distributions of securities falling within the covered security classification are inherently national in character, and should therefore be subject to exclusive federal regulation. NSMIA allows the states to continue to impose notice filing requirements for covered securities offerings, and to collect filing fees, but they may not otherwise exercise registration or review procedures. In those states that exercise full or partial merit review of securities offerings, NSMIA ended the process entirely where covered securities are involved.

The first critical factor in assessing the scope of preemption of state authority under NSMIA is whether a security is a

NSMIA "covered security." As seen above, the classes of "covered" securities are spelled out in NSMIA, but Congress made no provision for any determination as to the validity of a claim that a security in an offering is, in fact, a covered security. This is an important notion where, as with offerings made in reliance upon Rule 506 of federal Regulation D under the Securities Act of 1933,ⁿ²¹ there are conditions to be met for an issuer to avail itself of the exemption. Whether NSMIA preemption rests on the actual validity of--versus claimed reliance on--the Rule 506 exemption is critical in assessing the permitted scope of state authority to regulate offerings. State regulators and courts are today openly testing, if not outright challenging, the existence of NSMIA preemption when there is merely claimed reliance on, and perhaps not actual compliance with, the Rule 506 exemption.ⁿ²²

To be sure, by the time NSMIA was enacted, most states had already incorporated exemptions or exclusions into their Blue Sky laws and regulations that operated to exclude most types of NSMIA covered securities from registration and review requirements. The vast majority of states also authorized registration by "coordination," when a securities distribution is registered at the federal level. Moreover, the number of states fully engaged in merit regulation of securities offerings at the time of enacting NSMIA was relatively small. Thus, NSMIA did not in practical application dramatically alter the existing scheme of dual state/federal securities regulation. It did, however, speak loudly in defining the respective roles of federal and state regulators in the national market setting. For example, although NSMIA expressly preserved the full enforcement authority of states regarding fraud, without any covered security limitation, the Act makes clear that states are not empowered to use fraud enforcement authority as a roundabout means of interposing Blue Sky regulation on the offer and sale of such securities.

Although NSMIA realigned the dual system of state and federal securities regulation, preempting most state authority in the registration of securities or offerings that are national in character, the dual system remains viable and important considering the focus of state regulation that now underscores the following roles:

Registration. After NSMIA state administrators focus attention on smaller offerings having a local or regional character. Such offerings may be quite small, undertaken by entrepreneurial companies and issuers with little or no financial history, no profitability, and for which close consideration of the offering, including even merit review, is plainly beneficial. Blue Sky laws empower administrators to make determinations, with or without full-scale merit review, that are particularly suited to such offerings, and to directly impact the manner and extent of disclosure of risks associated with them as well as substantive fairness considerations. State authority to police the offering process includes the power to assure accountability to investors.

Licensing. States continue to make determinations that there are firms or people who should not be licensed as securities intermediaries. They do so on the basis of standards they set individually, regardless of whether the firm or individual is actively engaged in the business, registered at the federal level, or licensed elsewhere. States review disciplinary histories of intermediaries closely, mandate competence standards, and examine financial responsibility.

Enforcement. State securities administrators remain, in practical terms, the first line of defense against myriad investment schemes and scams, and the agencies that can most directly and efficiently respond to complaints. States can act quickly with cease-and-desist authority and other enforcement powers to deal with fraudulent and unfair practices at the local level, and have the resources to commit to enforcement at the community level, and to effective coordination with other local law enforcement authorities. State administrators today bring large numbers of administrative and civil proceedings aimed at the offer and sale of unregistered securities, mostly of some unconventional form or variety, and often by unlicensed people. Criminal referrals and criminal enforcement cases generally are more likely today at the state level as administrators apply resources more narrowly on the prevention and redress of fraud.

As a corollary consideration to the enforcement role of state securities regulation it is also true that many state Blue Sky laws create *private* rights of action and remedies that are broader than those available under federal law. It is common, for example, for Blue Sky laws to include a broad right of rescission based on any violation of the statute, and extending beyond the issuer to intermediaries and others who aid or participate in the transaction.ⁿ²³ In Texas, the private

rescission remedy has been held to apply against anyone who is a link in the selling process, including those who are involved in private, secondary market transactions.ⁿ²⁴ The reach of private rights of action under Blue Sky laws may also extend beyond the purchase and sale of securities as, for example, in Alaska, where the state securities law prohibits misrepresentations of material facts in *proxy* solicitations.ⁿ²⁵

Although NSMIA preserved the dual state/federal securities regulatory system, it mandated a greater degree of uniformity in certain of the areas preserved. States are thus uniformly limited in the extent to which they may impose certain financial responsibility or books and records requirements on intermediaries as a condition of licensing. Uniform jurisdictional limitations regarding intermediaries also assure that state licensing authority will be evenly applied in the context of nationwide securities activities and a mobile population that involve only limited or sporadic contact with persons in a particular state. These particular elements of post-NSMIA federal/state authority are considered elsewhere in this Treatise.ⁿ²⁶

Building uniformity in Blue Sky regulation among the states themselves has long been a significant consideration in the modern evolution of Blue Sky laws in a national setting, and thus the emergence of the Uniform Securities Act in 1956 and its evolution through later iterations, including that which will become the 2002 Uniform Securities Act, is essential to understanding Blue Sky regulation generally. That discussion follows in *section 1.03 below*. Before that, however, there remains for consideration one further element of federal preemption in the realignment of state and federal roles in securities regulation.

[5] The Securities Litigation Uniform Standards Act of 1998

In order to establish national standards for private securities class actions alleging fraud, the Securities Litigation Uniform Standards Act of 1998 ("SLUSA")ⁿ²⁷ amended the federal securities laws to provide, subject to certain narrow savings provisions, that no class action based on state law alleging fraud in connection with the purchase or sale of "covered" securities may be maintained in a state or federal court. SLUSA preempts not only claims but also state court jurisdiction over such covered class actions, and directs that any covered action commenced in state court shall be removed to federal court, where it may be dismissed. Covered securities for purposes of SLUSA are the same securities defined as covered under NSMIA, and a "covered class action" is one meeting certain numerosity or grouping criteria,ⁿ²⁸ and which is based upon the statutory or common law of any state that is brought by a private party alleging:

- (1) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or
- (2) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security.ⁿ²⁹

SLUSA thus eliminates class action claims made under private remedy provisions of Blue Sky laws, or which seek any class action recovery based on violations of state securities laws when the claim is premised on fraud or fraudulent conduct in connection with a covered securities transaction. The preclusion of such class action claims runs only to private actions, as SLUSA expressly preserves the authority of state securities commissions or administrators to investigate and bring enforcement actions.ⁿ³⁰ It further preserves the right of private plaintiffs to bring certain class actions that are based on the law of the state of an issuer's incorporation, and also, by excluding them from the definition of covered class action, SLUSA preserves the right of private plaintiffs to bring actions that are exclusively derivative on behalf of a corporation.ⁿ³¹

Class actions arising under state law that are preserved under SLUSA ("permissible actions") are those that are based upon the statutory or common law of the state in which the issuer is incorporated, in the case of a corporation, or organized, in the case of all other entities, and which involve:

(i) the purchase or sale of securities by the issuer or an affiliate of the issuer exclusively from or to holders of equity securities of the issuer; or

(ii) any recommendation, position, or other communication with respect to the sale of securities of the issuer that is made by or on behalf of the issuer or an affiliate to holders of equity securities of the issuer, and which concerns decisions of those holders in regard to voting, acting in response to a tender offer, or exercising dissenter's or appraisal rights.ⁿ³²

SLUSA also preserves the right of any state, political subdivisions of a state, and of a state pension plan to bring an action involving a covered security on its own behalf, or as a member of a class comprised entirely of other such named plaintiffs that have authorized participation in the action.ⁿ³³ Covered class actions based on contractual agreements between issuers and indenture trustees seeking to enforce the agreement are likewise preserved, and may be prosecuted in either state or federal courts.ⁿ³⁴

Although SLUSA thus federalizes private class actions alleging fraud in connection with the purchase or sale of a covered security, the scope of what is actually *preserved* as a matter of state law claims is not insignificant, and in the larger scheme of the realignment of state and federal securities regulatory roles in the wake of NSMIA, there is inherent logic. First, SLUSA does not prevent any individual, or small group of individuals,ⁿ³⁵ from bringing claims in state courts against the issuer or any other persons involved in the offer and sale of *any* security, whether a "covered" security or not. The SLUSA preemption applies only to class actions. Further, the SLUSA preemption does not prevent any suit, class action or otherwise, involving other than covered securities. Thus, "penny" stock frauds, or fraud in connection with transactions in any other stock not traded on a national securities exchange or falling within another covered category such as mutual funds, may continue to be pursued in state court class actions, under applicable state and common law. Express rights of action under Blue Sky laws can be particularly meaningful in this area. Finally, by reason of the preservation of rights to bring private actions based upon the statutory or common law of the state in which the issuer is incorporated or organized. The full range of Blue Sky law rights of action and remedies is preserved in those situations involving fraud on a localized or regional basis.

Under SLUSA, courts also closely examine whether claims asserted as a matter of state or common law are actually "covered" claims for determining preemption. Although there may be no issue whether covered securities are involved, allegations of a class action complaint may not in fact be grounded in fraud or fraudulent practices within the contemplation of SLUSA. Allegations involving only breach of contract, fiduciary duty, conversion and other types of state or common law claims for money damages that cannot be fairly read as asserting securities fraud will not be preempted.ⁿ³⁶ Similarly, whether alleged fraud is "in connection with" the purchase or sale of a SLUSA covered security also determines whether claims are preempted.ⁿ³⁷

FOOTNOTES:

(n1)Footnote 1. Mass. Acts and Resolves 1852, ch. 303.

(n2)Footnote 2. Conn. Pub. Acts 1903, ch. 196.

(n3)Footnote 3. Nev. Stat. 1909, ch. 56.

(n4)Footnote 4. Conn. Pub. Acts 1911, ch. 232.

(n5)Footnote 5. In 1910, for example, the Rhode Island corporation law was amended to include a provision aimed at regulating the issuance of shares in an investment company, or in a real estate, mining, or "cooperative" corporation by requiring a filing to be made initially, and annually thereafter, showing financial condition and other information. R.I. Acts and Resolves 1910, ch 557, § 39.

(n6)Footnote 6. See *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496, 502 (7th Cir.) , cert. denied, 493 U.S. 955, 110 S. Ct. 367, 107 L. Ed. 2d 353 (1989) ("States have regulated corporate affairs, including mergers and sales of assets since before the beginning of the nation").

(n7)Footnote 7. Kan. L. 1911, ch. 133.

(n8)Footnote 8. *Merrick v. N. W. Halsey & Co.*, 242 U.S. 568, 37 S. Ct. 227, 230, 61 L. Ed. 498 (1917) .

(n9)Footnote 9. See *William R. Compton Co. v. Allen*, 216 F. 537 (S.D. Iowa 1914) ; *Alabama & N. O. Transp. Co. v. Doyle*, 210 F. 173 (E.D. Mich. 1914) ; *N. W. Halsey & Co. v. Merrick*, 228 F. 805 (E.D. Mich. 1915) ; *Geiger-Jones Co. v. Turner*, 230 F. 233 (S.D. Ohio 1916) ; *Bracey v. Darst*, 218 F. 482 (N.D. W. Va. 1914) .

(n10)Footnote 10. *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 37 S. Ct. 217, 61 L. Ed. 480 (1917) (Ohio Blue Sky law comported with the Commerce Clause because they do not discriminate against interstate commerce); *Caldwell v. Sioux Falls Stock Yards Co.*, 242 U.S. 559, 37 S. Ct. 224, 61 L. Ed. 493 (1917) (purpose and general provisions of the South Dakota Blue Sky law equated to those of Ohio, which were permissible); *Merrick v. N. W. Halsey & Co.*, 242 U.S. 568, 37 S. Ct. 227, 61 L. Ed. 498 (1917) (Michigan statute upheld on same grounds).

(n11)Footnote 11. *Merrick v. N. W. Halsey & Co.*, 242 U.S. 568, 584, 37 S. Ct. 227, 61 L. Ed. 498 (1917) .

(n12)Footnote 12. *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 557-558, 37 S. Ct. 217, 61 L. Ed. 480 (1917) .

(n13)Footnote 13. *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 557-558, 37 S. Ct. 217, 61 L. Ed. 480 (1917) .

(n14)Footnote 14. See, e.g., *Carney v. Hanson Oil Co.*, 690 S.W. 2d 404 (Mo. 1985) ; *Travelers Health Ass'n v. Virginia*, 339 U.S. 643, 70 S. Ct. 927, 94 L. Ed. 1154 (1950) .

But see Hyde Park Partners, L.P. v. Connolly, 839 F.2d 837 (1st Cir. 1988) (Massachusetts statute which forbade any transfer of corporate shares for one year after failure to disclose any material fact held to be an unconstitutional regulation of interstate commerce).

(n15)Footnote 15. See, e.g., *North Star International v. Arizona Corp. Commission*, 720 F.2d 578 (9th Cir. 1983) (State statute to be upheld unless the burden imposed on interstate commerce is clearly excessive in relation to the putative local benefits).

(n16)Footnote 16. *Edgar v. MITE Corp.*, 457 U.S. 624, 102 S. Ct. 2629, 73 L. Ed. 2d 269 (1982) .

(n17)Footnote 17. In his message to Congress calling for enactment of federal securities legislation allowing for federal supervision of traffic in investment securities in interstate commerce, President Franklin Roosevelt voiced the concern: "In spite of many state statutes the public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities." S. Rep. No. 47, 73rd Cong., 2d Sess. 6-7 (1933); H.R. Rep. No. 85, 73rd Cong., 2d Sess. 1-2 (1933).

(n18)Footnote 18. Many states have, by regulations, also directly imported key self-regulatory organization imposed rules and responsibilities into their own set of mandated responsibilities or prohibited acts and practices, thus expanding enforcement authority in areas such as the suitability of investments. The full scope of state authority in the regulation of intermediaries is discussed in Chapters 11 and 14, *below*.

(n19)Footnote 19. H.R. Rep. No. 622, 104th Cong., 2d Sess. 16 (1996), *reprinted* in 1996 U.S.C.C.A.N. 3877, 3878. The Conference Committee Report on NSMIA added that the Act:

"[Amends] the Federal securities laws in order to promote efficiency and capital formation in the financial markets, and to amend the Investment Company Act of 1940 to promote more efficient

management of mutual funds, protect investors, and provide more effective and less burdensome regulation." H.R. Conf. Rep. No. 864, 104th Cong., 2d Sess. 39 (1996), *reprinted* in 1996 U.S.C.C.A.N. 3877, 3920.

(n20)Footnote 20. NSMIA covered securities, and the impact of the Act on state authority regarding registration of securities are discussed in Chapter 5 ("Registration") and Chapter 6 ("Merit Regulation"), *below*.

(n21)Footnote 21. 17 C.F.R. § 240.506 (2008).

(n22)Footnote 22. For a thorough examination of the scope of NSMIA preemption as state regulators continue to police "exempt" offerings that are undertaken at regional, state, and local levels, see R. Rapp & F. Berckmueller, *Testing the Limits of NSMIA Preemption: State Authority to Determine the Validity of Covered Securities and to Regulate Disclosure*, 68 *Bus. Law.* 809 (May 2008).

(n23)Footnote 23. See, e.g.,

Arizona: Ariz. Rev. Stat. § 44-2003 (liability for "participants" in securities transactions).

Ohio: Ohio Rev. Code § 1707.43 (liability for rescission extends to any person who aids or participates in an unlawful transaction).

(n24)Footnote 24. *Texas Capital Secs., Inc. v. Sandefer*, 58 S.W.3d 760, 776 (Tex. App. 2001) .

(n25)Footnote 25. See *Meidinger v. Koniag, Inc.*, 31 P.3d 77 (Alaska 2001) (affirming summary judgment on claims that proxy solicitation violated Blue Sky law antifraud provision and regulations).

(n26)Footnote 26. See, e.g., Chapter 4 ("State Jurisdiction"), *below*.

(n27)Footnote 27. Pub. Law 105-353, 112 Stat. 3227.

(n28)Footnote 28. A "covered class action" under SLUSA is defined as:

(i) any single lawsuit in which--

(I) damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of individualized reliance on an alleged misstatement or omission, predominate over any questions affecting only individual persons or members; or

(II) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated, and questions of law and fact common to those persons or members of the prospective class predominate over any questions affecting only individual persons or members; or

(ii) any group of lawsuits filed or pending in the same court and involving common questions of law or fact, in which--

(I) damages are sought on behalf of more than 50 persons; and

(II) the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose. 15 U.S.C. § 77p(f)(2).

(n29)Footnote 29. 15 U.S.C. § 77p (b).

(n30)Footnote 30. SLUSA section 101 (e), 15 U.S.C. § 77p (e), provides:

Preservation of State Jurisdiction.--The Securities Commission (or any agency or office performing like functions) of the State shall retain jurisdiction under the laws of such State to investigate and to bring enforcement actions.

(n31)Footnote 31. 15 U.S.C. § 77p(f)(2)(B).

(n32)Footnote 32. 15 U.S.C. § 77p (d)(1) (B).

(n33)Footnote 33. 15 U.S.C. § 77p(d)(2)(A). For purposes of this preservation of rights, "state pension plan" means:

[A] pension plan established and maintained for its employees by the government of the State or political subdivision thereof, or by any agency or instrumentality thereof. 15 U.S.C. § 77p(d)(2)(B).

(n34)Footnote 34. 15 U.S.C. § 77p(d)(3).

(n35)Footnote 35. See note 41, above.

(n36)Footnote 36. See *Burns v. Prudential Sec.*, 116 F.Supp. 2d 917 (N.D. Ohio. 2000) (Plaintiff class allegations of unauthorized trading did not amount to securities fraud in the absence of any allegation that Defendants' conduct involved any element of deception); *Shaw v. Charles Schwab & Co.*, 128 F.Supp.2d 1270 (C.D. Cal. 2001) (Class did not allege any misrepresentations or other malfeasance that is intrinsically related to the securities being traded).

(n37)Footnote 37. See *Green v. Ameritrade, Inc.*, 279 F.3d 590 (8th Cir. 2002) (Class complaint could not be fairly read as alleging a sale or purchase of a covered security made in reliance on faulty information provided by the defendant); *Spielman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [2001-2002 Transfer Binder] 332 F.3d 116 (alleged misrepresentations were not integral to the purchase of covered securities).

But see *Denton v. H & R Block Financial Advisors, Inc.*, [2001-2002 Transfer Binder] CCH Fed.Sec.L.Rep. P 91,618 (N.D. Ill. 2001) (State law claim of breach of fiduciary duty is preempted by SLUSA because it alleged intentional omissions and misrepresentations).



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Blue Sky Regulation

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CHAPTER 1 Introduction To Blue Sky Regulation

1-1 Blue Sky Regulation § 1.03

§ 1.03 The Uniform Securities Act(s)

The majority of state Blue Sky laws are based on one of two versions of the *Uniform Securities Act*. The *Uniform Securities Act of 1956* (the "Uniform Act") has been adopted in whole or part in thirty-seven jurisdictions.ⁿ¹ The *Revised Uniform Securities Act of 1985* (the "revised Uniform Act") has been adopted in only a handful of states.ⁿ² From the outset, the mission of the Uniform Acts has been to make uniform the law of those states which enact them and, expressly, "to coordinate the interpretation and administration of [the] act with the related federal regulation."ⁿ³

The latest version of the Act, the 2002 *Uniform Securities Act*, was drafted in response to the combination of the federal preemptive legislation discussed earlier, along with significant changes in the technology of securities trading and regulation, and the increasingly interstate and international aspects of securities transactions.ⁿ⁴ The 2002 Uniform Act not only supplies guidance to state legislatures and administrators in conforming Blue Sky regulation to NSMIA requirements, but also in addressing such areas as the broker-dealer aspects of the federal Gramm-Leach-Bliley Act, signed into law in November 1999,ⁿ⁵ in harmonizing key state and federal definitions in response to the Commodities Futures Modernization Act of 2000, and in giving effect to the Electronic Signatures in Global and National Commerce Act to permit the filing of electronic signatures and electronic records. The 2002 Uniform Act has been adopted in Missouri, Idaho, Iowa, Kansas, Oklahoma, South Dakota, U.S. Virgin Islands, Maine, Vermont, South Carolina, Minnesota, Hawaii, Indiana, Wisconsin, and Georgia. It is under active consideration in several other states.

The Uniform Acts currently in force are hybrid Blue Sky laws, in that they include provisions for securities registration,ⁿ⁶ intermediary regulation through licensing and supervision,ⁿ⁷ and antifraud protection through administrative enforcement authority and civil remedies.ⁿ⁸ The Acts are structured such that states may adopt them in whole or part, with each of the three areas of focus capable of standing alone, supported by a set of definitions, administrative provisions, exemptions, penalties, jurisdiction and other matters that may be adopted independently to tailor particular use of other provisions. There are also variants of some provisions of the Uniform Acts that have been developed by NASAA--the North American Securities Administrators Association--for selective consideration and adoption.ⁿ⁹

The Uniform Act was the first successful effort to coalesce all the elements of and approaches to Blue Sky regulation into a common frame of reference.ⁿ¹⁰ Just as important, it for the first time uniformly defined jurisdictional limits and in doing so established a higher level of predictability to applications of Blue Sky laws. Section 414 of the Uniform Act--"Scope of the Act and Service of Process"--prescribes the extent to which a state may regulate securities

1-1 Blue Sky Regulation § 1.03

transactions and intermediary activities based on whether or not an offer to buy is made in the state, or when an offer to sell is made and accepted in the state.ⁿ¹¹ More recently these basic defining limits on state jurisdiction under Blue Sky laws have been considerably tested and refined in the world of e-commerce and the Internet,ⁿ¹² nevertheless, the Uniform Act established essential boundaries that set in motion a rationalization of the role of the states in a national market setting. Section 414(e), for example, excludes bona fide newspapers and other publications "of general, regular, and paid circulation" from being an offer to sell or to buy in the state when it is not published in the state, or even when, if published in the state it has more than two-thirds of its circulation outside the state. Similarly, the Act excludes radio or television programming originating outside the state which is received in the state.ⁿ¹³

In its all-inclusive approach to state securities regulation the Uniform Act provided for merit regulation of securities offerings by authorizing administrators to deny effectiveness of a registration statement, or suspend or revoke it, on a finding that the "offering has worked or tended to work a fraud upon purchasers or would so operate."ⁿ¹⁴ The Act empowers administrators likewise to act when "the offering has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, promoters' profits or participation, or unreasonable amounts or kinds of options."ⁿ¹⁵ Although numerous states have since moved away from complete merit regulation of offerings, that is, merit review as a condition to effectiveness,ⁿ¹⁶ and adopted exemptions which limit its application generally,ⁿ¹⁷ the Uniform Act standard of what will tend to work a fraud or would so operate is in one form or another a part of the Blue Sky laws in forty-six jurisdictions as the basis on which administrators may issue stop orders in connection with an offering. Thirty five jurisdictions have adopted the Uniform Act provision in regard to unreasonable compensation.

Although the Uniform Act itself evolved into different versions through initiatives such as the various NASAA amendments or revisions that were in varying manner and degree melded into state laws and regulations, the degree of uniformity achieved through introduction of the Uniform Act was substantial. In practice today there are few significant structural or substantive differences between Uniform Act and Non-Uniform Act states, the latter having significantly conformed their Blue Sky laws over time such that key elements mesh well. All states, for example, and in one way or another, provide for registration by "coordination" covering a security for which a registration statement has been filed with the SEC under the Securities Act of 1933, or make an exemption from state registration requirements for SEC registered offerings. This form of registration streamlines the content of a registration statement and the procedure by which it becomes effective. Registration by coordination was one of the key innovations of the Uniform Act. NASAA guidelines for common application in reviewing certain types of offerings and other elements of offerings have likewise operated to merge differently worded substantive standards among states, such that the "grossly unfair" standard in Ohioⁿ¹⁸ differs little in application from the "unfair or inequitable" standard applicable in Arizona,ⁿ¹⁹ or the "tend[s] to work a fraud" standard of the Uniform Act. Additionally, the Uniform Act spawned development of uniform forms now utilized in all states, which meaningfully streamline procedures for issuers and regulators alike.

Coordination among the states, and between the states and the federal government, has been consistently pursued in the wake of the Uniform Act as an expressly mandated statutory policy.ⁿ²⁰ Indeed, today the following statement of objective included as section 608(a) of the 2002 Uniform Securities Act could not be any more certain:

The administrator shall, at the discretion of the administrator, cooperate, coordinate, consult, and ... share information with the securities regulators of one or more states, Canadian jurisdictions, or another country; the Securities and Exchange Commission, the Department of Justice, the Commodity Futures Trading Commission, the Federal Trade Commission, the Securities investor Protection Corporation, a self-regulatory organization, a national or international organization of securities regulators, federal or state banking and insurance regulators, and any governmental law enforcement agency in order to effectuate greater uniformity in securities matters among the federal government, self-regulatory organizations and state governments.ⁿ²¹

The impact of NSMIA preemption on securities registration provisions and procedures under Blue Sky laws generally

has previously been discussed, and is considered in greater detail in later chapters. Former provisions in Blue Sky laws based upon the Uniform Act have been largely revised. The impact of NSMIA on the Uniform Act was, however, broader. As to registration/licensing of broker-dealers, agents and investment advisers, NSMIA introduced the category of "federal covered adviser," "notice" filings, and uniform limitations on books and records requirements states may impose on both investment advisers and broker-dealers. The scope of Uniform Act intermediary licensing requirements was also limited as a result of exclusions of persons who engage in only *de minimis* activities or contacts with persons in a state, as defined by NSMIA. The patchwork of repairs on the Uniform Act mandated by NSMIA, along with the need today to mesh Blue Sky laws with other federal preemptive legislation is the main reason for promulgation of the 2002 Uniform Securities Act, designed to supplant the Uniform Act and the Revised Uniform Act in their entirety. Although it is thus a "new" Act, as a practical matter the 2002 Uniform Act molds its predecessors and their variants into a single version combining and modernizing the elements of both, all in conformity with federal preemptive legislation.

Despite federal preemption of significant elements of state authority under Blue Sky laws, the Uniform Acts, in whatever version, are important as ever. In the wake of federal preemption the focus of state administrators has shifted to smaller, local and regionalized offerings, and the people engaged in them. Uniformity, predictability and regulatory efficiency are as essential to capital formation in these settings as any other. Firmly anchored in the Uniform Act(s), state securities regulation remains both consistent and constant, thus assuring an even application and a high level of investor protection.

Because it addresses all elements of state securities regulation, the Uniform Act serves throughout this Treatise as the beginning point for considering each of those elements in detail. There are variations in provisions and particular elements as adopted in particular states, and these are particularly addressed, as are the alternative approaches in Non-Uniform Act states. It is clear, however, that with very few exceptions the Uniform Act is a roadmap to all of state securities regulation, and the backdrop against which a full understanding of the continuing role of Blue Sky law in not only national but also global capital markets is possible. Although the mission of Blue Sky laws is unchanged, uniformity in its execution is and will remain more important than ever. The drafters of the 2002 Uniform Securities Act made clear that the goal is to seek its enactment in all state jurisdictions as a replacement of all versions of the Uniform Act and the Revised Uniform Act.ⁿ²² It is, therefore, particularly helpful going forward to anchor consideration of each element of Blue Sky regulation in the Uniform Acts and the common elements that will mark the contours of the law across jurisdictions as the states continue to stake out their role in the protection of investors and the integrity of markets.

FOOTNOTES:

(n1)Footnote 1. These "jurisdictions" include the territories of Guam and Puerto Rico.

(n2)Footnote 2. The Revised Uniform Act has been adopted, either in its original or 1988 amended forms, in Nevada, New Mexico, and Rhode Island.

Both the Uniform Act and the Revised Uniform Act are reproduced in full in Volume 2, *below*.

(n3)Footnote 3. Unif. Sec. Act § 415 ("Statutory Policy").

(n4)Footnote 4. Drafting Committee Prefatory Note, Uniform Securities Act (2002), NCCUSL Discussion Draft (Apr. 2002).

(n5)Footnote 5. The Gramm-Leach-Bliley Act rescinded the former exemption of banks from the definitions of broker and dealer contained in the Securities Exchange Act of 1934, ushering in the notion of "functional" regulation in response to the considerably expanded securities activities of banks in the wake of the Act and its repeal of the 1930s era Glass-Steagall Act.

(n6)Footnote 6. Unif. Sec. Act §§ 301-306.

(n7)Footnote 7. Unif. Sec. Act §§ 201-204.

(n8)Footnote 8. Unif. Sec. Act §§ 101-102; 401-419.

(n9)Footnote 9. In 1987 NASAA promulgated amendments to various provisions of the Uniform Act, a number of which operate to mesh provisions of the Revised Uniform Act with the original. For example, from the broader authority of administrators to bring civil actions for the benefit of victimized investors that is contained in the Revised Uniform Act, a 1987 NASAA amendment to the Uniform Act expressly provides in section 408 of the Act that the administrator may seek and obtain an order of rescission, restitution or disgorgement directed at any violator.

(n10)Footnote 10. In 1929 the *Uniform Sales of Securities Act* was released as the first attempt to stabilize the rather haphazard approach to enactment of Blue Sky legislation that prevailed among the states. Although a few states embraced this first uniform statute, at least in parts, it was not widely accepted or acknowledged. The advent of federal regulation with enactment of the Securities Act of 1933 rendered the Uniform Sales of Securities Act largely obsolete, and in 1944 it was eliminated from the list of approved uniform laws by the NCCUSL. Later attempts to create uniform state securities laws were abandoned in the face of diverse regulatory philosophies and the recognition that substantial background study would be needed for any realistic chance of broad acceptance of a new version. *see* Loss & Cowett, *Blue Sky Law* 236, 233 (1958).

(n11)Footnote 11. Unif. Sec. Act § 414(b).

(n12)Footnote 12. The particular challenges involved in determining the scope of application of Blue Sky laws in a commercial and financial environment increasingly dominated by the Internet, and the responses of state regulators, are considered in depth in Chapters 3 ("State Jurisdiction") and 12 ("Blue Sky Laws and the Internet"), *below*.

(n13)Footnote 13. Unif. Sec. Act § 414(e).

(n14)Footnote 14. Unif. Sec. Act § 306((a)(E).

(n15)Footnote 15. Unif. Securities Act § 306(a)(F).

(n16)Footnote 16. *See, e.g.* Illinois: 121 Ill. Comp. Stat. Ann. 137.1 (1983 amendment to remove merit review provisions in favor of requiring full disclosure in registration); Louisiana: *La. Rev. Stat. §§ 51:707, 51:709(5)* (Amendments eliminating merit review provisions).

(n17)Footnote 17. The Revised Uniform Act reflects action by many Uniform Act states to expand limited offering exemptions in their Blue Sky laws, thus reducing the scope of merit review of offerings that would otherwise apply. The Revised Uniform Act includes some of these expanded exemptions. Section 302(a), for example, provides an exclusion from merit review for securities offerings by certain "seasoned" issuers, where there appears less need for detailed securities review in order to protect investors. Section 305(h) of the Revised Uniform Act limits authority of state administrators to require an escrow of "cheap stock" held by promoters. Section 402(11) also established an expanded limited offering exemption. Without regard for the Revised Uniform Act provision, the majority of states have since adopted the "Uniform Limited Offering Exemption" (ULOE), which coordinates to varying degrees with SEC Regulation D under the Securities Act of 1933.

(n18)Footnote 18. *Ohio Rev. Code § 1707.13* ("[T]hat such security is being disposed of or purchased on grossly unfair terms ...").

(n19)Footnote 19. *Ariz. Rev. Stat. § 44-1921(3)*.

(n20)Footnote 20. *See* Unif. Sec. Act § 415.

(n21)Footnote 21. 2002 Unif. Securities Act, § 608(a).

(n22)Footnote 22. In their Prefatory Note to the April 2002 Discussion Draft of the 2002 Uniform Securities Act, the drafters set the stage as follows:

This is a new Uniform Securities Act. Amendment of the earlier 1956 Act or RUSA [Revised Act] would not be wise given the different versions of the 1956 Act enacted by the States and the determination to seek enactment in all state jurisdictions of the new Uniform Securities Act after it is adopted by the National Conference.



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Blue Sky Regulation

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CHAPTER 1 Introduction To Blue Sky Regulation

1-1 Blue Sky Regulation § 1.04

§ 1.04 The Blueprint for Regulatory Reform and the Future of Blue Sky Regulation

In March 2008, the U.S. Treasury Department released its "Blueprint" for an improved financial regulatory structure in the United States. The *Blueprint for a Modernized Financial Regulatory Structure* n1 presents a series of short-term and intermediate-term recommendations for reform of the U.S. regulatory structure, with the stated objective of improving the competitiveness of the U.S. capital markets in the global marketplace. The Blueprint further addresses a long-term optimal regulatory structure that would eschew the present strong bias of rules over principles in favor of a principles-based system of regulation focused primarily on achieving desired policy goals.

The new regulatory structure would be centered on creating five objectives-based regulators into which all existing federal financial regulatory authorities would be subsumed. One agency would have "prudential" financial regulatory authority over all types of financial institutions, generally assuming the current role of the Office of the Comptroller of the Currency and the Office of Thrift Supervision, and which would address risk management issues. A second regulator would focus on market stability. In all likelihood, this role would fall on the Federal Reserve Board. A third agency would regulate business conduct across all types of financial firms. Business conduct regulation in this context would include key aspects of consumer protection, and would have responsibility for federally chartering a wide range of financial service providers. This agency would be the standards-setter for firms to be able to enter the financial services industry and sell their products and services to customers. It would cover some of the current functions of the Securities and Exchange Commission, the Commodities Futures Trading Commission, and some functions of the Federal Trade Commission. The Blueprint would create two additional regulatory authorities, one responsible for corporate finance regulation such as the oversight of corporate disclosure, corporate governance, and accounting. The second would be a federal governmental insurer, generally taking on responsibilities of the FDIC.n2

The Blueprint focuses heavily on eliminating overly prescriptive federal laws and redundant requirements that have vastly increased the complexity and cost of financial regulation. A fundamental premise is that the "rules based" U.S. regulatory structure reflects an antiquated system struggling to keep pace with market developments while facing increasing challenges to anticipate and prevent financial crises. The Blueprint criticizes the current regulatory system of "pure functional" regulation that has evolved over some 75 years, which maintains separate regulatory agencies across segregated functional lines of banking, insurance, futures, and securities, and is largely incompatible with modern financial markets. The Treasury Department argues that this system has several fundamental problems, including the lack of a single regulator to monitor systemic risk.

1-1 Blue Sky Regulation § 1.04

The Blueprint essentially deals with three interrelated aspects of the U.S. financial regulatory system that are seen as contributing to its structural weaknesses:

- (1) Regulatory agencies have different objectives. Diverse regulatory agencies at the national and state levels lack a common vision that systematically balance issues such as competitiveness, serving consumers, and risk management--all of which delays the implementation of needed policies and responses to market volatility;
- (2) The rules-based system of regulation is overly prescriptive, which leads to a focus on compliance with rules rather than outcomes. This in turn makes it difficult for regulators to adjust policies in a flexible manner in response to rapidly changing conditions. Additionally, it fosters a compliance-based and confrontational relationship between firms and regulators; and
- (3) The regulatory regime in the U.S. has been slow to react and adapt to the rapidly changing financial marketplace. For a lack of any overarching common set of objectives or mechanisms for regulators to take coordinated action, the system cannot effectively respond to international trends, market opportunities, and financial crises.ⁿ³

The principal impact on state securities regulation as it currently exists in the post-NSMIA environment is in the proposed structure for rationalizing the chartering of financial institutions. That structure would involve a federal charter for financial service providers. The new business conduct regulator contemplated in the Blueprint--initially named the "Conduct of Business Regulatory Agency (CBRA)"--would be responsible for business conduct regulation of federally chartered financial services firms such as broker-dealers and investment advisors. In providing for federally chartered financial services firms, the Blueprint does not specifically delineate the future role of state Blue Sky laws. It does recognize, however, that the proper role of state authorities should be established in the optimal regulatory structure. It also makes clear that in that structure, the new federal business conduct regulator would be responsible for setting national standards for a wide range of business conduct laws across all types of financial service providers. These national standards would apply to all types of financial services firms, whether federally or state chartered. In addition, the Blueprint makes clear that field preemption would be provided to the federal business conduct regulator, preempting state business conduct laws directly relating to the provision of financial services.ⁿ⁴

In the optimal structure, according to the Blueprint, states would still retain authority to enact laws and take enforcement actions against state-chartered financial service providers. However, in considering the future role of the states as to federally-chartered institutions, the Blueprint counsels that the optimal structure would acknowledge the existing national market for financial products, while at the same time preserve an appropriate role for state authorities to respond to local conditions.ⁿ⁵ Two options are identified in that regard:

- (1) State authorities could be given a formalized role in the business conduct regulator's rulemaking process as a means of utilizing their extensive local experience; and
- (2) States could play a role in monitoring compliance and enforcement.ⁿ⁶

Clearly, the optimal regulatory structure envisioned by the Blueprint would sharply diminish the role of state securities regulation in the area that Congress previously expressly recognized should be preserved, namely, the regulation of broker-dealers and other securities intermediaries, as well as the exercise of antifraud enforcement authority. With NSMIA, Congress did not alter the historic investor protection mission of state securities regulation.ⁿ⁷ Under the Blueprint's optimal structure, however, state authority would be limited to state chartered financial firms, of which there are likely to be few. Indeed, the current legal and regulatory structure for broker-dealers recognizes the existence purely intrastate broker-dealers, but in reality only a tiny percentage of the universe of securities broker-dealers in the United States conduct purely intra-state business, and would elect only to be state chartered.

As it is presently offered, the Blueprint is a call for an entirely new regulatory scheme. In the near term, however, it is presented primarily as the basis for encouraging a broad national debate on the importance of enhancing the competitiveness of U.S. financial firms, and how a principles- or objectives-based approach to financial regulation might contribute to achieving that goal. The future of Blue Sky regulation is a critical part of this debate.

FOOTNOTES:

(n1)Footnote 1. The Treasury Department Blueprint for a modernized Financial Regulatory Structure (March 2008) is referred to throughout this section simply as the "Blueprint."

(n2)Footnote 2. *See* Blueprint (Executive Summary), at 13-21.

(n3)Footnote 3. *See* Financial Services Roundtable, The Blueprint for U.S. Financial Competitiveness 33 (2008). The Financial Services Roundtable Blueprint is the product of a Blue Ribbon Commission created to develop policy reforms and specific recommendations for improving the U.S. legal and financial regulatory system based on "Guiding Principles" to provide regulators and firms with a common framework to guide policies and practices. The FSA Blueprint is available at www.fsround.org.

(n4)Footnote 4. Blueprint (Executive Summary), at 20.

(n5)Footnote 5. Blueprint (Executive Summary), at 20-21.

(n6)Footnote 6. Blueprint (Executive Summary), at 20-21.

(n7)Footnote 7. *See* R. Rapp & F. Berckmueller, *Testing three Limits of NSMIA Preemption: State Authority to Determine the Validity of Covered Securities and to Regulate Disclosure*, 68 *Bus. Law.* 809, 846-847 (May 2008).



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CHAPTER 2 Definition of Security

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CHAPTER 2 Definition of Security

1-2 Blue Sky Regulation § 2.01

§ 2.01 In General--The Meaning of "Security"

"Security" is a defined term in all state securities laws. Although the typology and construction of some state definitions may differ in ways that can be significant in particular situations, the common elements of each are distilled in the Uniform Securities Act, which provides:

"Security" means any note; stock; treasury stock; bond; debenture; evidence of indebtedness; certificate of interest or participation in any profit sharing agreement; collateral trust certificate; preorganization certificate or subscription; transferable share; investment contract; voting trust certificate; certificate of deposit for a security; certificate of interest or participation in an oil, gas, or mining title or lease or in payments out of production under such a title or lease; or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, guarantee of, or warrant or right to subscribe to or purchase any of the foregoing. "Security" does not include any insurance or endowment policy or annuity contract under which an insurance company promises to pay a fixed sum of money either in a lump sum or periodically for life or for some other specified period.ⁿ¹

Like their federal counterparts, state definitions of "security" are drafted sufficiently broad to include the types of instruments most generally perceived in the commercial world to be securities, while also encompassing less familiar forms and unconventional categories, such as "investment contracts." The intention is not to cabin the scope of blue sky law coverage. This is particularly evidenced in section 102(28) of the 2002 Uniform Securities Act, which expressly includes categories of options, derivatives and foreign currency-based securities that were not included in the original Uniform Act definition, as well as spelling out the application of the Act to both certificated and uncertificated securities. The 2002 Uniform Act also identifies specific elements of an "investment contract" within the scope of the definition, and makes clear that an investment contract includes interests in limited partnerships, limited liability companies and viatical settlements or other similar agreements.ⁿ²

The historic mission of state blue sky laws is to protect the investing public from spurious "investment" schemes, abuses and exploitation. Thus the manner in which the breadth and scope of statutory definitions of "security" have been interpreted and applied is typified by the observation of the California Supreme Court that: "Whether a particular instrument is to be considered a security within the meaning of the statute is a question to be determined in each case. In arriving at a determination the courts have been mindful that the general purpose of the law is to protect the public

against unsubstantial, unlawful and fraudulent stock and investment schemes."ⁿ³

Blue sky laws establish special protections for purchasers of securities. Historically, these protections have in many states included intervention in the offering or selling process via "merit" regulation, in which a regulatory authority is positioned between issuers and potential investors for the purpose of determining essential fairness and, basically, to make a determination whether citizens should be permitted to consider the offering. The interventionist role of blue sky regulatory authority was significantly altered by enactment of the federal National Securities Market Improvements Act of 1996 (NSMIA),ⁿ⁴ which eliminated most state regulatory authority over securities offerings that are national in character. Today, broad anti fraud provisions and associated enforcement powers are the primary focus of blue sky regulation in this setting,ⁿ⁵ while state regulatory authority over market intermediaries--broker-dealers, salespersons, and many investment advisers--remains in place in all settings.ⁿ⁶ Also, special private remedies that are relatively easy to invoke and generally free of constraints that would apply to common law tort or other remedies have not been affected.ⁿ⁷

As a practical matter, even before NSMIA, the impact of state blue sky laws on the offering and sale of securities that became NSMIA "covered securities" had substantially diminished as a result of other evolving regulatory changes. Nevertheless, NSMIA has operated to underscore the core mission of blue sky regulation to prevent the victimization of persons who cannot act for their own protection against fraud and overreaching in local or regionalized "investment" settings. Myriad scams and schemes for separating people from their money constantly mix with legitimate undertakings in capital formation for the pursuit of worthy and desirable business ventures. From the solicitation of elderly pensioners for unsecured "loans" on the promise of above-market interest payments to finance a risky start-up enterprise unable to secure financing elsewhere, to the sale of pay telephones promising extra income with little or no work, to "investment" agreements for blind venture capital pools, state securities regulators and blue sky laws under which they operate are in the *post*-NSMIA regulatory environment more focused than ever on assuring fairness and honesty in dealing with people who are in fact *investors*, and with situations in which the need for special protections of state securities laws is evident. The key to it all, however, is the presence of a "security."

The statutory definition of "security" in any state's blue sky law is in reality an amalgam of circumstances in which the potential for a specialized notion of "investment" fraud and abuse is ever present. In all its forms, a "security" is a type of property or an interest in an enterprise marked by characteristics that demonstrate the need for such special protection. All states define the term with a list of specific instruments and interests like that in the Uniform Act, but the existence of a security is not a matter of a particular form. It is rather a function of a set of characteristics and a relationship between parties involving aspects of ownership and control, access to information that is necessary to assess risk, and legitimate perceptions and expectations. The particular instruments and interests identified in the definition provisions of blue sky laws are there because they embody these characteristics and relationships. State regulators and courts have followed the lead of the Securities and Exchange Commission and the federal courts in considering specific forms and instruments within definitions of "security," and especially in identifying the essential elements that define the scope of categories of securities such as "investment contracts." Indeed, where the Uniform Act is involved, such coordination is mandated.ⁿ⁸

Nevertheless, states have not been constrained by binding federal precedent in defining the term "security." As the California Supreme Court has stated, the focus of blue sky laws is on "unsubstantial, unlawful and fraudulent" investment schemes.ⁿ⁹ State regulators may well proceed in the exercise of investigative and enforcement authority on the basis of perceptions, or in more practical terms, a "smell" test that is the product of the historically paternalistic mission to protect people from "bad" investments. In dealing with such schemes state regulators and courts have had the freedom to craft a notion of the term "security" that is in some applications considerably broader than its federal counterpart, but which best effectuates the purpose of blue sky laws.ⁿ¹⁰ This is perhaps best illustrated by development at the state level of the concept of "risk capital" as a fundamental characteristic of a security transaction, and the notion that a "paradigmatic" security may be identified by circumstances in which the realization of value or a future return objective of the suppliers of capital is dependent upon the use to which it is put in a venture in which the investor has no

meaningful participation.ⁿ¹¹

Four essential elements have been articulated under the concept of risk capital:

- (1) An offeree furnishes initial value to an offeror;
- (2) a portion of this initial value is subjected to the risks of an enterprise;
- (3) the furnishing of the initial value is induced by the offeror's promises or representations that give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise; and
- (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.ⁿ¹²

"Risk capital" as a defining concept in identifying a security is grounded in the notion of the risk to initial value given up in capital formation for an enterprise rather than the risk of the future operation of that enterprise. Where one provides the risk capital that is to be used to form and develop an enterprise, it is the initial risk that is meaningful. Indeed it is only because of that risk that there is any chance the enterprise will produce future profits. The emphasis in risk capital analysis is on the original value that could be lost because of the failure of an enterprise over which the buyer exercises no managerial control rather than the expectation of future gains or an income stream. But whether the focus is on risk to initial value or, as will be examined below, an expectation of future profits, the constant in all determinations is the extent of practical control over management of the business enterprise.ⁿ¹³

Despite its prominence in state securities law,ⁿ¹⁴ the risk capital approach to defining the existence of a security is only one available test for the existence of a security. "Investment contract" analysis, the progeny of the 1946 U.S. Supreme Court decision in *SEC v. W.J. Howey & Co.* ⁿ¹⁵ is also commonly applied among the states. "Investment contracts" are present in circumstances involving the tripartite combination of: (a) an investment of money; (b) in a "common enterprise"; (c) where the investor is led to expect profits solely from the efforts of a promoter or third party.ⁿ¹⁶ Still, the notion of risk capital is fundamental, and underlies *any* definition category of a security. "Investment contracts" are securities on the basis of the *Howey* criteria because of the presence of investment risk, that is, the separation of ownership of an asset from its value determinants. A security is present where the value of a thing purchased, or the value itself given up, is either presently or in the future a function of something other than the thing itself, and the realization of expected value is beyond the meaningful control of the "investor."

State courts have been cognizant of this baseline principle which defines the existence of a security, and have looked upon the "risk capital" approach as being:

[A] reasonably sound [approach] both from the standpoint of providing a pattern within which to compare the format, structure and scheme of the offering, and also providing the requisite flexibility demanded by the economic realities of modern day business ingenuity.ⁿ¹⁷

Thus, "risk capital" has played a prominent role in the formulation of common characteristics or factors used to characterize all securities. In *Grand Prairie Savings and Loan Ass'n v. Worthen Bank & Trust Co., N.A.*, ⁿ¹⁸ for example, the Arkansas Supreme Court identified five "significant common factors" of any security: (1) the investment of money or money's worth; (2) investment in a venture; (3) the expectation of some benefit to the investor as a result of the investment; (4) a contribution towards the risk capital of the venture; and (5) the absence of direct control over the investment or policy decisions concerning the venture.ⁿ¹⁹ This amalgam of risk capital and *Howey* investment contract elements was expressly endorsed by a Tennessee criminal appeals court as "the *Howey*-risk capital test, as stated in *Hawaii Market*,"ⁿ²⁰ as best effectuating the remedial purpose of the blue sky law to protect the public from fraud. The

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Tennessee court characterized the combined approach as being slightly more liberal than that which the federal authorities standing alone supply, and as allowing explicit statements of elements, in layman's terms, that are important in the instruction of juries.ⁿ²¹

Several states incorporate the notion of risk capital directly into the definition provisions of their blue sky laws. The Washington blue sky law, for example, provides that the definition of security includes an:

[I]nvestment of money or other consideration in the risk capital of a venture with the expectation of some valuable benefit to the investor where the investor does not receive the right to exercise practical and actual control over the managerial decisions of the venture.ⁿ²²

The focal point of a transaction may be a conventional, recognizable instrument such as common stock. Where instruments so commonly recognized as securities are involved, much of the case law now teaches that the fact that such instruments are securities is proved by the instrument itself. As the U.S. Supreme Court observed in regard to common stock in *Reves v. Ernst & Young*: "[T]he public perception of common stock as the paradigm of a security suggests that stock in whatever context it is sold, should be treated as within the ambit of the [federal] Acts."ⁿ²³

It is fair to conclude that the characteristics of "stock" in most corporate settings present the risk characteristics that are basic to any security transaction, and evoke concerns for "investor" protection that underlie blue sky laws. That is not always the case however. Where a "corporate" relationship is in fact only a general partnership or joint venture in a corporate form, the stock involved may not be deemed to be a security for purposes of blue sky law remedies. An Illinois Court of Appeals, emphasizing that "form is not to be regarded over substance," thus held that corporate stock purchased by one who became president of the enterprise and was responsible for client development, sales and operations was not a security. The transaction was instead, the court opined, "a creation of a partnership in a corporate form."ⁿ²⁴

To identify a security in any setting, a baseline investment risk must actually be present. Many bank instruments fall within the literal definition of securities under state blue sky laws as, for example, evidences of indebtedness. Yet, as the Nebraska Supreme Court counseled in *Wrede v. Exchange Bank of Gibbon*,ⁿ²⁵ certificates of deposit in a state chartered, federally insured, bank involve virtually guaranteed full payment and no assumption of the risk of a borrower's insolvency. Thus, the court stated that the loan of money to a heavily regulated banking institution at a fixed rate of interest with virtually no risk of loss would not fall within the ambit of the Blue Sky law.ⁿ²⁶

On the other hand, in 2004 the U.S. Supreme Court made clear in *SEC v. Edwards* ⁿ²⁷ as a matter of federal securities law that the focus is on *investments* in whatever form they are made and by whatever name they are called. In *Edwards*, which involved a passive sale and leaseback program for pay telephones promising a low risk *fixed* rate of return, the Supreme Court dispelled any notion that an investment within the ambit of securities law protections can only involve "profit" of an uncertain or variable nature. The fact that investors have bargained for a fixed return, said the Court, does not make any difference when the investor is attracted by representations of investment income, whether fixed or variable. Nor does it change the fact that whatever return is promised is dependent on the efforts of others.ⁿ²⁸

Nevertheless, what one might characterize as an "investment" in an attempt to invoke blue sky law protections may be viewed quite differently by another given the particular circumstances. In *State v. Hood*,ⁿ²⁹ the Kansas Supreme Court affirmed a lower court determination that insufficient evidence was presented to support criminal charges that a defendant violated that state's blue sky law by personally utilizing funds allegedly given for the purpose of an investment in a business enterprise. The putative victim had purchased a percentage interest in the business, but the court stated that while a wide variety of schemes, plans and arrangements have been held to constitute "investment" contracts, the written agreement by which the money was paid did not evidence that the money was to be invested in the business and become a part of the capital of the company. The court went on:

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Expansion or improvement of the business by virtue of the \$15,000 is not mentioned. Nothing in the contract indicates that the business will, in any way, be affected by the transaction. Rather, it is a side agreement between the owner of an interest in the business to sell part of his interest in the business. Based upon the agreement itself, Bowe could have no claim against the business itself, as a separate entity, as his money is not going to the business.ⁿ³⁰

There is always a challenge of assessing facts and circumstances in order to accept or reject the presence of a security where "paradigmatic" instruments are not involved. Indeed, as noted above, even where "stock" is present, the conclusion is not so simple. In all cases, evidence of actual risk capital and the baseline elements of any security transaction must be shown. To be sure, however, the greater challenge comes when the focus is on some other more esoteric, undefined category of a security in a blue sky law definition, such as "investment contract," or "certificate of interest or participation in any profit sharing agreement."

The issue in defining a security under blue sky laws is not the form of an instrument. Rather, what matters are the risk characteristics of the thing being examined, and the relationship between the parties that is created. As a Missouri court of appeals has counseled, one must look beyond the surface of a transaction or instrument "to examine the substantive relationship between the investors and the promoter of the investment and the economic realities surrounding the management and operation of the endeavor" to determine the existence of a security, regardless of terminology employed.ⁿ³¹ For example, state courts often consider whether "partnership" or "joint venture" interests are securities. A true general partnership or joint venture relationship is premised upon the ability and active involvement of each participant in the operation and control of an enterprise or undertaking, and thus, no security will be found in those circumstances.ⁿ³² However, a "general partnership" interest will be deemed to be a security where a "partner" is totally dependent on other partners for the operation of the business and lacks knowledge and experience necessary to be actively involved. In such situations, the partner is in reality an investor, who has no control over risks and who is merely a passive contributor of risk capital.ⁿ³³ That is why the notion of risk capital in defining a security is not only useful, but prevalent in one form or another, in blue sky analyses.

Three critical elements apply for purposes of identifying a security in any form under state blue sky laws:

- (1) present or future value being determined by something other than the thing itself;
- (2) separation of ownership from value determinants; and
- (3) disparate positions of a purchaser and seller with respect to information with which to evaluate risk.

State courts and securities regulators confront myriad "investment" programs or undertakings. Such programs may involve: oil, gas, or mineral interests; real estate; small business financing arrangements; "memberships"; promissory notes; distributorships; franchises; and various forms of personal property, from stamps and other collectibles to precious metals. By themselves, these things do not possess attributes which define the presence or absence of a security. External considerations become the key. Indeed, it is the meaning of *value* in all these things that translates "investment" expectations into the presence of a security for purposes of blue sky law protections.

There may be some intrinsic value in any thing or asset purchased. But such value does not reach the level of defined investment characteristics for purposes of securities laws. If the real value is the expected return the purchaser looks to derive from an enterprise or undertaking associated with the thing purchased, the risk of which the purchaser has no meaningful power to control or manage, then in the most practical terms the value given for the thing is true risk capital, and a security is most likely to be found.

It may also be that an asset purchased has no value apart from an enterprise. In an early examination of the meaning of security for purposes of the federal securities laws, the U.S. Supreme Court held in *SEC v. C.M. Joiner Leasing Corp.*

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n34 that the sale of assignments in oil leases was the sale of securities because the assignments (interests in real property) only had value because of the opportunity to share in discovery values that might follow the drilling of a test well nearby. The Court observed: "[T]he undertaking to drill a well runs through the whole transaction as the thread on which everybody's beads were strung...".n35 The assignments were essentially worthless but for the test well and the prospect of its success.

In *Joiner*, the Supreme Court also noted that the assignments had been held out as "investments" and that promotional efforts and literature fostered purchasers' investment expectations. Thus, the Court further declared: "In the enforcement of an Act such as this it is not inappropriate that promoters' offerings be judged as being what they were represented to be."n36 State courts have shown no less willingness to enforce investment protections where promotional efforts induce such expectations. A New York court, for example, held the sale of diamonds, touted as "investments" and a hedge against inflation, to be securities for purposes of that state's blue sky law. The investment oriented promotional campaign was central to the court's analysis:

Although the petitioners believe that it is crystal clear that the subject matter of sales by Diamond Resources Corporation are in the same nature as the sale of any item of personal property, and that the fact that a diamond may often have value as an investment does not change the nature of the transaction, it is also true that the manner in which an item is sold and presented to the buying public is very often a factor, if not the major one, in determining the nature of the relationship between the seller and the purchaser of an item.n37

Motivations for entering into transactions and the reasonable expectations of the public concerning what is being offered by a promoter are now benchmarks of any security transaction. Indeed, in *Reves v. Ernst & Young* n38 the U.S. Supreme Court articulated criteria of general application in determining the existence of a security as follows:

- (1) the motivations that prompt reasonable parties to enter into the transaction;
- (2) the "plan of distribution" involved;
- (3) the reasonable expectations of the investing public concerning the instrument involved; and
- (4) the presence of any factor which significantly impacts the risk associated with the particular instrument.n39

These are benchmarks of any security transaction. Taken together with the baseline notion of risk capital, they shape the definition of a security under state blue sky laws with a series of inquiries.

First, what is actually being acquired in the transaction? If the value of the thing or asset purchased is significantly measured by the thing itself, *i.e.*, its own worth, the presence of a security is less likely. Second, what is the post acquisition value of the thing, and what determines that value? If the motivation for the transaction is an expected return that is dependent upon factors not within the control of the purchaser, the presence of a security is indicated. Similarly, investment risk, and the presence of a security, is indicated where information bearing upon the validity of the purchaser's expectations is within the control of the seller. The purchaser is either denied or has no ability to obtain information with which to evaluate risk/return characteristics for the future. Such an evaluation was a mainstay of traditional merit regulation of securities offerings under state blue sky laws for decades, and the concern for it will continue to drive applications of their remedial provisions to prevent fraud or deception in the state/federal regulatory environment since redefined by NSMIA.

In the sections that follow, the enumerated instruments and categories of securities commonly defined as securities in state blue sky laws are examined. In each case the important inquiry and explanation is not what is listed in blue sky law

definitions of security, but why particular categories or instruments are listed. With such an explanation the mission of blue sky laws will not only be better understood in the myriad circumstances in which state courts, securities regulators and the public consider the need for special protection, but the operation of the blue sky laws will be more efficient.

FOOTNOTES:

(n1)Footnote 1. Unif. Securities Act § 401(l). The Uniform Act definition closely tracks the definitions of security found in both the Securities Act of 1933 and the Securities Exchange Act of 1934. Section 2(1) of the Securities Act, 15 U.S.C. § 77(b)(1), for example, provides:

[U]nless the context otherwise requires--

The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit sharing agreement, collateral trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas or other mineral rights, any put, call, straddle, option or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

The Exchange Act contains a definition of "security" which is virtually identical to that in the Securities Act as to enumerated instruments and categories. *See* 15 U.S.C. § 78c(10).

(n2)Footnote 2. 2002 Unif. Securities Act § 102(28). The 2002 Uniform Act has been enacted (although may not yet be effective) in Missouri, Oklahoma, Kansas, South Dakota, Idaho, Iowa, South Carolina, Maine, Vermont, Minnesota, Hawaii, and the U.S. Virgin Islands. It is under active consideration in several other states, including Alaska, Alabama, Nebraska, Virginia, and Michigan. The 2002 Uniform Act is reproduced in its entirety in Volume 2, *below*.

(n3)Footnote 3. *People v. Figueroa*, 41 Cal. 3d 714, 736, 224 Cal. Rptr. 719, 715 P.2d 680 (1986) ; *see also Cellular Engineering, Ltd. v. O'Neill*, 118 Wash. 2d 16, 23, 820 P.2d 941 (1991) (The primary purpose of the Securities Act is to "protect investors from speculative or fraudulent schemes of promoters"); *All Seasons Resorts, Inc. v. Abrams*, 68 N.Y.2d 81, 86, 87, 506 N.Y.S.2d 10, 497 N.E.2d 33, 35 36 (1986) ("We are mindful that the statute, as part of New York's blue sky law, should be liberally construed to give effect to its remedial purpose of protecting the public from fraudulent exploitation in the offer and sale of securities").

Note too that the definition of "security" for purposes of blue sky regulation is independent of any other statutory definition. In *Bahre v. Pearl*, 595 A.2d 1027 (Me. 1991), for example, the court cautioned that different underlying purposes of the Uniform Commercial Code and the state blue sky law mandate that the definitions of "security" in each be considered separate and distinct, and that the blue sky definition must be applied to effectuate the purpose of the law, which is to protect investors from speculative or fraudulent investment schemes.

But see *Gutmann v. Feldman*, 97 Ohio St. 3d 473, 2002-Ohio-6721, 780 N.E.2d 562, in which the Ohio Supreme Court held that an *oral* contract could not constitute a security under the Ohio blue sky law, which required a certificate or other written instrument. The holding was subsequently overturned by an amendment to the Ohio law, such that a security may now be an "oral, written or electronic agreement, understanding or opportunity," O.R.C. § 1707.01(B). However, the case suggests that an overarching remedial purpose will not supplant unambiguous statutory language for purposes of defining a security. This is also clearly the message of *Thomas v. State*, 65 S.W.3d 38 (Tex. Crim. App.

2002), in which the Texas court concluded that for an "evidence of indebtedness" to be a security under that state's Blue Sky law, a writing must be involved.

(n4)Footnote 4. P.L. 104 290, 110 Stat. 3416 (1996). NSMIA replaced, in its entirety, Section 18 of the Securities Act of 1933, 15 U.S.C. § 77r, which had preserved broad regulatory authority to the states, with a new scheme of allocated federal and state authority based upon the nature of a securities offering. The impact of NSMIA on state regulatory authority generally is considered in detail in ch. 5, *below*. Merit regulation, to the extent it remains intact, is considered further in ch. 5, *below*.

(n5)Footnote 5. *See* ch. 15 *below*.

(n6)Footnote 6. *See* ch. 11 *below*.

(n7)Footnote 7. *See* ch. 15 *below*.

(n8)Footnote 8. As a matter of "statutory policy," section 415 of the Uniform Act declares:

This act shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it and to *coordinate the interpretation and administration of this act with the related federal regulation*. (Emphasis added).

See also 2002 Unif. Securities Act § 608(b).

(n9)Footnote 9. *People v. Figueroa*, 41 Cal. 3d 714, 736, 224 Cal. Rptr. 719, 715 P.2d 680 (1986).

(n10)Footnote 10. Divergence between state and federal approaches is well illustrated by the treatment of "viatical settlements" under state and federal definitions. Viatical settlements, considered in more detail in § 2.08[2][g] *below*, involve the purchase by a third party of part of the life insurance policy of a terminally ill person in advance of that person's death. The offer and sale of such interests to the public by intermediary firms has been challenged under state and federal securities laws. In *SEC v. Life Partners, Inc.*, 322 U.S. App. D.C. 189, 102 F.3d 587 (D.C. Cir. 1996), a federal appeals court held that viatical settlements do not constitute "investment contracts" as a matter of federal law. In sharp contrast, state securities regulators almost universally hold that viatical settlements are securities, and several blue sky laws have been amended expressly to include them in the statutory definition. State regulators have concluded that viatical settlements involve risks that investors may not realize exist and that unscrupulous promoters may misrepresent or fail to disclose.

(n11)Footnote 11. In *People ex rel. Bender v. Wind River Mining Project*, 219 Cal. App. 3d 1390, 269 Cal. Rptr. 106 (1990), for example, a California appellate court declared that "[o]ur Corporate Securities Law was designed broadly to regulate all transactions by which promoters go to the public for risk capital." Gold production and delivery agreements sold in connection with a difficult and speculative mining operation were securities, said the court, because purchasers acquired only a "right and a hope," and that whether gold would ever be provided was dependent upon the use of the purchasers' risk capital raised through selling the certificates. 219 Cal. App. at 1402.

(n12)Footnote 12. *State by Commissioner of Sec. v. Hawaii Mkt. Ctr.*, 52 Haw. 642, 485 P.2d 105 (1971).

(n13)Footnote 13. *See Cox v. Lemond*, 107 Ohio App. 3d 442, 669 N.E.2d 23 (1995). In *Cox*, the court embraced the risk capital criteria for defining the existence of a security, but applying them it affirmed a trial court finding that no security was present in a partnership setting in which the controlling agreement between the parties allowed for sharing significant amounts of control over daily managerial matters by the plaintiff.

(n14)Footnote 14. The "risk capital" approach to defining the existence of a security under state blue sky laws is

more thoroughly considered in § 2.08[3], *below*.

(n15)Footnote 15. 328 U.S. 293, 66 S. Ct. 1100, 90 L. Ed. 1244 (1946) .

(n16)Footnote 16. 328 U.S. at 298-99 , 66 S. Ct. at 1102-03 , 90 L. Ed. at 1249-1250. Investment contracts are discussed in detail in § 2.08 *below*.

(n17)Footnote 17. State v. George, 50 Ohio App. 2d 297, 302, 362 N.E.2d 1223, 1227 (1975).

(n18)Footnote 18. 298 Ark. 542, 769 S.W.2d 20 (1989) .

(n19)Footnote 19. *Id.* at 22 ; *see also* Cook v. Wills, 305 Ark. 442, 808 S.W.2d 758 (1991) .

(n20)Footnote 20. State v. Brewer, 932 S.W.2d 1 (Tenn. Crim. App. 1996) .

(n21)Footnote 21. A sense of "common" characteristics or common usage of the term security is also evident in this observation of the Kansas Supreme Court in State v. Hodge, 204 Kan. 98, 460 P.2d 596, 601-602 (1969):

By common usage ... the term has acquired a much broader meaning. It is now generally used to refer to instruments for the payment of money, or evidencing title or equity with or without some collateral obligation, and which are commonly dealt in for the purpose of financing and investment. Instruments, whether secured or unsecured, which are used for the purpose of financing enterprises and promoting a distribution of rights in or obligations of such enterprises, and which are designed as a means of investment, are termed "securities."

(n22)Footnote 22. R.C.W. § 21.20.005(12).

The Risk Capital approach to defining a security is discussed specifically in § 2.09, *below*.

(n23)Footnote 23. 494 U.S. 56, 62, 110 S. Ct. 945, 949 50, 108 L. Ed. 2d 47, 58 , *reh'g denied*, 494 U.S. 1092, 110 S. Ct. 1840, 108 L. Ed. 2d 968 (1990) . The observation presupposes that the "stock" involved actually exhibits traditional corporate attributes. Earlier, in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 95 S. Ct. 2051, 44 L. Ed. 2d 621 (1975) , the Court held that shares of "stock" in a state subsidized housing cooperative were not securities as a matter of federal law. The shares had none of the traditional characteristics of corporate stock, and did not evoke any notion of an investment security. "Common sense suggests that people who intend to acquire only a residential apartment in a state subsidized cooperative, for their personal use, are not likely to believe that in reality they are purchasing investment securities simply because the transaction is evidenced by something called a share of stock." 421 U.S. at 851, 95 S. Ct. at 2060, 44 L. Ed. 2d at 631 .

"Stock" as a security under state blue sky laws is considered further at § 2.02 *below*.

(n24)Footnote 24. Doherty v. Kahn, 289 Ill. App. 3d 544, 682 N.E.2d 163, 224 Ill. Dec. 602 (1997). "Stock" as a security under blue sky laws is considered in detail in § 2.02, *below*.

(n25)Footnote 25. 247 Neb. 907, 531 N.W.2d 523 (1995) .

(n26)Footnote 26. The Nebraska court's conclusion follows from that of the United States Supreme Court in *Marine Bank v. Weaver*, 455 U.S. 551, 102 S. Ct. 1220, 71 L. Ed. 2d 409 (1982) , in which the Court held that a certificate of deposit issued by a regulated, federally insured bank is not a security for purposes of the federal securities laws.

See also Hooper v. McCray, 593 So. 2d 1018 (Ala. 1992) ("Insured premium money market investment account" is not a security).

(n27)Footnote 27. 540 U.S. 389, 124 S. Ct. 892, 157 L.Ed.2d 813 (2004) .

(n28)Footnote 28. *Edwards* focused on the offer and sale of pay telephones with an agreement under which the seller leased back the payphone from the purchaser for a fixed monthly payment. The U.S. Supreme Court concluded that the sale and leaseback program constituted an investment contract despite the fixed annual return. Pay telephone sale and leaseback programs have received a great deal of attention by state courts and securities regulators as investment contracts, and are considered further in § 2.08[1][c], *below*.

(n29)Footnote 29. 255 Kan. 228, 873 P.2d 1355 (1994) .

(n30)Footnote 30. 255 Kan. at 232 .

(n31)Footnote 31. *State v. Kramer*, 804 S.W.2d 845 (Mo. Ct. App. 1991).

(n32)Footnote 32. *See, e.g., Sparks v. Baxter*, [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,781 (5th Cir. 1988) (applying Texas law).

(n33)Footnote 33. *State v. Anderson*, 203 Wis. 2d 271, 551 N.W.2d 870 (1996) (defendant had exclusive control over the business operations as operating partner and the remaining partners had virtually no right to direct, control or influence the business operations); *Casali v. Schultz*, 292 Ark. 602, 732 S.W.2d 836 ; *see Corporate East Associates v. Meester*, 442 N.W.2d 105 (Iowa 1989).

(n34)Footnote 34. 320 U.S. 344, 64 S. Ct. 120, 88 L. Ed. 88 (1943) .

(n35)Footnote 35. 320 U.S. at 348, 64 S. Ct. at 122, 88 L. Ed. at 91 . The Court added: "It is clear that an economic interest in this [enterprise] ... was what brought into being the interests that defendants were selling and gave to the instruments most of their value and all of their lure." 320 U.S. at 349, 64 S. Ct. at 122, 88 L. Ed. at 92 .

(n36)Footnote 36. 320 U.S. at 353, 64 S. Ct. at 124, 88 L. Ed. at 94 .

(n37)Footnote 37. *In re Gardner*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,757 (N.Y. Sup. Ct. 1979) (emphasis added); *see also Anderson v. Grand Bahama Development Co.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,778 (Ill. App. Ct. 1979) (specific oral and written representations in promotional campaign).

But see Dept. of Commerce v. DeBeers Diamond Investment Ltd., 89 Mich. App. 406, 280 N.W.2d 547, 552 (1979) ("We do not read the cases interpreting the Uniform Securities Act and similar statutes as holding that advertisements which offer commodities as investments, coupled with a guarantee to buy the goods back at market price, are sufficient to transform a simple sale of personalty into an investment contract").

(n38)Footnote 38. 494 U.S. 56, 110 S. Ct. 945, 108 L. Ed. 2d 47 (1990) .

(n39)Footnote 39. 494 U.S. at 66-67, 110 S. Ct. at 951-952, 108 L. Ed. 2d at 60-61.



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CHAPTER 2 Definition of Security

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§ 2.02 Stock

"Stock" has been characterized as the "paradigm of a security,"ⁿ¹ and by the very label itself is the thing most immediately perceived to be a security among the list comprising state and federal statutory definitions. However, since the 1975 decision of the U.S. Supreme Court in *United Housing Foundation, Inc. v. Forman*,ⁿ² in which the Court held that shares of "stock" in a state sponsored cooperative housing project were not securities within the ambit of the federal securities laws, it is certain that there is more to finding a security than looking to a label. The status of "stock" as a security is largely defined by a set of particular attributes or characteristics. These were identified by the Supreme Court in *Forman* as follows:

- (1) the right to receive dividends, when profits are apportioned;
- (2) negotiability;
- (3) the capacity to be pledged or hypothecated;
- (4) voting rights proportionate to the number of shares owned; and
- (5) the potential to appreciate in value.ⁿ³

These are the traditional attributes of corporate stock. They are appropriately amplified by the notion that stock represents an equity interest in a corporate enterprise, which carries with it the right not only to whatever return results from an income stream and/or capital gain, but ultimately an identifiable interest in the value of the corporate assets net of creditors. A share of "stock" possessing these attributes evidences each of the fundamental economic characteristics of any security. But its corporate sense also identifies "stock" as a standardized instrument in commerce. As such, the U.S. Supreme Court has further observed, it evidences the typical kind of context in which the securities laws normally operate.

In *Landreth Timber Co. v. Landreth*,ⁿ⁴ and a companion case, *Gould v. Ruefenacht*,ⁿ⁵ the Supreme Court made clear that actual corporate stock possessing these traditional attributes is a security for purposes of the federal securities laws, regardless of the transactional setting in which the stock is involved. In *Landreth* and *Gould* the Court rejected the "sale of business" doctrine which had been formulated in several lower court decisions to deny protections of the federal

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securities laws to purchasers of all or substantially all of a corporation's stock to acquire control. Courts embracing the doctrine had held that despite the presence of corporate stock, no security should be found by reason of the control over the enterprise vested in the purchaser that was the result of the transaction. Notwithstanding this result, the Supreme Court found no good reason to excise traditional corporate stock from coverage of the securities laws, particularly where, contrasting *Forman*, the nature of the instrument itself would likely lead a purchaser to believe that securities law protections would apply.ⁿ⁶ The "sale of business" doctrine was thus rejected.

Landreth instructs a literal, or "plain meaning," reading of the definition of security where traditional corporate stock is the focus. Indeed, in *Gould*, the companion case, the Court stated:

In *Landreth*, we held that where an instrument bears the label "stock" and possesses all of the characteristics typically associated with stock, a court will not be required to look beyond the character of the instrument to the economic substance of the transaction to determine whether the stock is a "security" within the meaning of the Acts.ⁿ⁷

After *Landreth*, any "economic reality" or "economic substance" test for identifying a security should be strictly limited to those situations where the instrument involved is unusual and cannot be easily characterized as a security, or where it does not fall within the statutory definition. The point is well illustrated by the Hawaii Supreme Court decision in *Fong v. Oh*,ⁿ⁸ in which a lower court application of Hawaii's "risk capital" test to deny application of antifraud protections of the Hawaii Uniform Securities Act to the purchase of 100% of the stock of a corporation was flatly rejected. The lower court had not distinguished between "stock" and "investment contracts" as different types of securities for purposes of the Hawaii blue sky law. The Supreme Court, however, concluded that investment contract analysis is to be applied when an instrument does not fit within the specific types of securities delineated in the statute. The *Landreth* test, said the court, must be applied to determine whether an instrument labeled stock is a security.ⁿ⁹

Most state courts confronting the issue under blue sky law definitions have embraced this instruction as articulating a stock "characterization" test. Under this test, the controlling question is whether the stock is "traditional" stock, *i.e.*, whether it bears such characteristics usually associated with corporate common stock that a purchaser justifiably may assume that securities laws apply. The Georgia Supreme Court has illustrated the approach:

Landreth Timber provides appropriate guidance in resolving issues of whether particular "stock" is a security under [the Georgia Securities Law]. In applying the *Landreth* stock characterization test to ... transaction[s] ... we will use a balancing test. The appropriate test to be employed is whether the ... stock bears such characteristics usually associated with common stock that a purchaser justifiably may assume that appropriate security laws apply.ⁿ¹⁰

And as a Georgia Court of Appeals further explained: "If, and only if, the stock does not satisfy these criteria, then the next inquiry is whether the stock qualifies as a security under [other 'economic reality' tests]"ⁿ¹¹ Other state courts have simply adopted *Landreth* as rejecting the "sale of business" doctrine,ⁿ¹² or as necessary to carry out the mandate for state/federal coordination codified in the Uniform Securities Act.ⁿ¹³ One state, Washington, has simply reaffirmed its pre *Landreth* principle that its blue sky law applies to transactions involving the transfer of all of the outstanding stock of a corporation in a face to face negotiated transaction.ⁿ¹⁴

On the other hand, the "literalist" approach of *Landreth* has not universally been embraced by state courts. In *Anderson v. Heck*,ⁿ¹⁵ a Louisiana appellate court clung fast to the notion that the use of stock in a transaction which is, in reality, a sale of the assets of a business should not be deemed to be a security transaction. Chief among its considerations was the fact that the buyer had free access to and ample opportunity to examine the financial records, assets and other matters relating to the business enterprise. The court took its cue from the point emphasized by Justice Stevens in his dissent in *Landreth* that: "I believe Congress wanted to protect investors who do not have access to inside information and who are not in a position to protect themselves from fraud by obtaining appropriate contractual warranties."ⁿ¹⁶

1-2 Blue Sky Regulation § 2.02

An Illinois appellate court in *Saunders, Lewis & Ray v. Evans* n17 refused to extend coverage of the blue sky law rescission remedy to an individual who, simultaneously with purchasing what was undeniably corporate stock, was elected to the corporation's board of directors and made an officer. The court made no mention of *Landreth*, relying instead on pre *Landreth* cases in the state, to deny coverage on the proposition that the blue sky law was not intended to protect a non passive investor who "occupies a position giving him control over his investment."n18 Another Illinois appellate court likewise refused to extend the protection of the antifraud provisions of that state's blue sky law to the sale of corporate stock in a transaction that, according to the court, involved only the creation of a partnership in a corporate form. In *Doherty v. Kahn* n19 the plaintiff exchanged his employees, equipment and existing business accounts for 65 percent of the stock of another business enterprise in which he became the president. Although the seller of the stock retained a 35 percent ownership interest, and thus the transaction did not represent the sale of the business, Illinois case authority establishes the principle that if in fact the transaction involves creation of a *partnership*, the corporation and the stock involved are only incidental, and no security is present.n20 In *Doherty* the court observed that the transaction involved the plaintiff becoming president of the business, and taking responsibility for client development, sales and operations. Plaintiff shared in the control and management of the business. These factors, said the court, made for the creation of a partnership "in corporate form." The sale of stock was insignificant.

These Illinois cases illustrate the application of a joint venture or partnership gloss to ostensibly corporate relationships. The corporate "stock" in the transaction, regardless of its characteristics, is deemed insignificant in relation to the direct, contributions to the success of the enterprise that are the true focus of a transaction in which the combination of resources is paramount to any "investment" characteristics. Such a gloss might easily be applied in common start-up or other entrepreneurial settings in which individuals combine financial, technical and management resources in the shared creation of an enterprise. In these settings it may not be inappropriate to entertain certain presumptions concerning the control relationship among the parties and the true nature of their association, so as to conclude that no one among them is an "investor" entitled to the protections of blue sky laws. This is clearly at the heart of considerations of "close corporation agreements" discussed further below.

There is a danger that in applying a judicial gloss to relationships, disparate positions among participants with respect to information necessary to evaluate the risk of going forward, as well as the extent to which a participant may in fact be separated from true value determinants are too easily missed in a simple application of a joint venture or partnership gloss to a corporate enterprise. The plaintiff in *Doherty* alleged that he had been duped into entering into the relationship. His powers after becoming part of the enterprise were, in effect, alleged to be meaningless in light of the fraud he claimed had been perpetrated on him in the first place. It is important in the application of a joint venture or partnership gloss on corporate relationships that the underlying presumptions are valid, and that true "investment" risk is in fact missing. Despite residual tension grounded in the fundamental mission of blue sky laws to protect innocent public investors in speculative ventures, most state courts confronting the issue recognize that *Landreth* specifically rejected the argument that the securities laws are intended to cover only passive investors and not privately negotiated transactions involving the transfer of control between entrepreneurs.n21

Many challenges to the application of blue sky laws come in close corporation settings, privately negotiated transactions which may or may not involve a transfer of control, and transactions in which, increasingly, a shareholder or "close corporation" agreement may impact the relationship between participants. After *Landreth* the primary inquiry is whether a true "corporate" relationship based upon stock ownership is presented. In *Sulkow v. Crosstown Apparel, Inc.*, n22 for example, corporate stock of a closely held corporation involving three equal shareholders was held to be a security because the stock carried proportional voting rights, rights to dividends, and the capacity to appreciate in value. The fact that *Crosstown* was a close corporation, and that the shareholders' agreement placed limitations on transferability of the stock, was insufficient to negate the character of the stock as a security.n23

A "corporate" relationship evidenced by stock possessing traditional characteristics may, nevertheless, be sufficiently altered to affect the status of the instrument as a security. The advent of "close corporation agreements" as a matter of

state corporation law adds such a wrinkle in post *Landreth* analyses. The goal of these agreements is to allow for negotiated shareholder rights and responsibilities, minority protections and, in effect, to allow closely held corporations and their shareholders to create a relationship and be governed as if the corporation were a partnership. The typical "close corporation agreement" authorized under state lawsⁿ²⁴ empowers shareholders to agree among themselves on such matters as:

- (1) control of management in the business and affairs of the corporation;
- (2) the power of one or more shareholders to require dissolution of the corporation;
- (3) voting rights and obligations;
- (4) the designation of officers and directors;
- (5) terms and conditions of employment of officers and other employees;
- (6) dividend policy;
- (7) the scope of directors' authority;
- (8) access to books and records;
- (9) limitations on the issuance of new shares;
- (10) deadlock resolution procedures.ⁿ²⁵

Interests in true general partnerships and joint ventures are not securities because of the presumption, if not the fact, of shared control.ⁿ²⁶ "Corporate" relationships which fairly approximate a partnership or joint venture between participants, whether or not by reason of a close corporation agreement may, at the very least, shift the "stock" involved from the traditional notion of a standardized instrument in commerce, so as to require an examination of "economic substance." In *Cook v. Wills*,ⁿ²⁷ for example, the Arkansas Supreme Court held that stock involved in the merger of two closely held realty companies did not constitute a security subject to the anti fraud provisions of the Arkansas blue sky law. The determination was premised on evidence which showed that the plaintiff purchaser was to provide the necessary skill and expertise in the operation of the combined entity, and that the main point of her receiving an interest in the new business was her future creative ability to be used in its behalf. There was no agreement defining the relationship. However, the case illustrates that there is considerable room for state courts to craft applications of blue sky laws in a manner that best effectuates investor protection.ⁿ²⁸

Securities law protections are fundamentally intended to extend to those persons who are divorced from control over the value determinants of what they hold, and who are informationally disadvantaged. Corporate stock is "literally" a security because its traditional attributes reflect the need for such protection, and because, in the main, its character in commerce is established. But state courts and securities regulators struggle with the notion where the fundamental aspects of a transaction are not truly "corporate." As illustrated by *Cook*, application of a joint venture gloss in any setting may still defeat security status despite the presence of stock.ⁿ²⁹

There will be other settings in which non traditional stock will compel close examination of the actual relationship of the parties and the enterprise. Membership participations in housing or business cooperatives, for example, may be evidenced by "stock," but *Forman* continues to counsel that housing cooperatives present a much different set of expectations and characteristics from those suggested by the label. Even where profit seeking business cooperatives are involved, federal regulatory experience indicates that true cooperative ventures, in which all members participate

directly in management and, despite the presence of "stock," define the nature of their association and the instrument they hold in ways that differ from the traditional characteristics of the true corporate instrument, should not be deemed to involve a security.ⁿ³⁰

In the post *Landreth* era it is plain that "stock" is a security. Yet there is to be no absolutely "literal" application of securities laws where "stock" is the focal point. Innovations such as close corporation agreements and anything else that impacts the fundamental aspects of a security transaction must yet be confronted case by case to ascertain whether the traditional attributes signaled by the term "stock" are altered. What is certain, however, is that *Landreth* and its blue sky progeny focus attention on the reality of stock in a commercial universe rather than a transaction specific analysis of the meaning of the instrument for a particular purchaser.ⁿ³¹

FOOTNOTES:

(n1)Footnote 1. *Daily v. Morgan*, 701 F.2d 496, 500 (5th Cir. 1983) .

(n2)Footnote 2. 421 U.S. 837, 95 S. Ct. 2051, 44 L. Ed. 2d 621 (1975) .

(n3)Footnote 3. 421 U.S. at 851, 95 S. Ct. at 2060, 44 L. Ed. 2d at 631-632. The "stock" involved in *Forman* possessed none of these characteristics and represented only the right to a residential apartment in the non profit co op project. No purchaser could rationally look upon the "stock" issued as presenting any investment decision. As the Court opined:

There is no doubt that purchasers in this housing cooperative sought to obtain a decent home at an attractive price. But that type of economic interest characterizes every form of commercial dealing. What distinguishes a security transaction--and what is absent here--is an investment where one parts with his money in the hope of receiving profits from the efforts of others, and not where he purchases a commodity for personal consumption or living quarters for personal use. 421 U.S. at 858, 95 S. Ct. at 2063, 44 L. Ed. 2d at 635 .

(n4)Footnote 4. 471 U.S. 681, 105 S. Ct. 2297, 85 L. Ed. 2d 692 (1985).

(n5)Footnote 5. 471 U.S. 701, 105 S. Ct. 2308, 85 L. Ed. 2d 708 .

(n6)Footnote 6. See 471 U.S. 681, 693, 105 S. Ct. 2297, 2305, 85 L. Ed. 2d 692, 702 (1985) ("Persons trading in traditional stock have a high expectation that their activities are governed by the Acts").

(n7)Footnote 7. 471 U.S. 701, 704, 105 S. Ct. 2308, 2310, 85 L. Ed. 2d 708, 711 . The baseline premise in all this was stated by the Court in *Landreth*: "[s]tock" is relatively easy to identify because it lends itself to consistent definition... . Unlike some instruments, therefore, traditional stock is more susceptible of a plain meaning approach." 471 U.S. at 693.

See also *Barnes v. Sunderman*, 453 N.W.2d 793 (N.D. 1990) (corporate stock is traditional stock, and blue sky law applies).

Stock options, that is, standardized "put" or "call" options traded on national securities exchanges or over-the-counter, have also been held to fall within the purview of blue sky regulation. In *State v. Davidson*, 131 N.C. App. 276, 506 S.E.2d 743 (1998), the court affirmed the criminal conviction of a defendant who used funds obtained from others under false pretenses to engage in option trading for his own benefit. The defendant was convicted under antifraud provisions of the North Carolina blue sky law. On appeal, he argued, among other things, that his options trading did not meet the "security" requirement of the statute. Looking to federal authority, the North Carolina appeals court concluded that it is "well-settled" that stock options fall within the definition of security, and that defendant was properly convicted where

the fraud or misrepresentation was directly or indirectly connected to the offer, sale, or purchase of these securities.

Options, warrants and contract rights associated with stock are discussed further as separately identifiable securities in § 2.06, *below*.

(n8)Footnote 8. *Fong v. Oh*, 116 Haw. 187, 172 P.3d 499 (2007).

(n9)Footnote 9. *Fong v. Oh*, 116 Haw. 187, 197, 172 P.3d 499 (2007); *see also* *Disher v. Fulgoni*, 161 Ill. App. 3d 1, 10, 514 N. E.2d 767, 772, 112 Ill. Dec. 949 (1987); *see also* *Jabend, Inc. v. Four-Phase Systems, Inc.*, 631 F. Supp. 1339, 1342 (W.D. Wash. 1986) (in considering Washington state and federal definitions, the court stated: "After *Landreth*, an investment in common stock is presumptively an investment in a security. Thus, when faced with a claim involving an investment in common stock, a court should by pass the ... "economic reality" test, and begin its analysis under the Securities Acts").

(n10)Footnote 10. *Cohen v. William Goldberg & Co.*, 262 Ga. 606, 607 423 S.E.2d 231, 233 (1992).

See also *Andrews v. Browne*, 276 Va. 141, 662 S.E.2d 58 (2008) (if an instrument bears the label "stock" and possesses all of the characteristics typically associated with stock, it is a security within the meaning of the Virginia Securities Act).

(n11)Footnote 11. *Bell v. Sasser*, 238 Ga. App. 843, 520 S.E.2d 287 (1999).

See also *State v. Stuber*, 25 Kan. App. 2d 254, 962 P.2d 1104 (1998), in which the court rejected the convicted defendant's argument that a *Howey* investment contract jury instruction should have been given. The court opined that a *Howey* instruction is not appropriate in transactions involving the sale of stock. The instruments involved, said the court, "looked like stock, bore all of the characteristics of stock, and were admitted to be stock." 25 Kan. App. at 262.

See also *Manchester Mfg. Acquisitions v. Sears Roebuck & Co.*, 909 F. Supp. 47 (D.N.H. 1995) (sale of all stock of a distribution warehouse business was the sale of a security for application of the New Hampshire blue sky law); *Barnes v. Sunderman*, 453 N.W.2d 793 (N.D. 1990) (corporate stock in the sale of 50 percent interest of a business is traditional stock); *Carver v. Blanford*, 288 S.C. 309, 342 S.E.2d 406 (1986).

(n12)Footnote 12. *See* *Sparling Plastic Indus. v. Sparling*, 229 Mich. App. 704, 583 N.W.2d 232 (Mich. App. 1998); *Banton v. Hackney*, 557 So. 2d 807 (Ala. 1990); *Barnes v. Sunderman*, 453 N.W.2d 793 (N.D. 1990). *Cf.* *Disher v. Fulgoni*, 161 Ill. App. 3d 1, 514 N.E.2d 767 (1987) (the court found that voting trust certificates for stock were literally within the definition of security in the blue sky law and evidenced no unusual characteristics which, under *Landreth*, could override that inclusion).

(n13)Footnote 13. *See* *Specialized Tours, Inc. v. Hagen*, 392 N.W.2d 520 (Minn. 1986) (*en banc*).

In *Manchester Mfg. Acquisitions v. Sears Roebuck & Co.*, 909 F. Supp. 47 (D.N.H. 1995), the court called for uniformity with the observation that since the definition of security' is substantially similar under both federal and state law, there is "no principled reason" to draw a distinction between the two given their collective protective purpose.

See also *Kovatovich v. Barnett*, 406 N.W.2d 516 (Minn. 1987) (*en banc*). In this typical "sale of business" setting, the Minnesota Supreme Court reluctantly embraced *Landreth*, but tacitly invited the legislature to act to correct what the court considered to be an inequitable result. The legislature later responded with an amendment to the Minnesota blue sky law to exclude the sale of 100 percent of the stock of a closely held corporation from coverage of the law. *See* Minn. Stat. § 80 A.14, Subd. 18.

(n14)Footnote 14. *Aspelund v. Olerich*, [1990-1991 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,231 (Wash.

1990); see *Wisconics Engineering, Inc. v. Fisher*, 466 N.E.2d 745 (Ind. Ct. App. 1984) (Pre *Landreth*, but applying prior authority rejecting the sale of business doctrine); see also *Kovatovich v. Barnett*, 406 N.W.2d 516 (Minn. 1987).

(n15)Footnote 15. 554 So. 2d 695 (La. Ct. App. 1989) .

(n16)Footnote 16. *Id.* at 711 , quoting *Landreth* (Stevens, J., dissenting).

But see In re Fontana D'Oro Foods, Inc., 65 N.Y.2d 886, 493 N.Y.S.2d 300, 482 N.E.2d 1216, 1217 (1985) ("Given the form of their transaction, whether the parties might really have intended to transfer control of an ongoing business enterprise, rather than stock, can have no bearing on this conclusion [that a security is present]").

(n17)Footnote 17. 158 Ill. App. 3d 994, 512 N.E.2d 59, 111 Ill. Dec. 155 (1987).

(n18)Footnote 18. 158 Ill. App. 3d at 995, 512 N.E.2d at 60.

(n19)Footnote 19. 289 Ill. App. 3d 544, 682 N.E.2d 163, 224 Ill. Dec. 602 (1997).

(n20)Footnote 20. See *Condux v. Neldon*, 83 Ill. App. 3d 575, 585, 404 N.E.2d 532 (1980).

(n21)Footnote 21. See also *Anheuser-Busch Cos. v. Summit Coffee Co.*, 858 S.W.2d 928, 940 (Tex. App. 1993).

(n22)Footnote 22. 807 F.2d 33 (2d Cir. 1986) .

(n23)Footnote 23. See also *Cohen v. William Goldberg & Co.*, 262 Ga. 606, 423 S.E.2d 231, 233 (1992) (court held that a shareholders' agreement providing restrictions on transfer and other rights impairing negotiability did not negate the character of the stock as a security).

(n24)Footnote 24. See, e.g., 8 Del. Code Ann. § 351; Ohio Rev. Code § 1701.591.

(n25)Footnote 25. The use of close corporation agreements to define the relationship and rights among participants has diminished to an appreciable degree in favor of the widespread use of limited liability companies (LLCs). In an LLC, the "members" define their rights and establish the control structure through an "operating agreement" that functions in the same manner as a close corporation agreement. LLCs do not establish as "corporate" relationship as such, and no "stock" is involved. Whether LLC interests are securities under Blue Sky laws has primarily been addressed through express inclusion of them as a category of security. The treatment of LLCs under state securities laws is presented in section 2.07[4], *below*.

(n26)Footnote 26. See §§ 2.07 and 2.08[2][a] *below*.

(n27)Footnote 27. 305 Ark. 442, 808 S.W.2d 758 (1991) .

(n28)Footnote 28. See *Huggins v. Chapin*, 227 Ga. App. 340, 489 S.E.2d 109 (1997). In *Huggins* the purchaser of a ten percent ownership interest in a closely held corporation who claimed he was duped into investing by false information concerning the value of the company was deemed to have purchased an investment contract, and was thus entitled to invoke the protection of the Georgia blue sky law. There was no transfer of "stock," as such, as part of the transaction, only a later written affirmation that the plaintiff's investment represented a ten percent ownership interest. That interest entitled the plaintiff to share in the profits of the business relative to his ownership. In connection with the transaction, plaintiff was given the title Vice President of the company and was expected to engage in marketing activities, he had no executive or operational powers. All essential managerial control affecting the success or failure of the business rested with the defendant. The court found that although no "stock" was involved, the plaintiff's investment was nonetheless an investment contract.

(n29)Footnote 29. See also *Goodman v. DeAzoulay*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) P

99,140 (E.D. Pa. 1983) (what was clearly "stock" in the company was held not to be a security where the plaintiff was the president of the company and an active entrepreneur and participant in the management of its business).

But see Dinco v. Dylex Limited, 111 F.3d 964 (1st Cir. 1997) (applying New Hampshire law, the court cautioned that shareholders of a closely held corporation are not, ipso facto, partners).

See also Wakefield v. Crawley, 6 S.W. 3d 442 (Tenn. 1999), in which stock of a closely-held corporation was deemed to be within the definition of "security" under the Tennessee version of the Uniform Commercial Code because they are interests "of a type" commonly traded on securities exchanges.

(n30)Footnote 30. *See, e.g., Seger v. Federal Intermediate Credit Bank of Omaha, 850 F.2d 468 (8th Cir. 1988)* (stock of Production Credit Association that borrowers were required to purchase as a condition to obtaining a loan not a security under the Nebraska blue sky law).

Seger is an example of a "cooperative" organization in which the objective of participants is often mutual benefit from something other than profits of a business enterprise. Typical characteristics of any cooperative association which negate the presence of a security include:

- (1) all members participate directly in management;
- (2) the "stock" involved is non negotiable, and may not be pledged or hypothecated;
- (3) the "stock" cannot appreciate in value, termination of membership requires sale back to the co op at a predetermined price, or in accordance with a set formula;
- (4) no dividends are paid; income distributions are repaid in accordance with contributions to the productivity of the enterprise.

See also, Front Street Supermarkets, Inc., No Action Letter, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,352 (Div. Corp. Fin. 1982).

(n31)Footnote 31. The prominence of the "Limited Liability Company," another creation of state law, is today also a part of this analytical mix. The limited liability "company," a form of business organization affording "members" the limited liability associated with a corporation while at the same time permitting taxation of the entity as a partnership, is built around an operating agreement among members. The agreement prescribes the extent of participation in and control over the management of the enterprise. Examination of this form of business organization in light of state blue sky laws is presented in § 2.07[4], *below*.



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Blue Sky Regulation

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CHAPTER 2 Definition of Security

1-2 Blue Sky Regulation § 2.03

§ 2.03 Notes and Other Evidences of Indebtedness

[1] Generally

The array of instruments defined to be securities in all state securities laws, the Uniform Acts,ⁿ¹ and both federal acts, is headed by "any note," and also expressly includes "evidence of indebtedness."ⁿ² Nevertheless, despite literal inclusion within the definition, it is clear on the face of most state statutes that not all notes or evidences of indebtedness are intended to be covered.ⁿ³ All states, for example, make distinctions among kinds of notes by providing exemptions from coverage of their blue sky laws for certain types of debt instruments, such as short term, prime quality, commercial paper. The Uniform Act is representative in its express exemption from coverage for "[a]ny commercial paper which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which evidences an obligation to pay cash within nine months of the date of issuance."ⁿ⁴

Other exemptions in state laws exclude some notes or evidences of indebtedness from coverage by reason of particular characteristics of the instrument or, more commonly, the circumstances or characteristics of the transaction in which it is utilized. Arizona, for example, defines security to include any note, but at the same time statutorily excludes from coverage notes secured by mortgages or deeds of trusts on real estate or chattels.ⁿ⁵ Ohio qualifies its entire list of instruments included within the statutory definition of security with the requirement that the instrument, *inter alia*, "represents title to or interest in or is secured by any lien or charge upon, the capital, assets, profits, property, or credit of any person..."ⁿ⁶ In all cases, statutory exclusions of some notes or evidences of indebtedness from coverage are the result of legislative determinations that some characteristic of the instruments or the set of circumstances in which they arise either affects their risk characteristics or otherwise negates concern for "investor" protection.ⁿ⁷ Specific exemptions of some classes of debt instruments from blue sky laws are strictly construed in favor of investor protection, and one claiming an exemption has the burden of proving its applicability. In *Womack v. State*,ⁿ⁸ for example, the defendant was convicted of selling unregistered promissory notes in violation of the Georgia blue sky law. Affirming the conviction, the Georgia Supreme Court rejected the defendant's assertion that because the notes involved matured in less than nine months they were exempt from registration. The defendant, said the court, did not carry his burden of demonstrating that the exemption was applicable. The mere fact that the note matured in less than nine months was held not dispositive in the face of the actual "character" of the instrument. "It is the character of the evidence of indebtedness, note or security, not its maturity date, which determines coverage under the Securities Act."ⁿ⁹ The court concluded that the "characteristics" of the notes made them investments, not commercial transactions in which, presumably, the nine month maturity exemption would be meaningful. Decisions such as this one may in many cases be colored by the fact

that clever promoters seeking to rely on the nine month exemption may simply provide for continuing or automatic "rollovers" or renewals at the expiration of the stated term.ⁿ¹⁰

Nevertheless, state courts have historically approached the issue of notes and evidences of indebtedness as securities with a recognition that legislative intent for blue sky laws was not to bring every note or evidence of indebtedness, regardless of its nature and of the circumstances surrounding its issuance, within the definition of a security.ⁿ¹¹ All inclusive formulae by which every case can be tested have been eschewed in favor of case by case determinations carried out under the mantle of intended protection against fraudulent or abusive "investment schemes." State courts regularly extend the investor protections of blue sky laws to cover promissory notes where the circumstances are compelling. In Florida, for example, an appeals court acted "without hesitation" to conclude that transactions involving promissory notes represented an investment scheme, and to affirm the criminal conviction of a financial adviser under that state's blue sky law in circumstances in which multiple "investors" were offered opportunities to achieve high rates of return through the purchase of unsecured notes.ⁿ¹²

A California appellate court, affirming a trial court jury instruction, identified four prime elements or considerations in the analysis:

- (1) Whether funds are being raised for a business venture or enterprise;
- (2) Whether the promissory notes are indiscriminately offered to the public at large;
- (3) Whether the investors are substantially powerless to affect the success of the enterprise; and
- (4) Whether the investors' money was substantially at risk because it was inadequately secured.ⁿ¹³

The melding of risk capital into promissory note analyses is entirely consistent with state regulatory emphasis on actual "investment" characteristics of an instrument.

On the other hand, even in circumstances in which one "invests" money to fund the operations of a business enterprise, and thus provides risk capital, if the transaction amounts to nothing more than an ordinary secured commercial loan between two parties, no security will be found. In *Carder v. Burrow*, ⁿ¹⁴ for example, the plaintiff loaned money to an enterprise as an alternative to purchasing stock because of the added protection that would come with being a secured creditor. The loan was evidenced by a promissory note providing for interest at a variable rate, and collateralized by all of the furniture, fixtures, equipment and inventories of the business. A UCC security agreement was filed. The Arkansas Supreme Court affirmed a determination that the note was not a security under that state's blue sky law. The Supreme Court opined that the payment of interest, although at the highest rate that would be permitted, was not dependent upon the earnings of the company, and that repayment of the loan was expected regardless of profitability. There was no expectation of "profit," said the court, as if it were an investment transaction. The lender was a sophisticated businessperson who made a conscious choice to offer a commercial loan to the company rather than purchase stock. The loan was risk capital, and the lender was an investor in that sense. However, the transaction could only be viewed as an ordinary, isolated, commercial loan.ⁿ¹⁵

In the process of examining promissory notes and other evidences of indebtedness under blue sky laws, state courts have been guided by federal court considerations of the same issue arising under the federal securities laws.ⁿ¹⁶ State courts are most directly guided by the decision of the U.S. Supreme Court in *Reves v. Ernst & Young*.ⁿ¹⁷

In *Reves*, the Supreme Court clearly instructed that not all notes should be included in the definition of a security: "[T]he phrase 'any note' should not be interpreted to mean literally 'any note,' but must be understood against the backdrop of what Congress was attempting to accomplish in enacting the Securities Acts."ⁿ¹⁸ Because "note" is one of the items specifically included in the statutory definitions of security, there is a presumption, said the Court, that any

note is a security. However, the presumption may be rebutted by a showing that a particular note strongly resembles one of the types of notes that have been recognized as not falling within the intended scope of the definition, as, for example, with notes used in commercial financing transactions. The particular kinds of instruments recognized in *Reves* as falling outside the intended coverage of securities laws, as well as the factors identified by the U.S. Supreme Court for application in making assessments whether other forms of instruments or notes in particular settings should be deemed to be securities, are considered in more detail later.ⁿ¹⁹ As a prelude, however, the particular insights offered by state courts where, not surprisingly, the issue of whether particular debt or debt-related instruments or transactions should be brought within the ambit of protection under blue sky laws is most often raised, is especially instructive.

A critical economic distinction between notes or evidences of indebtedness that are deemed to be securities and those that are not lies in the notion of risk capital. In what is ostensibly a debtor/creditor relationship, the important question is whether the "lender" is in fact contributing risk capital to an enterprise over which it neither exercises, nor has the ability to exercise, meaningful managerial control. As a judicially crafted "risk capital" test in its own right for determining the existence of a security, first articulated by the California Supreme Court in *Silver Hills Country Club v. Sobieski*,ⁿ²⁰ the focus is on protection of the public:

[A]gainst spurious schemes, however ingeniously devised, to attract risk capital ... [and] to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return on their capital in one form or another.ⁿ²¹

Some states have built the notion of risk capital directly into their blue sky definitions of security. Washington, for example, includes the following in its definition:

"Security" means any ... investment of money or other consideration in the risk capital of a venture with the expectation of some valuable benefit to the investor where the investor does not receive the right to exercise practical and actual control over the managerial decisions of the venture...ⁿ²²

Such statutory incorporations of the "risk capital" test for a security are condensed restatements of the four elements of the test articulated by the Supreme Court of Hawaii in *State v. Hawaii Market Center, Inc.*,ⁿ²³ discussed earlier.ⁿ²⁴

Where notes and evidences of indebtedness are involved, the critical distinction to be made is between a true lender's risk and an investment risk. The former is typified by commercial debtor/creditor relationships in which the lender is presumed to be in a position to protect itself, or manage its own risk with such things as collateral, operational covenants and appropriate terms.ⁿ²⁵ In the latter, the lender is separated from risk determinants and is dependent upon, and induced to believe in, the success of the funded enterprise to realize an expected return.ⁿ²⁶ But a bona fide personal loan involving no expectation of a financial return that is dependent upon the borrower's entrepreneurial effort cannot be defined as having the risk characteristics of a security.ⁿ²⁷

The legitimate expectations of the parties is an important consideration. Purely commercial financing settings do not suggest any legitimate expectation of securities law protection. On the other hand, promotional characteristics and the economic reality of parting with true risk capital has a great deal to do with expectations and investment related protections.ⁿ²⁸

Investment oriented expectations are also involved in equity conversion or option features that are often attached to promissory notes given in return for funds advanced in the start up phase of an enterprise, or to meet particularly urgent needs for working capital. In *Williams v. Waves, Cuts, Colour & Tanning, Inc.*,ⁿ²⁹ a "loan" needed to pay taxes was to be repaid in shares of stock of the debtor corporation at some unspecified future time. The shares were never issued and the lender sued under the state blue sky law to recover the funds, alleging the unlawful sale of a security. The court opined that the promissory note, which promised that the investor would receive shares of stock in exchange for cash was a non exempt security and that the investor was entitled to protection under the statute. *Williams* illustrates a

common mistake made in the capital formation process in small, entrepreneurial business settings. Simple "loans" or notes casually written to provide for conversion to, or exchange for, equity are serious hazards under state blue sky laws, and careful attention must be paid to the risk capital characteristics that are amplified by the plain "investment" expectations of generally unsophisticated persons who advance funds.

Risk capital analysis of a note or other evidence of indebtedness focuses on the relationship between the lender and borrower, and the nature of the risk to the value being given up by the lender. It is an "economic reality" oriented approach that is consistent with the traditional "investment contract" analysis that has long been a baseline test for determining the existence of a security under the federal securities laws. As articulated in *SEC v. W.J. Howey Co.*,ⁿ³⁰ an "investment contract" means: "[a] contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party...".ⁿ³¹ Among state courts, investment contract and economic reality analysis has signaled the necessity of looking through form to the substance of a transaction or relationship to determine whether a security is present.ⁿ³²

In the past, when applied to notes and evidences of indebtedness, this type of analysis produced the "commercial/investment dichotomy," with which both state and federal courts sought to identify particular instruments as securities by a set of characteristics, such as: (1) being offered to a broad class of people; (2) being obviously acquired for speculation or investment; or (3) being utilized by the "borrower" to acquire investment assets.ⁿ³³ "Commercial" characteristics were identified by considering such things as: (1) how a "reasonable businessman in the commercial world" might characterize the instrument; (2) the use of proceeds to finance consumer goods or particular business goods or services; or (3) the term or demand character of the instrument. Application of all the common commercial/investment criteria is illustrated by the following example in Oklahoma:

[A]ccording to the testimony presented at trial, the interest which the victim was to have received was indeterminate, and the victim received no goods or services for her check. Furthermore, the testimony indicated that the defendant approached [the victim] with the prospect of investing her money in order to receive a higher yield on it. All the evidence leads to the conclusion that the parties considered that [the victim] was making an investment. Finally, it appears that [the victim] was in the class of persons that the legislature was trying to protect in passing the Oklahoma Securities Act. She was an uninformed, elderly woman on a fixed income who could not afford to be bilked out of her money.ⁿ³⁴

However the dichotomy was constructed by courts, the common thread was the notion of risk capital. Recognition that there was good reason for including some notes and evidences of indebtedness within the definition of security, while excluding others, was largely a function of state court assessments of the circumstances in which the instruments were utilized, and whether there was serious concern for investor protection. The purpose of a transaction, the nature and determinants of risk, and the transaction setting are all important in determining whether the special protections of securities laws should apply.ⁿ³⁵

For example, scripted "boiler room" telephone solicitations of loans, and the resulting issuance of interest bearing promissory notes for small contributions from many people to fund activities of a political organization presented every reason for applying protections of the Virginia blue sky law in *Ascher v. Commonwealth*.ⁿ³⁶ Similarly, in *State v. Taubman*,ⁿ³⁷ promissory notes and written agreements evidencing "loans" solicited from numerous friends and business clients by a tax advisor to fund a nursing home development had plainly apparent investment characteristics:

Although Appellant characterized her activity as merely borrowing money from friends in exchange for high rates of interest, the "agreement" which was given many of the victims clearly was an "investment agreement"... . The agreement provided that the victims would give money to Taubman to invest as she saw fit. The agreement provided for guaranteed profits and possible profit sharing. In effect, Taubman operated a mutual fund for the benefit of the investors. The agreement even required that

Taubman give an accounting so that the victims could report "the investment" for federal income tax purposes.ⁿ³⁸

Still, the commercial/investment dichotomy produced no meaningful criteria or objective standards to be applied from case to case. At the federal level, this prompted some courts to articulate an alternative "family resemblance" test, under which any note or evidence of indebtedness is compared to a set of notes about which there is no doubt that no security was presented. Under this approach, every note (and logically every evidence of indebtedness)ⁿ³⁹ is, presumptively, a security unless it bears a "strong family resemblance" to a list of instruments involved in commercial or consumer financing settings.

The initial set of "family" instruments, first identified in *Exchange National Bank v. Touche Ross & Co.*,ⁿ⁴⁰ as plainly not involving securities, includes:

[T]he note delivered in consumer financing, the note secured by a mortgage on a home, the short term note secured by a lien on a small business or some of its assets, the note evidencing a "character" loan to a bank customer, short term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized).ⁿ⁴¹

The appeal of a "family resemblance" test for determining whether a particular note or evidence of indebtedness is a security, and the presumption it embodies, is in the universal baseline it supplies. But it too is incomplete, since the list is not intended to be all inclusive. There must be criteria governing the determination whether other types of notes or evidences of indebtedness are to be added, and thus excluded from the definition. This task of filling this gap was taken on by the U.S. Supreme Court in *Reves v. Ernst & Young*,ⁿ⁴² which provides common guidance for all examinations of notes and evidences of indebtedness as securities.ⁿ⁴³

[2] *Reves v. Ernst & Young*: Family Resemblances

In *Reves*, the Supreme Court acted to resolve uncertainties surrounding the status of notes as securities. The Court eschewed the commercial/investment dichotomy and, in general, "economic reality" approaches to the question, in favor of adopting the "family resemblance" test articulated in *Exchange National Bank v. Touche Ross & Co.* as setting the parameters by which all notes would be evaluated for purposes of the federal securities laws. State courts have since uniformly looked to *Reves* in their own considerations.ⁿ⁴⁴

With the decision in *Reves* it is now presumed that every note is a security unless the presumption is rebutted by showing that a particular note bears a strong resemblance to identified categories of notes which are recognized as not constituting securities, *or is one that should be added to the list of such exceptions.*

Reves involved the issuance of variable rate demand notes by an agricultural cooperative. The notes were offered to a large number of people, including both members and non members of the co op, for the purpose of financing general business operations. The notes were marketed as an "investment program," and purchasers took them with the expectation of realizing an attractive interest rate set above that available from local financial institutions. In these circumstances the Supreme Court observed that from both sides a transaction involving these notes "[i]s most naturally conceived of as an investment in a business enterprise rather than as a purely commercial or consumer transaction."ⁿ⁴⁵ There was no resemblance between the notes and any category of non security note identified, and their status as securities was thus confirmed.

The *Exchange National Bank* "family" of notes excised from the definition of security includes those involved in consumer financing, residential mortgages, open account relationships and commercial lending.ⁿ⁴⁶ In *Reves*, the Supreme Court adopted that family.

The critical aspect of *Reves*, however, is not what is on the list of exclusions, but rather why a particular type of note either is or should be on it. The latter is important because the Court made clear that the *Exchange National Bank* list is not "graven in stone," and that it may be expanded. The myriad transactions and settings involving notes or other evidences of indebtedness which do not look at all like basic commercial or consumer credit instruments present the real test. For that analysis the Court acknowledged the need for standards, and articulated four controlling factors for determining whether a particular instrument should be added to the list:

- (1) the motivations that prompt reasonable parties to enter into the transaction;
- (2) the "plan of distribution" involved;
- (3) the reasonable expectations of the investing public concerning the instrument; and
- (4) the presence of any other factor which significantly impacts the risk associated with the particular instrument.ⁿ⁴⁷

Each of these criteria, in one form or another, earlier played an important role, either independently or as part of another "test," for answering the question whether notes are securities. Indeed, they combine to restate essential elements involved in any inquiry into the existence of a security previously undertaken by the Court.ⁿ⁴⁸ But their manner of presentation in *Reves* to explain why specific notes comprising the *Exchange National Bank* "family" are, conclusively, not securities, and to provide the means of assessing family resemblances of other notes is particularly instructive. This is especially true for state courts that historically have enjoyed greater freedom to define securities generally in terms of risk capital and promotional characteristics rather than the more constraining "investment contract" criteria that have shaped the contours of federal decisions.ⁿ⁴⁹

Post *Reves*, armed with the presumption of inclusion in the definition of security in their blue sky laws, state courts approach attempts to exclude promissory notes in particular settings with considerable confidence. Consider, for example, this assessment in *Caucus Distributors, Inc. v. Alaska*:ⁿ⁵⁰

The notes in this case bear no resemblance at all to any of the routine commercial financing arrangements excluded from coverage by *Reves* and *Touche Ross*, nor has *Caucus* shown any reason to exclude these notes from coverage. The notes were sold in order to finance *Caucus*' fund raising activity, and [lenders] were both led to believe they would be repaid... . Emphasized in *Reves* was that the notes there, like the notes here, were specifically offered at an interest rate higher than [lenders] were earning on their investments... . Moreover, as in *Reves*, the plan of distribution here was coordinated and national in scope... . [Lenders] were not the only targets of *Caucus*; ten others have made similar loans in Alaska, and similar cease and desist orders have been issued in [other states ... Lenders] were led to believe and did believe that they would earn a profit; the "public's reasonable perceptions" of notes as investments militate in favor of finding a security... . Finally, the notes here were not collateralized or insured; thus, just as in *Reves*, there was no risk reducing factor cutting against a finding of security.ⁿ⁵¹

Cases like *Caucus Distributors* illustrate that the criteria articulated in *Reves* for assessing "family resemblance" are not characteristics of particular instruments or classes of instruments, but rather are transactional or circumstantial criteria. Such cases reflect the earlier observation of the Supreme Court in *Marine Bank v. Weaver* that: "[t]he test is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."ⁿ⁵² They also counsel that there will be relatively few instruments considered in the typical blue sky law enforcement setting that will conclusively be excluded from the definition of security by reason of "family resemblance."ⁿ⁵³ Case by case, circumstantial evaluation under the mantle of *Reves* criteria is the protocol. Thus, closer attention to each of the criteria is warranted.

[3] Factors for Evaluating Notes as Securities

[a] Motivations Associated with the Transaction

If the purpose of a transaction in which a note is used is to raise money for the general operations of an enterprise or to finance an investment, and the purchaser/lender is interested primarily in the "profit" the note is expected to generate, the instrument is less likely to be excluded from coverage by blue sky laws. "Profit" in this context was defined by the Supreme Court to mean "a valuable return on an investment." This definition, the Court said, is meant to be less restrictive than that used in other settings, such as where the existence of an "investment contract" form of security is at issue.ⁿ⁵⁴ On the other hand, in *Reves* the Court pointed out that if a note is used in connection with a minor asset transaction, or to address cash flow difficulties, "family resemblance" is much more apparent. The issue is the motivation of a true lender capable of fending for itself, versus that of an investor providing risk capital. In *Reves* the Court spoke of motivation in terms of what is most naturally conceived by both sides of the transaction.

This *Reves* factor may well reincarnate the commercial/investment dichotomy in some situations, as motivation under *Reves* practically translates into the putative seller's purpose for entering into the transaction. In other situations a purpose distinction may easily be made. But it is certain that every consideration will be undertaken with the broadly protective purpose of blue sky laws tipping the balance in favor of coverage.

[b] The Plan of Distribution

The manner in which an instrument finds its way to the holder is always a significant consideration in identifying the presence of a security. Indeed, there may be no better indicator of a security transaction than the offering of any form of instrument characterized as an investment to a broad segment of the public, in circumstances that trigger all the concerns for blue sky law protection. The kind of "plan of distribution" evoking historic concerns is evident in this observation in *Caucus Distributors, Inc. v. Maryland Securities Commissioner*:

It may be that some investors, partial to the aims of an organization, may extend loans to that organization, even though they present a greater risk than those of more secure investments, such as a certificate of deposit at a bank. But as the evidence in the record discloses, and as the Commissioner found, Caucus's sale of its notes was neither isolated nor discriminating. Indeed, it raised funds by selling promissory notes to an undetermined number of persons, contacted through general solicitations... . [This] solicitation was not significantly different from other general solicitations in the securities business.ⁿ⁵⁵

[c] Reasonable Expectations of the Investing Public

Reves made clear that instruments would be considered to be securities on the basis of public expectations "[e]ven where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not securities as used in that transaction."ⁿ⁵⁶ The notes involved in *Reves* had been advertised as "investments." There were no countervailing factors that would have led reasonable persons to question that characterization. In *Perrysburg Township v. Rossford Arena Amphitheater Authority*,ⁿ⁵⁷ an Ohio appellate court found that a promissory note issued pursuant to an intergovernmental loan agreement constituted a security under the Ohio Securities Act. A central element in the court's analysis was how both parties characterized the loan:

Upon consideration of the entire record, we find that both parties referred to the \$5 million loan as an "investment" and not a short-term, collateralized business loan. The loan was clearly intended by all parties as "seed money" that would ultimately generate business development and more tax revenue for Perrysburg Township. In addition, the potential risk to the Township, while stated as unlikely at the time, was potentially great.ⁿ⁵⁸

Promotional characteristics have always played an important role in assessing the scope of protection under state blue sky laws,ⁿ⁵⁹ and it is certain that this particular factor identified by the Supreme Court in *Reves* will carry considerable weight. The historic mission of blue sky laws is to protect against fraudulent and abusive investment schemes perpetrated on the general public.ⁿ⁶⁰

There is little likelihood that in definition interpretations rendered in the light of *Reves* factors something indiscriminately marketed as an investment will be treated as anything else. Public expectations will easily be discerned in these situations. In the end, however, assessing reasonable expectations of the public will be a function of an identifiable need for special securities law protections.ⁿ⁶¹

Expectations may also be shaped by considerations other than marketing plans that induce public "investment" characterizations. An unsecured promissory note that is convertible into common stock, for example, might be reasonably viewed as an investment regardless of the manner in which it was characterized or whether there is broad-based marketing. Indeed, the convertibility feature may be a lender's principal, and most reasonable, focus. Securities law protections are aimed at investment decisions, and it is not difficult to construct a set of circumstances involving convertible debt which demonstrate every essential characteristic of an investment transaction and which deprive the debt instrument of any family resemblance to instruments that are excluded from the definition of security.

[d] Presence of Some Other Risk Reducing Factor

Other "risk reducing" factors which could operate to suggest a particular instrument is not a security include collateral,ⁿ⁶² or insurance (in the case of deposit instruments). In *Reves*, the Supreme Court drew a distinction between the notes involved there and FDIC insured certificates of deposit, or ERISA regulated pension plan interests. Some "other" comprehensive regulatory scheme does not change the most basic characteristics of a note or other evidence of indebtedness, but it does indeed change its risk characteristics. The notes in *Reves* were uncollateralized and uninsured. They were subject to no other regulatory scheme that could affect risk characteristics and, as the court pointed out, they would escape federal regulation entirely if the securities laws were not applied. Securities law protections are designed to protect where no other protection is available, and where persons are presumed unable to act for their own protection.ⁿ⁶³

In the context of deposit instruments, a California appellate court addressed the key point in *Reiswig v. Department of Corps.*,ⁿ⁶⁴ where a "CD-with-bonus" package was held not to be a security under the California Corporations Code. In order to attract prospective purchasers of annuities, an intermediary promoter for the annuity seller advertised the availability of certificates of deposit with a higher yield than was available at any bank. The certificates of deposit were FDIC insured, offered in the normal course of business by banks identified as paying the highest CD rates. Purchasers of the CD-with-bonus purchased a certificate of deposit directly from the FDIC insured bank, and were then paid a yield differential by the intermediary based on its own higher advertised rate. The intermediary paid the customer the amount of the rate differential as a "bonus" check within seven days of the customer returning proof that the certificate of deposit had been purchased. The undisputed intent of the program was not to sell certificates of deposit, for which the intermediary received no commission. Rather, the program was designed to attract potential annuity purchasers, on which the intermediary would earn a substantial commission.

The California Department of Corporations alleged that the "CD-with-bonus" program constituted the offer and sale of securities without qualification, by unlicensed persons, and in violation of antifraud provisions. However, applying both "risk capital" and *Howey* tests for defining a security, both the trial and appellate courts in *Reiswig* concluded that no security was present. Program advertising offered FDIC-insured certificates of deposit paying a higher rate of return than that offered by the issuing bank. The bank was not related to the promoter/intermediary, and by reason of FDIC insurance, the purchaser did not risk losing the money he or she invested. Although the promoter/intermediary paid the difference between its advertised rate and the bank's rate, none of the purchaser's funds were used for anything other than to purchase an FDIC-insured certificate of deposit. The "bonus" checks paid to purchasers for that yield differential

were not paid from earnings resulting from use of the purchaser's money. That is to say, the insured certificates of deposit were not integrated into any enterprise. The "bonus" payment was made solely as an inducement to allow an agent to pitch annuities, and nothing done or to be done by the agent affected the value of what was actually purchased. Finally, the court concluded that securities law protection was not needed regarding FDIC-insured certificates of deposit because their payment is virtually guaranteed. Another applicable regulatory scheme will surely not be determinative on the question of notes or other evidences of indebtedness as securities. FDIC insured certificates of deposit do not appear in the *Reves* "family," and there was no particular suggestion in the case that instruments such as these should be added to the list. But with the inquiry being whether there is any risk reducing factor that alters the character of an instrument, it is likely that this factor will carry great weight in blue sky law analyses, where the main focus is on filling a void in protection of the public against fraudulent schemes and worthless investments.

[4] Special Considerations: Commercial Paper and Demand Notes

As noted earlier, exemptions in blue sky laws generally operate to exclude at least some short term debt instruments from coverage where there are no countervailing concerns for protection of public investors. Many states (including all those adopting the Uniform Act) expressly include "commercial paper" as a descriptive qualifier on instruments to be excluded. Others follow the federal model, and exclude "notes, drafts, bills of exchange or bankers acceptance" usually adding a "current transaction" qualifier. In either case the focus is on short term instruments (those having maturities less than nine months) that are commonly considered to be "commercial paper." In *Reves*, the U.S. Supreme Court considered such exclusions under the federal securities laws for instruments having a maturity of less than nine months and confirmed, as the basic presumption of the "family resemblance" test, that any note with a term of more than nine months is a security.ⁿ⁶⁵ Separately concurring, Justice Stevens also made clear that the exclusion for short term instruments is intended to apply only to those instruments fairly characterized as commercial paper, and not to "investment securities."ⁿ⁶⁶

Blue sky laws with any form of "commercial paper" exclusion or exemption based upon a nine-month maturity constraint may obviously be guided by the *Reves* confirmation that such short term commercial paper is part of the "family" of instruments not deemed to be securities. However, the admonition that the exclusion is constrained by what is in fact "commercial paper," what was characterized elsewhere in *Reves* as "short term, high quality instruments issued to fund current operations and sold only to highly sophisticated investors,"ⁿ⁶⁷ is also a plainly critical consideration. Short-term commercial paper may be excluded from the definition of security, but other notes and evidences of indebtedness, however labeled, for which there is no "family resemblance" will not be excluded, notwithstanding their short terms. The *Reves* presumption necessarily leads to application of the four factors in each situation in those states without an express "commercial paper" qualifier,ⁿ⁶⁸ or in situations where purported "commercial paper" does not exhibit family resemblance.ⁿ⁶⁹

State courts and regulators will not hesitate to find that short term promissory notes are securities under their blue sky laws, regardless of any nine-month maturity exemption, where the character of the instrument and the circumstances in which it is used demonstrate an investment scheme. Where notes represent investments in a common scheme in which the "lender" looks to the efforts of a promoter for a return, the note will be deemed to be a security regardless of its maturity date.ⁿ⁷⁰ The potential for abuse of the short term commercial paper exemptions in blue sky laws is readily apparent, and examples have been all too common.ⁿ⁷¹

The matter of demand notes in this context may add a further dimension in the assessment of family resemblances. In *Reves* the Supreme Court considered an argument that because the notes involved were demand notes, and thus were subject to the possibility of demand being made within nine months of issuance, the Securities Exchange Act exclusion for short term instruments from the definition of security should apply. A majority of the *Reves* Court interpreted the federal statutory exclusion as not encompassing the notes because demand notes do not necessarily have short terms, and because exclusion of the notes would be inconsistent with the broadly protective purpose of the federal securities laws. However, the majority opinion on this issue left open the possibility of a different conclusion in situations where

both parties clearly contemplate demand being made within the recognized nine month period.ⁿ⁷²

Although the policy underlying blue sky laws militates in favor of the same conclusion where the circumstances involving issuance of demand notes trigger concerns for protection of the investing public, other provisions of state law may have an impact. The demand feature of the notes was an issue in *Reves* because state law operated to define the "maturity" of demand notes for purposes of the statute of limitations on collection actions. The Supreme Court rejected the contention that a state limitations provision could control the scope of federal securities law definitions. However, a different conclusion regarding demand notes could be reached at the state level, where other provisions defining terms associated with such instruments might be applied so as to affect the states of such a note as a security.

[5] The "Promissory Note" Epidemic

State securities regulators, who are referred to often and aptly as "cops on the beat," devote their resources heavily to protection against unabashed investment scams. A perennial object of their attention is the offer and sale of promissory notes issued by little known or nonexistent companies, promising--indeed often guaranteeing--above-market fixed interest rates, while safeguarding principal. Often, these instruments are offered and sold by independent insurance agents who are not licensed to sell securities, or by independent financial advisers who may be associated persons of a securities broker-dealer, but who act independently of that broker-dealer in the belief that the instruments are not securities (or are exempt securities) and are thus not subject to broker-dealer due diligence and compliance oversight. In many cases, the persons offering and selling these instruments are themselves deceived by intermediaries concerning any regulatory requirements, and are lured by lucrative front-end commissions.ⁿ⁷³ It is often the case that notes are offered and sold to trusting, elderly clients with significant retirement savings. Year after year the offer and sale of promissory notes is included by the North American Securities Administrators Association (NASAA) among the top ten investment scams.

As discussed extensively earlier in this chapter, promissory notes are defined as securities under all state blue sky laws. However, it has been shown that notes having certain characteristics or "family resemblances," issued in certain settings, may not as a matter of economic reality be considered securities. That is clearly not the case with short term promissory notes of unknown issuers offered and sold to unsophisticated individuals with the promise of double-digit, if not guaranteed returns, and as being suitable for retirement income. Under all of the factors applied for evaluating notes as securities, these promissory notes qualify and are subject to state securities laws. Whether they are notes, evidence of indebtedness, or simply "agreements," their characteristics, and the circumstances of their usage are such that a security will be found. In *Stas v. Pennsylvania Securities Commission*,ⁿ⁷⁴ for example, the court rejected a petitioner's assertion that only "personal loans" were involved in the following circumstances: The agreements were variously named private investment placement agreements, private tax-free agreements, or private agreements. The petitioner agreed to pay the parties interest rates ranging from nine percent to twenty percent per annum, which the petitioner told them would be "tax free." The duration of the agreements ranged from six months to five years.

The petitioner placed the proceeds into various accounts under her control, commingling them with personal funds in her personal bank accounts and her personal brokerage trading accounts. Also, petitioner used the proceeds obtained from her clients, the Bauschers and the Turners, to: (1) purchase a swimming pool and landscaping services; (2) eliminate her credit card debt; (3) purchase stock for cash; and (4) pay margin obligations following her purchases of stock on margin. However characterized, said the court, the agreements amounted to investment contracts and were offered and sold in violation of the Pennsylvania Securities Act.

In many cases, promissory notes or other "agreements" of the sort described above are offered and sold by unlicensed persons or, in the case of sellers who are licensed, they are sold "away" from the seller's broker-dealer.ⁿ⁷⁵ Intermediaries themselves can be misled because the promissory notes offered and sold in these scams typically are short term instruments, having maturities of nine months or less. In this manner, the issuer may claim that the notes are exempt from state or federal registration requirements by reason of "commercial paper" or other exemptions for short

term notes.ⁿ⁷⁶ As explained in § 2.03[4], however, state securities regulators will not be constrained from dealing with purportedly "exempt" promissory notes. First, there is nothing on the face of a note with a purported nine months or less maturity that qualifies it for an exemption from state registration requirements when tested against the four controlling factors articulated by the U.S. Supreme Court in *Reves v. Ernst & Young*. Courts and regulators will not hesitate to find that short term promissory notes are securities under their Blue Sky Laws, regardless of any nine months maturity exemption, where the character of the instrument and the circumstances in which it is used demonstrate an investment scheme.ⁿ⁷⁷ Moreover, it is typical for short term promissory notes offered and sold in these circumstances to be "rolled over" successively upon the expiration of each stated term. Stated nine months or less maturities are, and are intended to be, sham provisions. Second, without regard to stated term and any claimed exemption from registration, state regulators have ample antifraud authority to act for the protection of purchasers of promissory notes through investigative and enforcement proceedings. In many instances, of course, because the promissory notes have not been subjected to scrutiny through registration, the eventual enforcement action and application of remedies may come too late.

[6] Other Evidences of Indebtedness

[a] Generally

The presumption after *Reves* that all "notes" are securities may logically be extended to any evidence of indebtednessⁿ⁷⁸ which arises out of a debtor/creditor relationship. Such other instruments include debentures and a variety of instruments evidencing some basic obligation to pay value in the future. A Texas criminal appeals court opined that "other evidence of indebtedness" in that state's blue sky law, when taken in context, is meant to expand upon the grouping "note, bond, debenture, mortgage certificate," and thus must be a similar type of security as those forms.ⁿ⁷⁹ Thus, the Texas court concluded, an "other evidence of indebtedness" is a written instrument that evidences "the owing of a sum of money upon a certain and express agreement."ⁿ⁸⁰ On further review, the Texas Court of Appeals amplified the point that for an "evidence of indebtedness" to fall within the Texas Securities Act it must be in writing. The court made clear that not all securities must be written instruments. However, the court opined that the specific term "evidence of indebtedness" means something similar to other specific written instruments.ⁿ⁸¹ As an express rejection of the Texas requirement for a writing a new sentence was added in section 102(28)(A) of the 2002 Uniform Securities Act, to provide that securities within the definition may be either certificated or uncertificated.

Likely evidences of indebtedness include receipts or other writings memorializing or arising out of a loan transaction not otherwise evidenced by a promissory note.ⁿ⁸² In *Suave v. K.C. Inc.*,ⁿ⁸³ for example, a borrower corporation gave the lender plaintiff documents representing a security interest in appliances purchased with the plaintiff's money, which were then leased to third party customers of the borrower. Plaintiff was a person of limited means and experience who was solicited to loan money to the defendant company on the prospect of obtaining an interest rate higher than what was otherwise available from banks. Plaintiff's "loan" was evidenced by a receipt and printed form documents creating security interests in the appliances.

In this pre *Reves* analysis the court's conclusion that a security had been offered and sold in violation of the blue sky law was grounded in broader considerations than simply the existence of an "evidence" of indebtedness. What amounted to the *Reves* four factors were applied. The key point here, however, is that "evidence" of indebtedness means just that. Any writing that reflects the underlying debt relationship is susceptible of being deemed to be a security. In most cases, since no actual "note" evidences the debt, having such a writing will require further analysis under the *Reves* factors.ⁿ⁸⁴

[b] Loan Participations

Other evidences of indebtedness include loan participations or participations in pools of loans. A key consideration in whether such participations, and the evidences of indebtedness involved in them, are securities is the relationship of the lender to the borrower. Where lender/participants have a direct relationship with the borrower, whose note is the true

focal point of the transaction, the "participation" suggests nothing different from a normal commercial lending situation squarely within the *Reves* "family" of instruments or transactions that do not involve a security. For example, the Minnesota Court of Appeals described this scenario in concluding that a loan participation agreement was not a security: The overall motivation of the parties was to finance the borrowers' commercial purposes of acquiring one hockey team and refinancing the debts relating to another; the participation agreement was offered to financial and commercial institutions, and not to the general public; appellant received ample notice that the participation agreement was a participation in a loan and not an investment in a business; and, as appellant acknowledges, the Office of the Comptroller of the Currency has issued policy guidelines that address the sale of loan participations.ⁿ⁸⁵

[c] Funding Programs

In a scenario more likely to arise under state Blue Sky Laws, "blind pool" funding programs or schemes involving interests or participations offered and sold to individuals would suggest something quite different. Federal courts have labored to make the distinction on "investment contract" grounds,ⁿ⁸⁶ but depending upon the particular instrument involved, the *Reves* four factors may be instructive. The primary distinction is the degree of involvement with the lender/purchaser in the commercial transactions underlying the pool. Where individuals are divorced from that process, any "family resemblance" of the evidence of indebtedness taken by the individual ends.

Loan commitment or procurement programs and "advance fee" arrangements have also been held to involve evidences of indebtedness and, by definition, securities under blue sky laws.ⁿ⁸⁷ "Guarantees" of debts are also separate evidences of indebtedness, and may be deemed securities as such or, in other cases, in their own right when included within the list of enumerated instruments defined to be securities.

A "Double Your Money" or "Double Your Blessings" program involving pledge agreements by religious faithful that purported to show a rate of return and repayment program was held to constitute a security under the Florida blue sky law. On the other hand, pledge agreements given as "Faith Promises" in support of the ministry, which disclaimed any return except spiritual, were held in the same case not to be securities despite their available characterization as an evidence of indebtedness.ⁿ⁸⁸

In the end, it is plain that even in the wake of *Reves* the scope of the terms "note" and "evidence of indebtedness" in blue sky law definitions is not bounded by precise criteria. Nevertheless, the starting point is the *Reves* presumption in all cases where the instrument answers to the description. From there, analysis of the four factors will guide applications to the full range of instruments and transactions in debtor/creditor relationships in a manner consistent with the broadly protective purpose of blue sky laws.ⁿ⁸⁹

FOOTNOTES:

(n1)Footnote 1. *See, e.g.*, Uniform Sec. Act § 401(l).

(n2)Footnote 2. Whether a promissory note is properly considered to be a security may also be significant in applications of certain provisions of the Uniform Commercial Code. In *Highland Capital Mgmt. LP v. Schneider*, 8 N.Y.3d 406 (2007), for example, the New York Court of Appeals concluded that certain subordinated promissory notes satisfied the definition of "security" under § 8-102(a)(15) of the New York Uniform Commercial Code, such that an oral agreement to sell the notes would fall outside the statute of frauds defense.

(n3)Footnote 3. *See Ansorge v. Kellogg*, 172 Mich. App. 63, 67 431 N.W.2d 402, 404 (1988), in which the court declared: "We reject at the outset any suggestion that the present transaction, memorialized by the issue of "notes" and "evidence of indebtedness," must be considered a security transaction simply because the statutory definition of security includes the words... ." The court concluded that notes used as a result of an industry wide practice regarding the dealings between growers and independent fruit processors were bona fide loans and did not bear any of the characteristics of a security transaction.

(n4)Footnote 4. Uniform Act § 402(a)(10). "Commercial paper" is not a defined term. However, the Uniform Act tracks the commercial paper exemption contained in § 3(a)(3) of the Securities Act of 1933, 15 U.S.C. § 77c(3), where a more descriptive statement of the intended scope of the exemption is found ("any note, draft, bill of exchange, or bankers' acceptance which arises out of a current transaction"). State laws provide for "commercial paper" exemptions, but in many cases these exemptions are not absolute. Some states refer generally to "commercial paper," but add contextual qualifiers. In Ohio, for example, the exemption encompasses: "[c]ommercial paper and promissory notes ... when they are not offered directly or indirectly for sale to the public." *Ohio Rev. Code § 1707.02(G)*. Many states adopt the "prime quality" characteristics implied in the Uniform and federal acts, but a number add a similar qualifier to that in Ohio. *See, e.g.,* 70 Pa. Stat. Annot. 1202(c); *Cal. Corp. Code § 25100(l)*.

(n5)Footnote 5. *See* Ariz. Rev. Stat. §§ 44-1801(22), 44-1843(8). The effect of this and other statutory exclusions in the law is to exempt all consumer transactions involving the purchase of real property or goods where the buyer pays by giving a promissory note. *State v. Tober*, 173 Ariz. 211, 841 P.2d 206 (1992) .

(n6)Footnote 6. *Ohio Rev. Code § 1707.01(B)*. In *Buemi v. Van Dusen Acceptance Corp.*, 1979 Ohio App. LEXIS 12353 (Feb. 15, 1979), the statutory qualifier was applied to exclude evidences of indebtedness from the definition of security where secured loans negated any expectation of participation in, or charge upon, the profits of the debtor enterprise.

(n7)Footnote 7. Notes and other evidences of indebtedness exempted by reason of their particular risk characteristics include federal, state and some municipal debt instruments, certain bank or insurance company debt instruments, and "guaranteed" obligations of varying sorts. Other obligations, such as those of non profit charitable, educational or other like organizations are often also excluded where no "investment" expectations are presented.

But see Cal. Corp. Code § 25100(j) (Evidence of indebtedness of such issuers not statutorily exempted from coverage). Transactional exemptions for notes or other evidences of indebtedness, the principal one being the commercial paper exemption discussed above, are primarily based on the notion that no "investment" is present. *i.e.*, that the instrument arises in a setting in which the purpose of the transaction and the relative positions and expectations of the parties are such as to negate any perceived need for protection of the blue sky law.

(n8)Footnote 8. 270 Ga. 56, 507 S.E.2d 425 (1998) .

(n9)Footnote 9. *Id.*, 507 S.E.2d at 427, quoting *Blau v. Redmond*, 143 Ga. App. 897, 902, 240 S.E.2d 273 (1977).

(n10)Footnote 10. Special considerations relating to instruments falling under the heading "commercial paper" as securities are discussed in more detail in § 2.03[4], *below*.

(n11)Footnote 11. *See People v. Figueroa*, 41 Cal. 3d 714, 224 Cal. Rptr. 719, 715 P.2d 680 (1986) .

(n12)Footnote 12. *Brookhardt v. State*, 710 So.2d 700 (5th Dist. Fla. App. 1998) .

See also *People v. Figueroa*, 41 Cal. 3d 714, 224 Cal. Rptr. 719, 715 P.2d 680 (1986). The court stated: "In arriving at a determination the courts have been mindful that the general purpose of the law is to protect the public against the imposition of unsubstantial, unlawful and fraudulent stock and investment schemes and the securities based thereon." *Id.*, 715 P.2d at 715.

(n13)Footnote 13. *People v. Rangel*, 2002 Cal. App. Unpub. LEXIS 6212 (July 2, 2002).

(n14)Footnote 14. 327 Ark. 545, 940 S.W.2d 429 (1997) .

(n15)Footnote 15. Moreover, for a note to be a security, it must be the central element of the transaction and not simply part of the set of circumstances in which a security may be tangentially involved. In *Kinney v. Cook*, 159 Wash.

2d 837, 154 P.3d 206 (2007), for example, the Washington Supreme Court, sitting *en banc*, opined that payment on a promissory note did not constitute the sale of a security when the plaintiffs were legally obligated to make the payment, without regard to the fact that the note was secured by stock that they owned before the note was paid. Plaintiffs sought to invoke the antifraud provision of the Washington blue sky Law to obtain relief by claiming that fraud associated with paying the promissory note occurred in connection with either the "purchase" of stock that collateralized the note, or the "sale" of the note itself. The court rejected both arguments, emphasizing that the payment satisfied a debt that plaintiffs were legally obligated to make, and that it was not a consideration for any investment. Additionally, the payment of the note could not be a purchase or sale of the note itself. The court concluded: The alleged fraud inducing this payment was thus not in connection with the sale or offer to sell a security. To hold otherwise would be to conclude that every payment on a note secured by a security or interest in a security for value would trigger duties under RCW 21.20.010. We do not believe the legislature intended its protections for the sale of securities to extend so broadly. 2007 Wash. LEXIS 203, at *13.

(n16)Footnote 16. The definitions of "security" in both the Securities Act of 1933, 15 U.S.C. § 77b(1) and the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10), are substantially similar to state blue sky law definitions. For those states that have adopted the Uniform Act, federal court analyses of the point play an important role. *See, e.g.*, Md. Code Ann., Corps. & Assns § 11-804 (1985 Repl. Vol.), which provides in pertinent part: "[t]his title shall be construed to effectuate its general purpose to make uniform the law of those states which enact it and to coordinate the interpretation and administration of this title with the related federal regulation."

(n17)Footnote 17. 494 U.S. 56, 110 S. Ct. 945, 108 L. Ed. 2d 47, reh'g denied, 494 U.S. 1092, 110 S. Ct. 1840, 108 L. Ed. 2d 968 (1990).

See, e.g., Perrysburg Twp. v. City of Rossford, 149 Ohio App. 3d 645, 2002-Ohio-5498, 778 N.E.2d 619 (adopting the *Reves* four-factor test for determining whether a promissory note is a security within the scope of the Ohio blue sky law).

(n18)Footnote 18. 494 U.S. at 63, 110 S. Ct. at 950, 108 L. Ed. 2d at 58.

(n19)Footnote 19. *See* § 2.03[2], *below*.

(n20)Footnote 20. 55 Cal. 2d 811, 13 Cal. Rptr. 186, 361 P.2d 906 (1961).

(n21)Footnote 21. 55 Cal. 2d at 814-15. A strong sense of the protective purpose of blue sky laws as applied to notes was evident where unsecured, interest bearing promissory notes issued for loans to refurbish a hotel were held to be securities in *People v. Walberg*, 263 Cal. App. 2d 286, 291, 69 Cal. Rptr. 457 (1968) (scheme "was quite as dangerous to investors as the typical blue sky promotion of mining stocks and royalties").

(n22)Footnote 22. R.C.W. § 21.20.005(12); *see also* Alaska Stat. § 45.55.130(12); Ga. Code Ann. § 10-5-2(26); N.D. Cent. Code § 10-04-02(15); Ok. Sec. Act § 1-102(32).

(n23)Footnote 23. 52 Hawaii 642, 485 P.2d 105 (1971).

(n24)Footnote 24. *See* § 2.01, *below*.

(n25)Footnote 25. *See generally* *Carder v. Burrow*, 327 Ark. 545, 940 S.W.2d 429 (1997), discussed earlier. In *Carder* the court found no security involved in a transaction in which the lender was a sophisticated investor; the loan rate was not dependent upon earnings of the corporate borrower; repayment was expected regardless of the profitability of the borrower; and the loan was accounted for by the lender as an account receivable.

(n26)Footnote 26. *See* *Godair v. Place Vendome Corp. of America*, La. App. 93-1818 (La. App. 1 Cir. 12/22/94), 648 So. 2d 440, 445 ("the primary purpose of executing the promissory note to plaintiff was to raise money for the

general use of a business enterprise, namely Place Vendome, and that plaintiff's primary interest was in the profit the note was expected to generate"); *Schwartz v. Oberweis*, 826 F. Supp. 280 (N.D. Ind. 1993) (promissory note held to be a security under Indiana blue sky law where seller's purpose was to raise money for general use in a business enterprise and the buyer was primarily interested in profit).

(n27)Footnote 27. See *Crim v. E.F. Hutton, Inc.*, 298 S.C. 448, 381 S.E. 2d 492 (1989).

But see § 2.05, "The Promissory Note Epidemic," for rejection of claimed "personal loan" justification for avoiding application of blue sky laws.

(n28)Footnote 28. See *Rapp, The Role of Promotional Characteristics in Determining the Existence of a Security*, 9 Sec. Reg. L.J. 26 (1981).

Investment characteristics associated with or attached to a simple demand note that might in its own right escape security characterization can also operate to package the note into an arrangement that is held to be a security under investment contract analysis. See, e.g., *Martin v. ITM/International Trading & Marketing, Ltd.*, 343 Pa. Super. 250, 494 A.2d 451 (1985) (demand note for sum advanced coupled with a right to receive a 25 percent return on investment).

(n29)Footnote 29. 92 Ohio App. 3d 224, 634 N.E.2d 692 (1994); see also *Manns v. Skolnik*, 666 N.E.2d 1236 (Ind. App. 1996) (affirming that a promissory note constituted a security rather than a loan to correct a cash flow problem where in fact the money was advanced for use as start up capital, to "get the transaction off the ground").

(n30)Footnote 30. 328 U.S. 293, 66 S. Ct. 1100, 90 L. Ed. 1244 (1946) .

(n31)Footnote 31. 328 U.S. at 298 99, 66 S. Ct. at 1103, 90 L. Ed. at 1249 .

(n32)Footnote 32. See, e.g., *Boatmen's Bank of Benton v. Durham*, 203 Ill. App. 3d 921, 561 N.E.2d 206, 148 Ill. Dec. 900 (1990) (where a bank, in substance, was merely a lender, a note was not a security).

But see *State v. Argo*, 81 Wash. App. 552, 915 P.2d 1103 (1996), in which the court applied investment contract criteria to hold that notes given to investors as part of a Ponzi scheme were securities within the coverage of the Washington blue sky law. Despite the fact that the notes provided for a fixed rate of interest, there remained an "interdependence of fortunes" between the investors and the borrower. Investors risked the loss of their entire investment if the borrower's management skills failed to keep the underlying enterprise profitable. Perhaps most significantly, all of the "investments" were part of an overarching Ponzi scheme that formed the basis of a "common enterprise," and it is highly unlikely that in any such circumstances the application of blue sky laws can be avoided.

(n33)Footnote 33. See *McClure v. First Na'tl Bank*, 352 F. Supp. 454 (S.D. Tex. 1973), *aff'd*, 497 F.2d 490 (5th Cir. 1975).

(n34)Footnote 34. *State v. Hoephner*, 1978 OK CR 18, 574 P.2d 1079; see also *Caucus Distributors, Inc. v. Comm'r of Commerce*, 422 N.W.2d 264 (Minn. App. 1988), *cert. denied*, 488 U.S. 1006, 109 S. Ct. 786, 102 L. Ed. 2d 778 (1989).

(n35)Footnote 35. See, e.g., *Dinjian v. Dinjian*, 22 Mass. App. Ct. 589, 495 N.E.2d 882 (1986) (court affirmed a trial court conclusion that notes involved in the case were "simple loan transactions" and thus not securities, based upon material factors including the term of the notes, collateral, and a fixed rate of interest; the definition of security, said the court, should not include purely private transactions whose terms are negotiated between lender and borrower).

(n36)Footnote 36. 12 Va. App. 1105, 408 S.E.2d 906 (1991), *cert. denied*, 506 U.S. 865, 113 S. Ct. 190, 121 L. Ed. 2d 134 (1992).

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(n37)Footnote 37. 78 Ohio App. 3d 834, 606 N.E.2d 962 (1992) .

(n38)Footnote 38. 78 Ohio App. at 845.

(n39)Footnote 39. The status of evidences of indebtedness other than promissory notes as securities is considered further at § 2.03[5] below.

(n40)Footnote 40. 544 F.2d 1126 (2d Cir. 1976) .

(n41)Footnote 41. 544 F.2d at 1138 . Subsequently, the Second Circuit added to its list "notes evidencing loans by commercial banks for current operations." See Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930, 939 (2d Cir. 1984).

(n42)Footnote 42. 494 U.S. 56, 110 S. Ct. 945, 108 L. Ed. 2d 47 (1990) .

(n43)Footnote 43. See, e.g., State v. Johnson, 2002 WI App 224, 257 Wis. 2d 736, 652 N.W.2d 642.

But see Mosley v. State, 253 Ga. App. 710, 560 S.E.2d 305 (2002) (the test for determining if a note is a security is whether it meets investment contract criteria).

(n44)Footnote 44. See, e.g., Chrysler First Financial Services Corp. v. Kimbrough, Carson, & Woods, 1991 Tex. App. LEXIS 2534 (Oct 17, 1991); Caucus Distributors, Inc. v. Maryland Sec. Comm'r, 320 Md. 313, 577 A.2d 783 (Ct. Spec. App. 1990); Ascher v. Commonwealth, 12 Va. App. 1105, 408 S.E.2d 906 (1991), cert. denied, 506 U.S. 865, 113 S. Ct. 190, 121 L. Ed. 2d 134 (1992); State v. Saas, 58 Wash. App. 305, 792 P.2d 554 (1990), rev'd on other grounds, 118 Wash. 2d 37, 820 P.2d 505 (1991).

But see State v. Tober, 173 Ariz. 211, 841 P.2d 206 (1992) (statutory inclusion of "any note" leaves no room for judicial gloss in a criminal action arising out of alleged violation of registration provisions. The federal test under *Reves* evolved in the context of civil actions for fraud and is not needed to resolve any uncertainty in determining whether the statutory definition of a security is unconstitutionally vague).

(n45)Footnote 45. 494 U.S. at 68, 110 S. Ct. at 953, 108 L. Ed. 2d at 62.

(n46)Footnote 46. See § 2.03[1] above.

(n47)Footnote 47. 494 U.S. at 66, 110 S. Ct. at 60-61, 108 L. Ed. 2d at 51-52.

Applying *Reves* in the context of a state blue sky law, a Washington state appeals court described the inquiry thusly:

The *Reves* family resemblance test requires four considerations. First, why did the seller and buyer enter into the transaction? Specifically, is the purpose of the transaction to raise money for a business enterprise? Or is it, instead, for consumer goods or some other non-commercial reason? Second, is the note commonly traded for speculation or investment? Third, we look at the reasonable expectations of the investing public. What are the economic realities? Fourth, and finally, we look at whether another regulatory scheme significantly reduces the risk associated with the note and investment agreement and thereby renders application of the securities act regulation unnecessary. *Douglass v. Stanger*, 101 Wash. App. 243, 2 P.3d 998 (2000).

(n48)Footnote 48. For example, the motivations, or purpose, for a transaction are at the heart of *United Housing Found, Inc. v. Forman*, 421 U.S. 837, 95 S. Ct. 2051, 44 L. Ed. 2d 621 (1975), in which the Court held that "stock" in a state subsidized housing cooperative was not a security. The "plan of distribution" was critical in *SEC v. C.M. Joiner*

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Leasing Corp., 320 U.S. 344, 64 S. Ct. 120, 88 L. Ed. 88 (1943), and reasonable expectations of the investing public were a major focus in *Landreth v. Landreth Timber Co.*, 471 U.S. 681, 105 S. Ct. 2297, 85 L. Ed. 2d 692 (1985), where the question was whether corporate "stock" was a security. In *Marine Bank v. Weaver*, 455 U.S. 551, 102 S. Ct. 1220, 71 L. Ed. 2d 409 (1982), a significant risk reducing factor, namely, another regulatory scheme, operated to render application of the securities laws unnecessary.

(n49)Footnote 49. See, e.g., *Brannon v. Rinzler*, 77 Ohio App. 3d 749, 603 N.E.2d 1049 (1991) (application of "risk capital" criteria to examine whether an investment contract was present).

(n50)Footnote 50. 793 P.2d 1048, [1990-1991 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,263 (Alaska 1990).

(n51)Footnote 51. 793 P.2d at 1055 1056 (citations omitted). With *Reves*, the path to the opposite conclusion is more clearly marked. In *Campbell v. C.D. Payne & Geldermann Sec.*, 894 S.W.2d 411, 418-419 (Tex. App. 1995), for example, the court opined that promissory notes given in a private transaction between the parties were not securities:

We find the "family resemblance" test to be reasonable and applicable to the determination of whether the notes in question here were "securities" within the purview of the Texas Securities Act. Examination of the motives of the parties show that Campbell did not expect a "profit" in the sense of capital appreciation or participation in earnings; instead she expected only a fixed return in the form of interest on the notes. This record demonstrates that there was no plan for the notes that was intended to lead to their common trading for speculation or investment. The record also demonstrates that these notes were not of such a nature that would lead the general public to consider them as securities.

(n52)Footnote 52. *Marine Bank v. Weaver*, 455 U.S. 551, 102 S. Ct. 1220, 71 L. Ed. 2d 409 (1982). In *Marine Bank*, the Court held that a certificate of deposit issued by a federally insured bank was not a security.

(n53)Footnote 53. In *Guidry v. Bank of LaPlace*, 740 F. Supp. 1208 (E.D. La. 1990), *aff'd*, 954 F.2d 278 (5th Cir. 1991), a U.S. District Court consideration of the definition of security in the Louisiana blue sky law illustrates an emergent post *Reves* spin, holding that notes are not *per se* securities. Although doing no injustice to *Reves* in application, this emphasis actually sets *Reves* on its head. In *Guidry* the court held that post dated checks solicited and given in connection with an enterprise to purchase blocks of airline seats for gambling junkets were not securities. Plaintiff argued, *inter alia*, that the checks were non exempted notes, and therefore within coverage of the blue sky law. The court disagreed, applying the *Reves* four factors to find no "family resemblance" to things, apparently, that would be considered securities. 740 F. Supp. at 1214-1215. The approach is confounding, but illustrative of the point that post *Reves* the greatest effort will be expended applying the four factors on a case by case basis. See, e.g., *State v. Saas*, 58 Wash. App. 305, 792 P.2d 554 (1990), *rev'd on other grounds*, 118 Wash. 2d 37, 820 P.2d 505 (1991) ("Family resemblance" established by adding to excluded category through application of *Reves* criteria).

(n54)Footnote 54. 494 U.S. at 68, 110 S. Ct. at 952, 108 L. Ed.2d at 61-62.

But see *Campbell v. C.D. Payne & Geldermann Sec.*, 894 S.W.2d 411, 418-419 (Tex. App. 1995), in which the court defined profit as "capital appreciation or participation in earnings." This definition would seem to rule out *interest* as a "profit" motive to be considered under the family resemblance test, and appears to run counter to the broader notion of valuable return articulated by the U.S. Supreme Court in *Reves*.

(n55)Footnote 55. *Caucus Distributors, Inc. v. Maryland Securities Comm'r*, 320 Md. 313, 327, 577 A.2d 783 (Ct. Spec. App. 1990); see also *Ascher v. Commonwealth*, 12 Va. App. 1105, 408 S.E.2d 906 (1991), *cert. denied*, 506 U.S. 865, 113 S. Ct. 190, 121 L. Ed. 2d 134 (1992) ("Ascher and her organization had marketed more than \$10 million in promissory notes to over 2000 people throughout the U.S. By December 1985, the amount of money raised by loans had grown to \$30 million").

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(n56)Footnote 56. 494 U.S. at 66, 110 S. Ct. at 952, 108 L. Ed. 2d at 61.

(n57)Footnote 57. *Perrysburg Twp. v. Rossford Arena Amphitheater Auth.*, 175 Ohio App. 3d 549, 2008-Ohio-363, 888 N.E. 2d 440; *aff'd* 103 Ohio St. 3d 79, 2004-Ohio-4362, 814 N.E.2d 44.

(n58)Footnote 58. *Perrysburg Twp. v. Rossford Arena Amphitheater Auth.*, 175 Ohio App. 3d 549, 559, 2008-Ohio-363, 888 N.E. 2d 440.

(n59)Footnote 59. See Rapp, *The Role of Promotional Characteristics in Determining the Existence of a Security*, 9 Sec. Reg. L.J. 26 (1981).

(n60)Footnote 60. See, e.g., *Grand Prairie Sav. & Loan Asso. v. Worthen Bank & Trust Co., N.A.*, 298 Ark. 542, 545, 769 S.W.2d 20, 22 (1989) ("The purpose of the Act is clearly remedial and is intended to prevent fraudulent practices and activities from becoming a burden upon unsophisticated investors and the general public.").

(n61)Footnote 61. Thus, for example, in *State v. Argo*, *above*, the court applied the four *Reves* factors to conclude that notes given in furtherance of a Ponzi scheme were securities on conclusions that:

First, the investors were motivated by an intent to invest their funds at the high interest rates offered by Argo. Second, although the notes were probably not meant for common trading, they were transferable instruments and could have been traded among investors. Third, the investing public would reasonably expect the notes to be securities because Argo described them as investments that could earn substantial returns. Finally, there is no regulatory scheme other than the Securities Act that reduces the risk of investing in the notes. 81 Wash. App. at 564 .

(n62)Footnote 62. Although secured notes may by definition be securities, as noted earlier, some states exempt certain species from compliance with their blue sky laws without regard to other analysis. For example, the Arizona blue sky law is inapplicable to "[n]otes ... secured by a mortgage or deed of trust on real estate ... if the entire mortgage ... together with all notes ... secured thereby is sold or offered for sale as a unit." Ariz. Rev. Stat. § 1843(A)(10). However, securing a note in order to qualify for such an exemption must not be an afterthought, see *MacCollum v. Perkinson*, 185 Ariz. 179, 913 P.2d 1097 (Ct. App. 1996) .

As to whether securing a note can operate as a risk reducing factor, see *Schwartz v. Oberweis*, 826 F. Supp. 280 (N.D. Ind. 1993), in which the terms of a "secured demand note" were viewed as actually defeating risk reducing factors that would otherwise apply, such that the lack of any special protection indicated that the note was a security under the Indiana blue sky law.

(n63)Footnote 63. See *Brannon v. Rinzler*, 77 Ohio App. 3d 749, 603 N.E.2d 1049 (1991) ("sophisticated" investors involved); see also *Grand Prairie Sav. & Loan Asso. v. Worthen Bank & Trust Co., N.A.*, 298 Ark. 542, 769 S.W.2d 20 (1989) (transactions between "banks and bankers" indicated isolated commercial transactions outside the scope of intended protection of the blue sky law).

(n64)Footnote 64. 144 Cal. App. 4th 327, 50 Cal. Rptr. 3d 386 (2006).

(n65)Footnote 65. 494 U.S. at 63, 110 S. Ct. at 950, 108 L. Ed. 2d at 59.

(n66)Footnote 66. 494 U.S. at 74-75, 110 S. Ct. at 956-57, 108 L. Ed. 2d at 65-66. Justice Stevens characterized this conclusion as so well established that "[a] departure from this reliable consensus would upset the justified expectations of both the legal and investment communities." *Id.* Indeed, the generally accepted view of the intended scope of the federal exclusion is grounded in an early observation of the Securities and Exchange Commission that the focus is on "prime quality negotiable commercial paper of a type not ordinarily purchased by the general public, that is,

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paper issued to facilitate well recognized types of current operational business requirements and of a type eligible for discounting by Federal Reserve banks." Sec. Act Rel. No. 4412, 1 Fed. Sec. L. Rep. (CCH) (Sept. 20, 1961) (SEC interpretation of the short term paper exemption in Securities Act § 3(a)(3)).

(n67)Footnote 67. *Reves*, 494 U.S. at 70, 110 S. Ct. at 954, 108 L. Ed. 2d at 63.

(n68)Footnote 68. *See, e.g., Fla. Stat. § 517.051(8)*; 815 Ill. Comp. Stat. 5/3.

(n69)Footnote 69. *See People v. Dempster*, 396 Mich. 700, 242 N.W.2d 381 (1976) (rejecting reliance on Uniform Commercial Code definition of "commercial paper" for purposes of claimed blue sky exemption).

(n70)Footnote 70. *Womack v. State*, 270 Ga. 56, 507 S.E.2d 425 (1998) .

(n71)Footnote 71. *See also Tanner v. State Corp. Comm'n*, 266 Va. 170, 580 S.E.2d 850 (2003), in which the Supreme Court of Virginia, on reconsideration, held that promissory notes offered and sold in reliance upon a federal exemption from registration under Rule 504 of Regulation D under the Securities Act of 1933 are not exempt from state registration requirements.

(n72)Footnote 72. *494 U.S. at 73*, 110 S. Ct. at 955, 108 L. Ed. 2d at 65.

(n73)Footnote 73. Describing the anatomy of a promissory note fraud, the U.S. Securities and Exchange Commission has noted that among predictable, fraudulent fact patterns:

The fraudsters--who may or may not be affiliated with the company--persuade independent life insurance agents to sell promissory notes, luring them with lucrative commissions of up to twenty or even thirty percent. These agents often do not have a license to sell securities. And in selling the notes, they frequently rely solely on the information the company gives them--which later proves to be false or misleading.

Broken Promises: Promissory Note Fraud (SEC), available at <http://www.sec.gov/investor/pubs/promise.htm> See also *Promissory Notes: Promises, Problems (NASAA, NASD, SEC, SIA)*, available at <http://www.nasaa.org>.

(n74)Footnote 74. 910 A.2d 125 (Pa. Commw. Ct. 2006).

(n75)Footnote 75. *See, e.g., Department of Enforcement v. Hanson*, NASDR Disciplinary Proc. No. C9A000027 (Mar. 8, 2001). In *Hanson*, the respondent participated in the offer and sale of promissory notes without prior written notice to and approval of his broker-dealer employer. The respondent unsuccessfully argued that the promissory notes were not securities. An NASDR Hearing Panel, however, concluded that the notes could not legitimately be characterized as "commercial paper," and that purchasers bought the notes with "investment" expectations and needed the protection of securities laws.

(n76)Footnote 76. Registration exemptions in Blue Sky Laws applicable to "commercial paper" or generally to instruments having short maturities are considered in detail in Chapter 7.11, *below*.

(n77)Footnote 77. The controlling "character" of an instrument without regard to any specific term or other feature is discussed in § 2.03[1], *above*.

(n78)Footnote 78. "Evidence of indebtedness" is not defined in either federal or state securities laws, but may be fairly described as follows: "The term 'evidence of indebtedness' is not limited to a promissory note or other simple acknowledgment of a debt owing and is held to include all contractual obligations to pay in the future for consideration presently received." *United States v. Austin*, 462 F.2d 724, 736 (10th Cir. 1972).

(n79)Footnote 79. *State v. Thomas*, 919 S.W.2d 427 (Tex. Crim. App. 1996) .

(n80)Footnote 80. *Id.*, 919 S.W.2d at 432.

(n81)Footnote 81. *Thomas v. State*, 3 S.W.3d 89 (Tex. App. 1999) .

Such instruments could include bank checks and financial institution deposit relationships, although the settings involving these kinds of instruments do not evoke notions of "investments" and associated risk in what is normally an "other regulation" environment. Thus, the instruments associated with these relationships are for the most part excluded from blue sky law coverage by specific exemptions such as that found in § 402(a)(3) of the Uniform Act: "[A]ny security issued by and representing an interest in or a debt of, or guaranteed by, any bank organized under the laws of the U.S., or any bank, savings institution, or trust company organized and supervised under the laws of any state."

But see *McReynolds v. Pacific Exchangers Bank, Ltd.*, [1991-1993 Transfer Binder] CCH Blue Sky L. Rep. P 73,548 (Tenn. Ch. 1991) ("International certificates of deposit" and notes evidenced no risk reducing or other factors that would justify excluding the instruments from coverage of blue sky law); *Riedel v. Bancam, S.A.*, 792 F.2d 587 (6th Cir. 1986) (Mexican bank certificate of deposit held to be a security under Ohio blue sky law since exemption is applicable only to securities issued by a state or nationally chartered bank); *In re First American Bank Ltd.*, [1990-1991 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,247 (Iowa Ins. Div. 1990) (savings accounts and certificates of deposit offered by a bank operated under the laws of the Mariana Islands are securities).

On the other hand, "statements" of interest bearing accounts maintained by a commercial grower with a fruit processing and canning company were held not to be securities in *Ansorge v. Kellogg*, 172 Mich. App. 63, 67 431 N.W.2d 402, 404 (1988). The accounts arose as a result of industry wide practices regarding the dealings between growers and independent fruit processors.

(n82)Footnote 82. This category can also include preliminary or anticipatory writings in regard to a promissory note yet to be issued. In *Shavin v. Commonwealth*, 17 Va. App. 256, 437 S.E.2d 411 (1993), for example, a "temporary loan agreement" executed in anticipation of the issuance of a promissory note was held to be a security--either as an evidence of indebtedness or as an "interim certificate for a note."

(n83)Footnote 83. 19 Wash. App. 659, 577 P.2d 599 (1978) .

(n84)Footnote 84. *See also* *Stephenson v. Third Co.*, 2004 Tenn. App. LEXIS 140 (Feb. 27 2004) (In a setting not involving securities law claims, the circumstances of transaction involving a loan agreement were examined to determine whether a loan or an investment was actually intended).

Signature Bank v. Marshall Bank, 2006 Minn. App. Unpub. LEXIS 1159 (Oct. 10, 2006), *review denied*, 2006 Minn. LEXIS 992 (Dec. 20, 2006).

(n85)Footnote 85. *See also* *Noyd v. Claxton, Morgan, Flockhart & VanLiere*, 186 Mich. App. 333, 463 N.W.2d 268 (1990) (loan participation agreement held not to be a security where nothing more than the risk associated with a normal commercial loan transaction was indicated); *see also* *Grand Prairie Sav. & Loan Asso. v. Worthen Bank & Trust Co.*, N.A. 298 Ark. 542, 769 S.W.2d 20 (1989) (loan participations sold, in an isolated commercial transaction to a bank, savings and loan association, and a private trust held not to be securities).

(n86)Footnote 86. *See, e.g., Zolfaghari v. Sheikholeslami*, 943 F.2d 451 (4th Cir. 1991) (participation in a managed mortgage pool).

(n87)Footnote 87. *See State v. Gates*, 325 N.W.2d 166 (N.D. 1982) .

(n88)Footnote 88. *Greater Ministries Int'l v. State*, 689 So. 2d 328 (Fla. Dict. Ct. App. 1997).

(n89)Footnote 89. *But see* Thomas v. State, *above*, 919 S.W.2d at 431, in which the court cautioned that as a penal statute, the state blue sky law is to be strictly construed. Thus, "evidence of indebtedness" should be defined in a manner limited by the purpose of the law, and by the context in which it appears, to mean: "all contractual obligations to pay in the future for consideration presently received."



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Blue Sky Regulation

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CHAPTER 2 Definition of Security

1-2 Blue Sky Regulation § 2.04

§ 2.04 Bonds and Debentures

"Bonds" are a species of debt security specifically enumerated in the Uniform Act and most blue sky law definitions because, like stock, there is a common perception of a security associated with the label itself. Indeed, in *Marine Bank v. Weaver*,ⁿ¹ the U.S. Supreme Court simply noted without analysis that "ordinary bonds" are clearly securities.ⁿ²

A corporate bond evidences a loan, calling for repayment of a specific principal sum and, with the exception of so called "zero coupon" bonds, the periodic payment of a stated rate of interest. The promise to pay and the particular terms of a corporate bond is incorporated into an indenture. An indenture trustee, most often a commercial bank, is appointed to represent the interests of bondholders, and is empowered to take action in the face of any default by the corporate borrower. Bonds may be secured by particular assets or have other characteristics which render them "senior" securities.

"Debentures," on the other hand, are not as easily recognized on their face to be securities. They are debt instruments issued simply on the general credit and good faith of the issuer. They are often subordinate (indeed they may be heavily subordinated) to other creditor claims against corporate assets. They are generally unsecured and they are often convertible into common stock of the issuer on stated terms. However, they may also be utilized in the capitalization of a business enterprise in which the purchaser/lender expects to play a significant managerial role or where terms are more indicative of a commercial lending relationship rather than an "investment." Thus their character in commerce is not nearly as universally understood as that of "stocks and bonds." Nevertheless, as with ordinary bonds, debentures have been commonly recognized by courts as investment securities.ⁿ³

There are no self evident characteristics of either "ordinary" corporate bonds or debentures that settle their status as securities on the face of the instruments themselves. Still, both types of debt instruments are frequently offered in public distributions, most often have intermediate to long maturities, and the payment of the income stream along with face value at maturity in accordance with the terms of the instrument is ultimately dependent upon the success of the enterprise. Corporate debt instruments, utilized in the capital formation settings that are the common arena of operation of blue sky laws, more often than not manifest every bit of investment risk, and as many "risk capital" characteristics as their equity counterparts. Indeed, they may evidence the long term, unsecured or under collateralized outlay of capital for capital expenditures or "start up" of business by unsophisticated investors who have little or no access to financial information on which to evaluate risk, and no power to exercise any essential managerial control.ⁿ⁴

There are varying forms, risk characteristics, and types of issuers of "bonds." Blue sky laws provide no exclusion or exemption from the definition of security for any corporate bonds or debentures based upon the presence of any risk reducing characteristics. However, U.S. Treasury Bonds and other Treasury and agency securities backed by the full faith and credit of the government, as well as state and municipal debt securities, are generally exempted or excluded from coverage.ⁿ⁵ But the presence of such exempt bonds or debt securities does not automatically mean that blue sky law protections will not apply. For example, in *Probst v. State of Oklahoma*,ⁿ⁶ interests in an investment pool for the purchase of U.S. Treasury Bonds or Bills was held to be a non exempt security, separate and distinct from the Treasury securities themselves:

Appellant concedes he offered to sell T Bonds. This concession alone defeats his defense against Count I. While the T Bonds themselves are government securities exempt from registration ... the pool of several investors which the appellant created is a separate and distinct secondary or derivative security... . Even though the Treasury Bonds which are the underlying securities, are exempt from registration, the pool, or secondary security, is not.ⁿ⁷

Government bond or debt security derivative instruments or settings complicate the application of blue sky laws and the interpretation of exemptions. Still, the main focus is on those situations in which the need for blue sky law protection is not outweighed by other apparent factors. Thus, "zero coupon stripped certificates of accrual" on U.S. Treasury securities used in a promotional give away offer for a weight loss program were considered non exempt securities under the Pennsylvania blue sky law in *In re Amerdream Corporation*.ⁿ⁸ A major consideration for the court was the promotional setting, and the failure in advertising to disclose the true nature of the security involved, and its particular characteristics. On the other hand, in *Messer v. E.F. Hutton & Co.*, the 11th Circuit held that U.S. Treasury Bond *futures*, traded in commodity markets, were outside the scope of the Florida blue sky law and governed instead by provisions of the (federal) Commodity Exchange Act.ⁿ⁹

Whether a particular type of bond or debt security is exempt from registration or review provisions of a blue sky law, it will generally not escape coverage under anti fraud provisions and purchaser remedies. Moreover, sales practices will be subject to scrutiny by state securities regulators in the absence of state law provisions limiting authority, or an exemption for broker dealers and salespersons exclusively involved with exempt securities. It is also certain that investment programs or schemes built around otherwise exempt bonds or debt securities will not escape full coverage of blue sky laws, either through the creation of a separate secondary or "derivative" security, or via "investment contract" analysis.ⁿ¹⁰

FOOTNOTES:

(n1)Footnote 1. 455 U.S. 551, 102 S. Ct 1220, 71 L. Ed.2d 409 (1982) .

(n2)Footnote 2. 455 U.S. at 556, 102 S. Ct. at 1223, 71 L. Ed. 2d at 414 .

(n3)Footnote 3. See *E. H. Hinds, Inc. v. Coolidge Bank & Trust Co.*, 6 Mass. App. Ct. 5, 372 N.E.2d 259 (1978). Recognition among state courts, as illustrated by *E.H. Hinds*, has generally come in considerations of debenture instruments under the investment securities provisions of the Uniform Commercial Code. Article 8 provisions of the UCC are triggered by the presence of an instrument "[o]f a type commonly dealt in upon securities exchanges or markets or commonly recognized in any area in which it is issued or dealt in as a medium for investment." See U.C.C. § 8 102(1)(a)(ii); see also *Stoerger v. Ivesdale Co op Grain Co.*, 15 Ill. App. 3d 313, 304 N.E.2d 300 (1973).

For a useful consideration of characteristics which render debentures securities, see *First Financial Savings Bank, Inc. v. American Bankers Insurance Co. of Florida*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,824 (E.D.N.C. 1989).

(n4)Footnote 4. But see *Wingsco Energy One v. Vanguard Groups Resources 1984 Inc.* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,038 (S.D.Tex. 1988) (zero coupon "bonds" were the equivalent of commercial

notes used to secure a loan rather than representing any "speculation or investment").

(n5)Footnote 5. Section 402(1) of the Uniform Act, for example, exempts from coverage:

[A]ny security (including a revenue obligation) issued or guaranteed by the U.S., any state, any political subdivision of a state, or any agency or corporate or other instrumentality of one or more of the foregoing; or any certificate of deposit for any of the foregoing.

Other exemptions or exclusions for bonds or debt securities sold by particular types of issuers may also be found. They are based upon guarantees or other risk reducing characteristics, or situations where no "investment" risk is legitimately perceived, as evident in exemptions for securities of non profit, charitable or benevolent issuers.

But see Abell v. Potomac Insurance Company of Illinois, [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,965 (W.D. La. 1987) (applying Louisiana law, bonds issued by a non profit corporation were not entitled to exemption from coverage of the blue sky law where the "non profit" status of the issuer was specious; "[t]he mere non profit status of an entity does not assure entitlement to the exemption").

(n6)Footnote 6. [1991-1993 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,559 (Okla. Crim. App. 1991); *see also* SEC v. American Bd. of Trade, Inc., 751 F.2d 529 (2d Cir. 1984); SEC v. Capital Counsellors, Inc., 332 F. Supp. 291 (S.D.N.Y. 1971).

(n7)Footnote 7. CCH P 73,559, at 75,470.

(n8)Footnote 8. *In re Amerdream Corporation*, [1990-1991 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,250 (Pa. Sec. Comm. 1990).

(n9)Footnote 9. 847 F.2d 673 (11th Cir. 1988) ; *see also* Conroy v. Andeck Resources '81 Year End Ltd., [1986-1987 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,345 (Ill. App. Ct. 1985) (futures contracts on financial instruments do not constitute securities under Illinois blue sky law).

(n10)Footnote 10. "Investment contracts" are discussed at § 2.08, *below*.



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CHAPTER 2 Definition of Security

1-2 Blue Sky Regulation § 2.05

§ 2.05 Oil, Gas and Mineral Interests

Fractional interests in oil, gas and mineral rights are interests in real property. Nevertheless, investment programs, involving leases, assignments or other interests in regard to oil and gas wells or mineral rights, and the exploitation of such resources, historically have been prominent subjects of state securities regulatory activity. Generally, oil, gas and mineral interests, and programs involving them, are securities under Blue Sky laws as specific categories, such as section 401[l] of the Uniform Act: "certificate of interest or participation in an oil, gas or mining title or lease or in payments out of production under such a title or lease." Virtually all states have adopted that category, or a substantially similar one, in the definition of security.ⁿ¹

That such interests are securities is especially true considering the notion in *Landreth Timber Co. v. Landreth*,ⁿ² that when an instrument falls plainly within the statutory definition, there is no need to look beyond the thing itself to determine its status as a security. Thus, in *Cascade Energy and Metals Corporation v. Banks*,ⁿ³ a federal appeals court, applying California law, concluded that, on its face, an undivided one thirty fifth interest in a mining claim was a security under the blue sky law definition. That definition, said the court, includes "certificate[s] of interest or participation ... in a mining title or lease." The court found no ambiguity in the definition, or evidence that the working interests were anything other than what they purported to be. Investment programs built around royalty pooling, production payment sharing arrangements, "services" or other exploration/exploitation enterprises involving risk capital may also be brought within coverage via investment contract analysis.ⁿ⁴ In either case, coverage of blue sky laws in this area is broad.ⁿ⁵

Still, not all oil, gas or mineral interests are securities. In *Norden v. Friedman* ⁿ⁶ a Missouri appellate court articulated the baseline considerations for identifying such interests as securities in interpreting that state's inclusion of "certificate of interest or participation in an oil, gas, or mining title or lease." The court was confronted with the claim that an assignment of a three quarters working interest in an oil lease, which constituted the transfer of the seller's entire interest, constituted a security by reason of this provision in the blue sky law. It examined the focus of both state and federal protection where these interests are involved:

Determining what constitutes a security has been a complex task from the beginning. Oil and gas rights, in particular, posed difficult problems for the legislative draftsmen. "Such rights were notorious subjects of speculation and fraud, but leases and assignments were also indispensable instruments of legitimate oil exploration and production." Although Congress does not specifically mention "certificate

of interest or participation in an oil, gas or mining title or lease," not every sale of an interest in an oil lease amounts, ipso facto, to the sale of a "security"... . It was the drafters' intent to exclude from the scope of the Acts isolated sales or assignments of oil and gas leases or fractional parts thereof to specific persons, and to include as securities only that form of splitting up of mineral interests which have customarily been used for speculative purposes.

The courts have held that the sale of an entire leasehold interest in oil and gas rights does not constitute the sale of a security within the meaning of the 1933 and 1934 Acts... . If the seller transfers everything he owns there can be no creation of a fractional undivided interest in oil and gas, and this is so even though what he sold was a fractional interest therein.

These principles apply to the facts at hand. The Friedmans sold all of their interest in the Piper Lease. This is not a form of splitting up of mineral interests which has been used mostly for speculative purposes, but simply a sale of their leasehold interest.ⁿ⁷

SEC v. C.M. Joiner Leasing Corp. ⁿ⁸ amplifies the point that the prime focus where oil, gas or mineral interests are concerned is not on the conveyance of a property right, but rather on an enterprise and the expectation of profit to come from it. *Joiner Leasing* emphasizes the dependency of value of the real property interest upon the enterprise. The Court undertook to extend securities law protections to property rights that were clearly subject to speculation and fraud, and which had no value apart from the promoters' enterprise. Thus, as *Norden* counsels, while the sale of naked leasehold rights in oil or gas properties does not automatically involve the sale of a security, the conclusion is different where investment risk is added to the scenario.ⁿ⁹

Offering "investments" in the form of a one percent interest in a producing oil well constituted the sale of a security under the Montana blue sky law.ⁿ¹⁰ The program required a \$6,000 "investment" in a producing well that was claimed to be currently pumping 35 barrels per day, but for which an increase to 60 barrels per day was expected. In Illinois, the sale of an undivided fractional interest in two oil and gas wells, along with an agreement to pay a portion of the development costs, was held to be the sale of a security. The economic relationship between the parties, said the court in *Daleiden v. Wiggins Oil Company*,ⁿ¹¹ clearly involved a contract in which the purchasers invested money in the seller's enterprise, and that but for paying certain costs in addition to the leasehold interests their investment would be worthless. And in Wyoming, an undivided fractional working interest in an oil and gas lease was held to be a security where the seller retained exclusive control over drilling operations, and where promotional characteristics clearly defined the agreement involved and the substance of the rights and obligations between the parties, as an investment.ⁿ¹²

"Pooling" programs in regard to oil and gas production royalties likewise result in the creation of a security. In *Moffit v. Sederlund*, ⁿ¹³ a royalty pooling "deed" by which landowners conveyed undivided interests in all oil and gas produced from their land to a trustee of a royalty pool was held to be a security. The landowners conveyed interests to the trustee in exchange for the right to share in royalties generated from other interests conveyed to the pool. The "deed," said a Michigan appellate court, was a "certificate of interest or participation ... in payments out of production."ⁿ¹⁴

Despite the specific statutory classification, investment contract analysis is evident in many oil and gas cases, particularly where related ventures or enterprises are involved.ⁿ¹⁵ In *Johnson v. Rogers*, ⁿ¹⁶ for example, working interests in oil and gas leases were held to be securities by definition. In addition, however, "turnkey" contracts for drilling and completion of wells associated with those leases were held to be separate securities--investment contracts--because they were offered to investors as an inducement to purchase, and exploit, the leasehold interests.ⁿ¹⁷

In the context of oil and gas interests the Idaho Supreme Court cautioned, however, that the application of investment contract analysis must in fact be consistent with economic reality. In *Dept. of Finance v. Resource Service Co.*, ⁿ¹⁸ the court refused to characterize a program in which participants paid a fee to a promoter in order to enter their names in a

lottery for oil and gas leases offered by a state agency as involving a security. The court explained that by paying the fee participants did not contribute capital to any enterprise with the intention of sharing in its profits and earnings. The economic reality, said the court, was that participants paid a fee for a service. The promoter advertised its expertise in the procedures involved, but the purchaser could not reasonably expect anything other than the right to win or lose in the lottery in return. A purchaser who wins such a lottery may enjoy the good fortune associated with acquiring a valuable right, but does not share it with the provider of the service.ⁿ¹⁹

Mining and mineral related cases have also turned on investment contract analysis. Many mineral or mining related programs have focused on gold production, and more often involve risk capital for speculative mining operations than anything approaching the acquisition of a claim or leasehold interest. In *People ex rel. Bender v. Wind River Mining Project*,ⁿ²⁰ for example, "gold certificates" were acquired by persons who would have no role in specialized mining and refining operations financed with their capital. The production of gold was entirely dependent upon the success of the seller/promoters' venture, and the court had no trouble finding a security.ⁿ²¹ On the other hand, the outright purchase of gold ore, already mined and ready for shipment, was held not to involve a security where the seller retained no control over any subsequent storing, processing or refining of the ore, and there was no "common enterprise" between purchaser and seller.ⁿ²²

The mission of blue sky laws where interests in oil, gas or mineral rights are involved is not to regulate the acquisition and disposition of real property rights, or the exploitation of mineral resources. Rather, the goal is protection against fraud and overreaching in the creation and marketing of passive investment programs in which the fortunes of purchasers are interwoven with and dependent upon the seller/promoter.

This baseline concern is illustrated by *Dunbar v. RKG Engineering, Inc.*,ⁿ²³ in which a Texas court denied blue sky law protection to a purchaser of interests in several oil and gas leases where the purchaser was deemed to be a joint venturer in the leaseholds. Although the interests sold fell literally within the Texas definition of security, the court found the circumstances presented a common plan and joint venture between the parties well before the assignment of interests in the leases was undertaken. The court simply concluded that the blue sky law would not appropriately be applied to transactions between joint venturers.

What plainly emerges from the cases is that if an interest in an oil, gas or mining property, whether evidenced by a working interest, lease or other "certificate," represents only the opportunity to share in profits of an enterprise controlled by another, and from which it derives at least a substantial part of its value, a security is present. That is at least implicit in the definitions of most blue sky laws, which speak to certificates of interest in, or participation in, leases or production payments rather than fractional undivided interests themselves, in contrast to the federal definitions. The sense of the language, as succinctly expressed by a California court, is that the purchaser of a security in these circumstances looks to something beyond his or her own efforts, or the interest itself, to realize expected value:

It is settled law that any deed, certificate of interest or like instrument of conveyance or assignment falls within the act only when it appears directly or inferentially that the buyer contemplates receipt of profits from activities of other persons, such as carrying on a business, drilling an oil well, or sinking and operating a mine; the mere conveyance to him of a fractional interest in a piece of land or other type of property is not subject to the statute if the buyer must look only to the thing bought or his own efforts to produce a profit to himself.ⁿ²⁴

Given this long standing guiding principle, it is certain that few garden variety oil and gas drilling or exploration programs would ever escape blue sky coverage.ⁿ²⁵ Plainly, mineral exploitation programs that realistically represent only the opportunity to speculate on the success of another's enterprise, undertaking or "services" will almost invariably be deemed to be securities through investment contract analysis. In all cases, the manner of promotion involved in oil, gas and mineral exploitation programs will operate to erase any doubt.

FOOTNOTES:

(n1)Footnote 1. The majority of states include oil, gas and mineral interests within their definitions of security via the Uniform Act language. Three states: Arizona, Illinois and Kentucky, more closely track the language of the federal securities laws, which speaks only of "fractional undivided interests in oil, gas or other mineral rights" rather than certificates of interest or participation. Other states utilize variants of the certificate language. Florida, for example, defines security to include: "[a]ny certificate of interest in oil, gas, petroleum, mineral or mining title or lease, or the right to participate therein." *Fla. Stat. Ann. § 517.021(15)*.

(n2)Footnote 2. 471 U.S. 681, 105 S. Ct. 2297, 85 L. Ed. 2d 692 (1985) .

(n3)Footnote 3. 896 F.2d 1557 (10th Cir. 1990) .

(n4)Footnote 4. See *Shurley v. L & C Consultants, LLC*, CCH Blue Sky L. Rep. P 74,722, at 79,835, 2008 U.S. Dist. LEXIS 56438 (E.D. Ark. July 8, 2008) ("Participation Agreements" representing an undivided interest in a portion of oil and gas leases are readily identifiable as securities under the Arkansas Securities Act); *Manley v. State*, 774 S.W.2d 334 (Tex. App. 1989) (fractional share of working interest in oil and gas lease fits squarely within the definition of security, and was not entitled to "joint adventure" exclusion).

(n5)Footnote 5. See also *Manley v. State*, 774 S.W.2d 334 (Tex. App. 1989) (fractional share of working interest in oil and gas lease fits squarely within the definition of security, and was not entitled to "joint adventure" exclusion).

(n6)Footnote 6. [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,665 (Mo. Ct. App. 1987).

(n7)Footnote 7. P 72,665, at 72,774, quoting *SEC v. C.M. Joiner Leasing Co.*, 320 U.S. 344, 352, 611 S. Ct. 120, 124, 88 L. Ed. 93, 94 (1943) [citations omitted].

(n8)Footnote 8. 320 U.S. 344, 611 S. Ct. 120, 88 L. Ed. 83 (1943) .

(n9)Footnote 9. See also *State v. Cook*, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,329, at 68,082 (Okla. 1977):

A "flexible" construction of securities has evolved through case law and legislative history in order to meet the schemes of those who intend to use the money of others on the promise of profits. Although sales of undivided oil and gas interests are specifically excluded from the Oklahoma blue sky definition of "securities," when they are sold in conjunction with operation or management agreements which deprive the investors of any control over the investment they are securities. Even though an investment transaction contains an excluded security, the package as a whole may be considered a security; the economic realities of the transaction govern the determination. Thus, where an investor expects a profit on money which is subject to risk, and that profit is a product of the operator's actions alone, an exempt lease will not preclude the package from constituting a security.

Similarly, in *Shepperd v. Boettcher & Company, Inc.*, 756 P.2d 182 (Wyo. 1988) , the court opined that the substance of rights and obligations between parties to the sale of fractional working interests in an oil and gas lease control whether a security is present.

(n10)Footnote 10. *In re Osage Development Corp.*, [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,672 (Mont. Sec. Dept. 1987).

(n11)Footnote 11. [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,682 (Ill. 1987).

(n12)Footnote 12. *Shepperd v. Boettcher & Company, Inc.*, n. 8, *above*.

(n13)Footnote 13. [1986-1987 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,341 (Mich. Ct. App. 1985).

(n14)Footnote 14. *Id.* at 71,535.

(n15)Footnote 15. *See, e.g.,* People v. Smith, [1988-1989 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,054, at 74,240 (Cal. App. 1989). The catch all "investment contract" category is discussed in § 2.08 *below*.

(n16)Footnote 16. *551 F. Supp. 281 (C.D. Cal. 1982)* .

(n17)Footnote 17. As a matter of federal law, investment programs built around the sale or lease of mineral rights have regularly been held to involve securities, either by definition or investment contract analysis. *See also* SEC v. International Mining Exchange, Inc., [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,013 (D. Colo. 1981); *SEC v. Goldfield Deep Mines Co., 758 F.2d 459 (9th Cir. 1985)* .

(n18)Footnote 18. *130 Idaho 877, 950 P.2d 249 (1997)* .

(n19)Footnote 19. *See also* SEC v. Energy Group of America, Inc., 459 F. Supp. 1234 (S.D.N.Y. 1978) (customers paid a fee to participate in a lottery, but did not "invest").

(n20)Footnote 20. 219 Cal. App. 3d 1390, 269 Cal. Rptr. 106 (1990).

(n21)Footnote 21. The court observed:

[D]efendants are engaged in a difficult and speculative mining operation. They wish to finance their enterprise with other people's money and to that end have turned to random solicitation from the general public. The members of the public who subscribe to the gold certificate offering will have no part in the operation or management of the mining and refining operations. And the subscribers' money is at risk since whether they will realize their objective, the receipt of gold, will be entirely dependent upon the success of defendants' business venture. The sale of the Wind River gold certificates to raise risk capital is precisely the type of transaction the Corporate Securities Law of 1968 was intended to regulate and the gold certificates are paradigmatic examples of securities. *Id.*

See also In re Howerton, [1988-1990 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,053 (Texas Sec. Bd. 1989) (interests in an operation to recover gold from water).

(n22)Footnote 22. *Moreland v. Department of Corps.*, 194 Cal. App. 3d 506, 239 Cal. Rptr. 558 (1987).

(n23)Footnote 23. *746 S.W.2d 314 (Tex. Ct. App. 1988)* .

(n24)Footnote 24. *People v. Rankin*, 160 Cal. App. 2d 93, 325 P.2d 10 (1958).

(n25)Footnote 25. That is not to say that every such program would be subject to the full coverage of blue sky laws. An exemption from registration, merit review or other administrative procedures may be available. However, anti fraud and purchaser remedies would remain available.



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CHAPTER 2 Definition of Security

1-2 Blue Sky Regulation § 2.06

§ 2.06 Options, Warrants and Subscription Rights

[1] Options and Warrants Generally

The Uniform Act and those states adopting it bring within the definition of security any "warrant or right to subscribe to or purchase" any other enumerated form of security.ⁿ¹ Other states, following the federal model, expressly include "options to purchase securities" among the list of instruments and categories.ⁿ² In either case, options qualify as securities themselves under the "right ... to purchase" category in every definition.ⁿ³ Moreover, true to *Landreth*, guidance at the federal level leaves little room for doubt: "The option to purchase stock ... is such a traditional securities instrument that its existence may be shown 'by proving the document itself' without any need 'to look beyond the characteristics of the instrument... ' "ⁿ⁴

Equity options (either "calls" or "puts")ⁿ⁵ grant their purchasers the right, but not the obligation, either to buy or sell a fixed number of shares of an underlying stock at a specified "strike" price for a particular period of time. More complex options on the values of various stock indexes operate in the same fashion, except that no specific underlying stock is involved. Instead, their value is derived from a stock index such as the Standard and Poor's 500 Stock Index. These "index" options, more commonly referred to as "derivatives," are one form of an increasingly complex set of financial products used primarily by institutions to hedge against various financial market risks.ⁿ⁶

Warrants or "rights" operate in the same manner as options in regard to the right to acquire new or additional shares of an underlying security. However, they do not necessarily possess the standardized characteristics and terms that make for "listed" options, and which allow for the operation of continuous options trading markets on a national securities exchange like the Chicago Board Options Exchange. Distributions of warrants and rights are undertaken by corporate issuers. The instruments trade as listed securities or in over the counter markets, independently of the associated security although, as with options, their market value derives from the value of the associated security.

The role of state blue sky regulation and remedies with regard to options and warrants has been limited primarily to sales practices, and, in general, to the conduct of regulated persons such as broker dealers and salespeople under anti fraud and licensing provisions. The issuance of exchange listed options is generally immune from state registration and review processes by reason of exemptions contained in most blue sky laws for listed securities or rights to purchase listed securities.ⁿ⁷ The offer and sale of other options, namely commodity options, in "boiler room" operations and other circumstances that would trigger historic blue sky concerns for protection of the public, is likewise largely outside

state regulation under blue sky laws by reason of federal preemption.ⁿ⁸ Nevertheless, where not otherwise constrained, state courts are willing and able to extend the full range of blue sky protection in any context where the instrument involved answers to the description of an option or right.

In *Computer Concepts, Inc. Profit Sharing Plan v. Brandt*,ⁿ⁹ for example, an option to convert debt into equity that was incorporated into a negotiated loan agreement used for the financing of a proposed motion picture was held to be a security subject to registration and other provisions of the Oregon blue sky law. Responding to the contention that the loan agreement, as a whole, should not be deemed to include a security and that, in any event, the "option" contained in it was not exercised the court spoke of the breadth of coverage relating to options as follows:

[T]he very nature of an option is to permit a future act, and, as we have noted, the legislature has manifested a consistent intention to regulate the sale of options. The system would be unworkable if it required registration by a seller only at the point when the buyer decided to exercise an already purchased option. The question is whether an option, if exercised, would be a security.ⁿ¹⁰

The option, said the court, was part and parcel of the consideration paid and was, unambiguously, an integral part of a single transaction.ⁿ¹¹

Stock options involved in corporate compensation or incentive programs for executives plainly answer to blue sky law definitions of security. In most executive compensation situations, however, traditional concern for "investor" protection is not present, and transactional exemptions from coverage of blue sky registration and review provisions are likely to be available in any event. However, where stock options in an employment setting are actually a part of a corporate financing plan, serious concerns for investor protection may arise. In *People v. Carmichael*,ⁿ¹² criminal convictions for the offer and sale of stock options in violation of the California blue sky law were affirmed where stock options of varying types were sold as a condition of employment to people who answered various employment opportunity advertisements by a company undertaking the production and sale of a three wheeled vehicle. The advertisements indicated that an "investment" in the company of \$1,500 to \$2,000 was required. The court had no trouble concluding that the defendants had willfully offered and sold securities in violation of the California blue sky law. The stock options represented the right to subscribe to or purchase a security, and were at the same time investment contracts.ⁿ¹³ The entire scenario was one in which the options, and other forms of instruments, represented only devices by which the issuer and its principals sought to raise funds for the conduct of the business venture through a well organized promotional campaign.

In conventional corporate financing settings the issuance of: (i) options, warrants or rights in connection with the distribution of other securities; (ii) units comprised of both common stock and warrants; and (iii) options or warrants granted as part of underwriters' compensation in an offering will not escape registration or review procedures in accordance with any applicable blue sky provision or policy. Options or warrants granted as part of underwriters' compensation are reviewed under general fairness standards state by state, pursuant to any applicable percentage limitation or calculation of maximum fees and expenses of an offering that may apply.

While blue sky investor concerns may not arise where stock options are involved in the conventional corporate executive compensation setting, subsequent events or conduct in regard to options can trigger blue sky remedies. Inducements to surrender existing options in exchange for some other right to acquire stock on different terms, for example, give rise to investor protection concerns.ⁿ¹⁴

Finally, although options, warrants and "rights" generally are most likely to be considered securities by the nature of the thing itself and the express definitional category in blue sky laws, it is important to note that investment contract analysis may also operate to bring less conventional forms of options or rights within the ambit of blue sky coverage.ⁿ¹⁵

[2] Preorganization and Subscription Rights

In the preformation stage of an enterprise the nature of an investment decision made by one committing risk capital to the enterprise is no different than a post formation decision to do the same. The offer and sale of interests in a corporation to be formed, or, commonly, the solicitation of subscriptions for securities to be issued, present all of the concerns for investor protection associated with any security. The instrument represents a contract to buy, purchase or to otherwise acquire securities. Thus, the Uniform Act and all state blue sky laws, include, in one form or another, a "preorganization certificate or subscription" among the list of things defined as securities.ⁿ¹⁶

In the main, "preorganization certificate or subscription" refers to the pre incorporation subscription for capital stock.ⁿ¹⁷ The prime characteristics of such an instrument have been illustrated as follows:

[T]he "Agreement to Form a Corporation," whether it be considered an investment contract, a contract for the distribution of shares of corporate stock or a joint venture agreement, expressly provides for the distribution of shares of stock in a corporation to be thereafter formed. As such it is most certainly a contract to buy, purchase or otherwise acquire those shares of stock. And, it most assuredly comes within the definition of security as a preorganization certificate or subscription and an investment contract as well as being a certificate of interest or participation in or right to subscribe to or purchase stock.ⁿ¹⁸

The classification of preformation interests as securities may be impacted by other characteristics of the relationship between the parties that creates a joint venture interest or participation rather than a security. The preformation phase of a corporate enterprise may well involve the association of entrepreneurs in the organization of the enterprise, whose respective roles may be active. The inclusion of preorganization certificates and subscriptions in blue sky law definitions presumes that the interests entail no different characteristics from those associated with the security ultimately expected, and that the concern for investor protection is no different. It is quite possible in the preformation corporate setting, however, that a joint venture among entrepreneurs may be found, and that despite an instrument or agreement that answers to the name of preorganization certificate or subscription, the circumstances and relationship between the parties dictates that no security is present.

In the entrepreneurial, preformation, corporate setting it is not uncommon for a few individuals to agree to form a corporation in which each will contribute an equal amount of money and receive equal amounts of stock when issued. The money may be used up, and no corporation ever formed. Have the contributors purchased securities? Each can be said to have purchased or subscribed to a preorganization interest. But if they are all in fact to be equal participants in the organization and operation of the business, is there concern for investor protection under the blue sky law? Joint ventures and the joint venture "gloss" that may be placed on instruments otherwise answering to a listed category of security in blue sky definitions are considered later.ⁿ¹⁹ In those cases, however, where the preorganization subscription process involves solicitation and a selling process no different from that which marks the offering and sale of any conventional form of security, there is no question that the interests or instruments are securities under blue sky law definitions whether or not the ultimate entity is ever formed.ⁿ²⁰ Also, the form of preorganization instrument does not matter. In this setting the security may take the form of a note, a certificate of interest or participation, a temporary interim certificate, a receipt, a warrant or right to subscribe for an interest, or anything else that amounts to a commitment of risk capital in the initial stages of organization.ⁿ²¹

While preformation or preorganization interests fall within the definition of security under all state blue sky laws, most states also provide an exemption from registration or qualification requirements when they are offered only to a limited number of people and in circumstances involving no commissions or other indicia of a selling process. Some states also specifically exempt limited preformation activities and instruments as a means of encouraging capital formation by small businesses. In these limited offering settings there will nearly always be an available exemption in one form or another to permit the offer and sale of preorganization subscriptions, although a separate limited offering or other

exemption may be required to cover the distribution of the stock or other securities to which the subscription applies.ⁿ²²

FOOTNOTES:

(n1)Footnote 1. Uniform Act Section 401(l).

(n2)Footnote 2. *See, e.g.*, Cal. Corp. Code § 25019 (definition includes any put, call, straddle or privilege on any security); Ind. Code § 23-2-1-4(k) (any option to purchase any security); *N.Y. Gen. Bus. L.* § 352(l) (includes calls or options for stocks); *Ohio Rev. Code* § 1707.01(B) (options to purchase securities); Wis. Stat. Ann. § 551.02(13)(a) (any option or right to purchase a security).

(n3)Footnote 3. Whether or not expressly included, blue sky law definitions are broadly construed with respect to including options, even where the thing to which the right relates may not itself be a security. *See* Prudential Bache Securities, Inc. v. Cullather, [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,663 (E.D. Va. 1987) (applying Virginia law, currency options held to be securities under a "broad and open ended" view of the blue sky law).

See also SEC v. Unique Financial Concepts, Inc., 196 F.3d 1195 (11th Cir. 1999) (contracts for sale of foreign currency futures held to be investment contracts under the federal *Howey* test). The specific treatment of foreign currency and options or rights associated with foreign currency as securities under blue sky laws is discussed in § 2.09[3], below.

(n4)Footnote 4. *One-O-One Enterprises, Inc. v. Caruso*, 848 F.2d 1283, 1288, 270 U.S. App. D.C. 251 (D.C. Cir. 1988) .

(n5)Footnote 5. Although less familiar than their exchange-traded equity counterparts, options on debt securities (primarily U.S. government securities) trade in certain markets, as do derivative options such as equity market indexes or "interest options" deriving from government debt securities. Options on currencies are also available, and allow for hedging against exchange rate risks.

Commodity options represent another breed of option, not involving any right in regard to a security, but which may nevertheless by definition in some states be deemed to be a security. *See, e.g.*, *Alaska Stat.* § 45.55.130(12) ("Security means ... an option on a contract for the future delivery of agricultural or mineral commodities or any other commodity offered or sold to the public and not regulated by the Commodity Futures Trading Commission..."); 6 *Del. Code Ann.* § 7302(l)(1) ("Security means any ... options on commodities"); Ind. Code § 23-2-1(k) ("Security means any ... option on a commodity futures contract; option, put, call, privilege or other right to purchase or sell a commodity futures contract"). The extent of state authority, if any, to regulate in the area of commodity options is a matter dependent on the extent of federal preemption by reason of the exclusive grant of jurisdiction to the Commodity Futures Trading Commission in the Commodity Exchange Act. *See* 7 U.S.C. § 2. The exclusive jurisdiction provision of the federal act has been held to evidence a clear intention to exclude states from regulation of commodity options under blue sky laws. *See* *International Trading Ltd. v. Bell*, 262 Ark. 244, 556 S.W.2d 420 (1977); *State v. Monex Int'l, Ltd.*, 527 S.W.2d 804 (Tex. App. 1975).

(n6)Footnote 6. In addition to options, the major categories of derivatives are "forwards" and "futures," which obligate the holder to buy or sell a specific amount or value of an underlying asset, reference rate or index at a specified price at a particular future date, and "swaps," which are customized agreements between counterparties to make periodic payments to each other for a specified period. Forwards, futures and swaps are not themselves securities, and are not subject to blue sky laws, despite the fact that in some cases, as with "financial" futures traded in commodity futures markets, the underlying assets may be securities. *See* *Conroy v. Andeck Resources '81 Year-End Ltd.*, Ill. App. 3d 375, 484 N.E.2d 525 (1985); *Mallen v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 605 F. Supp. 1105 (N.D. Ga. 1985) (stock index futures are not securities).

See also Mount Lucas Assocs. v. MG Ref. & Mktg., Inc., 250 A.D.2d 245, 682 N.Y.S.2d 14 (1998) (swap agreements utilized in connection with oil price risk management services, based on oil futures and options, held not to be investment contracts).

(n7)Footnote 7. *See, e.g.*, Uniform Act § 402(a)(8). California includes a representative exemption:

Any security listed or approved for listing upon notice of issuance on a national securities exchange or designated or approved for designation upon notice of issuance as a national market system security on an interdealer quotation system by the National Association of Securities Dealers, Inc ... and any warrant or right to purchase or subscribe to the security...

Cal. Corp. Code § 25100(o) (emphasis added).

(n8)Footnote 8. *See* n.5 *above*. The scope of authority of any securities regulatory agency to deal with another species of options, foreign currency options, is discussed in § 2.09[3], *below*.

(n9)Footnote 9. 310 Ore. 706, 801 P.2d 800 (1990) .

(n10)Footnote 10. *Id.* at 712 .

(n11)Footnote 11. *Id.*

(n12)Footnote 12. 106 Cal. App. 3d 124, 164 Cal. Rptr. 872 (1980).

(n13)Footnote 13. The financing scheme also involved the offer and sale of demand notes redeemable in stock of the company, as well as the sale of "dealerships." Criminal charges included not only the failure to obtain a requisite permit for the offer and sale of securities, but also the sale of those securities by means of false statements and a fraudulent scheme.

(n14)Footnote 14. *See* Disher v. Fulgoni, 161 Ill. App. 3d 1, 514 N.E.2d 767 (1987) (surrender of stock option rights in exchange for voting trust certificates and the opportunity to buy twice as many shares represented a transformation of employees' interests and triggered blue sky law remedies).

(n15)Footnote 15. *See, e.g.*, *In re* Wellington Precious Metals, Inc., [1986-1987 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,405 (Wyo. Sec. of State 1986) ("Deferred delivery" contracts which have the attributes of an option are investment contracts).

(n16)Footnote 16. *See* Uniform Act § 401(l).

(n17)Footnote 17. *See* Anzai v. Kawai, 50 Hawaii 406, 411, 441 P.2d 345, 349 (1968) .

But see Curtis v. Johnson, 92 Ill. App. 2d 141, 234 N.E.2d 566 (1968) ("Trust receipt" amounted to a preorganization agreement or subscription).

(n18)Footnote 18. Stevens v. Vowell, 343 F.2d 374, 379 (10th Cir. 1965); *see* Getchell v. United States, 282 F.2d 681 (5th Cir. 1960); *see also* Commonwealth v. Bomersbach, 260 Pa. Super. 28, 393 A.2d 995 (1978) (sale of pre-incorporation subscriptions).

(n19)Footnote 19. *See* § 2.08[2][a] *below*.

See also Hathaway v. Porter Royalty Pool, Inc., 296 Mich. 90, 110, 295 N.W. 571 (1941) (preorganization certificates or subscriptions issued in a joint venture, using the medium of a corporate form for convenience in effecting

the joint venture, is not the issuance of securities contemplated by the blue sky law).

(n20)Footnote 20. *See Queen v. Commonwealth*, 434 S.W.2d 318 (Ky. Ct. App. 1968) .

(n21)Footnote 21. *See, e.g., Curtis v. Johnson*, 92 Ill. App.2d 141, 234 N.E.2d 566 (1968) ("Trust receipt" amounted to a preorganization agreement or subscription).

(n22)Footnote 22. Available exemptions for preorganization subscriptions or rights, either as specific transactional exemptions or limited offerings are presented in each of the State Guides contained in Vols. 3 and 4, *below*, and are also discussed generally in Chapter 8 (Exempt Issuer Transactions) and Chapter 10 (Regulation of Small Business Capital Formation).



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Blue Sky Regulation

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CHAPTER 2 Definition of Security

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§ 2.07 Partnerships and Joint Ventures

The existence of a security, in any form, is indicated by the presence of a passive investor. That is to say that value--risk capital--is committed to an enterprise by one whose expected return is largely dependent upon the managerial activities and success of someone else. People who come together as entrepreneurs, and who presumably have equal say in their joint undertaking, are not passive investors, even if they choose to delegate managerial responsibilities within their group. Implicit in this kind of relationship is the notion that all participants in the enterprise have the ability to protect themselves through the ultimate power to control, even though one or more of them may in fact be "passive" in day to day operations. Thus, because general partners have a legal right to participate in the management of the partnership, by applying investment contract analysis, the partnership's interest is presumed not to be a security.

A California appellate court addressed the essential and fundamental distinction between true joint venture relationships and those which amount to investment contracts in *Consolidated Management Group LLC v. Dept. of Corporations*.ⁿ¹ The question before the court was whether "joint venture" units were securities subject to qualification under the California Blue Sky law. In the situation presented, the "managing" venture had authority over the venture's day-to-day operations. However, other venturers had the right to remove the managing venture by a majority vote. The joint venture agreement provided generally for collective management and control by all of the venturers, and granted the venturers rights of general partners. In examining whether the joint venture interests constituted securities, the court applied investment contract analysis, with the essential question being the extent to which "venturers" were dependent upon the some unique managerial ability of the managing venture. The court concluded that the success of particular projects marketed to the putative joint venturers was uniquely dependent on the managing venturer's efforts, and that other venturers relied on those efforts in making their investments.ⁿ² The "joint venture" units were thus determined to be securities. The court observed that the investment was structured to avoid the appearance of dependence by joint venturers, but that in reality the investors were dependent upon the expertise of the manager.ⁿ³

Questions of control, and whether participants are indeed passive investors, commonly form the basis for considering interests in partnerships and joint ventures as securities under blue sky laws.ⁿ⁴ The Uniform Act definition includes no specific reference to partnerships or joint ventures, although both forms of association are easily considered under the specific category of "certificate of interest or participation in any profit sharing agreement," or, more commonly, "investment contract."ⁿ⁵ Moreover it can safely be said that limited partnerships involve interests that qualify as "any instrument or interest commonly known as a security."ⁿ⁶ These particular securities are further discussed *below*.

[1] Limited Partnerships

Limited partnerships are creations of statute in all states. The Revised Uniform Limited Partnership Act defines such an organization as: "[a] partnership formed by two or more persons ... having as members one or more general partners and one or more limited partners."⁷ The key consideration for limited partnership interests as securities is the legal separation of limited "partners" from control over the enterprise that is vested in the general partner(s).⁸ Indeed, the presumed absence of control by limited partners is determinative of blue sky law coverage in nearly all cases involving limited partnerships.⁹ As a federal court concluded in examining limited partnerships as securities: "Virtually by definition ... because of their restrictions on participation, limited partnership interests usually qualify as securities..."¹⁰

Apart from the accepted notion that true limited partnership interests are securities on their face, it is also certain that "investment contract" analysis would compel the same conclusion.¹¹

The structural and legal distinction between limited partnerships and general partnerships or joint ventures illustrates the significance of the "passive" investor notion in determining the existence of a security. In contrast to the statutory qualifications on limited partner participation, a general partnership, also a statutory creation, merely provides for an "association of two or more persons to carry on as co owners a business for profit."¹² Unless otherwise agreed, all general partners have an equal voice in management regardless of their financial interest in the partnership, and all partners share in the profits and losses.¹³ General partners act as principal for themselves, and as agents for the partners as a group. Presumably, a true general partner, or joint venturer,¹⁴ expects to derive profits from his individual contribution to the efforts of the partners or co venturers in the enterprise. Blue sky law implications for general partnerships and joint ventures thus differ considerably from those applicable in limited partnership settings.

[2] Limited Liability Partnerships

The limited partners in a typical limited partnership are not involved in or empowered in regard to managing the affairs of the partnership, and limited partners are not personally liable for the obligations of the partnership unless they participate in control of the business. They are passive investors. An emergent hybrid form of partnership known as a limited liability partnership, or LLP, combines characteristics of a traditional general partnership in regard to control with the limited liability feature of a limited partnership. Limited liability partnerships are also creatures of statute, and are now available in most states. Because LLPs are a form of general partnership their members are permitted to participate in the control and management of the business of the LLP. However, LLP members, as opposed to general partners, are entitled to the protections of limited liability. In some instances, as a matter of express or implied agreement, or simply as a practical matter, the LLP "partners" may have very limited or no control in the management of the LLP.

There is as yet little case law addressing the treatment of LLP interests under state or federal securities laws, although enforcement actions suggest that regulators will consider them to be securities depending upon particular circumstances.¹⁵ In *Toothman v. Freeborn & Peters* ¹⁶ a Colorado appellate court concluded that the structure of a limited liability partnership does not support a presumption that LLP membership interests are not securities. Rather, the characteristics and organizational structure of each LLP must be assessed using investment contract principles to determine whether the interest at issue is a security. In *Toothman* the plaintiffs alleged that defendants organized and sold interests in 53 limited liability partnerships established to sell prepaid cellular phone services to some 5000 investors. In connection with ruling on a request for class action certification the trial court concluded that LLP interests are presumed not to be securities. The Court of Appeals reversed, concluding instead that application of investment contract principles defeats any presumption that limited liability partnerships are not securities. The relevant inquiry, said the court, is to determine whether the partner/investors expected profits from the essential managerial efforts of someone else, and whether the partners had any substantial power to affect the success of the enterprise. The case was thus remanded for further consideration. It clearly leaves the inquiry open in all LLP cases to the same extent it is open

in regard to general partnerships, as discussed further below.

[3] General Partnerships and Joint Ventures

The characteristics of interests in general partnerships would seem to exclude them from being securities. The legal concept of a general partner's role is active participation in the firm, unlike the passive role of an investor in securities.ⁿ¹⁷ As noted above, general partnerships are associations of two or more co owners, who operate a business for profit,ⁿ¹⁸ and who, regardless of individual financial investment, have an equal voice in the management and control of the business.ⁿ¹⁹ In application, the controlling notion has been expressed by a federal appeals court as follows:

Normally a general partnership interest is not considered a 'security'... . The managerial powers vested in general partners and the express right of inspection of documents gives them the kind of leverage and ability to protect themselves that takes them outside the intended scope of the [Securities] Act.ⁿ²⁰

On the other hand, where a "partner" is totally dependent on others to operate the business, and has no control over the risk taken with her investment, a general partnership interest will be deemed to be a security. This assessment by a Washington appellate court, holding that a general partnership interest was in fact a security under that state's blue sky law, is particularly instructive concerning the distinction:

Here, we find that plaintiffs held a passive interest because they depended substantially upon defendants' management to obtain a profit. The purchasers executed a special power of attorney, relinquishing broad powers to the Board. The Board thus has extensive managerial responsibilities. Furthermore, testimony from prior defendants indicates that they perceived plaintiffs' role as passive. Finally, the purchasers were guaranteed a modest rate of return, demonstrating that they did not control the realization of a profit but were depending exclusively on the efforts of others.ⁿ²¹

The generally accepted criteria to be applied in determining whether a general partnership interest is a security were articulated under the aegis of the federal securities laws by the Fifth Circuit U.S. Court of Appeals in *Williamson v. Tucker*:ⁿ²²

A general partnership or joint venture interest can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.ⁿ²³

In setting out these criteria, the court emphasized that the delegation of rights and duties among partners, standing alone, does not create the sort of dependence on which the existence of a security is premised. Simply relying on others for management does not indicate that the partners are so dependent upon a particular manager that they cannot replace that person or otherwise exercise ultimate control.ⁿ²⁴ Thus, as another federal court, applying the Oregon blue sky law, observed, a "passive partner" may nevertheless be a partner with managerial powers significant enough to keep a general partnership interest from being deemed a security.ⁿ²⁵

State courts have applied *Williamson* by examining the extent to which partners are deprived of significant managerial powers. A South Carolina court, for example, considered interests in a general partnership which granted a managing partner "full charge of the management conduct and operation of the partnership business in all respects," to be a

security.ⁿ²⁶ Also, under Maryland lawⁿ²⁷ and Wyoming law,ⁿ²⁸ general partnerships were held to be securities where significant powers were granted to one partner. In an Arkansas case it was held that a general partnership interest was a security where only one partner had the knowledge and expertise to carry on the business of the partnership.ⁿ²⁹ However, in Maine, a partnership agreement was seen as providing "non managing partners" with significant powers, both individually and cumulatively, over the ultimate fate of the partnership, and no security was found.ⁿ³⁰

Not surprisingly, in enforcement cases under state blue sky laws the manner of offering "general partnership" interests, and general assessments of "economic reality" are prominent considerations. In Colorado, for example, the investigative and enforcement authority of that state's securities commissioner over general partnership interests that were marketed by telephone to persons, generally senior citizens, in several states by scripted calls in an operation described by regulators as a "boiler room" was affirmed.ⁿ³¹ Though described as a general partnership, the partnership was in fact under the management of a committee, on which none of the anticipated 400 "partners" was represented. Upholding the regulatory authority of the securities commissioner, the Colorado appeals court observed that not only would most of the partners be senior citizens, but also that they would be strangers to each other and to the promoter. They would be widely scattered geographically, and were solicited without regard to any expertise or ability to bring anything to the business of the partnership. In these circumstances, considerations of "economic reality" outweigh any theoretical notion of an actual partnership relation.ⁿ³²

No state specifically includes general partnership interests within the statutory definition of security. In some cases, however, specific exclusion from the definition has been accomplished by regulation.ⁿ³³ On the other hand, by regulation, one state has deemed all general partnership interests to be securitiesⁿ³⁴ and another has taken the same position where the interests are sold by public offering.ⁿ³⁵

The treatment of joint ventures under blue sky laws has reflected the fact that there is no functional difference between them and general partnerships in determining whether a security is present. Thus, as a general proposition, interests in joint ventures, with their presumption of shared control, are not securities. State courts have regularly so held.ⁿ³⁶

The statutory and regulatory approaches to joint ventures are consistent with those dealing with general partnerships as well. With the exception of Nebraska, blue sky law definitions of security are silent on the matter of joint ventures. California exempts interests in joint ventures from coverage of its blue sky law qualification provisions so long as no public offering of interests is involved.ⁿ³⁷ A regulation in Hawaii excludes most joint ventures as securities,ⁿ³⁸ while a New York regulation makes them subject to the state's regulatory scheme.ⁿ³⁹

[4] Limited Liability Companies

Nearly all states and the District of Columbia provide by statute for the creation of a "limited liability company" (LLC), a form of business organization affording "members" the limited liability associated with a corporation while at the same time permitting taxation of the entity as a partnership. LLCs are based upon a contractual arrangement among members, prescribing, among other things, the extent of participation in and control by the members in management and operations.ⁿ⁴⁰

Unlike limited partnerships, the limited liability advantage of an LLC is not lost with participation in control of the enterprise, although as discussed above the emergence of the limited liability partnership presents a new twist in liability-based analyses.

The issue of whether interests in LLCs are securities has largely been addressed via legislation and regulatory agency enforcement actions. In *SEC v. Vision Communications, Inc.*,ⁿ⁴¹ the U.S. Securities and Exchange Commission sought and obtained a permanent injunction against defendants who had formed a Pennsylvania LLC to develop a wireless cable broadcasting enterprise. The court did not specifically address the issue of whether LLC membership interests are securities, but rather assumed as much in the circumstances presented, which included defendants aggressively

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soliciting funds from individual investors on promises of future profits. In addition, the SEC characterized the operation as a "boiler room operation." The SEC has since instituted enforcement actions against the offering and sale of LLC interests in other ventures and has obtained permanent injunctions as well, although again without any express determination that LLC interests are securities.ⁿ⁴²

Most of these SEC cases arose out of circumstances involving high pressure sales tactics; widespread solicitation to numerous financially unsophisticated persons who were induced to invest through the use of false or misleading information. All of the concerns for investor protection are present and the characterization of LLC interests as securities in those circumstances is plainly consistent with the objectives of federal and state securities laws. As one commentator who has closely examined the securities regulatory approach to LLCs observes, prosecutors have primarily targeted those LLC investment opportunities that involve high risk promotions, mass marketed to unsophisticated investors using high pressure sales techniques and claims of immediate and exorbitant returns.ⁿ⁴³ State regulators have been equally, if not more, aggressive in pursuing such situations and have obtained several cease and desist orders against the offer and sale of LLC interests, based on findings of sufficient evidence to conclude that the interests are securities.ⁿ⁴⁴ Many state Blue Sky laws have been amended specifically to include limited liability company interests in the definition of securities, as reflected in the 2002 Uniform Securities Act which expressly includes limited liability company interests as investment contracts.ⁿ⁴⁵

Because of the context in which they arise--public offerings or systematic solicitation of unsophisticated prospective members--these cases do not address the more fundamental question that determines whether LLC interests are securities in the more common business setting, namely, the extent to which members' governance rights or control, as normally set out in an "operating agreement" for a particular LLC, render the member something other than a passive investor. In some states the extent of participation by members in control of the enterprise is dictated by statute. Some statutes require management by managers--a board managed or centralized form of organization in which management power is reserved to a limited number of persons.ⁿ⁴⁶ Others prescribe variants of both centralized and decentralized management, the latter leaving management in the hands of the members and allowing for specification of member roles and rights through an operating agreement.

Using risk capital or investment contract analysis, interests in those LLCs in which there is centralized management and members are merely passive investors will be deemed to be securities.ⁿ⁴⁷ On the other hand, an operating agreement among members that delegates control over day to day business decisions to certain managing members, but retains some ultimate authority, introduces a different dynamic, and any meaningful opportunity created for participation in operations and control takes the LLC closer to general partnership or joint venture status rather than a security. A U.S. District Court examining a New York LLC thus applied investment contract analysis to conclude that membership interests were not securities.ⁿ⁴⁸ The court found that the business association was a "member-managed" LLC which, under New York law, is controlled by its members, who possess a broad range of rights and powers. New York law granted members not only the right collectively to manage, but also the right to vote in proportion to their holdings, to participate in the cash flow distribution structure, to call meetings, and to enjoy certain meaningful protections. The court further concluded that the plaintiff did not at the time of his investment intend to remain passive, and ultimately that the degree of control he actually exercised was less than he may have expected, that fact would not operate to convert his LLC membership interests into securities.ⁿ⁴⁹

There is no clear line in determining whether LLC interests are securities. Thus, as noted earlier, several states have acted by statute, rule or policy statement to prescribe the status of LLC interests under blue sky laws. Those states that have expressly brought LLC interests within the scope of their blue sky laws, either via the definition of security or "person" subject to requirements, include: Alaska,ⁿ⁵⁰ California,ⁿ⁵¹ Connecticut,ⁿ⁵² Georgia,ⁿ⁵³ New Mexico,ⁿ⁵⁴ Ohio,ⁿ⁵⁵ Pennsylvania,ⁿ⁵⁶ Tennessee,ⁿ⁵⁷ and Vermont.ⁿ⁵⁸

Other states such as Arizona, Maryland, Michigan, New Jersey, North Carolina and Virginia have by rule or regulation, exemption, or some other statement of policy manifested the position that LLC interests fall within the ambit of their

Blue Sky laws.ⁿ⁵⁹ There may be other informal or unpublished positions in other states. In all cases, careful attention to "context" and the particular member control or participation characteristics of an individual LLC is necessary in the final analysis of whether a security is being created in the formation of an LLC.

FOOTNOTES:

(n1)Footnote 1. Consolidated Management Group, LLC v. Department of Corporations, 162 Cal. App. 4th 598, 75 Cal. Rptr. 3d 795 (2008).

(n2)Footnote 2. Consolidated Management Group, LLC v. Department of Corporations, 162 Cal. App. 4th 598, 614, 75 Cal. Rptr. 3d 795 (2008).

(n3)Footnote 3. Consolidated Management Group, LLC v. Department of Corporations, 162 Cal. App. 4th 598, 614, 75 Cal. Rptr. 3d 795 (2008).

(n4)Footnote 4. *See, e.g.,* Ito International Corp. v. Prescott, Inc., 83 Wash. App. 282, 921 P.2d 566 (1996) (assessment of "passive" interest in a general partnership involving equal shares, but in which purchasers relinquished broad powers to a controlling board of directors).

(n5)Footnote 5. The 1985 Revised Uniform Securities Act, however, specifically includes limited partnership interests within the definition of security, *see* Uniform Securities Act (1985) § 101(16), and this specific treatment has been carried into section 102(28) of the 2002 Uniform Securities Act.

(n6)Footnote 6. Some states expressly include limited partnership interests within their blue sky law definitions of security. *See* Ga. Code Ann. § 10-15-2(16); 32 *Me. Rev. Stat. Ann.* § 10501(18); Miss. Code Ann. § 75-71-105(k); *Mo. Rev. Stat.* § 409.401(1); N.M. Stat. Ann. § 58-13B-2(v); *N.Y. Gen. Bus. L.* § 352e (as to limited partnerships in real estate ventures); 70 *Pa. Stat.* § 1-102(t); *Cal. Corp. Code* § 25102(f); *see also* 1 Blue Sky L. Rep. (CCH) P 8,150 (July 1, 1995) (Alaska has included interests in limited liability companies within its definition of security); 3 Blue Sky L. Rep. (CCH) P 58,102 (Apr. 5, 1995) (Vermont has amended its definition of security to include limited liability companies); 2A Blue Sky L. Rep. (CCH) P 43,474 (Dec. 1, 1994) (North Carolina has adopted a rule *presuming* that interests in limited liability companies are securities).

(n7)Footnote 7. Rev. Unif. Lim. Part. Act § 101.

(n8)Footnote 8. Rev. Unif. Lim. Part. Act § 303 ("a limited partner is not liable for the obligations of a limited partnership unless the limited partner ... takes part in the control of the business").

(n9)Footnote 9. *See* Shinn v. Thrust IV, Inc., 56 Wash. App. 827, 786 P.2d 285 (1990); Topping v. Sullivan d/b/a American Cable Cartoons, 145 Ill. App. 3d 474, 496 N.E.2d 8, 99 Ill. Dec. 662 (Ct. 1986); Cook v. Pepco, Inc., [1986-1987 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,411 (Okla. Dist. 1986); *see also* Kosnoski v. Bruce, 669 F.2d 944 (4th Cir.), *cert. denied*, 459 U.S. 832, 103 S. Ct. 72, 74 L. Ed. 2d 71 (1982) (South Carolina law).

State regulators and law enforcement officials have uniformly viewed limited partnership interests as being securities under their respective blue sky laws. *See, e.g.,* Ga. Attorney General's Opinion [1954-1971 Transfer Binder] Blue Sky L. Rep. (CCH) P 70,830 (1969); Idaho Opinion of the Attorney General, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,315 (1972); Maryland Securities Commissioner, Securities Act Rel. No. 18, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 30,560 (1974); So. Dakota Securities Dept, Securities Bulletin, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 44,691 (1972).

(n10)Footnote 10. Henkind v. Brauser, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) (S.D.N.Y. 1989).

(n11)Footnote 11. *See, e.g.,* ITO International Corp. v. Prescott, Inc., 83 Wash. App. 282, 921 P.2d 566 (1996) ("Limited partnerships are generally considered securities because the investor puts his or her funds at risk and depends

largely upon the managing partners' efforts to realize a profit"); *Topping v. Sullivan*, 145 Ill. App. 3d 474, 496 N.E.2d 8, 99 Ill. Dec. 662 (1986); *In re EHI, Inc.*, [1986-1987 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,370 (Texas St. Bd. 1986).

But see Garbo v. Hilleary Franchise Systems, Inc., 479 S.W.2d 491 (Mo. Ct. App. 1972) (investment contract criteria rendered limited partnership interests securities, but "true" limited partnerships formed only for limited liability considerations may not involve securities). Investment contract analysis as applied to partnership and joint venture interests generally is further considered in § 2.08[2][a] below.

See also Cook v. Pepco, Inc., [1986-1987 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,411 (Okla. Co. Ct. 1986).

(n12)Footnote 12. Uniform Partnership Act § 18(e).

(n13)Footnote 13. Uniform Partnership Act § 18(a), (e).

(n14)Footnote 14. A joint venture is usually described as a partnership or association for a particular purpose. As defined by a Texas appellate court:

A joint venture is a species of partnership of a limited nature by two or more persons jointly prosecuting a particular transaction... . The four required elements for a joint venture are (1) a community of interest in the venture, (2) an agreement to share profits, (3) an agreement to share losses, and (4) a mutual right of control or management of the enterprise.

Russell v. French & Associates, Inc., 709 S.W.2d 312 (Tex. Ct. App. 1986) (citations omitted).

In considering blue sky law definitions of security, there is no meaningful distinction between a true general partnership and a joint venture.

(n15)Footnote 15. *See generally* Elaine A. Welle, *When Are Limited Liability Partnership Interests Securities?*, 27 *Iowa J. Corp. L.* 63 (2001).

(n16)Footnote 16. 80 P.3d 804 (Colo. Ct. App. 2002).

(n17)Footnote 17. *See Moulin v. Der Zakarian*, 191 Cal. App. 2d 184, 12 Cal. Rptr. 572 (1961) .

(n18)Footnote 18. Unif. Part. Act. § 6.

(n19)Footnote 19. Unif. Part. Act. § 18(e); *see also J & S Enterprises v. Warshawsky*, 714 F. Supp. 278 (N.D. Ohio 1989) (Ohio law).

(n20)Footnote 20. *Odom v. Slavik*, 703 F.2d 212, 215 (6th Cir. 1983) .

(n21)Footnote 21. *Ito International Corp. v. Prescott, Inc.*, 83 Wash. App. 282, 291, 921 P.2d 566, 572 (1996).

See also State v. Kramer, 804 S.W.2d 845, 847 (Mo. App. 1991) (in order to effectuate the purposes of the Uniform Securities Act, examination of the "totality of circumstances surrounding the transaction is required in order to determine if the investors of risk capital have, in fact, retained a realistic ability to participate in significant managerial decisions"); *Casali v. Schultz*, 292 Ark. 602, 732 S.W.2d 836 (1987) (one partner had absolute control over the operation of the partnership enterprise; the plaintiff was merely a passive contributor of risk capital); *Corporate East Associates v. Meester*, 442 N.W.2d 105 (Iowa 1989) (general partner had no expectation of being involved in management of what was actually a limited partnership).

But see Cox v. Lemond, 107 Ohio App. 3d 442, 669 N.E.2d 23 (1995) (partner had the right to provide input on all managerial matters); *Casablanca Productions, Inc. v. Pace International Research, Inc.*, 697 F. Supp. 1563 (D. Or. 1988).

(n22)Footnote 22. 645 F.2d. 404 (5th Cir. 1981) .

(n23)Footnote 23. *Id.* at 424 .

(n24)Footnote 24. *Id.* at 423 24. As the court declared:

[S]o long as the investor retains ultimate control, he has the power over the investment and the access to information about it which is necessary to protect against any unwilling dependence on the manager. It is not enough, therefore, that partners in fact rely on others for the management of their investment; a partnership can be an investment contract only when the partners are so dependent on a particular manager that they cannot replace him or otherwise exercise ultimate control.

Id.

(n25)Footnote 25. *See Casablanca Productions, Inc. v. Pace Int'l Research, Inc.*, 697 F. Supp. 1563 (D. Or. 1988) (delegation of management decisions did not deprive partner of significant managerial powers).

(n26)Footnote 26. *Garrett v. Snedigar*, 293 S.C. 176, 359 S.E.2d 283 (1987).

(n27)Footnote 27. *In re Deck*, [1982-1984 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,876 (Md. Div. of Sec. 1983).

(n28)Footnote 28. *Overthrust Mineral Corp. v. Secretary of State*, [1984-1985 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,243 (Wyo. Dist. 1985).

(n29)Footnote 29. *Casali v. Schultz*, 292 Ark. 602, 732 S.W.2d 836 (1987) .

(n30)Footnote 30. *Bahre v. Pearl*, 595 A.2d 1027 (Me. 1991) . The court identified controlling considerations as follows:

Most of the major decisions of the partnership specifically defined in the agreement could only be made by the unanimous vote of the partners. Each partner was entitled to inspect the partnership books at any time, to receive periodic financial reports from the managing partners, and to call special partnership meetings to discuss any of that partner's concerns about the business of the partnership. Notwithstanding that [the managing partner] by its control of a one half interest in the partnership could effectively veto any decisions made by the other partners and was immune from removal as the managing partner, the other partners individually retained the right to monitor Liberty's business judgment and cumulatively retained their own veto power over Liberty's discretion.

Id. at 1032 (footnote omitted),

(n31)Footnote 31. *Feigin v. Digital Interactive Associates, Inc.*, Blue Sky L. Rep. (CCH) 74,178 (Colo. App. 1999).

(n32)Footnote 32. *See also SEC v. Telecom Mktg.*, 888 F. Supp. 1160 (N.D. Ga. 1995) (stating that "the number of partnership units sold so dilutes each partner's power that in actuality it appears that none could exercise any meaningful

partnership control").

(n33)Footnote 33. See Hawaii Rules and Regulations Under the Uniform Securities Act (Modified) § 16-38-1. "Certificate of interest or participation in any profit sharing agreement shall not include any interest in a general partnership where the interest is not assignable without the consent of all other members and where all the members participate directly in managing the partnership."

(n34)Footnote 34. 13 N.Y. Comp. Codes R. & Regs. tit. 13, § 80.1(j)(4).

(n35)Footnote 35. *Cal. Corp. Code § 25102(F)*. What California has actually done is declare general partnerships as exempt from securities qualification if there is no public offering.

(n36)Footnote 36. See, e.g., *Polikoff v. Levy*, 55 Ill. App. 2d 229, 204 N.E.2d 807 (1965), cert. denied, 382 U.S. 903, 86 S. Ct. 237, 15 L. Ed. 2d 156 (1965); *Russell v. French & Associates, Inc.*, 709 S.W.2d 312 (Tex. Ct. App. 1986); *Schultz v. Recter Phillips Morse, Inc.*, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,357 (Ark. 1977).

See also *McConathy v. Dal Mac Commercial Real Estate, Inc.*, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,338 (Tex. Civ. App. 1976). Although the court held that the particular joint venture was not a security, it did not rule that joint ventures are always excluded from the law's definition of "security." It stressed that "the essential element of reliance of the managerial, operational or developmental efforts of others [was] missing"; since all the participants were friends, business associates or relatives of the defendants, this particular joint venture "was not the kind of transaction or scheme for which the Securities Act contemplates a need for the protection of investors."

(n37)Footnote 37. *Cal. Corp. Code § 25102(f)*; see also *Van Bourg, Nakamura, Katsura, Karney, Inc. v. Petroleum Management Corp.*, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,464 (Cal. 1978) (a good faith agreement between joint ventures is not a security within the meaning of Cal. Corp. Code § 25019, and no registration for the transaction was required).

(n38)Footnote 38. Hawaii Rules and Regulations Under the Uniform Securities Act (Modified) § 1.1(B)(4):

Certificate of interest or participation in any profit sharing agreement' shall not include any interest in a joint venture where the interest is not assignable without the consent of all the other members and where all the members participate directly in managing the joint venture.

(n39)Footnote 39. 13 N.Y. Comp. R. & Regs. § 80(j)(4).

(n40)Footnote 40. In some cases state law may specifically vest the members of an LLC with management powers in proportion to their contribution of capital, see, e.g., South Dakota, S.D. Con. Laws § 47-34-16.

(n41)Footnote 41. Litigation Rel. No. 14026, 56 SEC Docket 880 (Mar. 24, 1994).

(n42)Footnote 42. See Complaint, SEC v. Parkersburg Wireless Limited Liability Co., No. 94 1079 (SSH) (D.D.C. May 16, 1994), Litigation Rel. No. 14085 (SEC) (May 16, 1994); Complaint, SEC v. Knoxville, LLC, No. 94 1073B (RBB) (S.D. Cal. July 11, 1994); SEC v. Irwin Harry Bloch, Litigation Rel. No. 14511, 59 SEC Docket 931 (May 25, 1995); SEC v. United Communications, Ltd., Litigation Rel. No. 14477, 59 SEC Docket 424 (Apr. 25, 1995); SEC v. Future Vision Direct Marketing, Inc., Litigation Rel. No. 14384, 58 SEC Docket 1716 (Jan. 18, 1995).

(n43)Footnote 43. Elaine A. Welle, *Limited Liability Company Interests As Securities: An Analysis of Federal and State Actions Against Limited Liability Companies Under the Securities Laws*, 73 Den. U. L. Rev. 425, 430 (1996).

(n44)Footnote 44. *Id.*

(n45)Footnote 45. 2002 Unif. Securities Act § 102(28).

(n46)Footnote 46. *See, e.g.,* Colo. Rev. Stat. § 7- 80-401(1).

(n47)Footnote 47. *See* Nutek Info. Sys., Inc. v. Arizona Corp. Comm'n, 194 Ariz. 104, 977 P.2d 826 (Ct. App. 1998), in which more than 900 people were solicited by telephone and written materials to invest in several LLCs formed for the purpose of purchasing communications equipment and forming a network of telecommunications services. Each LLC entered into a system management agreement with the promoter, and all funds were pooled for the purchase of equipment and payment of expenses. The Arizona appeals court had little trouble concluding that individual LLC members had no ability to exercise effective control over the LLCs, despite the fact that governing agreements provided for "legal" control. The members, said the court, were no different than shareholders of a corporation, and had no ability to exercise even what legal control was provided in the enabling agreement.

See also Ak's Daks Communs. v. Maryland Secs. Div., 138 Md. App. 314, 771 A.2d 487 (Ct. Spec. App. 2001).

(n48)Footnote 48. *Keith v. Black Diamond Advisors, Inc.*, 48 F.Supp. 2d 326 (S.D.N.Y. 1999) .

(n49)Footnote 49. In *Tschetter v. Berven*, 2001 SD 11, 621 N.W.2d 372, the South Dakota Supreme Court came to the same conclusion where an LLC management agreement did not divest all power from the member, and in fact afforded members substantial power and ability to conduct necessary oversight of business operations. The court concluded that it was not a situation where the managers were so dominant that the members would be lost without them, and underscored the point that the mere choice by one to remain passive is not sufficient to make the membership interest a security.

(n50)Footnote 50. *Alaska Stat. § 45.55.990(12).*

(n51)Footnote 51. *Cal. Corp. Code § 25019* (except for interests in an LLC in which all of the members are actively engaged in management).

(n52)Footnote 52. Conn. Gen. Stat. Ann. § 36b 1.

(n53)Footnote 53. Ga. Code Ann. § 10 5 2(a)(22).

(n54)Footnote 54. N.M. Stat. Ann. § 58 13B 2(V).

(n55)Footnote 55. *Ohio Rev. Code Ann. § 1707.01(B), (D).*

(n56)Footnote 56. *Pa. Stat. Ann. tit. 70. § 1 102(t).*

(n57)Footnote 57. *Tenn. Code Ann. § 48 2 102(9).*

(n58)Footnote 58. Vt. Stat. Ann. tit. 9, chap. 150 § 5202(28)(E).

(n59)Footnote 59. As noted earlier, the 2002 Uniform Securities Act expressly includes limited liability company interests within the definition of security by expressly including them as investment contracts, *see* 2002 Unif. Sec. Act § 102(28)(E).



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Blue Sky Regulation

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CHAPTER 2 Definition of Security

1-2 Blue Sky Regulation § 2.08

§ 2.08 Unconventional Forms: Investment Contracts

[1] The Elements of an Investment Contract

"Investment contracts" represent the principal catch all category in blue sky law definitions of security. However, nothing in any statutory definition prescribes the attributes of such a security. An "investment contract" is not identifiable because of its particular character in commerce, or because of conventional attributes that prompt its common recognition as a security. It is, rather, a creature of circumstances and relationships.ⁿ¹

An investment contract arises in a transaction in which a person entrusts money or other capital to another, with the expectation of deriving a profit, income or some financial benefit from a business enterprise, the failure or success of which is dependent upon the managerial efforts of other persons.ⁿ² State and federal courts alike anchor their considerations of investment contract securities in the universal definition articulated by the U.S. Supreme Court in *SEC v. W.J. Howey Co.* ⁿ³ as follows:

[A]n investment contract ... means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by normal interests in the physical assets... ⁿ⁴

The essence of an investment contract is the extent to which the risk of an enterprise lies within the control of someone other than the purchaser.ⁿ⁵ Put another way, an investment contract is created where the expected value of a thing purchased, or an interest or right acquired, is either presently or in the future a function of something other than the thing itself, and the realization of that value is beyond the meaningful control of the purchaser. In *SEC v. C.M. Joiner Leasing Corp.*,ⁿ⁶ the U.S. Supreme Court first explained the notion of an investment in a "common enterprise" in terms of beads being strung on a common thread. There, assignments in oil leases were held to be securities because the assignments, interests in real property, only had value in the opportunity to share in discovery values that might follow the drilling of a test well nearby. Thus, said the Court: "[T]he undertaking to drill a well runs through the whole transaction as the thread on which everybody's beads were strung..."ⁿ⁷ *Joiner* illustrates that to find a security in the form of an investment contract one looks to determine if there is a separate and unmanageable risk affecting the actual or reasonably expected value of the asset purchased.ⁿ⁸ Thus, in *State v. Reber*, ⁿ⁹ for example, a promise to repay funds invested with the defendant electrical contractor in various phony electrical contracting jobs was held to be an

investment contract because the promise was conditioned on the defendant actually performing alleged job contracts, and being paid. Although the defendant contended that investors could have no reasonable expectation of profits, and that the transaction was merely a loan, the court concluded that repayment was not unconditional, and that any return to investors was dependent on the defendant's managerial efforts in completing electrical contracting work.

Howey crafted the essential notions of common enterprise and investment risk into the tripartite standard definition of investment contract quoted above. *Howey* focused on the sale of tracts in Florida citrus groves. The sales of the real estate were accompanied by optional service contracts for cultivating and marketing produce. The service contracts effectively gave the promoter/seller full control over the tracts. The return to purchasers was dependent upon the managerial efforts, and success, of the seller pursuant to the service contracts. The scenario in *Howey* is the model for investment contract circumstances and relationships:

The respondent companies are offering something more than fee simple interests in land, something different from a farm or orchard coupled with management services. They are offering an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by respondents. They are offering this opportunity to persons who reside in distant locations and who lack the equipment and experience requisite to the cultivation, harvesting and marketing of citrus products. Such persons have no desire to occupy the land or to develop it themselves; they are attracted solely by the prospects of a return on their investment. Indeed, individual development of the plots of land that are offered and sold would seldom be economically feasible due to their small size... . A common enterprise managed by respondents or third parties with adequate personnel and equipment is therefore essential if the investors are to achieve their paramount aim of a return on their investments.ⁿ¹⁰

The *Howey* definition of investment contract was articulated in the context of the federal securities laws. However, nearly every state blue sky law includes the category in the definition of security,ⁿ¹¹ and *Howey* has long supplied the common frame of reference in all investment contract analyses.ⁿ¹² It is a definition particularly suited for use in the application of blue sky laws. Indeed, it "[e]mbodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."ⁿ¹³

Howey thus prescribes criteria for identifying an investment contract security:

- (1) an investment of money;
- (2) a common enterprise; and
- (3) an expectation of profits to come solely from the efforts of others.ⁿ¹⁴

Through the years, these three elements of an investment contract under *Howey* have been dissected in the courts, most recently again by the U.S. Supreme Court in *SEC v. Edwards*,ⁿ¹⁵ and thus a closer look at each of them in application is necessary to a full understanding of the meaning of the term.

[a] Investment of Money

For investment contract analysis, "investment of money" is a broader notion than the payment for purchase of property or an interest in some tangible thing. First, "money" in this context means anything of value, any consideration, including, as one state court has said, any "benefit to the promisor or detriment to the promisee."ⁿ¹⁶ Whether the value given up fits the notion of traditional purchase consideration, is labeled a "fee,"ⁿ¹⁷ or is characterized in any other manner, the most important notion here is that money or value is committed to something having no separate value or

economic viability apart from some coupled scheme or mechanism for shared fortunes. Any purchase, of any thing, may well be considered an "investment" by the purchaser, but this general perception is not the focus of securities law protection. The U.S. Supreme Court has itself said that "economic interest" characterizes every form of commercial dealing, but that naked interest is not what operates to create a security.ⁿ¹⁸

The *Howey* notion of investment of money means that investors commit value to an enterprise or venture in such a manner as to subject themselves to financial loss from a risk they cannot effectively manage. It is the "investment" in the common enterprise, not the thing itself, that matters in the creation of a security.

Rzepka v. Michael ⁿ¹⁹ illustrates this point. The purchaser of discounted accounts receivable of an on going business sought relief under the Michigan blue sky law, claiming he had purchased an investment contract. The court disagreed, explaining that the transactions may have amounted to the purchase and sale of accounts governed by the Uniform Commercial Code, but no investment contract was present. The purchase of the accounts receivables was more of an investment in those accounts rather than in the common enterprise, said the court. The court found essential that:

[R]egardless of what might happen to Personnel, plaintiff had a right to the proceeds of the receivables. The plaintiff did not subject his capital to the risks of the enterprise. Rather, plaintiff subjected his capital to the risks that the receivables listed in the agreements, or others of equal value, would not eventually be paid.ⁿ²⁰

[b] Common Enterprise

Plainly, the root of any investment contract is a common enterprise--the common thread on which "investments" of money are strung. Common enterprise connotes some form of pooled interest. As a Washington appellate court succinctly stated, the term denotes "a dependence by one party for his profit on the success of some other party in performing his part of the venture."ⁿ²¹ A simple contract relationship with another will not generally constitute a common enterprise, which presumes the existence of other investors, and an intertwining of the investors' interests and expectations.

Interpretations of the common enterprise element of an investment contract have spawned two views of the type of "commonality" required. Horizontal commonality requires the pooling of funds of multiple participants in a single project or program.ⁿ²² On the other hand, vertical commonality, a less stringent approach, requires only that the fortunes of an investor be tied to and dependent upon the success of the seller or a third party. This approach allows for a common enterprise between a single investor and the promoter/seller without regard to the presence of others or any pooling of interests.ⁿ²³ Critics of vertical commonality being sufficient for finding a security argue that the approach actually eliminates the *Howey* common enterprise requirement.ⁿ²⁴ Nevertheless, even where vertical commonality is accepted as a sufficient common enterprise, it must still be shown that there is actual interdependence between the parties.ⁿ²⁵

It is also clear today that common enterprise for purposes of an investment contract does not mean that investors must share proportionately in profits or losses of the enterprise. Individual contracts providing for a fixed rate of return satisfy the common enterprise element when any expected return is tied to the significant managerial efforts of others. In *SEC v. The Infinity Group Co.* ⁿ²⁶ investors were offered an opportunity to invest with the expectation of exceedingly high returns and minimal risk. They executed "property transfer contracts" pursuant to which they contributed large sums of money to a trust for the trust to invest. The trust guaranteed investors that they would receive an annual rate of return ranging from 138 percent to 181 percent depending on the amount of the participant's investment. The guarantees were based upon the trust's purported experience, financial connections, and the ability to pool large amounts of money. Each individual contract provided for repayment on demand. It was in fact a Ponzi scheme. Defendants argued, however, that there was no requisite common enterprise by which the property transfer contracts could be made into securities. The court flatly rejected the argument because it was clear that investors had in

fact "pooled" their contributions through the trust to create highly leveraged investment power that would yield high rates of return. The fact that each participant investor entered into a separate contract providing for a fixed rate of return payable on demand was inconsequential because the fixed return was dependent upon the overarching enterprise of the trust.

This fundamental notion of common enterprise is key to many particular applications of investment contract analysis that are presented below. It is also very much involved in the 2004 assessment by the U.S. Supreme Court in *SEC v. Edwards* of the expected "profit" element of investment contracts that is discussed immediately below.

[c] An Expectation of Profits to Come Solely From the Efforts of Others

The third criterion of *Howey*, an expectation of profits to come solely from the efforts of others, has received the greatest attention in investment contract analysis. There are two aspects to the element: (1) an expected "profit"; and (2) the extent to which it is to come from the "efforts of others." In *SEC v. Edwards* n27 the U.S Supreme Court spoke definitively to the "profit" element of investment contract analysis.

The defendant in *Edwards* was the chairman, chief executive officer and sole shareholder of ETS Payphones, Inc, which sold pay phones to the public through a network of independent distributors. The pay phones were offered with an agreement under which ETS leased back the pay phone from the purchaser for a fixed monthly payment, thereby providing purchasers a fixed 14 percent annual return on their investment. The leaseback arrangement included a site lease, a management agreement, and a buyback agreement. Purchasers were not involved in any day-to-day operation of the payphones they owned. ETS selected the site for the payphone, installed the equipment, arranged for connection and long distance service, collected coin revenues and maintained and repaired the payphones. The payphones ultimately did not generate enough revenue for ETS to meet its payment obligations to purchasers. An SEC enforcement action was brought on the premise that the payphone sale and leaseback program created an investment contract. The defendant successfully argued in the Tenth Circuit Court of Appeals, however, that there was no investment contract because the arrangement did not offer either capital appreciation or a participation in the earnings of an enterprise. The Court of Appeals also concluded that because the purchasers had a contractual entitlement to return the payphones and repayment of their purchase price the requirement that a return on the investment be derived solely from the efforts of others could not be satisfied. The Supreme Court reversed on both grounds, focusing principally on the erroneous notion that an investment contract cannot be found where a fixed obligation or rate of return is involved.

The Supreme Court made clear in *Edwards* that "profits" for purposes of investment contract analysis means the profits that investors seek on their investment, not the profits of the scheme in which they invest. Profit, said the Court, is used in the sense of income or return to include, for example, dividends, other periodic payments, or the increased value of the investment. There is no reason to distinguish between promises of fixed returns and promises of variable returns for purposes of the investment contract test. To conclude otherwise would read into the securities laws a limitation that would undermine the laws' purposes. The Court also summarily dismissed the notion that because purchasers had a contractual entitlement to a return, the "solely from the efforts of others" could not be satisfied. The fact that investors have a bargained-for return on their investment, said the Court, does not mean that the return is not also expected to come solely from the efforts of others.

An investment contract will not be found where putative "investors" are empowered in the transaction with the leverage or ability to protect themselves, and to manage the enterprise risk in which they are participating. It cannot be gainsaid that the existence of an investment contract presumes a passive investor.ⁿ²⁸ This is the baseline difference between security transactions and joint venture or general partnership relationships, which are the antithesis of investment contracts.ⁿ²⁹ This *Howey* criterion suggests that any involvement in those activities or efforts that are important in the success of the enterprise would preclude investment contract status. Courts have not applied the criterion so strictly,ⁿ³⁰ particularly where it is clear that the investor's ability to exercise, or control, the significant managerial activities of an enterprise is curtailed to the point that there is no reasonable alternative to reliance on the seller/promoter. Thus, in *Ball*

v. *Volken*, n31 an investment contract was present where a franchise agreement granted the right to sell frozen food distributorships, and receive income from bulk sales of frozen foods through them. However, the franchisee had no choice but to rely on the efforts and activities of the franchisor to ensure the viability of the business and produce most of any profit that might inure from it. The same rationale has been applied to convert what are ostensibly general partnerships, in which there is a presumption of shared control, into investment contracts when the empowerment is in fact illusory.n32

Among federal courts, the *Howey* "solely" term has been interpreted in a manner such that when the functions or activities an investor performs are not managerial, but are rather ministerial, investment contract status will not be denied merely because profits are not derived "solely" from the efforts of others.n33 State courts have followed the federal lead, with the focus today being on an expectation of profits based *primarily* on the efforts of others.n34

The risk capital alternative in defining a security has also been embraced, either in case law or by express incorporation into the blue sky law definition, where the *Howey* "solely" language might limit application of investment contract analysis in other situations, but where blue sky law protection is nevertheless deemed necessary in the eyes of courts or legislatures. In some situations, as illustrated by this approach in Ohio case law, an investment contract is thus defined in terms of the "risk capital" definition of a security generally, rather than the *Howey* tripartite construct. Under this approach, an investment contract is created whenever:

- (1) an offeree furnishes initial value to an offeror;
- (2) a portion of the initial value is subjected to the risks of the enterprise;
- (3) the furnishing of the initial value is induced by the offeror's promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise; and
- (4) the offeree does not receive the right to exercise practical and actual control over managerial decisions of the enterprise.n35

Howey otherwise enjoys widespread acceptance among the states as the baseline test for the existence of an investment contract.n36 Inroads upon it through "risk capital" analysis,n37 or the importation of broader notions associated with risk capital, only serve to underscore that the presence of a security, in any form and in any set of circumstances, is a function of the separation of an "investor" from control over value determinants of the thing acquired or the expected return on the interest obtained. Closer consideration of particular blue sky law applications of the investment contract definition further exemplify the critical point.

[2] Particular Applications

[a] Partnerships and Joint Ventures

There is perhaps no better illustration of the fundamental elements of a security, and of investment contracts in particular, than in the treatment of partnerships and joint ventures under state and federal securities laws. The creation of securities through these forms of organization and association in the pursuit of an enterprise has already been considered in depth.n38 Apart from consideration of partnership and joint venture interests as securities in their own right, however, investment contract analysis is often applied to determine whether ostensible "general partnership" or joint venture interests are in fact securities.

In the main, whether partnership or joint venture interests are deemed investment contracts is generally a function of the degree of managerial control actually retained by the putative partner. State courts apply the third *Howey* element, an

expectation of profits solely from the efforts of others, to determine whether a "partner" who invests in a common enterprise retains a measure of control over the partnership and its activities such that he or she is not dependent on the entrepreneurial or managerial ability of the promoter or manager, or that he or she cannot replace the manager or otherwise exercise meaningful powers.ⁿ³⁹ In *Sparks v. Baxter*,ⁿ⁴⁰ for example, an argument that joint venture interests in oil and gas projects were actually investment contracts within the ambit of the Texas blue sky law was rejected where the appeals court found, among other things, that:

[t]he record reflects that the enterprise vested considerable power in the Baxters, including the selection of investors and the choosing of oil and gas properties. The record reveals the experience of the Baxters, particularly that of the senior Baxter, as a businessman, financier, entrepreneur and oilman. Sparks brought to the enterprise relevant experience and expertise, but his ability was not unique, or so irreplaceable that it prevented the Baxters' exercise of meaningful venture powers.ⁿ⁴¹

On the other hand, in *Corporate East Associates v. Meester*,ⁿ⁴² a general partnership interest was held to be an investment contract under the Iowa blue sky law where:

[t]he partnership agreement provided that the managing partner had exclusive authority to conduct the ordinary business of the partnership, including negotiating leases and refinancing the building... . Meester owned two units. He had no expectation of being involved in the operation of the partnership. Under the agreement he could not do anything unless he acted in concert with others who, with him, owned sixty six and two thirds percent of the partnership. Taking substance over form, we think his rights are those of a limited partner.ⁿ⁴³

The baseline issue for investment contract analysis of partnership and joint venture interests will always be one of fact. Yet it is important to remember that in assessing the actual powers of a partner under the *Howey* construct, it is not whether one has been deprived of or denied the right to exercise partnership powers, but rather whether the structure of the partnership or joint venture is such that the participant has no real opportunity to exercise the power presumed to be available to a true general partner or joint venturer. Even when general partners do not individually have decisive control over major decisions, if they do have the sort of influence which generally provides them with access to important information and protection against a dependence on others, a security is not likely to be found.ⁿ⁴⁴

[b] Real Estate

Howey, of course, stands as the model for application of blue sky laws to the sale of interests in real estate via investment contract analysis. State courts have had little difficulty with its application to a wide variety of real estate related investment programs and schemes.ⁿ⁴⁵ There are determinative factors which consistently emerge when real estate transactions are examined under Blue Sky laws. If the investor is induced by a profit motive for entering the venture and is truly passive in regard to management or operation of the property, a security will likely be found.ⁿ⁴⁶ It does not matter that purchasers, as property owners, have the usual rights of ownership if in fact they are led to expect profits derived mainly from the managerial efforts of others.ⁿ⁴⁷

Moreover, most real estate related programs deemed to be securities involve agreements, guarantees, or some other mechanism directly that plainly impacts the "investment" expectations of purchasers, which create a common enterprise, and which lead the purchaser to expect significant value from the efforts or associated program of the sellers.ⁿ⁴⁸

Motives for entering into the transaction typically depend on the promotional efforts and intended activities of the seller.ⁿ⁴⁹

On the other hand, in *Almaden Plaza Associates v. United Trust Fund Limited Partnership* ⁿ⁵⁰ the sale and leaseback of

an office building in an arrangement involving the purchaser/landlord's unconditional right to receive a fixed rental payment and to realize any future gain in the value of the property was held not to be a security. The plaintiffs purchased a heavily encumbered property, which they leased back to the seller for rents substantially above market. They argued that because no other tenant would be willing to pay such rents, the arrangement left them dependent on the lessee's profitability, and thus created an investment contract. The court rejected the notion because there was no sharing of profits, and because, subject to certain options, the ultimate value of the property inured solely to the benefit of the purchaser/lessors. Thus, said the court, because the fixed rent lease did not include any conditions to payment, and any change in the value of the property would not be shared between the parties, there was no intertwining of profits and losses, and no common enterprise.ⁿ⁵¹

Cases such as this illustrate the importance of focusing on the actual risk involved in a transaction. The risk of non payment of an above market rate of rent was not an *investment* risk. The same notion applies when there is no profit to be anticipated in purchasing the realty interest, such as when it is to be used for the buyer's own residential or recreational purposes. In *All Seasons Resorts, Inc. v. Abrams*,ⁿ⁵² for example, the sale of campground "memberships," which conferred upon purchasers the right to nonexclusive, nonspecific use of campgrounds and related facilities was held not to involve the sale of a security. Purchasers did not have a profit motive, and acquired no opportunity to share in any gains, or acquire any interest in the promoter's assets.ⁿ⁵³ As the U.S. Supreme Court made clear in *United Housing Foundation, Inc. v. Forman*,ⁿ⁵⁴ the same holds true where the purchase involves residential real estate.ⁿ⁵⁵

All of this is baseline investment contract analysis under the *Howey* construct. It may be insignificant, however, in some states which expressly include or exclude particular real estate interests in the definition of security.ⁿ⁵⁶ The effect of some of these statutes may be to turn what would ordinarily be considered a non security transaction into one covered by blue sky laws.

An example of this type of situation arises in those states that have statutes requiring sales of real property located outside of the state to be treated as securities.ⁿ⁵⁷ A Missouri court interpreting such a provision pointed out that the purpose of making these interests securities is to protect residents from being cheated when purchasing land in distant places where opportunity for examination prior to purchase is extremely limited.ⁿ⁵⁸

Against the *Howey* backdrop, and apart from the impact of any specific state provision relating to particular types of real estate or interests in real estate as securities, common questions under blue sky laws arise in regard to the particular real estate interests considered further below.

[i] Cooperative Housing

There is some disagreement as to whether or not interests in cooperative housing are securities. While cooperatives may exist in a number of different forms,ⁿ⁵⁹ the commonly used form is a corporation. In simplest terms, under the corporate plan, the real estate containing the housing is owned by a corporation. Housing residents purchase shares of stock which they receive coupled with a lease granting the right of occupancy in a particular apartment or housing unit.ⁿ⁶⁰

Whether any form of interest or instrument associated with a housing cooperative may be deemed to be a security has today largely been resolved by the U.S. Supreme Court in *United Housing Foundation, Inc. v. Forman*,ⁿ⁶¹ which has had substantial impact on decisions under the blue sky laws because of the similarities in state and federal definitions of security. The Supreme Court held in *Forman* that "stock" in a non-profit cooperative housing project was not a security. The fact that interests, representing the right to reside in the project, were represented by stock was held not to have the same meaning as stock holdings have in the commercial world.ⁿ⁶² The Court further opined that the interests represented by "stock" did not constitute investment contracts, despite any monetary gains to tenants from tax deductions, rental charges to commercial enterprises and lower rental for apartments than was otherwise available. The overriding feature of cooperative housing in the Court's mind was its residential purposes, not commercial investment as

it is ordinarily understood.ⁿ⁶³

All of this does not mean that cooperative housing interests will always free from state blue sky regulation. New York, for example, has a separate section in its securities law relating solely to real estate syndication offerings, specifically including cooperatives.ⁿ⁶⁴ In addition, Connecticut, Florida, Hawaii, Iowa and Massachusetts provide that certain cooperative housing interests are exempt from their securities acts, thus implying that such interests ordinarily constitute securities and that some such interests are subject to regulation.ⁿ⁶⁵ These interests have been made subject to other laws in some states.ⁿ⁶⁶ With the application of investment contract analysis, variations on residential cooperative arrangements and relationships might well fundamentally alter expectations of purchasers, and operate to separate them from value determinants associated with their property interest. In the end, however, whether any particular cooperative interest is deemed to be a security under state or federal securities laws will be a function of the expectations of participants in the relationship. People entering into a housing cooperative relationship generally do so intending to reap the benefits of the relationship, not in the expectation of profits to be generated from it. Advantages of a housing cooperative accrue because of the association with others in an ownership vehicle. Profit is not an incident of membership, and while the perception of residential cooperative members or participants may involve ultimate gains or appreciation in the value of property, such expectations are not derived from any independent enterprise.

[ii] Condominiums

Although there are many differently worded definitions of "condominium," the modern concept anticipates ownership of a real property interest, usually in fee simple, in a particular portion or unit of multi-unit property, together with an undivided interest with other owners in common areas of the whole property. The creation or sale of condominiums may be subject to particular regulation,ⁿ⁶⁷ but in the absence of other circumstances which transform the simple ownership of real property into an investment risk undertaking by the purchaser, condominiums are not considered securities. This is true even when the buyer plans to lease his individual unit for profit, since it has been ruled that such situations are not within the *Howey* investment contract test.ⁿ⁶⁸

If the nature of the offering is one where condominium purchasers are expected to buy for the purpose of leasing their interests to others through the agency of the promoter or a third party, then the transaction may be held to be an investment of money in a common enterprise with the expectation of profits solely from the efforts of others, and thus an investment contract.ⁿ⁶⁹ Where condominium properties are offered for sale with emphasis on investment considerations, and with coupled programs for management and income production--particularly rental pooling arrangements--investment contract analysis is easily applied.ⁿ⁷⁰

Blue sky statutes in some states can be interpreted to include "condominium" within the meaning of "security."ⁿ⁷¹ Out of state condominium interests would probably be considered securities in those states having provisions making interests in realty located in other states securities.ⁿ⁷² Only the New York statute leaves no doubt that condominium interests are always securities.ⁿ⁷³ The New York and New Jersey securities statutes were compared in *Maplewood Village Tenants Association v. Maplewood Village*,ⁿ⁷⁴ a New Jersey case involving condominiums. The court noted that New Jersey's statute was fashioned after New York's and since the New York statute included condominiums within the definition of security and New Jersey did not, it was the unmistakable intent of the latter's legislature to exclude such interests from the securities act.ⁿ⁷⁵

[iii] Cemetery Lots and Burial Rights

The sale of a cemetery lot to an individual is usually for the use of the individual and is analogous to any other purchase of real estate. As such, it would not generally come within the notion of something that is commonly understood as involving a security.ⁿ⁷⁶ Nevertheless, historically circumstances have arisen in which sales of burial plots have triggered concerns for investor protection under blue sky laws, and securities have been found. In those situations it is commonly the case that the number of burial plots purchased is well beyond what the buyer could use, and both the

seller and the buyer expected that the plots would be resold at a profit.ⁿ⁷⁷

The cemetery lot cases mostly predate the pronouncement of investment contract principles in *Howey* and its progeny. But the message of state courts in them was a precursor of what was to come. In one of the early considerations of the sale of burial plots in circumstances giving rise to investor protection concerns, a New York court spoke of the "modern" way in which a security is used when it held the sale of burial plots to be within the purview of blue sky regulation: "In general, it may be said that any form of instrument used for the purpose of financing and promoting enterprises, and which is designed for investment, is a security according to the modern meaning of the term."ⁿ⁷⁸

Through the years, the issue of whether the sale of burial plots is impacted by blue sky laws has been confronted in Maine,ⁿ⁷⁹ Indiana,ⁿ⁸⁰ Minnesota,ⁿ⁸¹ and Utah (by statute).ⁿ⁸²

[c] Investment Programs in Personal Property

"Investment" inducements associated with the sale of personal property often create investment contracts and trigger blue sky law coverage. Most often such inducements are a function of "repurchase guarantees" or other mechanisms for enhancing the investment potential.

As is common with real estate related investment contracts, attached management or "service" agreements most often convert the sale of property into a passive investment. In *Waterman v. Alta Verde Industries, Inc.*,ⁿ⁸³ for example, plaintiff purchased cattle and feed from the inventory of defendant in transactions arranged and financed by defendant. Defendant's service to purchasers consisted of feeding and maintaining the cattle, and in being available as a ready repurchaser of the fattened cattle. Sales literature emphasized the increase in value a purchaser could expect through the feeding program, and the defendant's expertise in the selection and sale of cattle. An investment contract was found because, among other things, the purchaser had no real control over the management of the investment, and because the defendant represented to investors that its program would provide "a turnkey package of buying, financing and caring for on a first class basis."ⁿ⁸⁴

Cattle breeding or feeding programs, in which not only breeding, but managed maintenance and sale of animals in a herd are critical to the success or failure of the program, and which control the value of the livestock actually owned by an investor, are invariably found to be investment contracts under blue sky laws.ⁿ⁸⁵ On the other hand, livestock purchase programs that allow the purchaser to exercise practical and actual control over managerial decisions concerning the livestock will be denied investment contract status. For example, in *Pride of the Andes, Inc. v. Soberay*ⁿ⁸⁶ the purchase of a herd of pregnant Alpacas on terms that permitted the seller to purchase offspring was not an investment contract under the Ohio blue sky law because the herd purchaser retained a contractual right to determine if any offspring would in fact be sold to other buyers. This retained authority to control the ultimate disposition of the offspring amounted to the right to exercise practical and actual control over managerial decisions of the enterprise and precluded an investment contract. The court thus affirmed a directed verdict on a statutory claim for rescission under the Ohio Securities Act.

Precious metal sales programs,ⁿ⁸⁷ art works programs,ⁿ⁸⁸ rare coin programs,ⁿ⁸⁹ master video or audio recordings,ⁿ⁹⁰ and programs involving everything from macadamia nutsⁿ⁹¹ and lactic culturesⁿ⁹² to financial interests in the outcome of an intended lawsuitⁿ⁹³ have been held to create investment contract securities. Ahead of the 2004 U.S. Supreme Court decision in *SEC v. Edwards* pay telephone programs dominated the enforcement agendas of state securities administrators, and continue to receive close attention.ⁿ⁹⁴ The value of the thing purchased, or in many cases leased,ⁿ⁹⁵ is determined not by the thing itself, but rather by the coupled marketing mechanism or services. The common enterprise in these cases may or may not involve traditional pooling of investors' fortunes. Indeed, in many such cases the relationship between the seller/promoter and the purchaser/investor may be a unitary one, in which the fortunes of other purchasers of the same items are not intertwined. However, the key consideration in these programs is the degree to which the value of the thing involved depends on the managerial efforts of the promoter/seller, and the

presence of a marketing effort built around "investment" potential.ⁿ⁹⁶

The defining consideration is perhaps best illustrated by the court's assessment of allegations in *Rzepka v. Michael* ⁿ⁹⁷ that the purchase of a corporation's accounts receivable was the purchase of a security under the Michigan blue sky law. In *Rzepka*, a corporation advertised and contacted financial brokers in an effort to obtain financing for accounts receivable. A newspaper ad placed by the corporation spoke of a good investment for high profits. Plaintiff responded, entering into a "Finance Broker Agreement," pursuant to which he was to be paid a fifteen percent return based upon all cash payments received from the particular debtor identified in the agreement. In exchange for a post dated check for the full amount of the receivable and the corporation's agreement to pursue collection, the plaintiff paid the corporation two thirds of the face value. However, the corporation eventually ceased operations, and the receivables went uncollected. Plaintiff sought recovery under the blue sky law, claiming that the agreements by which he financed the corporation's receivables constituted securities.

The court declined to extend the reach of blue sky remedies to this transaction, holding that no security was created. The rationale is instructive:

"[T]he agreements at issue clearly set forth that plaintiff purchased, and Personnel sold, accounts receivable, with recourse, at a discount. Plaintiff received the accounts receivable in exchange for his capital. Regardless of what might happen to Personnel, plaintiff had a right to the proceeds of the receivables. The plaintiff did not subject his capital to the risks of the enterprise. Rather, plaintiff subjected his capital to the risks that the receivables listed in the agreements, or others of equal value, would not eventually be paid."ⁿ⁹⁸

The court added that the purchase of accounts receivable amounted to an investment in those accounts, rather than in any common enterprise. Thus, in finding no security the court necessarily found that the value of the thing purchased was not determined by anything other than the thing itself. The risk involved was not tied to the success or failure of the corporate enterprise.

Meaningful participation by the purchaser in value determining activities also prevents investment contract status from attaching to sales of personal property. Thus, in *Routh v. Philatelic Leasing, Ltd.*, ⁿ⁹⁹ no investment contract was found in the lease of photographic equipment and plates used for printing postage stamps. The court found that the plaintiff/lessee was obligated to perform the essential managerial efforts which affected the success or failure of the enterprise. Namely, plaintiff had to distribute stamps printed from the master; the defendant/lessor had no role in this. The plaintiff/lessee's role precluded the existence of any requisite common enterprise between the parties.ⁿ¹⁰⁰ In other situations the absence of a common enterprise in a traditional pooling, or "horizontal" sense, has also been determinative.ⁿ¹⁰¹ But where "syndications" of personal property are involved, as, for example, with race horses,ⁿ¹⁰² no such problem will be presented.

In the end, with "investment" programs in personal property, as with real estate and any other program, the caveat found in *SEC v. C.M. Joiner Leasing Corp.* is universal: "In the enforcement of an act such as this it is not inappropriate that promoters' offerings be judged as being what they were represented to be."ⁿ¹⁰³

[d] Pyramids, Multi-level Distributorships and Franchises

The existence of an investment contract is premised on the fact that profits from an enterprise will derive from the seller's or some third party's entrepreneurial or managerial efforts. Where a purchaser is required to make some significant effort toward the success of the enterprise, or be involved in its operation in such a fashion as to retain some control over realization of an expected return, the third element of the tripartite *Howey* test will not be met. Moreover, characterization of the investment as "risk capital" is inappropriate since both case law and statutory formulations of that approach to defining a security also entail a presumption that the purchaser has no practical or actual control over

"managerial" decisions.n104

The application of blue sky laws to pyramid sales schemes, multilevel distributorships and franchises generally is almost always a function of the degree of managerial control vested with the participant/franchisee. Attempts to characterize business franchises as securities through investment contract analysis have most often failed by reason of the control retained by the franchisee.n105 A typical business franchisee is not presumed to be a passive investor, and usually must work to make the franchise succeed. The promise of profit from the performance of one's own efforts does not create a security.n106

On the other hand, a "franchise" in name only will be deemed an investment contract where the "franchisee" is in fact required to rely upon the efforts of others to generate profit. In *Ball v. Volken*, n107 a franchisee/licensee acquired the right to sell other frozen food distributorships/franchises for area sales offices. The franchisee's expected profit derived from those sales, and from a division of the profits, if any, from the bulk sales of frozen food by the area offices. The plaintiff was prohibited from selling frozen food directly. Although the defendant urged that success or failure of the business depended primarily on the plaintiff's efforts, the court held that the real profit generating efforts, those essential to the success of the business, would not come from plaintiff.n108

This is the premise for holding multi-level distributorships and pyramid sales schemes to be securities. The assessment of a Michigan court in *People v. Cooper* n109 is illustrative. In *Cooper*, participants purchased skin care products, and, more importantly, paid for the right to recruit other participants. Their primary profit potential was the right to receive bonuses based upon those subsequent participants' purchases of skin care products, and the subsequent participants' successful recruiting of still more participants. The only effort required of original participants was to bring in others as the next level of participants. Thus, the court concluded:

[O]nce a participant in the plan recruited the first generation of people, the participant merely continued to invest \$20 per month. The success or failure of the plan essentially depended upon the managerial and entrepreneurial skills of defendants.n110

Cooper exemplifies the typical form of multilevel distributorship, established through "pyramid" promotions in which a company represents its intention to manufacture or sell a line of products. The company purports to offer franchises or distributorships for those products, but the real focus is on a series of levels of distributorships which link the promoting company and the entire distribution chain, and in which the "profit" potential is entirely a function of continuous enrollment of new participants rather than any "sales" effort involving the company's product.

The treatment of pyramids and multi-level distributorships under state and federal securities laws has been dictated to a large extent by federal court decisions in *SEC v. Koscot Interplanetary, Inc.*, n111 and *SEC v. Glen W. Turner Enterprises*, n112 both of which involved multilevel distributorships holding out the promise of profits based upon the continuous entry of new participants. The significant efforts in making this happen were those of the promoters, who would induce others whom existing purchasers had recruited to invest in the program. Applying *Howey* investment contract analysis in these settings, both courts concluded that despite the fact that "distributors" had to expend some effort in recruiting people, the promoters' efforts were managerial and were the undeniably significant ones affecting success or failure.n113 This modification of the "solely from the efforts of others" element of *Howey* is important, and necessary for the extension of securities law protections into an area that is otherwise plainly an "investment" scenario.n114

A pure pyramid scheme, involving no product or distribution network, further de-emphasizes any meaningful role of the participant. The Nebraska Supreme Court, for example, affirmed the criminal conviction of the participation manager of "The Friends Network," a pyramid gifting program in which participants made money "gifts" to other participants above them in the pyramid.n115

A participant in the program was required to recruit others to join the pyramid in order to herself advance up the pyramid to a level at which she would receive gifts. However, the promoter managed the lists that moved participants to the top of the pyramid, and set up new lists to continue the scheme. The promoter distributed the "gifts" from new participants, and collected a substantial management fee from participants who arrived at the top of the pyramid. The promoter met with new recruits and assisted participants in finding new participants. All of this, said the court, demonstrated that the promoter's managerial efforts were the important ones for the success of the pyramid, and that investment contract analysis was properly applied.ⁿ¹¹⁶

Pyramids and multi-level distributorship programs have attracted specific legislative attention in some states. In North Dakota, for example, a security is expressly defined to include:

[A]ny ... arrangement in which persons invest in a common enterprise the returns of which depend to any extent upon inducing other persons to participate or invest in the enterprise... ⁿ¹¹⁷

Legitimate franchises, conventional distributorships, and any form of business opportunity in which the purchaser is in control of her own business and profit potential do not present any investment contract. But if the real economic attraction, and viability of the enterprise, depends on what the seller/promoter is to do, blue sky laws have plain impact.

[e] Insurance and Annuities

Standard "insurance" products are generally excluded from the definition of security in blue sky laws. The Uniform Act expressly provides: " '[S]ecurity' does not include any insurance or endowment policy or annuity contract under which an insurance company promises to pay [a fixed sum of] money either in a lump sum or periodically for life or for some other specified period."ⁿ¹¹⁸

Where other "insurance products," typically variable annuities, are deemed to be investment contracts, it is because they present investment characteristics. A variable annuity contract which provides for deferred income based upon the value of an interest in a managed portfolio of investment assets evidences far more in the way of investment risk than it does any characteristics of an insurance policy. The purchaser of a variable annuity assumes all investment risk concerning the value of his or her interest and the success of the issuing company's success in managing the investment portfolio. In *SEC v. Variable Life Insurance Co. (VALIC)*, ⁿ¹¹⁹ the U.S. Supreme Court determined as a matter of the federal securities laws that by reason of these risk characteristics variable annuities would be deemed to be securities, either as investment contracts or as certificates of interest or participation in a profit sharing agreement. A variable annuity, said the Court, "places all the investment risks on the annuitant, none on the company. The holder gets only a pro rata share of what the portfolio of equity interest reflects--which may be a lot, a little, or nothing."ⁿ¹²⁰

VALIC notwithstanding, the majority of states have excluded annuities generally from coverage of their blue sky laws, although several impose the condition that the annuity be issued by an "insurance company" otherwise regulated by the state. Thus, in California, for example:

"Security" does not include ... any insurance or endowment policy or annuity contract under which an insurance company admitted in this state promises to pay a sum of money (whether or not based upon the investment performance of a segregated fund) either in a lump sum or periodically for life or some other specified period... ⁿ¹²¹

Generally, exclusion of annuities from blue sky coverage is a function of other state regulation of insurance and insurance companies.ⁿ¹²² Some states, however, provide no blue sky exclusion, and thus leave open the opportunity for regulation of the products as securities in addition to subjecting issuers to the entire scheme of state insurance regulation.ⁿ¹²³

Other "insurance" related programs or arrangements may be subject to blue sky laws notwithstanding any applicable exclusion for the underlying product. For example, insurance premium funding plans, under which securities (such as mutual fund shares) are purchased and then pledged to secure a loan to finance the purchase of an insurance policy plainly involve securities transactions as an integral part of the plan. Such "life funding" or "secured funding" programs have been deemed to be investment contracts as a matter of federal law.ⁿ¹²⁴ There is no obvious reason for state regulators or courts to opine otherwise simply because "insurance" is involved.

[f] Equity-Indexed Annuities

Equity-indexed annuities (EIAs) are a hybrid species of annuity contract offered by insurance companies. EIAs guarantee a minimum value to purchasers if the contract is held to maturity, but provide for a return in excess of the minimum that is linked to returns to the performance of an equity index during an accumulation period.ⁿ¹²⁵ A single premium EIA, for example, might guarantee a minimum value not less than 90% of the premiums paid, plus at least 3% in annual interest, less any withdrawals. However, the key feature of an EIA is that during an accumulation period the insurance company will credit the purchaser with a return that is based on changes in an equity index, such as the S & P 500 Composite Stock Price Index. The value built up during the accumulation period becomes the basis for determining the amount of annuity payments that will be made to the purchaser (or paid as a death benefit). To the extent the accumulated value exceeds the guaranteed minimum at the maturity date, the purchaser benefits from capital appreciation in the linked equity index. The minimum value guaranteed for an EIA is a benchmark of a fixed annuity. But the index-linked return is a function of investment performance, which as discussed above is a benchmark of variable annuities.

Simply applying investment contract analysis, the similarities of EIAs with variable annuities argue persuasively for concluding EIAs are securities. There is little case authority on point, however, although one federal District Court has implicitly held that EIAs fall under the broad definition of security that includes all investment contracts.ⁿ¹²⁶ But EIAs are complex contracts. Their complexity is largely the result of varying ways in which index-based returns to be credited during the accumulation period are determined. For example, EIAs vary as to indexing methods, indexing periods, participation rates in the index used, or upper limits (caps) on the index-linked rate. To be sure, in simplest terms, EIAs combine features of a traditional fixed annuity (guaranteed minimum return) and securities (return linked to equity markets). Although the indexed rate or return payable by the insurance company may exceed the amount guaranteed under the contract, insurance company issuers have generally taken the position that because of the guaranteed minimum value and the asserted absence of investment risk because a purchaser cannot lose money, EIAs are not securities and thus are not subject to registration requirements and antifraud protections under federal and state securities laws.

Although losses can be incurred with an EIA depending on terms related to early cancellation--as, for example, if the EIA guaranteed minimum is based on an amount less than the full amount of the purchase payments. There also may be significant surrender charges. It has been suggested, however, that such losses are irrelevant to "investment risk" that is the essential element of a security, and at least one court has agreed.ⁿ¹²⁷ On the other hand, the amount of any excess return, which is the key marketing feature of EIAs, is entirely dependent upon the performance of the index, which is undeniably an "investment" risk. Moreover, the complexity in methodologies used to determine the gain on the index itself that actually inures to the benefit of the EIA purchaser may add meaningful risk to attaining an expected or desired return that is borne by the purchaser.

As insurance products, regulation of EIAs is left solely to state insurance authorities. But some state securities regulators argue that EIAs impose significant investment risks, and are too often instruments of fraud and abuse, particularly given the fact that marketing initiatives disproportionately targeted senior citizens. Securities regulators also focus on the fact that EIAs involve steep front-end charges and substantial surrender charges, such that the guaranteed cash value is significantly less than the original investment for many years after the purchase. The debate continues.

In 2008, the U.S. Securities and Exchange Commission proposed a rule that would subject EIAs to regulation under the federal securities laws.ⁿ¹²⁸ Proposed Rule 151A under the federal Securities Act would clarify the status under the federal securities laws of indexed annuities in which payments to the purchaser are dependent on the performance of a securities index. In the proposing Release, the SEC observed:

Individuals who purchase indexed annuities are exposed to a significant investment risk--i.e., the volatility of the underlying securities index. Insurance companies have successfully utilized this investment feature, which appeals to purchasers not on the usual insurance basis of stability and security, but on the prospect of investment growth. Indexed annuities are attractive to purchasers because they promise to offer market-related gains. Thus, these purchasers obtain indexed annuity contracts for many of the same reasons that individuals purchase mutual funds and variable annuities, and open brokerage accounts.ⁿ¹²⁹

The Commission further concluded that when amounts payable by an insurance company are more likely than not to exceed the minimum amount guaranteed under the contract, the majority of investment risk is borne by the purchaser. Yet they do not receive the benefits of mandated disclosure and sales practice protections.ⁿ¹³⁰ To assure that EIAs are subject to securities regulation, proposed Rule 151A would define a class of indexed annuities that are not eligible for the federal exemption under section 3(a)(8) of the Securities Act,ⁿ¹³¹ by specifically excluding any annuity contract: (1) for which amounts payable by the issuer under the contract are calculated in whole or in part by reference to the performance of a security, including a group or index of securities; and (2) amounts payable by the issuer under the contract are more likely than not to exceed the amounts guaranteed by the contract.ⁿ¹³²

State securities laws vary in their statutory treatment of insurance products as securities, although the common definition of "security" based on the Uniform Securities Act provides that security does not include "any insurance or endowment policy or annuity contract under which an insurance company promises to pay [a fixed sum of] money either in a lump sum or periodically for life or for some other specified period."ⁿ¹³³ This exclusion has been carried into the 2002 Uniform Securities Act, except that an optional term "or variable" is inserted in addition to the exclusion for fixed annuities.ⁿ¹³⁴ The variable insurance product exclusion in the 2002 Uniform Securities Act reflects the fact that a considerable number of states exclude variable annuities from their definitions of security, or provide an exemption from registration.ⁿ¹³⁵

Blue Sky laws do not contain any specific provision dealing with EIAs as securities. Thus, investment contract analysis would necessarily be applied to make the determination. That would be problematic in those states which exclude variable annuities from the definition of security, or provide an exemption from registration. Proposed SEC Rule 151A assumes that EIAs are securities, because its function is to eliminate them as a category of exempt securities. Of course, the proposed SEC rule would not control determinations and treatment of EIAs under state securities laws. It is a powerful statement of the need for regulation under securities laws, however, and may well influence state administrators in proposing their own rules or encouraging legislative action. What is clear, however, is that EIAs present an emergent challenge to state regulators, and to purchasers in need of the protection and remedies from abusive sales practices that only state Blue Sky laws can provide.

[g] Viatical and Life Settlements

Viatical settlements are transactions or arrangements whereby one or more persons acquire an interest in the future death benefit of the life insurance policy of a terminally ill person in exchange for current payment of some discounted percentage of the future benefit. "Life Settlement" contracts are functionally the same, although without the specific focus on a terminally ill person. With a Life Settlement contract, typically, an elderly person chooses to sell his or her life insurance policy to a company that would offer it to investors who would purchase the policy at less than face value. With Life Settlements, the insured would, for example, be expected to live three to six years based on a represented medical evaluation.ⁿ¹³⁶

As investment opportunities, viatical and life settlements have been offered by promoters who acquire policies, package interests in them, and resell them to third parties. The promoters offering interests in viatical and life settlements undertake to determine life expectancy of the insureds whose policies are purchased, and to provide various post-sale services such as continuing premium payments, tracking the status of the insured, and obtaining payment of death benefits. "Investor" funds are used to maintain the policies in force, and to pay fees and commissions of the offering companies, salespersons, and escrow agents. There are variations in programs, and in the types of services undertaken or offered by promoters. In the main, however, purchasers of interests in viatical and life settlements expect very large percentage returns on their investments representing the spread between what is currently paid and the death benefit eventually collected. In *SEC v. Life Partners, Inc.*,ⁿ¹³⁷ a sharply divided U.S. Court of Appeals for the D.C. Circuit held that viatical settlements, or fractional interests in them, are not securities subject to regulation under the federal securities laws. Applying investment contract analysis a majority of the court concluded that pre-purchase services of the promoting company in the evaluation of life expectancy, and largely ministerial post-purchase services were not sufficient to establish that investor profits would flow predominantly from the efforts of others. On the other hand, although the death benefit of each life insurance policy involved in a viatical settlement is fixed, and the investor has no control over the eventual date of death of any insured, actual return to a completely passive as tied to efforts of the promoter company in making evaluations, reviewing policies, negotiating the actual purchase of policies and drafting necessary documents. These are managerial or entrepreneurial efforts that are not insubstantial. Moreover, viatical settlements may be offered and sold as investments, advertising high rates of return and thus inviting investor protection expectations.

Life Partners was never well-received among federal courts. In *Securities & Exchange Commission v. Mutual Benefits Corp.*,ⁿ¹³⁸ for example, the Eleventh Circuit U.S. Court of Appeals concluded that viatical contracts were plainly intended to be, and were considered investments in a common enterprise, involving an expectation of profits. On the critical point, whether the expected profits was based upon the efforts of the promoter or third party, the *Mutual Benefits* court flatly rejected Life Partners and its notion that with viaticals, there is no significant post-purchase activity, and therefore, no reliance upon the efforts of others. The *Mutual Benefits* court reasoned that there are very significant pre- and post-purchase efforts of the promoters that are essential to making investments in viatical settlements profitable. Investors relied on the promoter to identify terminally ill insureds, negotiate purchase prices, pay premiums, and perform life expectancy evaluations that were critical to the success of the venture. The combination of significant pre- and post-purchase managerial activities were sufficient to make the viatical settlements into investment contracts. Rejecting Life Partners was made easier by the fact that in the interim U.S. Supreme Court decision in *Securities & Exchange Commission v. Edwards*,ⁿ¹³⁹ re-emphasized the importance of broadly defining "security" to encompass virtually any instrument that might be sold as an investment. State regulators exhibited no hesitation in their response to the offer and sale of viatical settlements, and to the potential for fraud or abuse that exists by reason of risks of which investors may not be aware, and the potential for unscrupulous promoters to misrepresent them. Viatical settlements were quickly subjected to regulation as securities under Blue Sky Laws. In Ohio, for example, the Division of Securities announced that "in virtually all instances," viatical settlements are securities subject to the regulatory framework of that state's Blue Sky Law.ⁿ¹⁴⁰ This view is premised entirely upon investment contract analysis, amplified by a risk capital assessment that investors' initial value is "clearly" subject to the risks of an enterprise in which all managerial responsibilities are either retained by the viatical company or delegated to an escrow agent. State courts throughout the country agree.ⁿ¹⁴¹

Several states have amended their blue sky law definitions expressly to include viatical settlements. "Viatical settlement contracts" are, for example, expressly included in the definition of security in North Dakota.ⁿ¹⁴² They have also been addressed administratively under securities laws in several other states.ⁿ¹⁴³ Other states approach viaticals as a matter of insurance regulation. In all cases, however, the concern evidenced by state regulators is a reflection of the historic mission of blue sky regulation to protect the public from fraud. Regardless of what evolves as a matter of federal securities regulation, it is clear that state regulators are prepared to act under the broadest interpretation of investment contract or risk capital principles to extend the reach of blue sky laws where protection is needed. Thus, emergent

variants on viatical settlements such as "senior" settlements will be subjected to the same investment contract analysis.ⁿ¹⁴⁴

FOOTNOTES:

(n1)Footnote 1. *See, e.g., Gaudina v. Haberman*, 644 P.2d 159 (Wyo. 1982) ("Inter vivos trusts" held to be investment contracts in circumstances in which they were sold to individuals who were in reality investing money with an expectation of profits from the efforts of a promoter); *see also* *Fore Way Express v. Bast*, 178 Wis.2d 693, 505 N.W.2d 408 (Ct. App. 1993) (employee "profit sharing plan" held not to be an investment contract).

(n2)Footnote 2. *People v. Smith*, 215 Cal. App. 3d 230, 263 Cal. Rptr. 684 (1989).

(n3)Footnote 3. 328 U.S. 293, 66 S. Ct. 1100, 90 L. Ed. 1244. (1946) .

(n4)Footnote 4. *Id.* Prior to *Howey*, indeed before enactment of the federal securities laws, state courts interpreted investment contracts in terms of an outlay of capital in expectation of a profitable return. In *State v. Gopher Tire & Rubber Co.*, 146 Minn. 52, 177 N.W. 937 (1920) , for example, the court offered the meaning of investment contract as: "the placing of capital or laying out of money in a way intended to secure income or profit from its employment... ." 177 N.W. at 938 . *Gopher* involved the sale of certificates that entitled purchasers to assist in the sale of the seller/defendant's products, and to receive a percentage of sales revenues, along with the opportunity to obtain additional cash or stock through distributions of excess earnings.

(n5)Footnote 5. *See* *People v. Frederick*, 142 Cal. App. 4th 400, 48 Cal. Rptr. 3d 585 (2006), in which an "elaborate chain scheme" was held to be an investment contract. Criminal convictions for violation of the California Corporate Securities Law were affirmed, with the court finding: Mercedes, Felix, and Frederick carried out the managerial functions of LLDO. They alone made the important management decisions essential to LLDO's operations. LLDO members, many of whom were poor and uneducated, were not in charge and could not influence the management of LLDO. The success or failure of LLDO rested upon defendants' managerial efforts, not the efforts of its members... . When an investor entrusts money or other consideration to a promoter through any arrangement but retains substantial power to affect the success of the enterprise, he has not "risked capital" within the meaning of the Corporate Securities Law... . Here, LLDO investors did not retain "substantial power" to affect the success of LLDO. 142 Cal. App. 4th at 414 (citations omitted).

(n6)Footnote 6. 320 U.S. 344, 64 S. Ct. 120, 88 L. Ed. 88 (1943).

(n7)Footnote 7. *Id.* at 348, 64 S. Ct. at 122, 88 L. Ed. at 92 .

(n8)Footnote 8. Contrast the notion of unmanageable risk that is essential to the presence of an investment contract with a negotiated service agreement entered into between parties. In *Broadview Fin. v. Entech Management Servs. Corp.*, 859 F. Supp. 444 (D. Colo. 1994), the court held that a financial consulting agreement, whereby one party was retained to assist the other in the identification of a suitable acquisition candidate was not an investment contract within the coverage of the Colorado blue sky law. Although the agreement provided that the consultant would be entitled to a fee of 10 percent of the value of any transaction ultimately consummated, such expected "profit" would come as a result of its own efforts. The agreement constituted only a contract for a private service transaction.

(n9)Footnote 9. 977 S.W.2d 934 (Mo. App. 1998) .

(n10)Footnote 10. 328 U.S. 293, 299, 66 S. Ct. 1100, 1103, 90 L. Ed. 1244, 1250 (1946) .

(n11)Footnote 11. Only New York, Rhode Island and Vermont do not expressly include investment contracts within their statutory definitions of security. In New York, however, the term is specifically included in a regulation defining certain securities. *See* 13 N.Y. Comp. R. & Regs. § 80.1(j)(4).

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(n12)Footnote 12. *See, e.g.,* Gallion v. Alabama Market Centers, Inc., 282 Ala. 679, 23 So. 2d 841 (1968); Sauer v. Hays, 36 Colo. App. 190, 539 P.2d 1343 (1975); State v. Bull Inv. Group, Inc., 32 Conn. Supp. 279, 351 A.2d 879 (1974); Georgia Mkt. Ctrs. v. Fortson, 225 Ga. 854, 171 S.E.2d 620 (1969); Polikoff v. Levy, 55 Ill. App. 2d 229, 204 N.E.2d 807 (1969); Scholarship Counselors, Inc. v. Waddle, 507 S.W.2d 138 (Ky. Ct. App. 1974); State v. Investors Sec. Corp., 297 Minn. 1, 209 N.W.2d 405 (1973); Garbo v. Hilleary Franchise Systems, Inc., 479 S.W.2d 491 (Mo. Ct. App. 1972); State v. Silberberg, 166 Ohio St. 101, 139 N.E.2d 342 (1956); Commonwealth ex rel. Pennsylvania Sec. Com. v. Consumers Research Consultants, Inc., 414 Pa. 253, 199 A.2d 428 (1964); Koscot Interplanetary, Inc. v. King, 452 S.W.2d 531 (Tex. Civ. App. 1970); First National Savings Foundation v. Samp, 274 Wis. 118, 80 N.W.2d 249 (1956).

(n13)Footnote 13. *SEC v. W.J. Howey Co.*, 328 U.S. at 299, 66 S. Ct. at 1003, 90 L. Ed. at 1250; *see also* Cellular Engineering, Ltd. v. O'Neill, 118 Wash. 2d 16, 820 P.2d 941 (1991) (the purpose of securities laws is to regulate investments, in whatever form they are made and by whatever name they are called).

(n14)Footnote 14. The three *Howey* criteria have on occasion been divided into four, with "expectation of profit" being separated for consideration in its own right. *See In re Walling Heirs Association*, [1991-1993 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,530 (Okla. Ad. Proc. 1990). There may be some logic in doing so where it appears that the expected return on an investment of money is in no way dependent upon the activities of a common venture. *See, e.g.,* Straub v. Mountain Trails Resort, Inc., [1988-1990 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,931 (Colo. Ct. App. 1988) (no expectation of profit associated with non profit campground memberships). However, it makes no practical difference in the analysis and there is no compelling reason to carve out a separate element.

(n15)Footnote 15. *540 U.S. 389, 124 S. Ct. 892, 157 L. Ed. 2d 813 (2004)* .

(n16)Footnote 16. *Murphy v. Dare to Be Great, Inc.*, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,053 (S. Ct. D.C. Civ. 1972); *see also* *State ex rel. Healy v. Consumer Business System, Inc.*, 5 Or. App. 19, 482 P.2d 549 (1971) (omitting "money" reference entirely).

(n17)Footnote 17. In *Cellular Engineering Ltd. v. O'Neill*, 118 Wash. 2d 16, 820 P.2d 941 (1991), individuals paid "fees" to the plaintiff firm for the preparation and submission of application materials for participation in the lottery system for licenses to establish cellular telephone systems in particular areas. In an action to collect fees from a dissatisfied participant, the plaintiff firm confronted a defense assertion that the arrangement created an investment contract, for which there had been no blue sky law compliance. Whether an "investment of money" was present depended upon whether the payment of fees which, admittedly, did not represent capital to finance a common business venture, nevertheless satisfied the first *Howey* element. The court agreed that there was a requisite investment of money. Not the least among reasons offered in support of the conclusion was the fact that the firm's promotional literature emphasized the tremendous profit potential of the cellular telephone industry. Viewing the scheme in its entirety, said the court, demonstrated that customers did anticipate a return on their payment of fees.

See also *American Microtel v. Secretary of State*, 3 Mass. L. Rptr. 479 (Mass. Super. 1995) (fee for one time "investment" for wireless cable television lottery application filing service held to be the basis for an investment contract).

(n18)Footnote 18. *See United Housing Found., Inc. v. Forman*, 421 U.S. 837, 852, 95 S. Ct. 2051, 2062, 44 L. Ed. 2d 621, 632 (1975).

(n19)Footnote 19. 171 Mich. App. 748, 431 N.W.2d 441 (1988).

(n20)Footnote 20. *Id. at 758* .

See also *Roddy v. Alexander*, 2001 Ohio App. LEXIS 4487 (Oct. 5, 2001), in which the court found no investment

contract where plaintiffs purchased, and were titled owners of, separate real estate properties that were not part of any combined project or otherwise connected to each other, and over which they retained practical and actual control.

But see Securities Adm'r v. College Assistance Plan (Guam), Inc., 533 F. Supp. 118, *aff'd*, 700 F.2d 548 (9th Cir. 1983) in which interests in a pre need college tuition purchase plan in which the plan agreed to pay for the college costs of a designated beneficiary upon remittance of a lump sum or installment payments were investment contracts, and therefore securities, under the Guam Uniform Securities Act, considering the plan provided broad opportunity for wrong doing and the plan's activities were not regulated by any governmental agency.

(n21)Footnote 21. State v. Argo, 81 Wash. App. 552, 560, 915 P.2d 1103, 1107 (1996); *see also* Jenkins v. Jacobs, 748 P.2d 1318 (Colo. 1987) .

(n22)Footnote 22. *See, e.g., Rother v. La Renovista Estates, Inc.*, 603 F. Supp. 533 (D. Colo. 1984) (Oklahoma law).

But see Roddy v. Alexander, 2001 Ohio App. LEXIS 4487 (Oct. 5, 2001), in which the transactions at issue involved 41 separate real estate purchases of existing properties, as to which there was no "project" and no indication that the transactions shared any type of commonality. The only common thread, said the court, was the alleged intent of the defendants to fleece the plaintiffs, a fact that does not transform real estate sales into securities.

(n23)Footnote 23. *See, e.g., Activator Supply Company, Inc. v. Wurth*, 239 Kan. 610, 722 P.2d 1081 (1986).

Courts uncertain of the specific applicable standard in case law often accept either horizontal and vertical commonality, *see* Integrated Research Servs. v. Ill. Secy. of State, 328 Ill. App. 3d 67, 765 N.E.2d 130, 262 Ill. Dec. 304 (2002) (discretionary trading account).

Others apply both tests, *see* 537721 Ontario, Inc. v. Mays, [1988-1990 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,042 (Kan. Ct. App. 1989). Indeed both tests, as alternatives, may be encompassed in applicable law. *See* Daggett v. Jackie Fine Arts, Inc., [1986-1987 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,466 (Ariz. Ct. App. 1986).

(n24)Footnote 24. *See, e.g., Deckebach v. La Vida Charters, Inc.*, 867 F.2d 278 (6th Cir. 1989).

(n25)Footnote 25. *Winkler v. Trico Financial Corp.*, 693 F. Supp. 896 (W.D. Wash. 1988) (Washington law). *Winkler* illustrates the notion of interdependence in a vertical commonality relationship. The case focused on an equipment leasing program involving computers designed to conserve energy. Plaintiffs alleged that the program created an investment contract, and that a common enterprise existed between the lessor/promoter and the individual lessees by reason of the involvement of the lessor or its affiliate in locating sites, and in managing computer units efficiently. Defendants claimed that there was no direct relationship between the success of the lessors and individual lessees, and thus no requisite commonality for the creation of an investment contract. The court disagreed, and offered this explanation of why vertical commonality was satisfied:

[F]irst, the success of the Winklers' investment was directly dependent [on] ALH's ability to locate a profitable site for the Energy Brain and manage the unit efficiently. Second, since the Winklers' lease payments to Saxon after the first year were equal to 75 percent of the Winklers' net revenues from the system, Saxon remained a viable lessor only to the extent that the Winklers and its other lessees prospered. Third, Enersonics relied on Saxon to repay a 25 year note for each Energy Brain. Thus, the entire Leasing Program survived only if Saxon located enough investors to generate profitable leases... . [T]he Winklers' fortunes were inextricably and directly tied to the efforts and fortunes of their promoters. 693 F. Supp. at 899.

(n26)Footnote 26. 212 F.3d. 180 (3d. Cir. 2000) .

(n27)Footnote 27. 540 U.S. 389, 124 S. Ct. 892, 157 L. Ed. 2d 813 (2004) .

(n28)Footnote 28. See *Weiss v. Lehman*, 713 F. Supp. 489 (D.D.C. 1989) (D.C. law); see also *Torres v. Divis*, [1986-1987 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,447 (Ill. App. Ct. 1986).

(n29)Footnote 29. For an evaluation of partnerships and joint ventures under investment contract criteria, see § 2.07[2], *below*.

(n30)Footnote 30. See, e.g., *State v. Dare to Be Great, Inc.*, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,096 (Utah Dist. Ct. 1972).

(n31)Footnote 31. 741 P.2d 958 (Utah 1987) .

(n32)Footnote 32. The willingness of state courts to broadly interpret the third *Howey* criteria is well illustrated by *People v. Sala*, 258 A.D.2d 182, 695 N.Y.S.2d 169 (App. Div., 3d Dept. 1999) , in which the court opined that *Howey* merely requires that investors be led to *expect* profits solely from the efforts of others. In *Sala* the defendant was portrayed to investors as an expert in the numismatic coin market, and that profitability of coin investments was ensured by such expertise in selecting coins, monitoring their value and aiding in resale transactions. This, said the court, supported a finding that investors *were led to believe* that the promoter's efforts would influence the value of their coin portfolios.

See also *State v. LaCount*, 2008 WI 59, 750 N.W.2d 780, in which the Wisconsin Supreme Court rejected the argument that in order for a security to be found, an investor may not put forth any efforts himself or herself. The Court opined that such an approach would frustrate the remedial purposes of the state securities law by making it easy to evade the law by having an investor put forth a modicum of effort. Instead, the court concluded that an investor may have a role in managerial efforts so long as the investor does not provide the essential managerial efforts.

(n33)Footnote 33. See *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir.) , *cert. denied*, 414 U.S. 821, 94 S. Ct. 117, 38 L. Ed. 2d 53 (1973) .

(n34)Footnote 34. See *State v. Danek*, 118 N.M. 8, 878 P.2d 326 (1994) . The New Mexico Supreme Court upheld a jury instruction defining "investment contract" as:

[A]contract where an individual invests his or her money ... in an undertaking or venture of two or more people or entities ... with an expectation of profit ... based primarily on the efforts of others. An 'investment' is the use of money to make more money.

(n35)Footnote 35. *State v. George*, 50 Ohio App. 2d 297, 302 362 N.E.2d 1223, 1227 (1975). This is the definition for a security articulated in *State by Commissioner of Sec. v. Hawaii Mkt. Ctr.*, 52 Hawaii 642, 485 P.2d 105 (1971).

(n36)Footnote 36. See *Gallion v. Alabama Market Centers, Inc.*, 282 Ala. 679, 213 So. 2d 841 (1968); *Wheeler v. State*, 659 P.2d 1241 (Alaska 1983); *Sullivan v. Metro Products*, 150 Ariz. 573, 724 P.2d 1242 (1986), *cert. denied*, *State ex rel. Miller v. Pace*, 479 U.S. 1102, 107 S. Ct. 1334, 94 L. Ed. 2d 185 (1987); *In re Secured Commodities of Ark., Inc.*, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,125 (Dep't of Commerce, Sec. Div. 1974); *Jenkins v. Jacobs*, [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,644 (Colo. 1987); *State v. Bull Inv. Group, Inc.*, 32 Conn. Sup. 279, 351 A.2d 879 (1974); *Yeomans v. State*, Dep't of Banking & Finance, Div. of Sec., 452 So. 2d 1011 (Fla. 1984); *Georgia Mkt. Ctrs. v. Fortson*, 225 Ga. 854, 171 S.E.2d 620 (1969); *Polikoff v. Levy*, 55 Ill. App. 2d 229, 204 N.E.2d 807, *cert. denied*, 382 U.S. 903, 86 S. Ct. 237, 15 L. Ed. 2d 156 (1965); *Schwartz v. Bache & Co.*, 340 F. Supp. 995 (S.D. Iowa 1972); *Activator Supply Co. v. Wurth*, 239 Kan. 610, 722 P.2d 1081 (1986);

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Scholarship Counselors, Inc. v. Waddle, 507 S.W.2d 138 (Ky. Ct. App. 1974); State v. Investors Security Corp., 297 Minn. 1, 209 N.W.2d 405 (1973); Garbo v. Hilleary Franchise Systems, Inc. 479 S.W.2d 491 (Mo. Ct. App. 1972); Conroy v. Schultz, 80 N.J. Super. 443, 194 A.2d 20 (1963); New Mexico v. Shade, [1986-1987 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,452 (1986); People v. Monex Int'l, Ltd., [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,156 (N.Y. Sup. 1974); Waterman v. Alta Verde Industries, Inc., 643 F. Supp. 797 (E.D.N.C. 1986); Emery v. So-Soft of Ohio, Inc., 94 Ohio Law Abs. 357, 199 N.E.2d 120 (1964); Commonwealth *ex rel.* Pennsylvania Sec. Com. v. Consumers Research Consultants, Inc., 414 Pa. 253, 199 A.2d 428 (1964); Bruner v. State, 463 S.W.2d 205 (Tex. Crim. App. 1970); Payable Accounting Corp. v. McKinley, 667 P.2d 15 (Utah 1983); Overthrust Mineral Corp. v. Wyoming Secretary of State, [1984-1985 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,243 (Wyo. 1985).

(n37)Footnote 37. See § 2.01 above.

(n38)Footnote 38. Partnerships and interests in joint ventures as securities are specifically considered at § 2.07, above.

(n39)Footnote 39. See Garrett v. Snedigar, 293 S.C. 176, 359 S.E.2d 283 (Ct. App. 1987).

(n40)Footnote 40. 854 F.2d 110 (5th Cir. 1988) .

(n41)Footnote 41. *Id.* at 114 ; see also Kansas v. Ribadeneira, [1991-1993 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,551 (Kan. Ct. App. 1991) (whether a general partnership interest is a security is a question of fact involving whether the investor does or does not have any real managerial functions).

(n42)Footnote 42. 442 N.W.2d 105 (Iowa 1989) .

(n43)Footnote 43. *Id.* at 107 .

(n44)Footnote 44. See *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 650 F. Supp. 1378, 138-84 (W.D. Va. 1986) (managerial powers and the right of inspection vested in general partners takes them outside the intended scope of the federal securities laws).

(n45)Footnote 45. See, e.g., State v. Brill, [1961-1971 Transfer Binder] Blue Sky L. Rep. (CCH) P 70,918 (Wis. Cir. 1971), in which the defendant sold parcels of real estate, or undivided interests in them, to individual investors at inflated prices, and then leased back the property. Investors were promised that defendant's management of the property would yield a 12 percent annual return on this investment. The arrangement, defendant argued, was no more than a lease arrangement. Although the court suggested that had this been a single transaction there would be an open question as to whether a security was created, the defendant's repeated activities over a period of years brought the scheme within coverage of the Wisconsin blue sky law.

(n46)Footnote 46. See People v. Miller, [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,632 (Cal. App. 1987) (sale of fractional shares of real property trust deeds securing notes held to be securities under the risk capital test); Smith v. Sherman, 206 Cal. App. 2d 93, 23 Cal. Rptr. 487 (1962); State v. Investors Security Corp., 297 Minn. 1, 209 N.W.2d 405 (1973); Bergquist v. Int'l Realty, Ltd., 272 Or. 416, 537 P.2d 553 (1975).

(n47)Footnote 47. See, e.g., People v. Destro, 2008 Colo. App. LEXIS 896 (May 29, 2008). In *Destro*, a program involving the purchase and "flipping" of real estate was held to be an investment contract security under the Colorado Blue Sky law. Under the program the promoter purchased properties for resale to participating buyers. The buyers signed a contract to lease the properties to the promoter, and to sell the property back to the promoter within one year, at which time the buyer and the promoter would split any profits. Essential aspects of financing the properties and making mortgage payments remained the responsibility of the promoter, and the buyers of the properties were dependent upon the promoter to meet these obligations. The buyers were "owners" of the properties, but they were dependent upon the promoter for the generation of profits from their purchase and eventual resale.

(n48)Footnote 48. *See, e.g., In re Hilton Head Vacation Rentals and Sales, Inc.*, [1991-1993 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,674 (So. Car. Admin. 1992) (agreement for property management and rental guarantee).

(n49)Footnote 49. In contrast, *see Weiss v. Lehman*, 713 F. Supp. 489 (D.D.C. 1989) (no investment contract where purchasers of real estate assumed active management roles with regard to the properties, and their motives for purchasing did not depend on the efforts of the sellers).

(n50)Footnote 50. 123 Or. App. 372, 860 P.2d 289 (1993).

(n51)Footnote 51. *See also* Roddy v. Alexander, 2001 Ohio App. LEXIS 4487 (Oct. 5, 2001) (purchasers maintained control over real estate properties and each transaction was a separate purchase involving no common enterprise).

(n52)Footnote 52. 68 N.Y.2d 81, 506 N.Y.S.2d 10, 497 N.E.2d 33 (N.Y. 1986) .

(n53)Footnote 53. *See also* Straub v. Mountain Trails Resort, Inc., [1988-1990 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,931 (Colo. Ct. App. 1988). *But see* State v. Shade, [1986-1987 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,452 (N.M. Ct. App. 1986) (time share memberships held to be securities).

(n54)Footnote 54. 421 U.S. 837, 95 S. Ct. 2051, 44 L. Ed. 2d 621 (1975) .

(n55)Footnote 55. The approach has been extended to residential leases as well. *See, e.g., Aschenbach v. Covenant Living Centers-North, Inc.*, 482 F. Supp. 1241 (E.D. Wis. 1980); *see also* AMR Realty Co. v. State, Bureau of Sec., 149 N.J. Super. 329, 373 A.2d 1002 (1977) (shares in housing cooperative entitling purchaser to lease an apartment are not securities unless further evidence would show investment contract criteria being met). Interests in housing cooperatives as securities are considered in further detail in § 2.08[2][i], *below*.

(n56)Footnote 56. *See, e.g., Alaska Stat. § 45.55.130(12)* ("security" means a certificate of interest or participation in any sale of or indenture or bond or contract for the conveyance of land or interest in land"); *see also Ga. Code Ann. § 10-5-2(16)*:

"[S]ecurity" shall not mean any interest in a residential unit and a rental management arrangement relating to such residential unit so long as the owner participant under the rental management arrangement, whether optional or mandatory, do not participate directly in the income derived from the rental of units owned by others.

(n57)Footnote 57. *See e.g., 9 Vt. Stat. ann. § 4202*: " 'Security' shall include land situated outside of the state."

See also Wash. Rev. Code § 21.20.005(12):

"Security" means any sale or indenture, bond or contract for the conveyance of land or any interest therein where such land is situated outside of the state of Washington and such sale or its offering is not conducted by a real estate broker licensed by the state of Washington.

(n58)Footnote 58. *Florida Realty, Inc. v. Kirkpatrick*, 509 S.W.2d 114, 117 (Mo. 1974).

(n59)Footnote 59. Possible cooperative forms include joint tenancies, tenancies in common and trusts.

(n60)Footnote 60. Other features of cooperatives give the shareholder tenant the right to vote in the management of the corporation and the right to take income tax deductions on part of the shareholder tenant's share of carrying charges. If commercial enterprises are part of the premises, this income is generally used to decrease the monthly expenses of

residents.

(n61)Footnote 61. 421 U.S. 837, 95 S. Ct. 2051, 44 L. Ed. 2d 621 (1975) .

(n62)Footnote 62. 421 U.S. at 851 .

(n63)Footnote 63. See 421 U.S. at 851, 95 S. Ct. at 2061, 44 L. Ed. 2d at 631 ; see also *AMR Realty Co. v. New Jersey* [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,350 (N.J. Sup. A.D. 1977):

[S]hares in a housing cooperative which entitle the purchaser to lease an apartment in the cooperative and do not possess the common attributes of stock ... are not securities within the intendment of [the New Jersey] Uniform Securities Law. Therefore, one who engages in the business of selling such shares is not required to register with the Bureau of Securities as a broker dealer or agent, as the case may be. *Id.* at 68,147.

(n64)Footnote 64. See *N.Y. Gen. Bus. Law* § 352-e(1)(a).

(n65)Footnote 65. See *Conn. Gen. Stat. Ann.* § 36-490(a)(12); *Fla. Stat. Ann.* § 517.061(15); *Hawaii Rev. L.* §§ 485-6(13), 485-7; *Iowa Code* § 502.202(12); *Mass. Gen. L. Ann., ch. 110A*, § 402(b)(13) and *Mass. Reg.* § 402(b)(13)(C)(iii).

Although the Pennsylvania statute is silent on the subject, a Securities Commission Bulletin indicates that cooperative interests will be considered securities. See [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 41,340 (June 1, 1971).

(n66)Footnote 66. See, e.g., *Fla. Stat. Ann.* § 711-31; *N.J. Stat. Ann. Sections* 49:3-27 *et seq.*

(n67)Footnote 67. See, e.g., *Md. Code Ann., Real Prop.* § 11-101; *Mich. Comp. Laws* § 559.31; *N.Y. Real Prop. Law* §§ 339-d, 339-ii; *Va. Code Ann.* §§ 55-79.1, 55-79.38.

(n68)Footnote 68. See, e.g., *Dufour v. U.S. Home Corp.*, 581 So. 2d 765 (La. App. 1991) (court held that the purchase of condominium units for investment purposes does not create an investment contract in the absence of a showing that purchasers were required to participate in a rental program managed by the promoter or a third party).

See also Opinion of the Attorney General, No. 73 100, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,215 (Ga. 1973); Opinion of the Attorney General, No. 66- 8 (Hawaii); Maryland Securities Act Releases Nos. 4, 8, 1A Blue Sky L. Rep. (CCH) PP 30,553 and 30,554; Ohio Securities Bulletin, October 1973, 2 Blue Sky L. Rep. (CCH) P 38,759; Oregon Securities Rule 815 30 056; Statement of Policy, Deputy South Carolina Securities Commissioner, January 2, 1985.

(n69)Footnote 69. See *New Mexico v. Shade*, [1986-1987 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,452 (N.M. 1986). This case involved the sale of time share intervals in condominiums. The purchase of a time share entitled the purchaser to a minimum of one week's use of the condominium every year for 40 years. Title in the condominium property never passed to the purchaser. The purchasers were induced to purchase time shares based on representations that the purchase was a good investment and would be profitable. The court held that this offering was an investment contract under the *Howey* test.

But see *O'Quinn v. Beach Associates*, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,450 (S.C. 1978) (no investment contract where the sale of condominium units was without substantial reliance on the efforts of the seller or third parties for a return on the investment).

(n70)Footnote 70. At the federal level, in 1973 the U.S. Securities and Exchange Commission addressed offerings of resort condominiums in which "investment" opportunities were the major marketing thrust, and supplied useful guidelines in determining whether a security is likely to be found in the sale of condominium units. *See Securities Act Rel. No. 5347, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,163 (SEC Jan. 4, 1973).*

(n71)Footnote 71. *See, e.g., Alaska Stat. § 45.55.130(12).*

(n72)Footnote 72. This basic provision, with some variation, exists in Maine, Missouri, Ohio, Vermont and Washington.

(n73)Footnote 73. Section 339-ee(1) of the New York Real Property Law mandates that condominiums be deemed securities under Section 352-e of the General Business Law.

(n74)Footnote 74. *116 N.J. Super. 372, 282 A.2d 428 (1971) .*

(n75)Footnote 75. *Id. at 431-32.* It was also decided that condominium interests for non income generating purposes was not a security within the definition "real property security" under N.J. Stat. Ann. § 49:3-27.

(n76)Footnote 76. *See Memorial Gardens v. Love, 5 Utah 2d 270, 300 P.2d 628, 630 (1956).*

(n77)Footnote 77. *Holloway v. Thompson, 112 Ind. App. 229, 42 N.E.2d 421 (1942) ; State v. Cushing, 137 Me. 112, 15 A.2d 740 (1940) ; see State v. Lorentz, 221 Minn. 366, 22 N.W.2d 313 (1946); In re Waldstein, 160 Misc. 763, 291 N.Y.S. 697 (1936) .*

(n78)Footnote 78. *In re Waldstein, 160 Misc. 763, 291 N.Y.S. 697, 700-701 (1936) .*

(n79)Footnote 79. *State v. Cushing, 137 Me. 112, 15 A.2d 740 (1940) (burial lots fell within the statute).*

(n80)Footnote 80. *Holloway v. Thompson, 112 Ind. App. 229, 42 N.E.2d 421 (1942) (circumstances such that cemetery lots could be interests commonly known as securities).*

(n81)Footnote 81. *State v. Lorentz, 221 Minn. 366, 22 N.W.2d 313 (1946) (Joiner analysis applied to find a security).*

(n82)Footnote 82. *See Utah Code Ann. § 61-1-13(17). But see Memorial Gardens v. Love, 5 Utah 2d 270, 300 P.2d 628 (1956) (added services insufficient to bring sale of burial plots within statutory coverage).*

(n83)Footnote 83. *643 F. Supp. 797 (E.D.N.C. 1986) (North Carolina law).*

(n84)Footnote 84. The court added:

[W]hile plaintiff may have expressed more interest in his investment than some others, there is nothing to indicate that he ever intended to become involved in the maintenance and care of his cattle or that defendant had the least expectation that he would do so.

Id. at 806 .

(n85)Footnote 85. *See, e.g., Busse v. Pacific Cattle Feeding Fund #1, 896 S.W.2d 807 (Tex. App. 1994); Ronnett v. American Breeding Herds, Inc., 124 Ill. App. 3d 842, 464 N.E.2d 1201 (1984).*

(n86)Footnote 86. *Pride of the Andes, Inc. v. Soberay, 2001 Ohio App. LEXIS 36 (Jan. 10, 2001).*

(n87)Footnote 87. *In re Certified Silver Exchange, [1986-1987 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,353*

(Montana Sec. Dept. 1985).

Precious metals or gemstones may also fall within an express "commodity" definition, and as such be subject directly to particular state blue sky laws. Michigan, for example, extends coverage of its blue sky law to "commodity contracts." In *Aaronson v. Lindsay & Hauer International Ltd.*, 235 Mich. App. 259, 597 N.W.2d 227 (1998), the court concluded that the offer and sale of precious or semi-precious gemstones, the value of which was not readily ascertainable by members of the general public, and which were offered to the general public as an investment, involved contracts for the sale of commodities and fell directly under the Michigan Uniform Securities Act. The court particularly emphasized the manner in which the stones were marketed, noting, for example, that the seller's literature was "punctuated with investment terminology." Although the Michigan court looked to the express coverage of commodity contracts under the Blue Sky law, precious stone "investment" programs are subject to the same assessments under straightforward investment contract analysis.

(n88)Footnote 88. *Daggett v. Jackie Fine Arts, Inc.*, [1986-1987 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,466 (Ariz. Ct. App. 1986).

(n89)Footnote 89. *People v. Sala*, 258 A.D.2d 182, 695 N.Y.S.2d 169 (1999) (numismatic coin portfolio program satisfied *Howey* elements); *In re Gold Coast Rarities, Inc.*, [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,765 (Wis. Comm. 1987).

(n90)Footnote 90. *Sullivan v. Metro Prods.*, 150 Ariz. 573, 724 P.2d 1242 (Ct. App.), *cert. denied sub nom. State ex rel. Miller v. Sullivan*, 479 U.S. 1102, 107 S. Ct. 1334, 94 L. Ed. 2d 185 (1987) (master videotape sales program); *Allison v. Southampton Music Company*, [1986-1987 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,441 (D. Or. 1986) (audio records and tapes).

(n91)Footnote 91. *In re Macadamia Plantations of Panama, Inc.*, [1986-1987 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,360 (Me. Bureau 1985).

(n92)Footnote 92. *Activator Supply Co. v. Wurth*, 239 Kan. 610, 722 P.2d 1081 (1986).

(n93)Footnote 93. *State v. Tyler*, 512 N.W.2d 552 (Iowa 1994) (expectation of profit contingent upon completion of a lawsuit); *see also State v. Kraklio*, 560 N.W.2d 16 (Iowa 1997) (sale of claims in a non existent suit against the federal government held to be investment contract securities).

(n94)Footnote 94. *See, e.g., Garvin v. Secretary of State*, 266 Ga. App. 66, 596 S.E.2d 166 (2004); *State ex rel. Miller v. Pace*, 677 N.W.2d 761 (2004).

(n95)Footnote 95. Equipment leasing programs have often been deemed to be investment contracts. *See, e.g., Winkler v. Trico Financial Corp.*, [1988-1990 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,949 (W.D. Wash. 1988) (Wash. law).

(n96)Footnote 96. *See, e.g., In re Gardner*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,757 (Spec. Ter. N.Y. S. Ct. 1979); *State v. Gertsch*, 137 Idaho 387, 49 P.3d 392 (2002) ("Investment" opportunity presented to individuals to provide loans to Defendant to finance complementary vacation packages).

(n97)Footnote 97. 171 Mich. App. 748, 431 N.W.2d 441 (1988).

(n98)Footnote 98. 171 Mich. App. at 757.

(n99)Footnote 99. [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,707 (E.D.Wash. 1988) (Wash. law).

(n100)Footnote 100. *See also Information Leasing Corp. v. Borda*, 2003-Ohio-4834, 2003 Ohio App. LEXIS 4367

(Sept. 12, 2003) (ATM lease agreements were not investment contracts where the lessee was to provide a place of business at which the ATMs would be located, and there was no pooling of lease payments).

(n101)Footnote 101. *See, e.g., Deckebach v. La Vida Charters, Inc.*, 867 F.2d 278 (6th Cir. 1989) . In *Deckebach* a yacht purchase and associated management program did not create an investment contract under the Ohio blue sky law where there was no contribution or pooling of venture capital. A finding of "horizontal commonality" would be required. The relationship involved, however, was known by the purchaser from the outset to be "[e]ssentially the hiring of an independent contractor to perform services to produce rental income to permit ultimate payment and retention of the yacht for personal use." *Id.* at 283 .

(n102)Footnote 102. *See In re Croy Thoroughbreds*, [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,653 (Ga. Comm. 1987).

(n103)Footnote 103. 320 U.S. 344, 353, 64 S. Ct. 120, 124, 88 L. Ed. 88, 94 (1943) .

(n104)Footnote 104. *State by Commissioner of Sec. v. Hawaii Mkt. Ctr.*, 52 Hawaii 642, 485 P.2d 105 (1971).

(n105)Footnote 105. Regardless of whether blue sky laws are applied to a franchise through investment contract analysis, other state laws addressing franchising, or franchise investments generally, may apply. *See, e.g., California Franchise Investment Law, Cal. Corp. Code §§ 31000-31019.*

(n106)Footnote 106. *See Emery v. So-Soft of Ohio, Inc.*, 94 Ohio Law Abs. 357, 199 N.E.2d 120 (Ct. App. 1964). In *Emery*, plaintiff purchased a water softener unit in a program involving a "referral" agreement under which the defendant seller was to pay \$100 for each person referred by plaintiff. The court held that the referral agreement was not an investment contract under the Ohio blue sky law: "[S]uch instrument or certificate cannot be deemed a security when it merely represents a purchaser's right to reap a profit from his own services, and such profit is guaranteed upon the performance of those services..." *Id.* at 124.

(n107)Footnote 107. 741 P.2d 958 (Utah 1987) .

(n108)Footnote 108. The court noted:

Ball could not sell food directly to the public, and he had to rely on the efforts of others to generate those profits. Because his efforts would generate only limited profits and he had to rely on the efforts of others to ensure the viability of his business, Ball's contract with Westland was an investment contract.

Id. at 960 .

(n109)Footnote 109. [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,729 (Mich. Ct. App. 1987).

(n110)Footnote 110. *Id.* at 73,089.

(n111)Footnote 111. 497 F.2d 473 (5th Cir. 1974) .

(n112)Footnote 112. 474 F.2d 476 (9th Cir.) , *cert. denied*, 414 U.S. 821, 94 S. Ct. 117, 38 L. Ed. 2d 53 (1973) .

(n113)Footnote 113. *See also Webster v. Omnitrition Int'l*, 79 F.3d 776 (9th Cir. 1996).

(n114)Footnote 114. Thus, in *People v. Cooper*, 166 Mich. App. 638, 421 N.W.2d 177 (1987), for example, the court observed that once a participant in such a plan recruited the first generation of people, the participant merely continued to invest \$20 per month. The success or failure of the plan essentially depended upon the managerial and entrepreneurial skills of the promoters.

(n115)Footnote 115. *State v. Irons*, 254 Neb. 18, 574 N.W.2d 144 (1998) .

(n116)Footnote 116. *See also State v. Jones*, 235 Neb. 1, 453 N.W.2d 447 (1990) (eliminating the *Howey* requirement that profits must be derived solely from the entrepreneurial or managerial efforts of others).

(n117)Footnote 117. N.D.C.C. § 10 04 02(12); *see also Meadow Fresh Farms v. Sandstrom*, 333 N.W.2d 780 (N.D. 1983).

(n118)Footnote 118. Unif. Securities Act § 401(1). The bracketed words are optional, intended to allow states the opportunity to exclude variable annuities along with so called "orthodox," or fixed, annuities from blue sky laws. *See* Official Comment, § 401(1). States adopting the Uniform Securities Act, but not the bracketed language, thus simply exclude any insurance policy or annuity contract which promises to pay money "either in a lump sum or periodically for life or some other specified period." *See, e.g., Ind. Code § 23-2-1-1(k)(i)*. The option to exclude variable annuities from the definition of security is carried into the 2002 Uniform Securities Act, *see* 2002 Unif. Securities Act § 102(28).

See also Dryden v. Sun Life Assurance Co., 737 F. Supp. 1058 (S.D. Ind. 1989) (court held that the right to receive such dividends as may be declared in the discretion of the board of directors does not operate to convert a standard life insurance policy into a security as a matter of Indiana and federal securities laws).

(n119)Footnote 119. *359 U.S. 65, 79 S. Ct. 618, 3 L. Ed. 2d 640 (1959)* .

(n120)Footnote 120. *Id. at 71-72 , 79 S. Ct. at 621, 3 L. Ed. 2d at 644* . In a subsequent case, focusing on an annuity product in which the allocation of investment risk was changed to shift some risk to the issuing company, while still preserving the "variable" feature, the Court still found an investment contract. The thrust of the program was the opportunity to share in the investment experience of the company's portfolio, a point that was "pitched" to purchasers. *See SEC v. United Benefit Life Insurance Co.*, 387 U.S. 202, 87 S. Ct. 1557, 18 L. Ed. 2d 673 (1967) .

(n121)Footnote 121. *Cal. Corp. Code § 25019; see also Idaho Code § 30-1402(12)* (annuity must be issued by an insurance company that is subject to supervision of the state Department of Insurance); Conn. Gen. Stat. Ch. 662, § 36-471(m); Ga. Code Ann. § 10 5 2(16); *La. Rev. Stat. Ann. § 51:702(15)(a)*; N.C. Gen. Stat. § 78A 2(11).

(n122)Footnote 122. *See, e.g., People v. Coventry First LLC*, 52 A.D. 3d 345, 861 N.Y.S. 2d 9, CCH Blue Sky L. Rep. P 74,716, at 79,799 (1st Dept. 2008) (variable annuity policies already subject to regulation by the Department of Insurance are not securities under the New York Blue Sky Law--the Martin Act).

(n123)Footnote 123. States making no mention of insurance or annuities in their blue sky law definitions of security include: Arizona, Florida, Illinois, Nevada, New Mexico, New York, North Dakota, Ohio, and Rhode Island.

(n124)Footnote 124. *See Securities Act Rel. No. 4491, 1 Fed. Sec. L. Rep. (CCH) P 1043 (1962)*. Concluding that such plans or programs are themselves investment contracts, the SEC opined, among other things: "The several components should ... be considered realistically as a single investment medium in which the purchaser invests his money and depends upon the efforts of the promoters or other third persons to garner for him the benefits of the enterprise."

(n125)Footnote 125. Although the focus here is on *equity* indexed annuities, other indexed annuities offered and sold by insurance companies may be linked to some other index, a bond index for example, to determine the return to be credited during the accumulation period.

(n126)Footnote 126. *Holding v. Cook*, 521 F. Supp. 2d 832, 836 (C.D. Ill. 2007).

See also Associates in Adolescent Psychiatry, S.C. v. Home Life Ins. Co., 941 F. 2d 561, 565 (7th Cir. 1991), *cert. denied*, 502 U.S. 1099 (1992) (concluding that all annuity products "are securities, broadly understood, because they

entail entrusting money to the hands of others in pursuit of appreciation").

The debate over the status of EIAs as securities follows logically from the 1967 decision of the U.S. Supreme Court in *SEC v. United Ben. Life Ins. Co.*, 387 U.S. 202 (1967). In *United Benefit*, the Supreme Court considered whether a "flexible fund" annuity product was a security. With this annuity contract, the purchaser was credited during the accumulation period with an amount that depended upon the investment performance of a separate fund. At maturity, the contract was converted into a fixed annuity based upon the amount thus accumulated, and the annuity pay-out was that amount. The product also featured a guaranteed minimum amount that would be credited to the annuitant to fund the payments. On this basis, and the conversion feature, the company argued that sufficient investment risk related to return was assumed by the insurance company as to keep the annuity from being deemed a security. The Supreme Court disagreed. The Court acknowledged that the company had taken risk as to the minimum amount to be credited at maturity, the minimum was fixed so low that it did not significantly impact the investment risk being taken by the annuitant.

(n127)Footnote 127. *See* *Malone v. Addison Ins. Mktg., Inc.*, 225 F. Supp. 2d. 743, 753 (W.D. Ky. 2002). In *Malone*, the court disregarded risks such that the guaranteed return was contingent on a ten-year holding period.

(n128)Footnote 128. Securities Act Rel. No. 33-8933, 73 F.R. 127 (July 1, 2008).

(n129)Footnote 129. Securities Act Rel. No. 33-8933, 73 F.R. 127, at 37752.

(n130)Footnote 130. *Id.*

(n131)Footnote 131. 15 U.S.C. § 77c(a)(8) (2000). Section 3(a)(8) provides an exemption from federal registration requirements for:

Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia.

(n132)Footnote 132. Proposed Rule 151A(a)(1)-(2), Rel. No. 33-8933, *above*.

(n133)Footnote 133. Unif. Sec. Act § 401(l).

(n134)Footnote 134. 2002 Unif. Sec. Act § 102(28)(B).

(n135)Footnote 135. 2002 Unif. Sec. Act § 102(28)(B), Official Comment 27; *see also* § 2.08[2][e], *above*.

(n136)Footnote 136. *See, e.g.*, *Steller v. Pennsylvania Sec. Comm'n*, 877 A.2d 518 (Pa. Commw. Ct. 2005) (Life Settlements are viaticals based on recognized and accepted definitions, and despite the fact that they involve individuals whose life expectancies are greater than the two years for terminally ill persons upon which viatical settlements are often based).

(n137)Footnote 137. 87 F.3d 536, 318 U.S. App. D.C. 302 (D.C.Cir. 1996) , *reh'g denied*, 102 F.3d. 587, 322 U.S. App. D.C. 189 (D.C. Cir. 1996) .

(n138)Footnote 138. 408 F.3d 737 (11th Cir. 2005).

(n139)Footnote 139. 540 U.S. 389, 157 L. Ed. 2d 813, 124 S. Ct. 892 (2004).

(n140)Footnote 140. "Division Announces its Position on Viatical Settlements," *Ohio Sec. Bulletin* 98:3 (1998).

(n141)Footnote 141. *See, e.g.*, *Security Trust Corp. v. Estate of Fisher*, 797 N.E.2d 789 (Ind. Ct. App. 2003); *Accelerated Benefits Corp. v. Peaslee*, 818 N.E.2d 73 (Ind. Ct. App. 2004) (As further noted below, Indiana amended its Blue Sky Law specifically to include viatical settlements among the statutory list of "securities." At the time of activities out of which the decisions in *Security Trust Corp.* and *Accelerated Benefits* arose, the statute had not yet been changed.); *Kligfeld v. Office of Financial Regulation*, 876 So. 2d 36 (Fla. Dist. Ct. App. 2004); *Siporin v. Carrington*, 200 Ariz. 97, 93 P.3d 92 (Ct. App. 2001); *Michelson v. Voison*, 254 Mich. App. 691, 658 N.E.2d 188 (2003); *Joseph v. Viatica Mgmt. LLC*, 55 P.3d 264 (Colo. Ct. App. 2002); *Poyser v. Flora*, 780 N.E.2d 1191 (Ind. Ct. App. 2003).

(n142)Footnote 142. *N.D. Cent. Code § 10-04-02(15)*. Subject to certain exclusions, North Dakota defines "viatical settlement contract" as:

[a]n agreement for the purchase, sale, assignment, transfer, devise, or bequest of any portion of the death benefit or ownership of a life insurance policy or certificate, for consideration that is less than the expected death benefit of the life insurance policy or certificate.

(n143)Footnote 143. For a thorough examination of the extent of state securities regulatory attention to viatical settlements *see* Miriam R. Albert, *The Future of Death Futures: Why Viatical Settlements Must be Classified Securities*, 19 *Pace L. Rev.* 345 (Spring 1999).

(n144)Footnote 144. "Senior settlements" involve life insurance policies acquired from elderly persons. Functionally, they are no different from any other viatical or "life settlement" contract.

See, e.g., In re Robert Kurtis Mauss, SSB Dkt. No. 03-027, 2003 Tex. Sec. LEXIS 34 (Tx. Sec. Bd. 2003).



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Blue Sky Regulation

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CHAPTER 2 Definition of Security

1-2 Blue Sky Regulation § 2.09

§ 2.09 Risk Capital as Defining the Existence of a Security

[1] Risk Capital--Generally

Defining the existence of a security using strict investment contract analysis may result in too much emphasis being placed on specific *Howey* elements without adequate focus on the fundamental element of investment risk that is the basis for any determination. To assure a broader assessment based upon economic reality, the "risk capital" approach to defining a security, which developed in state courts, teaches that investment risk is risk to initial value as capital for an enterprise, rather than the risk of the future operation of that enterprise. While the reasonable understanding that some future "profit," a valuable benefit of some kind over and above the initial value will accrue is important, the main focus is on the extent to which the "initial value" paid in is immediately consumed as risk capital of an enterprise over which the contributor will have no control over managerial decisions.

The risk capital approach to defining a security is more often than not best understood in terms of venture capital. There is a broader notion, however. There is implicit here, the notion that if the fair market value is paid in exchange for something, and all other things being equal, no portion of "initial value" can be said to be risk capital. This is so in spite of whatever expectation the purchaser may have for realizing some future benefit from what he or she purchases. On the other hand, payment of initial value in excess of what is shown to be actual or fair market value, such that the excess value is deemed to be given in consideration for the right to receive the future benefit to be produced by an enterprise being financed by the excess initial value leads to a different conclusion. The Supreme Court of Hawaii, which first articulated the risk capital approach, has further explained the point.

In *Trivectra v. Ushijima*,ⁿ¹ the court applied risk capital analysis to uphold a determination by the Hawaii Commissioner of Securities that rights sold to individual to operate online "shopping malls" by hosting a customized Internet Web site containing links retailers were securities. Under the program, purchasers ("mall owners") paid \$79 for three months of service through the seller/promoter's program, which included maintenance, server hosting, and assistance with web design. Mall owners could make money either: (1) through commissions paid by online merchants whenever a purchase was made by a third party using a link from the mall owner's website; or (2) by recruiting other people to purchase online shopping malls. A prime focus in the case was whether the \$79 price paid by mall owners represented "initial value" for purposes of the risk capital analysis in finding a security.

As it had in its seminal *Hawaii Market Center* case,ⁿ² the Hawaii Supreme Court determined the existence and amount

of "initial value" paid in by an investor to participate in a program by focusing on the disparity between the amount paid for the product and the wholesale cost of the product. In *Trivectra*, the appellants argued that the \$79 paid to become a "mall owner" represented the fair market price for the online shopping mall site that it supplied. The Securities Commissioner, on the other hand, maintained that of the \$79 price, \$49 represented initial value invested by a purchaser based on undisputed evidence that the actual operating cost of the website was approximately \$30 per owner, and that the rest of the price paid was used to pay commissions to people selling additional online shopping malls. The Supreme Court agreed that at least \$49 of the price was given in consideration of the right to receive future income, and thus, was initial value. The court then concluded that even though the excess value being paid by individual mall owners was not traditional venture capital, the seller company was nevertheless engaged in raising capital that was necessary to the continuing business from which mall owners would derive income, not the least of which was the payment of commissions for selling malls to other people. The court explained:

"[U]nder *Trivectra's* program, the payment of initial capital was required for an individual to participate in the OSM commission program While, in order to earn commissions, it was necessary that a member make actual sales, by requiring the initial investment payment, *Trivectra* transformed garden variety sales representatives into equity holders in the enterprise. As such, members could only realize a return if *Trivectra* remained viable and sufficiently capitalized to honor its OSM commission commitments."³

Finding a security in spite of the fact that a purchaser had to be actively involved in making sales on which commissions would be paid perfectly, illustrates the key distinction between the risk capital approach to defining a security and the alternative investment contract analysis. The time and energy committed by mall owners in *Trivectra* produced value only to the extent that the promoter's business venture succeeded. Thus, a security is present when capital is paid into a business by investors, in order to derive income from the use of that capital in the business, is put at risk in the event the business venture fails.

The genesis of the risk capital approach to defining a security is in "membership" cases, where up-front fees or the cost of membership are in fact financing development of the project in which memberships are sold. The particular application of risk capital analysis in this context is discussed below.

[2] Memberships

"Memberships" that in reality only mask the commitment of risk capital to an enterprise are often deemed investment contracts. Often, however, what is labeled a "membership" does not immediately evidence the profit expectation most closely associated with the notion of a securities investment. Historically, without the expectation of pecuniary gain, the common view was that a "membership" transaction should not be subject to securities regulation.⁴ Whether a security was created by the payment of money toward membership in organizations depended heavily upon the monetary advantage offered to those joining, and investment contract analysis most often controlled. That continues to be true.⁵

A different challenge is presented to courts and blue sky administrators by memberships in country, social, or athletic clubs. These clubs offer the member no right to share in the profits of the enterprise, and limit membership rights to the use of club facilities. Memberships in campgrounds and recreational facilities present the same problem. Indeed, memberships that represent only the right to personal use and enjoyment of any facility hold out no economic "profit" potential, and do not normally produce concern for securities law protection.

On the other hand, a program that entitled "charter members" to receive 16 percent interest, share equally in a percentage of the profits of an enterprise, and have the option of acquiring stock in exchange for each \$1,500 paid to become a "charter member" of the enterprise, held out an inducement that was entirely economic. Thus, in *State v. Jones*,⁶ the Nebraska Supreme Court had no trouble concluding: "It is self evident from the membership sale agreement that each member's \$1,500 was an investment, and that there was a common enterprise involving at least 100

people." The court found that the written investment contract did not require the purchaser to do anything more than invest funds.

Although expectations and inducements associated with "membership" may not be plainly economic, concern for protection under blue sky laws may nevertheless arise when membership programs are in fact capital formation or financing vehicles. When money paid for a "membership" becomes risk capital is perhaps best illustrated by *Silver Hills Country Club v. Sobieski*,ⁿ⁷ in which the California Supreme Court held that the outright purchase of a country club membership is not in and of itself the purchase of a security, but if the promoters use purchase funds to finance the venture, the purchaser runs a high risk of losing his money. This, said the court, is enough to establish the existence of a security.ⁿ⁸ *Silver Hills* established two important concepts in finding a membership to be a security under blue sky laws:

- (1) the outright application of the independent "risk capital" test;ⁿ⁹ and;
- (2) elimination of the necessity of strict economic "profit" from the traditional definition construct.

While other courts have applied the risk capital approach to profit motivated investments, California has at least paved the way to its application where economic profit is not the motivation associated with a commitment of value in a transaction.ⁿ¹⁰ The more common approach to non-economic motivation is illustrated by the New York Court of Appeals examination of a program involving the sale of memberships allowing the use of outdoor resort campgrounds in *All Seasons Resorts, Inc. v. Abrams*.ⁿ¹¹ The court held that memberships in a system of outdoor resort campgrounds did not constitute securities. The court determined that a security was not present under *Howey* because there was no expectation of financial gain or profit, and while not specifically endorsing the risk capital test, went on to further conclude that members bought the right to use existing campgrounds and were not funding a developing business.

Under the terms of the offering in *Abrams*, each campground was or would be developed for recreational vehicles with electrical, water, and sewer services. In addition, at a typical campground, All Seasons provided a general store, recreational hall, a swimming area, and facilities and equipment for various athletic and recreational activities. Members paid an initial fee ranging from \$4,995 to \$6,095 depending on certain optional features, and a yearly dues of \$152, which could increase only up to the yearly increase in a specified consumer price index. Membership conferred only a license for nonexclusive use of any facilities that might be made available by All Seasons through purchase, lease, operation, or otherwise. The location and nature of these facilities were subject to change by All Seasons, but it undertook to use best efforts to maintain or improve the existing quality of the properties and resorts. All Seasons was not obliged to increase the number of resorts and could dispose of resorts at any time, but in that event would provide alternate facilities. Finding no investment contract in these circumstances, the New York court also opined that the interests were not participation interests or investments in real estate or a cooperative interest in real estate, which are specifically included under the New York definition of securities.

One who acquires only a privilege through a membership does not purchase an investment contract, even if the privilege is such as to permit the purchaser to engage in a revenue producing activity. Stock exchange memberships, for example, entitle holders to engage in certain trading activities on the exchange, and revenues realized by the exchange reduce the dues and assessments of members. However, applying investment contract analysis "profit" to members of an exchange is a result of their own profit-making activity. Exchange membership supplies the platform, or privilege, but the essential efforts for success are those of the member.ⁿ¹²

To be sure, membership cases do illustrate that the expectation of future "profit" can be defined in terms of an expectation of some valuable benefit, and that a security may be present if there is actual risk to initial value being given up pursuant to that expectation. The risk, however, is that associated with capital formation and financing, where the payment of initial value is not for the privilege to use or consume, but rather to finance the development of the subject facility or enterprise. The critical inquiry in these is whether true risk capital is involved, and whether the "membership"

is in fact a financing device. In some cases, this leads to a distinction between initial and subsequent members.ⁿ¹³ But applying the more flexible "risk capital" approach to defining a security, such a distinction may be quite logical.ⁿ¹⁴

Traditional venture capital risk, of course, continues to be important in other settings. "Membership" cases like *Silver Hills Country Club v. Sobieski*,ⁿ¹⁵ illustrate that where one contributes the risk capital that is used to create an enterprise, it is the initial risk that is meaningful. Indeed, it is only because of that risk that there is any chance for an enterprise capable of producing any future benefit.ⁿ¹⁶ A risk capital orientation in defining unconventional forms of securities like investment contracts for purposes of state blue sky laws is not inconsistent with the traditional tripartite *Howey* federal model. In practice, and as the risk capital approach continues to be refined in case law and now expressly included in some blue sky law definitions,ⁿ¹⁷ there are likely to be relatively few instances in which an investment contract or other unconventional form of security would be found by applying one approach but not the other, although *Trivectra*, discussed above, presents an excellent example of circumstances in which it can happen. A risk capital approach is more fluid and flexible, but in practice, it still focuses on an assessment of managerial control over an enterprise, the separation of ownership from value determinants that is a fundamental element of any security under any approach.

The Tennessee Supreme Court decision in *King v. Pope* ⁿ¹⁸ provides an excellent illustration of the application of risk capital analysis in circumstances that have for the most part been evaluated using traditional *Howey* investment contract criteria. *King* involved the offer and sale of a pay telephone program for a company that provided discount pay telephone long distance service. The offering was a sale and leaseback program in which participants bought at least three pay telephones at a fixed price, but did not take possession and did not choose locations for their phones. There was no pooling in the traditional "common enterprise" sense, and a lower court determination that no security was present based on this finding was challenged in the state supreme court. The Tennessee Supreme Court reversed, holding that risk capital analysis should have been applied, and finding that its elements were all established.

Initial value was furnished by purchasers by paying for the telephones in circumstances demonstrating clearly that the selling company was raising money for its own capital expenditures and expansion. The company was not in the business of selling pay telephones, but rather was in the business of providing discount long distance service. The initial value given up by purchasers, said the court, was then made subject to the risks of the enterprise, the success of which depended upon the profitability of the entire enterprise. The participants were plainly induced to expect a benefit in excess of the initial value, in this case an exceptional 18 percent return for five years. Finally, the purchasers had no right to exercise practical or actual control over managerial decisions of the enterprise.

King adopts the risk capital test generally for application to defining a security in Tennessee. In this particular application the court well illustrated its greater flexibility. In applying conventional *Howey* criteria to find no security the lower court demonstrated at least the danger that investor protection might be thwarted by a too rigid analysis. The Supreme Court emphasized: "This Court also believes that the danger in adopting the stricter *Howey-Forman* test for 'investment contract' is that it allows unscrupulous promoters to circumvent the law."ⁿ¹⁹

Applying a risk capital "test" or approach to defining a security does not violate any principle enunciated in *Howey*. State courts and regulators often assess situations under both approaches.ⁿ²⁰ However, in some cases it assures that the historic mission of state blue sky regulation to protect the public against fraudulent "investment" schemes will be carried out by permitting flexibility in localized, solicitation settings and ostensible capital formation or franchise schemes that are commonly confronted by state regulators.ⁿ²¹ There is no common approach to application of risk capital analysis among the states,ⁿ²² and none should be expected. Each situation must be evaluated independently. Where risk capital is the dominant feature, state courts and regulators at least have the option to concentrate the focus on risk capital rather than on the *Howey* mandated role of "others" in producing expected profits in the operation of an enterprise. And as the statutory approach discussed above that has been taken in North Dakota illustrates, regulators will take the broadest view of value committed to the risk of a venture and the benefit expectations associated with it.

FOOTNOTES:

(n1)Footnote 1. *Trivectra v. Ushijima*, 112 Haw. 90, 144 P.3d 1 (2006).

(n2)Footnote 2. *State by Commissioner of Sec. v. Hawaii Mkt. Ctr.*, 52 Haw. 642, 485 P.2d 105 (1971).

(n3)Footnote 3. *Trivectra v. Ushijima*, 112 Haw. 90, 100, 144 P.3d 1, 11 (2006).

(n4)Footnote 4. *But see In re Walling Heirs Association*, [1991-1993 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,530 (Okla. Admin. 1990). In *Walling Heirs*, memberships in an "association" created to facilitate the identification of assets and claims that might be owed to "members" from an estate also evidenced plain economic motivation, and were deemed to be investment contracts. The association was in the nature of a syndicate, and the individuals who became members expected to profit from sharing in assets, without exercising any control over the activities, including any lawsuits that would be necessary (and funded by memberships). The expectation associated with "memberships" such as these is plainly economic, and the inducement is quite different from that associated with clubs or recreational facilities.

(n5)Footnote 5. *See, e.g., Caldwell v. State*, 95 S.W.3d 563 (Tex. App. 2002) (defendant recruited people to join an "investment club" by paying an annual fee, joining a team, and giving the team money for investment, with an expectation of profits from 100 to 300 percent); *In re Daily Portfolios.com* and Matthew Taylor, No. 2001-11-021 (Pa. Sec. Comm., Nov. 29, 2001) ("Members" were offered an investment opportunity involving FOREX trading by the Respondents' traders).

See also *Scholarship Counselors, Inc. v. Waddle*, 507 S.W.2d 138 (Ky. Ct. App. 1974), in which memberships were sold in a scholarship trust fund. After the entrance fee required of a participant was paid, he was to place a stated amount of money into a savings account and irrevocably assign the interest on the account to the trust fund. Administration of the trust was handled by a group of trustees without any control of the member. The member also named a beneficiary who would receive the benefit of the fund in the future or, more specifically, upon entrance of the beneficiary into his or her sophomore year in college. When the beneficiary became eligible, certain college expenses were to be paid out of the fund. However, success of the plan was dependent on the fact that not all named beneficiaries would be eligible for the fund. Taken into account were school dropout and death factors which would eliminate a number of beneficiaries from eligibility. The argument was that the "solely from the efforts of others" portion of the *Howey* test should be strictly applied in order to find participation by the investor in that the investor was required to make the deposit and not withdraw it, and remain qualified to receive the scholarship. The court refused to sustain the argument and instead applied the more liberal interpretation of the *Howey* rule, implying that the member's control of the funds was not substantial. The court also found that efforts of the member or the beneficiary did nothing to produce the profit necessary to the scholarship fund.

(n6)Footnote 6. *State v. Jones*, 235 Neb. 1, 453 N.W.2d 447 (1990).

(n7)Footnote 7. *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 13 Cal. Rptr. 186, 361 P.2d 906 (1961).

(n8)Footnote 8. *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 13 Cal. Rptr. 186, 361 P.2d 906, 908-909.

(n9)Footnote 9. *See* § 2.08[3], *below* for discussion of the risk capital approach to defining a security.

(n10)Footnote 10. Interestingly, California also explicitly includes memberships within the statutory definition of security. *See* Cal. Corp. Code § 25019: "'Security' means any ... membership in an incorporated or unincorporated association."

The California Commissioner of Corporations, in Release No. 15 C (1970), has stated with respect to this section:

The term "membership" as used in Section 25019 refers to memberships, such as those issued by nonprofit organizations, which confer a proprietary right on the holder. A proprietary right may be

defined as a right to the ownership of the assets or earnings of an organization or the right to control of such organization. A right to control is normally evidenced by voting rights, whether conferred by the charter documents or under the provisions of the Corporations Code.

A membership sold by a profit making organization which is a license to use the facilities constitutes a security if the proceeds from the sale of such membership are used to provide facilities necessary to the full utilization of the membership, that is, where the purchaser provides the risk capital for the enterprise, such as for the construction of a golf course and related facilities.

Not every right, privilege, benefit or license sold by a profit making organization and which is labeled a "membership" is a membership within the meaning of Section 25019. A membership which confers upon the holder nothing more than the right to enjoy the facilities which are provided, such as key club privileges, the use of a swimming pool, or the use of golf facilities, is not a membership within the meaning of Section 25019 and, in the absence of the "risk" element, is not a security. If the sale of a right to use facilities includes a right to a return of money paid or a right to share in the income or profits, it constitutes the sale of a security, in the nature of an evidence of indebtedness or of an investment contract.

Wisconsin uses a definition similarly worded to the California statute in its blue sky regulations. *See* Wis. Adm. Code § 1.05(5).

(n11)Footnote 11. *All Seasons Resorts, Inc. v. Abrams*, 68 N.Y.2d 81, 506 N.Y.S.2d 10, 497 N.E.2d 33 (1986).

(n12)Footnote 12. *American Stock Exchange, Inc.*, SEC No Action Letter [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) [par] 77,472 (July 10, 1998).

(n13)Footnote 13. *See Jet Set Travel Club v. Corporation Comm'r*, 21 Or. App. 362, 535 P.2d 109 (1975), in which memberships in an airline travel club were held not to be securities. The court opined that "risk capital" must be "initial capital." The club, in this case, had existed for a year before any memberships were sold in Oregon. Initial capital had been raised through membership sales in the state of Washington and such members had already realized club benefits. The court observed:

We have searched the record and conclude that the initial capital used by Jet Set to initiate its operations was not provided by memberships sold in Oregon. Jet Set had been flying scheduled flights for a full year before any memberships were sold in Oregon. The money provided by the sale of the "select memberships" in Washington, plus the money from the promotional agreement with the Seattle area spas, provided at least a part of the initial operating capital. "Select memberships" were not sold in Oregon. Jet Set was a fully operating organization by the time the first memberships were sold in Oregon.

The case at bar is different from *Silver Hills* in that the memberships are nothing more than a sale of a right to use existing facilities. The requirements of the "risk capital" test are not fulfilled because the benefits of the membership have materialized and have been realized by other members prior to any capital raised by the sale of Oregon memberships.

(n14)Footnote 14. *See also* Opinion of the Georgia Attorney General, No. 73-25, 3 Blue Sky L. Rep. (CCH) P 71,213 (1973), which held that recreational memberships similar to those in *Silver Hills* were securities. However, in *Dunwoody Country Club of Atlanta, Inc. v. Fortson*, [1978-1981 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,493 (Ga. 1979), the Georgia Supreme Court said it was looking to the "underlying economic reality" to find that redeemable membership certificates in a nonprofit country club were not securities. The purchasers acquired no expectation of profit

from the memberships, only social or recreational opportunities. Interestingly, the court said it would reach the same result under the combined form of "risk capital" and managerial efforts test that the legislature added to the statute.

(n15)Footnote 15. *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 13 Cal. Rptr. 186, 361 P.2d 906 (1961).

(n16)Footnote 16. The notion of venture capital is prominent here. In *Cunha v. Ward Foods, Inc.*, 545 F. Supp. 94 (D. Haw. 1982), the court rejected a claim that an employee's interest in a company's non-contributory, compulsory pension plan was a security. The court applied risk capital analysis to conclude that there was no risk of loss associated with an investment of "venture capital to be used in a business enterprise," and that no one had solicited funds from participants for the purpose of raising venture capital.

(n17)Footnote 17. North Dakota has uniquely incorporated the risk capital concept directly into its definition. In addition to the common list of instruments and categories, North Dakota also includes the:

"[i]nvestment of money or money's worth including goods furnished or services performed in the risk capital of a venture with the expectation of profit or some other form of benefit to the investor where the investor has no direct control over the investment or policy decisions of the venture... ." N.D. Cent. Code § 10-04-01(15).

Washington similarly, although not quite so broadly, defines security specifically to include the "investment of money or other consideration in the risk capital of a venture with the expectation of some valuable benefit to the investor where the investor does not receive the right exercise practical and actual control over the managerial decisions of the venture." Rev. Code Wash. § 21.20.005(12).

See also Michigan: Mich. Comp. Laws § 451.801 (2002) (Security defined by using the language of Hawaii Market Center).

(n18)Footnote 18. *King v. Pope*, 91 S.W.3d 314 (Tenn. 2002).

(n19)Footnote 19. *King v. Pope*, 91 S.W.3d 314, 324 (Tenn. 2002).

(n20)Footnote 20. See, e.g., *Artistic Door Corp. v. Rheney*, 384 So. 2d 179 (Fla. Dist. Ct. App. 1980) (solicitation of "subcontractor agreements" were found to involve investments of money under *Howey* criteria, and also represented risk capital to be used to initiate the seller corporation's business).

Some jurisdictions prefer only a "liberalized" *Howey* approach. See, e.g., *Murphy v. Dare to Be Great, Inc.*, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,053 (D.C. Sup. Ct. 1972).

(n21)Footnote 21. See *State ex rel. Healy v. Consumer Business System, Inc.*, 5 Or. App. 19, 482 P.2d 549 (1971); *Fulsas v. Janitorial Enterprise, Inc.*, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,345 (Ga. Ct. App. 1977); *Bergquist v. International Realty, Ltd.*, 272 Or. 416, 537 P.2d 553 (1975) .

(n22)Footnote 22. States differ, for example, on whether use of risk capital analysis should be limited to initial capital formation settings. California and Oregon have such limitations. This has been criticized, however, as ignoring situations in which an unseasoned enterprise sets out to raise additional capital, and which presents a risk little different from that of initial capital formation. See *State ex rel. Park v. Glenn Turner Enterprises, Inc.*, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,023 (Idaho Dist. 1972). Other states that have included risk capital expressly within the statutory definition of security--Alaska, Georgia, Michigan, North Dakota, Oklahoma and Washington--make no limitation, and the most recent analysis by the Hawaii Supreme Court in *Trivectra*, discussed above, makes clear that there should be none.



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Blue Sky Regulation

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CHAPTER 2 Definition of Security

1-2 Blue Sky Regulation § 2.10

§ 2.10 Other Categories of Securities

[1] Certificate of Interest or Participation in Any Profit Sharing Agreement

Among the unconventional, catch all categories of securities in blue sky law definitions, "certificate of interest or participation in any profit sharing agreement," though often referenced in tandem with "investment contract,"ⁿ¹ is an independent category of security included in most blue sky law definitions. Apart from the criterion that a "certificate" be involved, there are no prescribed attributes of this form of security. Its usefulness is illustrated in situations involving such things as "certificates of beneficial interest" offered as "gifts" in a promotional offering for ski resorts,ⁿ² or certificates of participation in a church trust fund.ⁿ³ The availability of such a category is primarily important as a vehicle of maximum flexibility for blue sky regulators to respond to the ingenuity of promoters and the variety of "investment" schemes that may be deemed to be securities via its application.

[2] Any Interest or Instrument Commonly Known as a Security

The broad undefined category of any interest or instrument commonly known as a security is included in the Uniform Act, the vast majority of blue sky law definitions, and the federal definitions. Guidance in its application is available mostly at the federal level, through cases such as *United Housing Foundation, Inc. v. Forman*,ⁿ⁴ in which the U.S. Supreme Court held that shares of "stock" in a state sponsored housing cooperative project were not securities, and *Landreth v. Landreth Timber Co.*,ⁿ⁵ in which corporate stock possessing traditional attributes was deemed to be a security on its face. In *Landreth* the Court suggested that an interest commonly known as a security should be defined in terms of "investment contract" criteria if the instrument or interest being examined did not hold true to a label attached. Explicating its earlier analysis in *Forman*, the *Landreth* Court stated:

We stated, as part of our analysis of whether the instruments were "investment contracts," that we perceived "no distinction for present purposes between an 'investment contract' and an instrument commonly known as a 'security'" This was not to say that the *Howey* test applied to any case in which an instrument was alleged to be a security, but only that once the label "stock" did not hold true, we perceived no reason to analyze the case differently whether we viewed the instruments as "investment contracts" or as falling within another general category of the definition--an "investment commonly known as a 'security.'" Under either of these general categories, the *Howey* test would apply.ⁿ⁶

In determining what may be "commonly" known as a security, federal and state courts are often urged to look to each

others' decisions for precedent. For example, in *SEC v. Koscot Interplanetary Inc.*,ⁿ⁷ the SEC argued that several states had accepted the risk capital approach to defining a security and, thus, that: "[a] security is 'commonly known' to exist whenever an investor subjects his money to the risk of an enterprise over which he exercises no management control...".ⁿ⁸ The court was not satisfied that the existence of some degree of state precedent was sufficient to establish what is commonly known to be a security for purposes of federal law, but the approach to the question is illustrative of the search for a common perception or standard. Thus, in another setting, Texas authorities accepted federal precedent as a standard for what is commonly known as a security for purposes of that state's blue sky law.ⁿ⁹

Other states have functionally construed the category in terms, for example, of any form of instrument used for financing or promoting enterprises, or which is designed for investment.ⁿ¹⁰ Holding that an investment in a trust qualifies as an interest commonly known as a security, a Connecticut court looked to the *Black's Law Dictionary* definition of security to anchor its determination.ⁿ¹¹ In the end, one may safely conclude that any "common" perception of a security will be a function of developed criteria of general application, which, in turn, means investment contract analysis or, where available, risk capital assessment.

[3] Foreign Currency

Several states specifically address foreign currency within the definition of security. In Ohio, for example, "the currency of any government other than those of the United States and Canada" is explicitly defined itself to be a security.ⁿ¹² More commonly, blue sky definitions include exchange-traded options or rights associated with foreign currency. California, Illinois, Maine, New Mexico, Rhode Island, Vermont and Washington all specifically include a "put, call, straddle or option entered into on a national securities exchange relating to foreign currency" within their definitions.ⁿ¹³ North Dakota includes "foreign currency commodity contract."ⁿ¹⁴

Any "investment" program involving foreign currency or currency options is likely to face scrutiny under Blue Sky laws, whether or not expressly covered in the definition of security. In *Prudential Bache Securities, Inc. v. Cullather*,ⁿ¹⁵ for example, commodity options were held to be within the "broad and open ended" provisions of the Virginia blue sky law despite the fact that they were not explicitly mentioned in the statute. The court was satisfied that because federal acts include commodity and currency options within their definitions, they should fall within the state definition as well. In any event, investment contract analysis may be applied to bring foreign currencies or programs involving them within the ambit of blue sky laws.ⁿ¹⁶

The scope of state securities regulatory authority where foreign currency is involved may be ultimately limited by the so-called "Treasury Amendment" to the federal Commodity Exchange Act,ⁿ¹⁷ which excepted foreign currency from federal regulation under the Act, and which has been interpreted by the U.S. Supreme Court as impacting federal authority to regulate non-exchange traded foreign currency options as well.ⁿ¹⁸ Although there is no clear intent to preempt any state securities regulatory authority where foreign currency or non-exchange traded currency options are involved, the combined effect of the Treasury Amendment and federal case law may be such as to exclude state authority in an area in which "boiler room" practices and the potential for fraud would otherwise invite active attention under blue sky laws.ⁿ¹⁹

[4] Miscellaneous Securities

Individual state Blue Sky definitions vary in their inclusion of other interests or instrument categories in addition to the common categories heretofore considered. Some of these include commodity futures or other commodity related investments, particular forms of real estate interests, "beneficial" interests of various forms,ⁿ²⁰ "investment certificates," and whiskey warehouse receipts. Where included, or where other interests or instruments fairly fit within their scope, these kinds of special provisions are broadly interpreted.

The inclusion of any particular miscellaneous interest or instrument within the definition of security reflects only that

the thing involved is susceptible to use or promotion as an "investment" vehicle. Whiskey warehouse receipts, for example, have been held to be investment contracts,ⁿ²¹ regardless of whether they are expressly included as a separate category in a definition. Thus, the fact that a handful of states expressly include themⁿ²² is inconsequential.ⁿ²³ Any such instrument promoted as an investment and representing a financing device for the seller/promoter will not escape blue sky law coverage under one of the catch all categories. The controlling consideration is not the particular features or characteristics of a whiskey warehouse receipt, but rather the manner in which it is promoted and what it represents in the hands of the purchaser.

FOOTNOTES:

(n1)Footnote 1. Indeed, as a matter of federal law, the U.S. Supreme Court has suggested that the test for determining an investment contract and other catch all categories is essentially the same. See *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 105 S. Ct. 2297, 85 L. Ed. 2d 692 (1985) .

(n2)Footnote 2. *In re Strack Securities Service Corp.*, [1990-1991 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,350 (Pa. Admin. 1991).

(n3)Footnote 3. *In re Missions and Church Extension Trust Fund*, [1991-1993 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,630 (Mich. Admin. 1992).

(n4)Footnote 4. 421 U.S. 837, 95 S. Ct. 2051, 44 L. Ed. 2d 621 (1975) .

(n5)Footnote 5. 471 U.S. 681, 105 S. Ct. 2297, 85 L. Ed. 2d 692 (1985).

(n6)Footnote 6. *Id.* at 692, 105 S. Ct. at 2304, 85 L. Ed. 2d at 701 .

(n7)Footnote 7. 365 F. Supp. 588 (N.D. Ga. 1973) , rev'd, 497 F.2d 473 (5th Cir. 1974) .

(n8)Footnote 8. 365 F. Supp. at 591 .

(n9)Footnote 9. See Texas Attorney General Opinion No. H-116, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,100 (1973).

(n10)Footnote 10. See *Holloway v. Thompson*, 112 Ind. App. 229, 42 N.E.2d 421 (1942).

Other attempts to establish some standard or "common" criteria have been undertaken in Pennsylvania. See Attorney General Opinion No. 49, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,094 (1973); see also *In re Secured Commodities, Inc.*, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,125 (1974).

Other states making findings or conclusions on the point include Wisconsin, see *First Nat'l Sav. Foundation v. Samp*, 274 Wis. 118, 80 N.W.2d 249 (1956)>; Maryland, see *Shapiro v. First Federated Commodity Trust Corp., Inc.*, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,071 (Md. Cir. 1973), *aff'd*, 272 Md. 329, 322 A.2d 539 (Md. Ct. Spec. App. 1974); Oklahoma, see *In re Goldstein, Samuelson, Inc.*, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,095 (Okla. Sec. Dept. 1973).

(n11)Footnote 11. *Champaign v. Scarso*, 25 Conn. L. Repr. 368 (Conn. Super. 1999). *Black's Law Dictionary* (5th ed. 1979) defines "security" as:

[W]hether the scheme involves an investment of money in the common enterprise with profits to come solely from the efforts of others so that whenever an investor relinquishes control of his funds and submits their control to another for the purpose and hopeful expectation of deriving profits therefrom he is in fact investing his funds in a security.

(n12)Footnote 12. *Ohio Rev. Code § 1707.01(B)*.

(n13)Footnote 13. *See e.g., Gen. Laws. R.I. § 7-11-101(20)*.

(n14)Footnote 14. *N.D. Cent. Code § 10-04-01 (15)*.

(n15)Footnote 15. *678 F. Supp. 601 (E.D. Va. 1987)* (Virginia and federal law).

(n16)Footnote 16. *See Integrated Research Servs. v. Ill. Secy. of State*, 328 Ill. App. 3d 67, 765 N.E.2d 130, 262 Ill. Dec. 304 (2002).

(n17)Footnote 17. *7 U.S.C. § 2(ii)*.

(n18)Footnote 18. *Dunn v. CFTC*, 519 U.S. 465, 117 S. Ct. 913, 137 L. Ed. 2d 93 (1997).

(n19)Footnote 19. *But see Eastern Vanguard Forex, Ltd. v. Ariz. Corp. Comm'n*, 206 Ariz. 399, 79 P.3d 86 (Ct. App. 2003) (Treasury Amendment did not preempt state authority to regulate off-exchange transactions in foreign currency when they are offered and sold as securities in the form of commodity investment contracts).

(n20)Footnote 20. *See, e.g., 70 Pa. Stat. § 1-102(t)* ("security means any ... share of beneficial interest in a business trust").

(n21)Footnote 21. *See, e.g., Iowa Attorney General's Opinion*, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,153 (1973) (*Howey* investment contract analysis applied); *Maryland Securities Act Rel. No. 17*, 2 Blue Sky L. Rep. (CCH) P 23,624 (1974).

(n22)Footnote 22. Blue sky law definitions in Florida, North Carolina and Ohio expressly include warehouse receipts for intoxicating liquor as securities, although (as in Ohio) there is typically an exclusion for sales of warehouse receipts to distillers, rectifiers or to any person engaged in the business of dealing in warehouse receipts.

(n23)Footnote 23. *See Commentary, Uniform Act § 401(1)* ("some legislatures have outdone themselves in the addition of altogether unnecessary phrases").



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CHAPTER 3 "Offers" or "Sales" of Securities

1-3 Blue Sky Regulation 3.syn

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CHAPTER 3 "Offers" or "Sales" of Securities

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§ 3.01 Introduction

Given the existence of a security, what constitutes an "offer" or "sale" of that security is of paramount importance, as these are the events that trigger concerns for investor protection and the operation of Blue Sky laws. There must be an "offer" or "sale" of a security for a transaction to come within the scope of Blue Sky laws.

An "offer" of a security, standing alone, has consequences under Blue Sky laws without regard to whether there is in fact a subsequent "sale." Liability under Blue Sky laws attaches to an offer of a security in violation of the law as well as to a completed sale in violation of the law.ⁿ¹ Fraud in connection with the "offer" of a security will subject the party committing the fraud to the same potential enforcement consequences as fraud in connection with the completed sale of a security.ⁿ² However, civil liability will not normally result from an offer only, because there is no transaction upon which the typical rescission or damages civil remedy in Blue Sky laws may be based. Nevertheless, civil liability may in fact result from:

- (1) a fraudulent statement made in an offer and a purchase of the securities at a later date by the party to whom the statement was made;
- (2) an illegal offer of unregistered securities and a subsequent registration prior to sale;ⁿ³ and
- (3) an illegal offer in one state followed by a legal sale in another state.

For the most part, the focus in Blue Sky regulation is on the meaning of "sale," which broadly encompasses the elements of an "offer" as well. To engage in the "sale" of a security is to undertake any attempt to dispose of the security *for value*. To offer a security for sale is to confront another with an investment decision. Blue Sky laws protect persons making investment decisions through qualitative or merit review processes where applicable today, or by assuring adequate and accurate information upon which to base a decision otherwise, coupled with administrative and enforcement powers and civil remedies. The essence of a "sale," and the setting in which this protection operates, is an *attempt to dispose* for value.ⁿ⁴ In this analysis, definitions or interpretations of the terms employed in the common law for contracts or other purposes are irrelevant.ⁿ⁵

The principal characteristic of a sale is the presence of "value" -- something given up either for or in connection with the

receipt of a security. The presence of value is not determined by consideration in the traditional contract sense, but rather in a manner consistent with the intended protections of Blue Sky laws. First and foremost is the presence of an investment decision brought about by any set of circumstances in which a purchaser meaningfully alters an economic position or interest in reliance upon the value of the security received. This may occur with the payment of money, but it may as easily occur with an exchange of securities. It may occur with "bonus" distributions of stock, or indeed, even with the "free" distribution of stock, warrants or rights. The essential element of "value" involved in a sale may be that obtained by the "seller," whether or not it is represented by anything tangible actually given up by the buyer. This is particularly well illustrated in "free" stock and other "bonus" promotions involving the distribution of shares.

As seen below, statutory definitions of "sale" illuminate two constituent considerations: (1) the process leading up to or bringing about an investment decision; and (2) an actual disposition of the security *for value*. In the analysis of each, it is essential to recognize that the terms "sell" and "sale" are used in a broad sense. In discussing corollary considerations under the federal securities laws, the U.S. Supreme Court observed in *United States v. Naftalin*:ⁿ⁶ "The statutory terms ["offer" and "sell"], which Congress expressly intended to define broadly, are expansive enough to encompass the entire selling process ..." Thus, courts will look to any attempt to dispose a security, and to find "value," in ways that will best effectuate investor protection by requiring Securities Act compliance and by allowing operation of liberalized antifraud protections.ⁿ⁷ But it will also be seen that for purposes of Blue Sky laws, "value" may be related to induced expectations of the putative purchaser or to value on the other side of the transaction, that is, value that comes as consequence of or is generated for the benefit of one inducing a decision. "Value" is a two-sided concept. The disposition or attempted disposition of a security may be for value that is substantially, if not entirely, meaningful only to the seller, as, for example, in the creation of a trading market for shares distributed to the public through a stock dividend to holders of shares of a shell corporation where the intent is to avoid compliance with provisions of the Securities Act.

Against this backdrop the meaning of offer and sale under Blue Sky laws in a variety of contexts may be considered further. In all of it the constant key to application, as with the critical definition of "security" in Blue Sky laws, is identification of those circumstances in which the need for Blue Sky protection is manifest. The starting point in all cases is the statutory definition, the discussion of which follows below.

[1] Statutory Definitions The Uniform Act section 401(j)(1) provides: " 'Sale' or 'sell' includes every contract of sale of, contract to sell, or disposition of, a security or interest in a security for value." "Offer" or "offer to sell" are defined in the Uniform Act to include: "every attempt to offer to dispose of, or solicitation of an offer to buy, a security or interest in a security for value."ⁿ⁸ The basic Uniform Act definition of "sale" or an analog is in place in all states.ⁿ⁹ Variations among states involve the extent to which the specific inclusions and exclusions made a part of Uniform Act section 401(j) are incorporated, although most have adopted the specific inclusions in section 401(j), such that:

- (A) Any security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing is considered to constitute part of the subject of the purchase and to have been offered and sold for value;
- (B) A purported gift of assessable stock is considered to involve an offer and sale; and
- (C) Every sale or offer of a warrant or right to purchase or subscribe to another security of the same or another issuer, as well as every sale or offer of a security which gives the holder a present or future right or privilege to convert into another security of the same or another issuer, is considered to include an offer of the other security.ⁿ¹⁰

Specific *exclusions* from the definition contained in the Uniform Act are not so commonly adopted as such. However, if not adopted as definition exclusions, states include them among transaction exemptions, and thus, one way or another, offer to sell and sale do not include:

(A) any bona fide pledge or loan; (B) any stock dividend, whether the corporation distributing the dividend is the issuer of the stock or not, if nothing of value is given by stockholders for the dividend other than the surrender of a right to a cash or property dividend when each stockholder may elect to take the dividend in cash or property or in stock; (C) any act incident to a class vote by stockholders, pursuant to the certificate of incorporation or the applicable corporation statute, on a merger, consolidation, reclassification of securities, or sale of corporate assets in consideration of the issuance of securities of another corporation; or (D) any act incident to a judicially approved reorganization in which a security is issued in exchange for one or more outstanding securities, claims, or property interests, or partly in such exchange and partly for cash.ⁿ¹¹

As a matter of statutory construction, some states have broadened their definition of "sale" to include offers or offers to sell.ⁿ¹² As seen above, this is not the approach of the Uniform Act, which separately defines "offer" or "offer to sell."ⁿ¹³ The differing approaches have no practical significance.

The statutory definitions do not encompass attempts to purchase securities. The "solicitation of an offer to buy," is covered, but not an unsolicited offer otherwise.ⁿ¹⁴ Thus, if a person in the market to buy securities makes an offer to buy, it is not an "offer" within the statutory definition unless the offer has been solicited by the seller. This principle is also applicable in states not adopting the Uniform Act definition, although as noted earlier, antifraud remedies may expressly extend to defrauded purchasers. These express remedies key on the presence in the statute of a general antifraud provision addressing fraud or deception in connection with the offer, sale or purchase of securities. An offer to purchase, however, is generally not a defined term in these states.ⁿ¹⁵ That the offer is made by the purchaser does not, however, exclude the transaction from being a sale once the sale is consummated or a contract to sell is executed.ⁿ¹⁶

The statutory intent is to expand the definition of "offer" and "sale" beyond their common law limitations;ⁿ¹⁷ how far beyond is the question. California courts have held that mere talk by promoters to possible investors as to the possibility of organizing a corporation does not amount to solicitation or preliminary negotiations contemplated by the California statute.ⁿ¹⁸ A distinction has also been drawn in that state between an offer to sell a corporate interest and participation of entrepreneurs who stand on equal footing;ⁿ¹⁹ and, in a criminal prosecution for securities act violations, the court refused to hold that a contract to form a corporation in the future constituted an offer or sale under California law where the buyers involved were to manage stores owned by the corporation.ⁿ²⁰ However, that the securities are not in existence at the time the offer is made is not enough to remove the offer from the scope of the California Blue Sky law.ⁿ²¹

California also has a unique provision in its "sale" definition. Under California law, a change in the rights, preferences, privileges, or restrictions of or on outstanding securities constitutes a sale.ⁿ²² Accordingly, a change in stock voting rights from cumulative voting to straight voting has been held to be a sale of securities.ⁿ²³ The same result was reached when a corporation attempted to change its nonassessable outstanding stock into assessable shares.ⁿ²⁴

As a general rule, a change in the form of an enterprise will not result in a sale under the Blue Sky laws. For example, when a partnership incorporates, the transfer of partnership assets for corporate stock has been held not to be a sale under the Blue Sky laws.ⁿ²⁵ Similarly, a syndicate that transferred its realty in exchange for stock in a corporation formed to succeed the syndicate was not a sale of securities.ⁿ²⁶

In the latter case, it was held that the transfer did not involve consideration and was therefore not a sale.ⁿ²⁷ What type of consideration will bring a transaction within the definition of a sale of securities has been addressed generally in the Blue Sky statutes. Every state defining "offer" or "sale" requires that the sale or offer be in exchange for some value.ⁿ²⁸ In the early days of Blue Sky regulation, it was contended in one state that an exchange or trade of securities constituted a barter and was not a sale encompassed by the statute.ⁿ²⁹ The view was rejectedⁿ³⁰ and the decision that security trades were sales was followed in other states.ⁿ³¹ Today, a number of states specifically include exchanges of securities as sales in the statutes,ⁿ³² although it is unlikely that the omission of such phrasing (as in the Uniform Securities Act)

would remove barter from the scope of Blue Sky laws.ⁿ³³

[2] "Value" Determinations--Generally Clearly, under the statutory definitions a transfer of a security, or interest in a security, must be "for value." For that reason outright *gifts* of securities are not sales within the meaning of the definition and are therefore excluded from the scope of Blue Sky laws.ⁿ³⁴ On the other hand, an ostensible "gift" of securities can plainly be seen as a sale for value when other considerations are involved. For example, the "gift" is effected with payment of "administrative fees" or "transfer fees" that exceed the actual cost of the transfer, and actually represent payment for the securities, or that are part of an inducement program for the purchase of further shares.ⁿ³⁵ Similarly, "promotional" gifts of stock, in exchange for visiting a resort development, have been deemed to be sales.ⁿ³⁶ Additionally, the distribution of gift shares by a privately held shell corporation without remuneration has been held to be the sale of those shares where economic benefits were obtained *by the seller*, even though the benefits flowed indirectly from the marketplace rather than directly from the recipients of the stock. In *Capital Gen. Corp. v. Utah* ⁿ³⁷ the court rejected an assertion that a "good faith gift" was involved in these circumstances, and agreed with an administrative determination that: "CGC's veiled but fairly obvious purpose was to advance its own economic objectives rather than to make a gift for reasons of simple generosity." In an administrative proceeding arising out of the same situation, the SEC concluded that the distribution of "gift" shares was a sale within the meaning of the Securities Act because of the value which accrued to the issuer by virtue of creating a public market for its securities.ⁿ³⁸ Even states that have adopted "sale" definitions different from the Uniform Act provision are in accord with this principle.ⁿ³⁹

"Free" stock promotions and distributions, most of which have been associated with visiting or registering on Internet sites, have raised similar "value" issues. The distribution of "free" stock to individuals who visit or register on an Internet site constitutes a sale of the shares when there is in fact something given up in order to obtain them, or when a valuable benefit accrues to the issuer in the distribution. In *HotYellow98.com, Inc.*, ⁿ⁴⁰ for example, Respondents offered and sold, or participated in the offer and sale of, unregistered securities by giving "free" stock as an inducement to purchase goods and services, including lifetime charter webmaster memberships. And in *James Bartel, et al.*, ⁿ⁴¹ for a one year subscription to a financial news publication at a price of \$49.00, subscribers would receive 100 shares of "free" stock in a public company. The subscriber to a \$79.00 two year subscription was offered 300 shares of the free stock. In both cases the Alaska administrator brought enforcement proceedings based on the offer and sale of the unregistered "free" securities.ⁿ⁴²

Normally a "sale" presumes a decision to give up something of tangible value, "Free" stock promotions illustrate, however, that traditional value assessments involved in identifying a sale for purposes of state securities law protections may be given a different meaning through emphasis placed on value obtained by an issuer in a distribution process rather than a transaction supported by particular consideration. Enforcement authority under Blue Sky laws is not limited to the conventional purchase and sale context, and will, rather, extend to situations in which a security is used to induce or encourage people to make decisions or take particular actions on the expectation of some valuable benefit associated with receiving the security.

Long before on-line promotions and other marketing campaigns involving distributions of free securities, the drafters of the Uniform Act recognized specific situations in which "bonuses," "gifts" of stock, or some rights to acquire securities must be included in the definition of offer or sale, and thus fall within the scope of Blue Sky law coverage. Conversely, there are particular situations in which it is clear that no need for protection is presented, and which should clearly be excluded from coverage. It is for that reason that the key definition provisions of the Uniform Act and its progeny provide, in addition to a basic definition, specific inclusions and exclusions. These are "value" based provisions, and they are discussed more fully in *sections 3.03 and 3.04 below*.

FOOTNOTES:

(n1)Footnote 1. The securities registration requirement in the Uniform Act, for example, declares: "It is unlawful for any person to offer *or* sell any security in this state unless (1) it is registered under this act or (2) the security or transaction is exempted under section 402." Unif. Sec. Act § 301 (emphasis added). This prohibition is found in all state securities laws, and any violation triggers both civil and criminal liabilities.

(n2)Footnote 2. Section 409 of the Uniform Act, for example, prescribes criminal penalties for any person who willfully violates *any* provision of the act. Analogs of Uniform Act section 409 are found in all state securities laws.

(n3)Footnote 3. *see Diskin v. Lomasney & Co.*, 452 F.2d 871 (2d Cir. 1971) (rescission of sale for violation of Federal Securities Act of 1933 section 5 registration and prospectus requirements)

(n4)Footnote 4. The traditional role of state securities law protections has been oriented to the distribution, or offering, side of transactions. Antifraud provisions and remedies in Blue Sky laws are not so limited however. Indeed, several state civil remedy provisions expressly extend protection to *sellers* who are deceived by purchasers of their securities. New Hampshire, for example, extends its civil remedy for fraud as follows:

Any person who violates [the general antifraud provision] in connection with the purchase or sale of any security shall be liable to any person damaged by the violation of that section who sold such security to him *or to whom he sold such security*... Damages in an action pursuant to this paragraph shall include the actual damages sustained plus interest from the date of payment or sale, costs, and reasonable attorney's fees. *N.H. Rev. Stat. § 421-B:25(II)*.

Thus, while the common focus of state securities regulators in applications of Blue Sky laws is on the distribution side of transactions or activities, antifraud remedies are often broader. The scope of antifraud protection and remedies is presented in Chapters 13 and 15, *infra*.

(n5)Footnote 5. *See Green v. Weis, Voisin, Cannon, Inc.*, 479 F.2d 462 (7th Cir. 1973) (the state in which the common law definition of "sale" would place the consummation of the sale is irrelevant to the definition of "sale" under the Illinois Securities Act).

The Uniform Act definitions of "offer" and "sale" were "borrowed substantially" from § 2(3) of the Securities Act of 1933. Official Code Comment to Uniform Securities Act § 401(j)(1)(2). The definition of the term "offer to sell" in § 2(3) of the Securities Act of 1933 goes "well beyond" the common law concept of an offer. 1 Loss & Seligman, Securities Regulation 1138.19. (Aspen Law & Business 3d ed.).

(n6)Footnote 6. 441 U.S. 768, 773, 99 S. Ct. 2077, 2081, 60 L. Ed. 2d 624, 629 (1979) (citations omitted); *see also Pinter v. Dahl*, 486 U.S. 622, 108 S. Ct. 2063, 100 L. Ed. 2d 658 (1988) . In *Pinter*, the Supreme Court considered the scope of "seller" liability under Securities Act § 12 as including persons who actively solicit a buyer.

(n7)Footnote 7. *See also Cook v. Goldman, Sachs & Co.*, 726 F. Supp. 151 (S.D. Tex. 1989) ; *Hocking v. DuBois*, 885 F.2d 1449 (9th Cir. 1989) , *cert. denied*, 494 U.S. 1078, 110 S. Ct. 1805, 108 L. Ed. 2d 936 (1990) (the term "offer" has a far different and far broader meaning in securities law than in contract law); *Raiford v. BusLease, Inc.*, 825 F.2d 351 (11th Cir. 1987) . *See also Pinter v. Dahl*, 486 U.S. 622, 108 S. Ct. 2063, 100 L. Ed. 2d 658 (1988) . In *Pinter*, the Supreme Court observed that the statutory definitions of "sale" and "sell" are expansive and intended to encompass the entire selling process.

The "for value" element in defining a sale clearly implies the notion that a change of position or change of investment risk is present. As thoroughly discussed in Chapter 2, committing to an investment risk means subjecting some value to the risks of an enterprise. A transaction need not involve cash consideration to constitute a sale under Blue Sky laws. However, there must be some identifiable economic change of position in relation to investment risk or what the security represents. Thus, for example, a stock split that simply distributes two or more pieces of paper for one cannot

be deemed to be a "sale." Some states expressly exclude such transactions from the statutory definition of sale or offer to sell. In Nevada, for example, the terms expressly do not include:

[A] stock dividend, whether the corporation distributing the dividend is the issuer of the stock or not, if:

- (1) The distribution of the dividend is not for the purpose of evading the provisions of this chapter governing the registration of securities; and
- (2) Nothing of value is given by the stockholders for the dividend other than surrender of a right to a cash or property dividend and each stockholder may elect to take the dividend in cash, property or stock.

Nev. Rev. Stat. § 90.280(6)(b). Other specific statutory exclusions from definitions of these terms in Blue Sky laws are discussed in § 3.03, *infra*.

(n8)Footnote 8. Unif. Sec. Act § 401(j)(2); *see also* Rev. Unif. Sec. Act § 101(13); Unif. Sec. Act (2002) § 102(36), which parallel Unif. Sec. Act 401(j).

(n9)Footnote 9. *See, e.g., Cal. Corp. Code § 25017(a); Iowa Code § 502.102(16)(a)*.

(n10)Footnote 10. Unif. Sec. Act § 401(j)(3)-(5); *see also* Rev. Unif. Sec. Act § 101(13)(iii)-(v); Unif. Sec. Act (2002) § 102(26)(A)-(C).

(n11)Footnote 11. Unif. Sec. Act § 401(j)(6); *see also* Rev. Unif. Sec. Act § 101(13)(vi). The Uniform Securities Act (2002) no longer retains the provision in the definition section, but deals with each circumstance by way of transaction exemptions.

(n12)Footnote 12. *See, e.g., Ore. Rev. Stat. 59.015(17)(b)*.

(n13)Footnote 13. Uniform Sec. Act § 401(j)(2) defines "offer"; "Offer" or "offer to sell" to include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security for value." *See also* Rev. Unif. Sec. Act § 101(13)(i). In some states, the definition is very close to the Uniform Act definition except that the terms include a "solicitation of an order to buy" a security in addition to a "solicitation of an offer to buy." As a practical matter, this excess verbiage probably would not change the meaning of the section. In other respects, the definition in these states is substantially the same as that contained in the Uniform Act. *See, e.g., Miss. Code Ann. § 75-71-105(L)(2); N.D. Cent. Code § 10-04-02(13)*.

(n14)Footnote 14. *See Kreis v. Mates Investment Fund, Inc., 473 F.2d 1308 (8th Cir. 1973)*, applying Missouri law.

(n15)Footnote 15. *But see* Rhode Island: R.I. Gen. Laws § 7-11-101(19)(iii) ("Offer to purchase" includes every attempt, or offer to obtain, or solicitation of an offer to sell, a security or interest in a security for value...").

New York has no provision defining "offer." However, in New York's regulation governing registration of intrastate offerings of securities an "offering" includes "a written or oral request to participate in an investment initiated initially by either a potential seller or buyer of a security." 13 N.Y. Comp. Codes R. & Regs. § 80.1(j)(1); *see also* State v. American Microtel, Inc., No. CV 93-21626 (Super. Ct. Ariz. 5/26/95) (Memorandum informing investors of wireless cable enterprise and requesting payment constitutes offer).

(n16)Footnote 16. *But see* Lane v. Griswald, 273 N.C. 1, 159 S.E.2d 338 (1968), in which it was held that when a purchaser of securities places an unsolicited order with her broker, a principal-agent relationship is created. The broker, acting as agent, is not the seller, since title passes directly to the purchaser once the broker obtains the securities from

his vendor. As a result, as between a buyer placing an unsolicited order and a broker acting as agent on that order, a sale does not take place.

A number of states have an exemption for non-issuer transactions made pursuant to an unsolicited offer to buy securities. The exemption would, therefore, cover the sale as well as the offer. *See* ch. 9 *infra*.

(n17)Footnote 17.

Illinois: Green v. Weis, Voisin, Cannon, Inc., 479 F.2d 462 (7th Cir. 1973) , *rev'g*, 348 F. Supp. 558 (N.D. Ill. 1972) .

Iowa: Getter v. R.G. Dickinson & Co., 366 F. Supp. 559 (S.D. Iowa 1973) .

Missouri: Kreis v. Mates Investment Fund, Inc., 473 F.2d 1308 (8th Cir. 1973) .

Wisconsin: Klatt v. Guaranteed Bond Co., 213 Wis. 12, 250 N.W. 825 (1933) .

(n18)Footnote 18. *B.C. Turf & Country Club v. Dougherty*, 94 Cal. App.2d 320, 210 P.2d 760 (1949) . *Cf.* *State v. American Microtel, Inc.*, No. CV 93-21626 (Super. Ct. Ariz. 5/26/95) (memoranda informing investors of wireless cable enterprise and requesting payment constitutes offer).

(n19)Footnote 19. *Holmberg v. Marsden*, 39 Cal.2d 592, 248 P.2d 417 (1952) .

(n20)Footnote 20. *People v. Staver*, 115 Cal. App.2d 711, 252 P.2d 700 (1953) .

(n21)Footnote 21. *People v. Jacques*, 137 Cal. App.2d 823, 291 P.2d 124 (1955) . The court in this case also held that an agreement to agree on a future sale of stock constituted an "offer to sell" securities. *See also Towery v. Lucas*, 128 Or. App. 555, 876 P.2d 814 (Or. Ct. App. 1994) (settlement agreement providing for issuance of stock in formation of new corporation).

(n22)Footnote 22. *Cal. Corp. Code § 25017(a)*:

"Sale" or "sell" includes every contract of sale of, contract to sell, or disposition of, a security or interest in a security for value. "Sale" or "sell" includes any exchange of securities and any change in the rights, preferences, privileges, or restrictions of or on outstanding securities.

See also § 3.03[3] infra. Except for some provisions in other states, that exclude from the definition of "sale" certain corporate reorganizations, it is unclear how far this view of the law would apply in such other states. A judicial approach much like the view taken in the California statute was enforced under the Federal Public Utility Holding Company Act. The definition of "sale" in that statute is similar to the one contained in the Securities Act of 1933. *See SEC v. Associated G. & Elec. Co.*, 99 F.2d 795 (2d Cir. 1938) .

(n23)Footnote 23. *Western Air Lines, Inc. v. Schutzbank*, 258 Cal. App.2d 218, 66 Cal. Rptr. 293 (1968) ; *Western Air Lines, Inc. v. Sobieski*, 191 Cal. App.2d 399, 12 Cal. Rptr. 719 (1961) .

(n24)Footnote 24. *Keller Street Develop. Co. v. Department of Investment*, 227 Cal. App.2d 760, 39 Cal. Rptr. 44 (1964) .

(n25)Footnote 25. *Fayette Wholesale Grocery Co. v. Brown Bros.*, 102 W.Va. 181, 135 S.E. 235 (1926) ; *Conway v. Bailey*, 91 W. Va. 324, 112 S.E. 579 (1922) . *See also Doherty v. Kahn, et. al.*, Blue Sky L. Rep. (CCH Dec.

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1996-1997), 74,145 (Ill. Ct. App. 1997).

(n26)Footnote 26. *Lapidus v. Rever*, 174 So.2d 459 (Fla. App.) *cert. denied*, 183 So.2d 210 (Fla. Supp. 1965) .

(n27)Footnote 27. *Id.*, 174 So.2d at 461 .

(n28)Footnote 28. *See Lawn v. Camino Heights, Inc.*, 15 Cal. App.3d 973, 93 Cal. Rptr. 621 (1971) where a promise of labor to and for a corporation in exchange for stock was held a sale; *see also* *Computer Concepts, Inc. Profit Sharing Plan v. Brandt*, [1988-1990 Transfer Binder] CCH Blue Sky L. Rep. P 73,037 (Ore. Ct. App. 1989) (movie investment contract with profit sharing option could constitute sale).

(n29)Footnote 29. *Marney v. Home Royalty Ass'n*, 34 N.M. 632, 286 P. 979 (1930) .

(n30)Footnote 30. *Id. See also Farrar v. Hood*, 56 N.M. 724, 249 P.2d 759 (1952) .

(n31)Footnote 31. *See Wigington v. Mid-Continent Royalty Co.*, 130 Kan. 785, 288 P. 749 (1930) ; *Thomas v. United Royalty Co.*, 1937 OK 183, 180 Okla. 230, 68 P.2d 490 (1937) ; *Hofer v. General Discount Corporation*, 86 S.D. 133, 192 N.W.2d 718 (1971) ; *Klatt v. Guaranteed Bond Co.*, 213 Wis. 12, 250 N.W. 825 (1933) ; *Josslyn v. Dahinden-Schmitz Co.*, 208 Wis. 468, 243 N.W. 473 (1932) .

(n32)Footnote 32. *See, e.g., Ohio Rev. Code Ann. § 1707.01(C)(1)*: " 'Sale' also includes a contract to sell, an exchange, an attempt to sell, on option of sale, a solicitation of sale, a solicitation of an offer to buy, a subscription, or an offer to sell, directly or indirectly, by agent, circular, pamphlet, advertisement, or otherwise."

See also 70 Pa. Stat. Ann. § 1-102(r)(i): " 'Sale' or 'sell' includes every sale, disposition or exchange, and every contract of sale of, or contract to sell, a security or interest in a security for value..." However, many states exempt from registration exchanges of securities where the trade involves an exchange by an issuer for other securities of the same issuer. *See* ch. 8 *infra*. *See also* the discussion of the reorganizational exclusion at § 3.03[3] *infra* .

(n33)Footnote 33. Since the intent of the Blue Sky laws is to prohibit more than actual sales of unregistered securities, nondelivery of a promised consideration for a security would not take the transaction out of the statutory scheme. *See Ogier v. Pacific Oil and Gas Development Corporation*, 135 Cal. App.2d 776, 288 P.2d 101 (1955) . *See also Levitz v. Warrington*, 877 P.2d 1245 (Utah Ct. App. 1994) .

(n34)Footnote 34. *See Andrews v. Chase*, 89 Utah 51, 49 P.2d 938 (1935) , *reh'g denied*, 89 Utah 73, 57 P.2d 702 (1936) . It was further held that gifts of securities are not within the statute even when the donor hopes to receive something in return.

But see In the Matter of H & B Carriers, Inc., Fed. Sec. L. Rep. (CCH) P 72,727 (Utah Sec. Comm. 1988), where the Utah Securities Commission held that a corporation's program of incorporating other companies and causing them to go public by acquiring their stock for a nominal amount and gifting the shares to numerous individuals was a sale of the shares because it involved a distribution for value. The value included the benefit to the corporation of the creation of goodwill and the promotion of the corporation's business. *See also* In the Matter of the Offering of Securities by Wade Bruce Cook, *et al*, [1988-1990 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,976 (Arizona Corp. Comm. 1989) (sale includes every contract of sale or disposition of a security or interest in a security for value; offer includes every attempt or offer to dispose of or solicitation of an offer to buy).

See § 3.02[2] *infra* for a discussion of gifts of assessable stock as being within the definition of "sale."

(n35)Footnote 35. *In re Offering of Securities by Wade Bruce Cook*, Ariz. Corp. Comm. Dec. No. 56492, Blue Sky L. Rep. (CCH) P 72,976 (1989).

(n36)Footnote 36. *In re Strack Sec. Serv. Corp.*, Pa. Sec. Comm. Dkt. No. 8812-25, Blue Sky L. Rep. (CCH) P 72,979 (1989).

The transfer of shares of stock as either "boot" or a commission for a real estate transaction has been held to be the sale of the securities for value where they were given or delivered with the purchase of another thing offered and sold for value. *Dean v. Humphries*, Blue Sky L. Rep. (CCH) P 73,026 (Idaho 1989).

(n37)Footnote 37. [1988-1990 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,997 (Utah App. 1989).

(n38)Footnote 38. *In the Matter of Capital General Corp.*, Sec. Act Rel. No. 7008, [1993 Transfer Binder] Fed.Sec.L.Rep. (CCH) P 85,223 (1993).

(n39)Footnote 39. *See, e.g., Ariz. Rev. Stat. § 44-1801(21)*: " 'Sale' or 'sell' means a sale or other disposition of a security or interest in a security for value and includes a contract to make such sale or disposition."

See also Tex. Rev. Civ. Stat. Ann. § 581-4(E): "The terms 'sale' or 'offer to sell' or 'sell' shall include every disposition, or attempt to dispose of a security for value."

(n40)Footnote 40. Alaska Order No. 00- 11 S, 2000 Alas. Sec. LEXIS 15 (Div. Banking, Sec. and Corp., May 31, 2000)

(n41)Footnote 41. Alaska Order No 91-1, 1990 Alas. Sec. LEXIS 1 (Div. Banking, Sec. and Corp., Nov. 6, 1990) .

(n42)Footnote 42. *See also* Citizens Power of Alaska, LLC., Order No. 98- 09 S, 1998 Alas. Sec. LEXIS 2 (Div. Banking, Sec. and Corp., Mar. 19, 1998) (Mailing and door-to-door solicitation campaign requesting residents to identify and register themselves to receive stock as a bonus in connection with an offer to purchase property interests).



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Blue Sky Regulation

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CHAPTER 3 "Offers" or "Sales" of Securities

1-3 Blue Sky Regulation § 3.02

§ 3.02 Statutory Inclusions within the Definitions of "Offer" and "Sale"

In addition to the basic definition of "offer" and "sale" Blue Sky laws also define specific types of dispositions of securities (such as securities given as bonuses, gifts of assessable stock, warrants, subscriptions, and convertible securities) as an offer *and* sale. Many of the statutory inclusions within the definition of "offer" and "sale," such as a security given as a bonus, as well as many of the statutory exclusions from those definitions, such as stock dividends,ⁿ¹ result from a determination that the disposition has been made either for value or not for value.

[1] Securities Given as Bonuses Most states provide that if a security is given with the purchase of any other property, it constitutes an offer and sale of the security.ⁿ² The Uniform Securities Act states: "Any security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing is considered to constitute part of the subject of the purchase and to have been offered and sold for value."ⁿ³ The focus here is plainly upon the value given up in the context of the transaction and, as with "free" securities transferred in connection with promotional campaigns, inducements, or purchases of something else, the presence of value is a function of the entire transactional context.ⁿ⁴ The objective is to identify those settings in which securities law protection is necessary and appropriate. For example, a parent company plan to issue American Depositary Receipts (ADRs) for its stock to a broad class of employees of the company and its subsidiaries, at no direct cost to such individuals (but subject to a vesting schedule) as an additional incentive to make their maximum contribution to the growth and development of the company, was viewed as not triggering investor protection concerns and not involving a sale within the ambit of section 2(3) of the federal Securities Act of 1933.ⁿ⁵ As will be seen, however, other employment-related situations could involve an investment-oriented election to receive shares, and trigger concern for protection. In a federal case, *Feret v. Corestates Financial Corp.*,ⁿ⁶ company employees who voluntarily entered into agreements under which they received incentive stock options in exchange for continuing services were deemed to be purchasers for purposes of asserting antifraud claims despite the fact that they did not make any direct payment to obtain the options. The court was satisfied that an employment agreement containing stock options constitutes a sale.ⁿ⁷

In the light of the broad statutory definition of "sale," which includes bonuses, generally in effect today, a different result would probably be reached.

[2] Gifts of Assessable Stock When a corporation has the power to have its stockholders pay additional sums for their stock, the stock is referred to as "assessable."ⁿ⁸ The word "assessable" is used in connection with corporate stock to mean that the corporation has the right to demand that shareholders pay additional amounts on fully paid stock.ⁿ⁹ Assessments may be enforced by suits against the stockholder or by forced sale of the stock.ⁿ¹⁰ Unpaid stock subject to

call is sometimes said to be subject to assessment.ⁿ¹¹

Under the provisions of the Uniform Securities Actⁿ¹² and the statutes of a number of states,ⁿ¹³ gifts of assessable stock are transactions involving an offer and sale. This is entirely consistent with the statutory definitions of "offer" and "sale," since stock recipients must pay value to retain their securities.

The draftsmen of the Uniform Securities Act indicate that at least two states had taken this position even though their statutes did not have the specific requirement.ⁿ¹⁴ Whether all states without the statutory provision will take a similar position when assessable stock is given as a gift is uncertain. Prior to Utah'sⁿ¹⁵ adoption of the Uniform Act inclusion, the Utah Supreme Court held, over a strong dissent, a gift of assessable stock was not a sale.ⁿ¹⁶ The deciding factor was that the recipients had a choice in paying assessments.ⁿ¹⁷ The Uniform Act's draftsmen expressly intended to include the gifts of assessable stock described in this case as offers and sales under the statutory definition.ⁿ¹⁸

[3] Warrants, Subscriptions, and Convertible Securities When warrants, subscriptions, or similar rights to purchase other securities are offered or sold, the problem arises as to when the "other" securities must be registered. Does the offer or sale of a subscription right to stock immediately constitute the offer of the stock that must be registered at the time the subscription is offered, or is the underlying security not considered offered until the right is exercised? The same problem arises with respect to convertible securities. Does the offer of a debt security convertible into a company's stock mean that the stock itself is being simultaneously offered?

In a comparatively early Oregon case,ⁿ¹⁹ the position was taken that the offer of a stock subscription was a continuing offer of the stock itself which culminated in a sale when the stock was paid for, regardless of whether an actual stock certificate was then delivered. Consequently, a permit to sell the stock was required before the subscriptions were offered.

A principle similar to this has been codified in a number of states that have adopted the provision recommended by the Uniform Securities Act.ⁿ²⁰ Under the Act, the offer or sale of a warrant, purchase right, or subscription to another security, or the offer or sale of a convertible security, is an offer of the other security. Even the gift of a warrant involves an offer to sell the underlying stock called for by the warrant.ⁿ²¹ A statutory inclusion similar in purpose to the Act provision has also been adopted in some non-Uniform Act states.ⁿ²² In all of these jurisdictions, the security that the holder of the rights is entitled to purchase or convert for must be registered at the time the warrant, right or convertible security is offered, unless there is an exemption.ⁿ²³

The approach of the Uniform Securities Act is not exclusive. The purpose of the Act's provision is to make it unnecessary to decide whether the right is exercisable at the time of its sale or some time in the future. This is accomplished by deeming all underlying securities as being offered at the time the warrant, purchase right, or convertible security is offered or sold.ⁿ²⁴ But some states have preferred to follow the example set in the Federal Securities Act of 1933.ⁿ²⁵ In these states a distinction is drawn between a purchase or conversion right that is immediately exercisable and one exercisable in the future.ⁿ²⁶ If the right may be exercised immediately, the offer of both securities is considered to have been made at the same time and both must be registered at the time the rights offering is made. However, if the purchase or conversion right may not be exercised until some future date, although the initial security must be registered at the time it is offered or sold, the security that may be called or converted for cannot be registered until the right is exercised. The offer and sale of the second security is not deemed to have occurred until the right is exercisable.

There are even variations on this theme. Texas does not refer to either immediate or future rights in its statute,ⁿ²⁷ but sets forth the rule that the second security is not deemed offered or sold until the right is actually exercised. Presumably this means that the underlying security need not be registered until the right is exercised, even if the right may be exercised immediately. The Illinois statuteⁿ²⁸ refers only to convertible securities (there is no mention of warrants or subscription rights), and does not include the conversion into the second security as a sale unless additional

consideration is paid.

Some states have no statutory provision bringing warrants, subscriptions, and convertible securities within the definition of "offer."ⁿ²⁹ However, many states have provisions that exempt from registration securities that are the subject of a conversion privilege.ⁿ³⁰

[4] Rescission Offers Pennsylvania has a unique provision that includes an offer of rescission within its definition of offer and sale.ⁿ³¹ A rescission offer may be made by a buyer or seller as a defense against a civil action for violation of the registration or antifraud provisions. The offer must be sent before suit is commenced and (1) state the respect in which liability arises; (2) advise the potential plaintiff of his rights; (3) state the terms of the rescission and restitution offer regarding the security and the consideration; and (4) provide that the offer may be accepted within thirty days or such shorter period as the Commission may prescribe.ⁿ³²

Rescission offers are processed in the same way as offerings to be registered by qualification; there are no exemptions from registration for rescission offers.ⁿ³³

FOOTNOTES:

(n1)Footnote 1. Statutory exclusions from the definitions of "offer" and "sale" are discussed in § 3.03 *infra*.

(n2)Footnote 2. *See, e.g.,* D.C. Code Ann. § 2-2601(11)(C): "Any security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing is considered to constitute a part of the subject of the purchase and to have been offered and sold for value."

In Ohio, the provision does not include the giving of securities with property other than other securities: "Any security given with, or as a bonus on account of, any purchase of securities is conclusively presumed to constitute a part of the subject of the purchase, and has been 'sold.'" *Ohio Rev. Code Ann. § 1707.01(C)(5)*.

(n3)Footnote 3. Unif. Sec. Act § 401(j)(3); *see also* Rev. Unif. Sec. Act § 101 (13)(iii).

Most states which differ from the Uniform Act provision use stronger language with respect to the presumption which arises when securities are given or delivered with other securities or other property. In these states such gifts or bonuses are "conclusively presumed" to be sales of securities. *See, e.g., Fla. Stat. Ann. § 517.021(18)*: Any security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing, is conclusively presumed to constitute a part of the subject of the purchase and to have been sold for value.

A number of states have issued interpretive opinions regarding registration requirements in cases of promotional offerings of securities. For example, Illinois holds that the delivery of zero coupon bonds with, or the giving of promotional securities as a bonus for, the purchase of goods, services, or merchandise constitutes the sale of a security. As such it and requires compliance with the applicable securities, dealer, and salesperson registration provisions, advertising submission provisions, and antifraud prohibitions of the Illinois Blue Sky law. However, the Securities Department will not require the registration of the vendor as a dealer or its employees as salespersons for transactions in which a registered dealer is involved, if the promotion is limited in duration, advertising meets predissemination requirements, and required disclosures are made. *See* Securities Department Special Bulletin No. 6, March 25, 1985.

Kansas considers a promotional campaign in which a customer receives a security, usually a zero-coupon bond, upon the purchase of a particular item to be the sale of a security. Automobile dealers, home builders, and others in retail trade involved in such transactions are subject to the broker-dealer registration requirements under Kansas Blue Sky

law. Quarterly Bulletin, July-September 1984.

In Michigan, the offer of a bonds, debentures, stock, or government securities to customers who purchase specified products or services involves the offer or sale of securities. Such promotional campaigns are permissible, however, if the securities are exempt from registration, the securities are adequately described, and the campaign is of limited duration and frequency. Rel. No. 84-28, November 2, 1984.

Wisconsin determined to take no action to require broker-dealer registration of a realtor who proposed to offer for a two-year period municipal bonds in a face amount equal to the sales price of residential property purchased by buyers who obtained delivery of the bonds through licensed broker-dealers. The no-action letter declared, however, that the promotion involved the offer and sale of securities and was subject to the securities registration, advertising-filing, and antifraud provisions of the securities law. No-Action Letter, November 16, 1984, amended December 12, 1984.

(n4)Footnote 4. "This [bonus portion of federal Securities Act § 2(3)] means, for example, that a package transaction which includes the sale of a horse for \$100 and a gift of a security to the purchaser nevertheless constitutes an offer and sale of the security for value within the meaning of the Securities Act of 1933." *SEC v. Addison*, 194 F. Supp. 709, 722 (N.D. Tex. 1961) .

A more practical example might occur when shares of stock are used as an inducement for a loan, *e.g.*, the borrower, in addition to his promissory note for the loan, gives the lender corporate stock. Even though the lender will receive a return of his principal with interest according to the terms of the note, the delivery of the stock constitutes a sale under the Blue Sky law. *State v. MacLean*, 142 Kan. 215, 46 P.2d 879 (1935) ; *State v. Dobson*, 140 Kan. 445, 37 P.2d 10 (1934) .

See also Computer Concepts, Inc. Profit Sharing Plan v. Brandt, Blue Sky L. Rep. (CCH Dec. 1988-1990), 73,037 (Ore. Ct. App. 1989) (movie investment contract with profit sharing option could constitute sale); *see also* *Lawrence v. SEC*, 398 F.2d 276, 280 (1st Cir. 1968) ; *Diskin v. Lomasney & Co.*, 452 F.2d 871 (2d Cir. 1971) .

(n5)Footnote 5. MCA Inc., SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,251 (May 26, 1992).

(n6)Footnote 6. [1998 Transfer Binder] Fed.Sec.L.Rep. (CCH) P 90,267 (E.D. Pa. 1998).

(n7)Footnote 7. *But see* *Beebe v. Compaq Computer Corp.*, 940 S.W.2d 304 (Tex. App. 1997) (No investment decision, and thus no sale, possible when plaintiffs' employment terminated with them holding options that never vested).

But see *State v. Svoboda*, 147 Kan. 245, 76 P.2d 814 (1938) in which the purchaser bought an interest in a gold mine. He then had the option of leasing the interest back to an operating company in exchange for company stock. The purchaser was entitled to his share of the mine's production regardless of whether he participated in the lease arrangement. It was acknowledged to the purchaser that the company stock was worthless but would not affect his income from the mine's production. The court held the stock in the operating company was part of a separate transaction and would not be considered a bonus given with the purchase of the mining interests.

(n8)Footnote 8. *Arroyo Ditch & Water Co. v. Superior Court*, 92 Cal. 47, 28 P. 54 (1891) ; *Stewart v. Walla Walla Print & Pub. Co.*, 1 Wash. 521, 20 P. 605 (1889) .

(n9)Footnote 9. *More v. Courier-News*, 29 N.D. 385, 151 N.W. 2 (1915) .

(n10)Footnote 10. *Quintet Oil Co. v. Big Five Oil Co.*, 71 Colo. 232, 205 P. 949 (1922) .

(n11)Footnote 11. *Porter v. Northern Fire & Marine Ins. Co.*, 36 N.D. 199, 161 N.W. 1012 (1917) . Actually, there is a distinction between a call and an assessment. Call refers to payments due on unpaid subscriptions and assessment refers to additional payments on fully paid shares. See *Wall v. Basin Mining Co.*, 16 Idaho 313, 101 P. 733 (1909) .

The term "assessment" has also been used when referring to forced payment by shareholders of sums due corporate creditors under statutory liability. See *Leach v. Arthur Sav. Bank*, 203 Iowa 1052, 213 N.W. 772 (1927) .

(n12)Footnote 12. Unif. Sec. Act § 401(j)(4): "A purported gift of assessable stock is considered to involve an offer and sale." See also Rev. Unif. Sec. Act § 101(13)(iv).

(n13)Footnote 13. See, e.g., 6 Del. Code Ann. § 7302 (16)(b); Idaho Code § 30-1402(10); Ky. Rev. Stat. Ann. § 292.310(11). All of these provisions specifically include the levying of an assessment within the definition of offer and sale.

(n14)Footnote 14. Draftsmen's Commentary to Unif. Sec. Act § 401(j), Loss & Cowett, Blue Sky Law, at 345 (1958) . The two states are California and Iowa and involved comparatively early positions stated in opinions of the attorneys general.

(n15)Footnote 15. Utah Code Ann. § 61-1-1322(c)(ii).

(n16)Footnote 16. *Andrews v. Chase*, 89 Utah 5, 49 P.2d 938 (1935) , *reh'g denied*, 89 Utah 73, 57 P.2d 702 (1936) .

(n17)Footnote 17. *Id.* On the question of what constitutes a gift, the court noted that although the donor hoped for something in return (that the donees would pay assessments) for his gift, that alone was not enough to turn the gift into a sale. 49 P.2d at 942 .

(n18)Footnote 18. See n. 14 *supra*.

(n19)Footnote 19. *State v. Gerritson*, 124 Ore. 525, 265 P. 422 (1928) .

(n20)Footnote 20. Every sale or offer of a warrant or right to purchase or subscribe to another security of the same or another issuer, as well as every sale or offer of a security which gives the holder a present or future right or privilege to convert into another security of the same or another issuer, is considered to include an offer of the other security.

Uniform Sec. Act § 401(j)(5); see also Rev. Unif. Sec. Act § 101(13)(v).

See N.C. Gen. Stat. § 78A-2(8)(e). North Carolina requires registration of an offer of securities to be issued pursuant to warrants held by North Carolina residents in the absence of an exemption, notwithstanding the fact that the warrants, when originally offered, were not subject to registration because they were not offered in the state. Opinion Letter of North Carolina Securities Deputy (June 20, 1983).

See also 70 Pa. Stat. Ann. § 1-102(r)(iv); Tenn. Code Ann. § 48-2-102(12)(E).

(n21)Footnote 21. Consequently, registration of the underlying stock is necessary before the warrants can even be given away. Official Code Comment to Unif. Sec. Act § 401(j)(5). See also Rev. Unif. Sec. Act § 402(14).

Moreover, as long as the conversion privilege or purchase right remains exercisable, the underlying security remains registered and the issuer subject to any reporting requirements which may be imposed under such state's securities laws. *Id.*

However, Uniform Act § 402(b)(11) exempts offers to existing security holders under certain conditions. *See* ch. 8 *infra*. This exemption does not excuse registration of the underlying security at the time the warrant is offered because there is a continuing offer of the underlying security and the offerees are not yet existing security holders. The exemption becomes available, however, when the warrant is exercised within the required 90 days of its issuance. Official Code Comment to Unif. Sec. Act § 401(j)(5).

(n22)Footnote 22. The provision in these states makes it unmistakable that the intent of the statutes is to include all the "other" securities as being offered at the time the warrant, subscription, or conversion right is offered or sold. There is a certain amount of uniformity *See N.D. Cent. Code § 10-04-02(9)*:

Every sale or offer for sale of a warrant or right to subscribe to another security of the same issuer or of another issuer, and every sale or offer for sale of a security which gives the holder thereof a present or future right or privilege to convert such security into another security of the same issuer or of another issuer, shall be deemed an offer to sell the security to be acquired by subscription or conversion.

See also Cal. Corp. Code § 25017(e):

Every sale or offer of a warrant or right to purchase or subscribe to another security of the same or another issuer, as well as every sale or offer of a security which gives the holder a present or future right or privilege to convert the security into another security of the same or another issuer, includes an offer and sale of the other security only at the time of the offer or sale of the warrant or right or convertible security; but neither the exercise of the right to purchase or subscribe nor the issuance of securities pursuant thereto is an offer or sale.

(n23)Footnote 23. *See* ch. 8 *infra* for discussion of the transactional exemption for exchanges of convertible securities and the exercise of the right to purchase other securities.

(n24)Footnote 24. Draftsmen's Commentary to Unif. Sec. Act § 401(j)(5):

This Clause is designed to avoid the ambiguities and difficulties inherent in most of the state statutes as well as the federal statute with reference to convertible securities and warrants or rights. When a company offers bonds or preferred stock convertible into common, or employs warrants or rights, the question immediately arises: Must there be registration of one or both securities--or perhaps three securities in the case, for example, of an offering of preferred stock with warrants attached to buy common, since the warrants themselves are defined as securities in § 401(1)? The answer may depend, under existing statutes, on a number of factors: Is the bond or preferred stock convertible immediately or only at some future date? Is the warrant or right exercisable immediately or only at some future date? Is the warrant or right distributed to existing stockholders, or is it attached to stock which is sold, in which event the warrant or right, too, is the subject of a "sale" under § 401(j)(3)? Even though the conversion privilege or warrant is immediately exercisable as a *legal* matter, what if it will not be exercised in the foreseeable future as a *practical* matter because the exercise price is substantially higher than the current market price of the stock called for? Clause (5) neatly resolves all these questions by providing that there is always an 'offer' of the security called for by the conversion privilege or the warrant.

(n25)Footnote 25. 15 U.S.C. § 77b(3). *See also* Sec. Act Rel. 4936 (1968).

(n26)Footnote 26. *See, e.g., La. Rev. Stat. Ann. § 51:702(13)*.

"... The issue or transfer of a right or privilege, when originally issued or transferred with a security, giving the holder

of such security the right to convert such security into another security of the same issuer or of another person, or giving a right to subscribe to another security of the same issuer or of another person, which right cannot be exercised until some future date, shall not be deemed to be an offer or sale of such other security, but the issue or transfer of such other security upon the exercise of such right of conversion or subscription shall be deemed a sale of such other security."

Often there is an exemption available for this type of transaction. See ch. 8 *infra*.

(n27)Footnote 27.

Tex. Rev. Civ. Stat. Ann. art. 581-4(E): The sale of a security under conditions which entitle the purchaser or subsequent holder to exchange the same for, or to purchase some other security, shall not be deemed a sale or offer for sale of such other security; but no exchange for or sale of such other security shall ever be made unless and until the sale thereof shall have first been authorized in Texas under this Act, if not exempt hereunder, or by other provisions of law.

(n28)Footnote 28. Ill. Comp. Stat., Ch. 815 § 2.5: "A privilege to convert a security into another security shall not be deemed a sale of such other security, provided no consideration from the holder in addition to the surrender or cancellation of the convertible security is required to effect the conversion."

(n29)Footnote 29. *E.g.*, New York, Ohio and Vermont.

(n30)Footnote 30. See ch. 8 *infra* for discussion of the transactional exemption from registration.

(n31)Footnote 31. 70 Pa. Stat. Ann. § 1-102(r)(vi): "An offer of rescission made pursuant to section 504(e) involves an offer and sale."

(n32)Footnote 32. 70 Pa. Stat. Ann. § 1-504(e).

(n33)Footnote 33. Bongiovanni & Bongiovanni, 2 Pennsylvania Transaction Guide at 10-124 .



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CHAPTER 3 "Offers" or "Sales" of Securities

1-3 Blue Sky Regulation § 3.03

§ 3.03 Statutory Exclusions from the Definitions of "Offer" and "Sale"

[1] Pledges or Loans A security given as an inducement for a loan¹ constitutes a sale of the security.² The issuance of a promissory note in exchange for a loan also constitutes the sale of a security.³ These fact patterns are distinguishable from a situation where X lends money to Y, and Y, in return, hands over to X securities as a pledge or collateral for the cash loan. Absent a statutory provision, courts had been in conflict as to whether pledges of securities were sales under the securities acts.⁴ A majority of jurisdictions exclude these transactions from their Blue Sky laws by providing that "any bona fide pledge or loan" is not to be included within the definitions of "offer" and "sale."⁵ This is the provision recommended in the Uniform Securities Act.⁶ However, if the pledge is not *bona fide* (i.e., made with the intent of evading the statute) then it would constitute a sale and be subject to all Blue Sky requirements. A problem may arise, however, when the borrower defaults on his loan and the lender sells the securities to recoup his losses. Pledge transactions are sales under the Blue Sky laws, but in most states they are exempt from registration.⁷

[2] Stock Dividends The declaration and distribution of an ordinary stock dividend by a corporation does not require shareholders to pay any additional value or consideration for the dividend; consequently, there is no offer or sale under the Blue Sky laws. A problem may arise if the corporate dividend permits the shareholder to choose between receiving his dividend in cash or in stock. If stock is taken, the right to the cash has been forfeited, and value has been given for the stock dividend.

The problem has been solved under the Uniform Securities Act by excluding from the definitions of "offer" and "sale:"

[a]ny stock dividend, whether the corporation distributing the dividend is the issuer of the stock or not, if nothing of value is given by stockholders for the dividend other than the surrender of a right to a cash or property dividend when each stockholder may elect to take the dividend in cash or property or in stock.⁸

Although this provision has been adopted in a number of states,⁹ other states limit the nature of the dividend that may be declared without complying with the Blue Sky laws. In California¹⁰ a stock dividend is excluded from the Blue Sky law only if the corporation has only one class of voting stock, the dividend is distributed to holders of common stock, and the subject of the dividend is such common stock.¹¹ The exclusion is further restricted by the Corporation Commissioner's regulation taking a position totally opposite to the Uniform Securities Act recommendation. In California, distribution of the stock that is the subject of the dividend is a sale of securities which must be registered (unless otherwise exempted) if the shareholders are given the choice of accepting cash or the additional shares of

common stock.ⁿ¹²

The Pennsylvania exclusionary provision is silent on the election of dividends, but is still more restrictive by its terms than the comparable section of the Uniform Securities Act. Under Pennsylvania law, a stock dividend constitutes a sale of securities if the dividend securities are issued by any entity other than the one distributing the dividend, even if the recipient of the dividend gives no value or consideration for the dividend.ⁿ¹³

Several states exclude stock dividends as sales, but the statutes do not address the choice of dividend questions.ⁿ¹⁴

That stock dividends are not excluded from Blue Sky law coverage in a particular jurisdiction does not necessarily mean that registration is required. A number of state statutes treat transactions in these interests as sales, but exempt stock dividends from registration. Again, the same questions with respect to an election of dividends arise. A few states have substantially adopted the Uniform Securities Act's exclusion as a transactional exemption from registration.ⁿ¹⁵ Other states have adopted an exemption for stock dividends, but have left the choice of dividend questions in a gray area.ⁿ¹⁶

As noted, California and Pennsylvania specifically require that stock distributed as a dividend be issued by the declarer of the dividend. It seems likely that that requirement is directed against the practice of "going public through the back door," that is, distributing stock to the public without going through the registration process. Thus, private company A may "go public" in the following manner: (1) it exchanges its stock for stock of company B, an issuer whose stock is held by the public (2) B then distributes its A stock to its shareholders in the form of a dividend. A's stock becomes publicly held and, as B's shareholders trade their A shares, a public market develops.ⁿ¹⁷ "Going public through the back door" has been made the subject of an important Securities and Exchange Commission Releaseⁿ¹⁸ and enforcement action under federal law has successfully attacked the practice in some instances.ⁿ¹⁹ Because the Uniform Securities Act and states following its example permit the dividend to consist of stock not issued by the declarer, it is unclear whether the "back door" methods that utilize stock dividends would be required to be registered under many state securities laws.

None of the states nor the Uniform Act specifically address the handling of the liquidating dividend, the net balance remaining to be distributed among the shareholders after all the assets of a dissolved corporation have been collected and all the debts paid.ⁿ²⁰ If the liquidating dividend were treated as an ordinary stock dividend, it would not involve an "offer" or "sale" under the Uniform Act exclusion of "any stock dividend."ⁿ²¹

[3] Changes in Securities Provisions and Business Combinations As previously noted, California considers changes in the rights, preferences, privileges, or restrictions of or on outstanding securities as sales.ⁿ²² This rule has been applied to such corporate actions as a change from cumulative voting to straight voting.ⁿ²³ The implications of the California provision reach even further. In the case of a corporate merger or consolidation there is, to say the least, a change in the nature of corporate stock.ⁿ²⁴ A similar situation exists where corporate assets are sold in exchange for securities of the purchasing corporation. In fact, the California statute would apply to any reclassification of corporate securities, or any other comparable action permitted by charter or law that the corporation may take affecting its securities.ⁿ²⁵

The approach of the Uniform Securities Act is to exclude all such corporate actions affecting securities from the definitions of "offer" and "sale" where the action is taken by a class vote of stockholders.ⁿ²⁶ The exclusion applies to "any act incident to a class vote by stockholders, pursuant to the certificate of incorporation or the applicable corporation statute, on a merger, consolidation, reclassification of securities, or sale of corporate assets in consideration of the issuance of securities of another corporation. ..."n27

These corporate actions are treated as Blue Sky exclusions rather than registration exemptions since, *inter alia*, remedial measures for breaches of good faith on the part of the corporation toward its stockholders are within the province of corporation law rather than securities law. Although a few states have adopted this view,ⁿ²⁸ others have preferred to

leave the anti-fraud provisions applicable to the situation by granting only a transactional exemption from registration. The transactional exemption provisions display a distinct lack of uniformity.ⁿ²⁹

Further excluded from "offer" and "sale" under the Uniform Act are securities issued pursuant to a judicially approved corporate reorganization when the securities are exchanged for outstanding securities, claims, or property interests. The exclusion applies to "[a]ny act incident to a judicially approved reorganization in which a security is issued in exchange for one or more outstanding securities, claims, or property interests, or partly in such exchange and partly for cash."ⁿ³⁰

The provision has been substantially adopted in a number of states as either an exclusionⁿ³¹ or as a transaction exempt from registration.

[4] Advertisements, Circulars, Pamphlets, and Prospectuses The exclusions from "offer" and "sale" discussed to this point encompass all the exclusions recommended by the Uniform Securities Act. In addition, a few states have enacted other exclusions. Primary among these is the use for specified purposes of advertising and sales literature.

An advertisement soliciting purchasers of securities constitutes an offer under the Blue Sky laws.ⁿ³² Some states include advertising generally within their statutory definitions of "offer" or "sale."ⁿ³³ However, in a couple of jurisdictions, the use of certain advertising material and sales literature is deemed to be outside the scope of the securities acts.

Illinois,ⁿ³⁴ for example, permits the circulation of an identifying statement, circular, or preliminary prospectus in accordance with regulations of the Secretary of State.ⁿ³⁵

In Ohio there are two provisions allowing the use of certain advertising material without constituting a sale. In the first, the advertising material must bear a certain legend, and the sale must be made to the issuer, a dealer or an institutional investor.ⁿ³⁶ In the second, the offering may be made by any person in conjunction with an offering by a licensed dealer if there is no other attempt to sell the securities in the state.ⁿ³⁷

FOOTNOTES:

(n1)Footnote 1. See § 3.02[1] *supra*.

(n2)Footnote 2. See § 3.02 *supra*; see also *Computer Concepts, Inc. Profit Sharing Plan v. Brandt*, Blue Sky L. Rep. (CCH Dec. 1988-1990), P 73,037 (Ore. Ct. App. 1989); *Bellevue v. Business Files Institute, Inc.*, 61 Cal.2d 488, 393 P.2d 401, 39 Cal. Rptr. 201 (1964), *rev'd* 37 Cal. Rptr. 382 (Cal. App. 1964); *People v. Smith*, 180 Cal. App.2d 420, 4 Cal. Rptr. 282 (1960).

(n3)Footnote 3. *State v. Weisser*, 161 N.W.2d 360 (N.D. Sup. 1968).

(n4)Footnote 4. In *Cecil B. De Mille Productions v. Woolery*, 61 F.2d 45 (9th Cir. 1932), a federal court, interpreting California law, held that pledges of securities for loans were sales under the Blue Sky law. See also the ruling of the Court in *SEC v. Guild Films Co. Inc.*, 178 F.Supp. 418 (S.D.N.Y. 1959) *aff'd* 279 F.2d 485 (2d Cir. 1960) where a bank was found to have engaged in a sale transaction when it offered for sale shares of stock which had been pledged as collateral for a loan which subsequently went into default. The federal Holding Company Act defines sale to include a pledge.

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(n5)Footnote 5. *See, e.g.,* Ore. Rev. Stat. § 59-01517(c)(A): " 'Sale' and 'sell' do not include... a bona fide pledge or loan of securities."

The Pennsylvania provision excludes "any bona fide secured transaction in, or loan of, outstanding securities." 70 *Pa. Stat. Ann. § 1-102(r)(vii)(A)*.

(n6)Footnote 6. Unif. Sec. Act § 401(j)(6)(A); *see also* Rev. Unif. Sec. Act § 101(13)(vi), substituting "security interest" for "pledge" to reflect current usage. Official Code Comment to RUSA 101(13)(vi).

(n7)Footnote 7. Some states that exempt the sale by the pledgee do not have a statutory exclusion or exemption for the transaction between the pledgor and the pledgee. None of these states has any judicial decisions on the subject, but it would seem illogical to exempt the pledgee sale while requiring registration of the initial transaction. However, if the assumption is made that the initial transaction is not required to be registered, the question still remains whether it is exempt or excluded from these Blue Sky laws.

The National Securities Markets Improvements Act ("NSMIA"), Pub. L. No. 104-290, 110 Stat. 3416 (1996), effective October 11, 1996, as amended by Pub. L. No. 105-353, effective November 3, 1998, amended 18 of the Securities Act of 1933 and other federal statutes regulating the securities industry by providing for limited pre-emption of state Blue Sky laws. The legislation pre-empts state authority to require registration of "federal covered securities" and limits state regulation of securities disclosure documents and certain investment personnel. NSMIA also pre-empts state regulation of advertising or sales literature with regard to a federal covered security. The states retain their authority to bring enforcement actions with respect to "fraud or deceit" or "unlawful conduct by a broker or dealer." However, states may not use their retained authority to circumvent pre-empted regulation. *See* 18(c)(1), National Securities Markets Improvement Act, Pub. L. No. 104-290, 110 Stat. 3416 (1996), effective October 11, 1996; H.R. Rep. No. 104-622, 104th Cong., 2d Sess. (June 17, 1996).

(n8)Footnote 8. Unif. Sec. Act § 401(j)(6)(B); *see also* Rev. Unif. Sec. Act § 101(13)(vi).

The election of dividends question has been answered differently under federal securities law than under the Uniform Act. The General Counsel of the SEC took the position that there is a sale when a cash dividend is first declared and then shareholders are given a right to take stock instead, because the shareholders are giving value (their pre-existing and vested right to the dividend in cash) for the securities, *see* Sec. Act. Rel. No. 929, 1 Fed. Sec. L. Rep. (CCH) P 1121 (1936). On the subject of stock dividends under federal securities law, *see* Federal Securities Act of 1933, § 2.02[2] (Matthew Bender); 2 Loss & Seligman, Securities Regulation 1138.28 (3d ed. Aspen Law & Business).

The position that there is an "offer" when stockholders may waive a cash dividend already declared in favor of securities, but no "offer" when the dividend is declared in cash or stock in the alternative has been criticized as "illogical." *See* Comment (4)(b) to Section 202(143), ALI Federal Securities Code, which treats the issuance of a security in return for the surrender of a right or alternate right to a cash or property dividend as an "offer" and "sale." *Id.*, Section 202 (143)(F)(iii)(II).

(n9)Footnote 9. *See* A.C.A. § 23-42-102 (2006); Ark. Stat. Ann. § 23-42-102(13)(B)(ii); *Ind. Code* § 23-2-1-1(i)(8)(ii); *N.C. Gen. Stat. § 78A-2(8)(f)(2)*.

In North Carolina, the statute speaks of a "security dividend" rather than a "stock dividend." The draftsmen of the Uniform Securities Act have taken the position that as a practical matter there is no difference in principle between the two. *See* Draftsmen's Commentary to Unif. Sec. Act. § 401(j)(6)(B), Loss & Cowett, Blue Sky Law p. 346 (1958): "The phrase 'stock dividend' rather than 'security dividend' was chosen because dividends in other securities are rare; but, since there is no difference in principle, the phrase 'security dividend' might well be substituted when technical amendments of the Act are considered."

But note that the referred to technical amendment was not made.

North Carolina's provision also removes stock splits from the "offer" and "sale" definitions. This may be the unspecified intention of the Uniform Act and its following states since the proportion of equity an individual has in the corporation would not be affected. In this connection, see *Mertz v. H.D. Hudson Mfg. Co.*, 194 Minn. 636, 261 N.W. 472 (1935). A few states treat stock splits as exempt transactions. See ch. 8 *infra*.

The Virginia provision is not an exclusion from the definition, but is stated as a total exemption that removes stock dividends from all the provisions of the Blue Sky law including the fraud provisions. The effect of the Virginia provision is the same as under the Uniform Act. See *Va. Code Ann. § 13.1-514(B)(14)*.

(n10)Footnote 10. *Cal. Corp. Code § 25017(f)(2)*:

"Sale," "sell," "offer" or "offer to sell" does not include:

any stock dividend payable with respect to common stock of a corporation solely (except for any cash or script paid for fractional shares) in shares of such common stock, if the corporation has no other class of voting stock outstanding; provided, that shares issued in any such dividend shall be subject to any conditions previously imposed by the commissioner applicable to the shares with respect to which they are issued. ...

(n11)Footnote 11. The California Corporation Commissioner has attempted to explain the statute in Regulation 260.017. The Commission's theory is that if the issuer has more than one class of voting stock or the dividend is not in common stock or payable in common stock, the rights preferences, privileges, or restrictions of or on other outstanding securities of the issuer will be changed. The California "sale" definition contains a clause which includes as a sale any change in such rights, preferences privileges or restrictions of or on outstanding securities. See *Cal. Corp. Code § 25017(a)*.

(n12)Footnote 12. California Securities Rule 260.017.

However, the California Securities Rule definition of "stock dividend" excludes a stock split (as defined in Securities Rule 260.103(f)) or an exchange or reclassification of shares.

The Iowa statute is similarly restrictive. See *Iowa Code § 502.102(6)(f)(2)*. The exclusion from "offer" and "sale" in Iowa is for:

[a]ny stock split, other than a reverse stock split, or security dividend payable with respect to the securities of a corporation in the same or any other class of securities of such corporation, provided nothing of value, including the surrender of a right or an option to receive a cash or property dividend, is given by security holders for the security dividend.

For exclusion eligibility, the securities must be:

1. Issued by the corporation declaring the dividend.
2. Not in exchange for *any* value including an option to receive cash or property.

However, *Iowa Code § 502.203(15)* provides a registration exemption where dividend securities of the issuer are

offered in lieu of cash or property dividend when each shareholder may elect to take the dividend.

(n13)Footnote 13. *70 Pa. Stat. § 1-102(r)(vii), (viii)*:

(vii) The terms 'sale,' 'sell,' 'offer' and 'offer to sell' do not include ... any dividend payable with respect to the securities of a corporation in the same or any other class of securities of such corporation.

(viii) A dividend or distribution by any person to all or any class of its security holders of the securities of any other person, whether or not such dividend or distribution is for value, involves a sale.

However, there is a transaction exemption for "any stock dividend, where the corporation distributing the dividend is not the issuer, if nothing of value is given by stockholders for the dividend other than the surrender of a right to a cash or property dividend in lieu of the stock and if the dividend is issued pro rata by class. ..." *See 70 Pa. Stat. § 1-203(q)*.

(n14)Footnote 14. *See, e.g., Colo. Rev. Stat. § 11-51-201(13)(h)*: "The terms included in this subsection ... do not include ... any stock dividend if nothing of value of given by stockholders for the dividend."

See also Minn. Stat. Ann. § 80A.14(p)(17)(6): "The terms defined in this subsection... do not include... any stock dividend whether the corporation distributing is the issuer of the stock or not."

(n15)Footnote 15. For example, the Alabama provision exempts:

The issuance of any stock dividend, whether the corporation distributing the dividend is the issuer of the stock or not, if nothing of value is given by the stockholders for the distribution other than the surrender of a right to a cash dividend where the stockholder can elect to take a dividend in cash or stock.

Ala. Code § 8-6-11(a)(12).

(n16)Footnote 16. *See, e.g., Ariz. Rev. Stat. § 44-1844(5)*, which exempts "the distribution by a corporation of capital stock or other securities to its stockholders or other security holders as a stock dividend or other distribution out of retained earnings."

See also Tex. Rev. Civ. Stat. art. 581-5(D), which exempts "[t]he distribution by a corporation of securities direct to its stockholders as a stock dividend or other distribution paid out of earnings or surplus."

(n17)Footnote 17. This is only one of several methods of "going public through the back door."

(n18)Footnote 18. *Sec. Act Rel. No. 4982 [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,516 (1969)*.

(n19)Footnote 19. *SEC v. Datronics Engineers, Inc.*, 490 F.2d 250 (4th Cir. 1973) , *cert. denied sub. nom.*, Fed. Sec. L. Rep. (CCH Dec. 1973-1974) 94,470 (4/15/74); *SEC v. Harwyn Industries Corp.*, 326 Fed. Supp. 943 (SDNY, 1971) . *See also Rathbone v. Rathbone*, 508 F. Supp. 515 (E.D. La. 1980) , *aff'd on other grounds*, 683 F. 2d 914 (5th Cir. 1982) .

See also United States v. Robinson, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,508 (2d Cir. 1976).

(n20)Footnote 20. *See Hampton Roads Fire & Marine Ins. Co. v. Coburn Motor Car Co.*, 158 Va. 675, 164 S.E. 723, 724 (Va. 1932) .

(n21)Footnote 21. *See Loss*, n. 8 *supra*.

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(n22)Footnote 22. 'Sale' or 'Sell' includes... any change in the rights, preferences, privileges, or restrictions of or on outstanding securities." *Cal. Corp. Code § 25017(a)*.

(n23)Footnote 23. See *Western Air Lines, Inc. v. Schutzbank*, 258 Cal. App.2d 218, 66 Cal. Rptr. 293 (1968) ; *Western Air Lines, Inc. v. Sobieski*, 191 Cal. App.2d 399, 12 Cal. Rptr. 719 (1961) .

(n24)Footnote 24. Since a merger or consolidation usually requires at least some shareholders to exchange their stock for the stock of the new or surviving corporation, a sale would probably exist unless there were a statutory provision to the contrary.

(n25)Footnote 25. Logic would seem to dictate that under the broad definition of "sale," such actions would be sales unless there were a statutory provision to the contrary. One case under the federal securities laws has already been noted, see § 3.01[1] n. 22 *supra*. An early Blue Sky case under a former Michigan statute was in accord. See *Edward v. Ioor*, 205 Mich. 617, 172 N.W. 620 (1919) .

(n26)Footnote 26. The Act's draftsmen have stated that the term "class vote" is intended to mean that a specified majority of a class may bind all members of that class, subject to appraisal rights of dissenters. There is no intention to make the provision inapplicable when there is only a single class of stock. See Draftsmen's Commentary to Unif. Sec. Act 401(j)(6).

See also: Missouri: 15 CSR § 30-50.010(S)(1):

For the purpose of Section 409.401(j)(6)(C) of the Act, the phrase 'any act incident to a class vote by stockholders' shall include the issuance of securities by a corporation and the distribution thereof to its security holders or to another corporation or to the security holders of such other corporation, by the issuing corporation or by such other corporation in connection with any merger, consolidation, reclassification of securities, or sale of corporate assets referred to in [said section].

(n27)Footnote 27. Unif. Sec. Act § 401(j)(6)(C); see also Rev. Unif. Sec. Act § 101(13)(vi), which deletes the exception for statutory mergers and sales of assets in light of the federal registration requirements under SEC Rule 145 under the 1933 Act for corporate combinations involving the exchange of stock. Official Code comment to RUSA 101(13)(vi). But see the RUSA 402(17) exemption.

(n28)Footnote 28. See, e.g., *Colo. Rev. Stat. § 11-51-201(13)(g)*; *Mich. Comp. L. § 451.802(b)(19)*; *N.J. Rev. Stat. Ann. § 49:3-49(j)(6)(iii)*.

Delaware also has an exclusionary provision based on the Uniform Act's. However, the Delaware exclusion has been modified to coincide with the corporation law that permits certain corporate actions without a formal meeting of shareholders. See *8 Del. Code Ann. § 228*.

The Delaware Blue Sky provision (*6 Del. Code Ann. § 7302(a)(11)(d)*) excludes from "offer" and "sale":

[a]ny act incident to a vote by stockholders or approval pursuant to § 228 of Title 8 without a meeting, pursuant to the certificate of incorporation or the provisions of this title, on a merger, consolidation, reclassification of securities, dissolution, or sale of corporate assets in consideration of the issuances of securities of the same or another corporation. ...

Note that the above provision also excludes corporate dissolutions.

Pennsylvania takes the opposite approach and *includes* as a "sale" "[a]ny issuance of securities pursuant to any

merger, consolidation, sale of assets or other corporate reorganization, involving the exchange of securities, in whole or in part, for the securities of any other person." 70 Pa. Stat. Ann. § 1-102(r)(i).

See, however, the transaction exemption provision in Pa. Stat. Ann. § 1-203(o).

(n29)Footnote 29. For example, the Michigan exemption applies to:

- (1) "phantom bank" reorganizations used by bank holding companies to acquire an operating or target bank;
- (2) "share exchanges," in which shareholders of the target corporation in a merger vote to approve an exchange of their target shares for shares of the surviving corporation; and
- (3) the purchase of assets and assumption of liabilities of a business trust or real estate investment trust ("REIT") in exchange for a corporation's stock and the subsequent termination of the trust or REIT with the distribution of the stock to the beneficial owners of the trust or REIT.

See Mich. Comp. L. § 451.802(b)(19). Michigan will not issue no-action letters and interpretive opinions concerning transactions substantially similar to these fact situations. Release No. 82-5, "Availability of Section 402(b)(19) Exemption," Corporation and Securities Bureau (July 26, 1982).

The extent to which the statutes apply varies. Each should be consulted before a decision is made on exemption status. While virtually all the states that provide a transactional exemption exempt security exchanges pursuant to mergers or consolidations, such actions as sale of corporate assets in exchange for securities or reclassifications are not always mentioned. Further, a number of conditions may have to be fulfilled. A few states, for example, require filings for the exemption.

See, e.g., Minn. Stat. § 80A.15(2)(l), which exempts

"[t]he issuance and delivery of any securities of one corporation to another corporation or its security holders in connection with a merger, exchange of shares, or transfer of assets whereby the approval of stockholders of the other corporation is required to be obtained, provided, that the commissioner has been furnished with a general description of the transaction and with other information as the commissioner by rule prescribes not less than ten days prior to the issuance and delivery."

(n30)Footnote 30. Unif. Sec. Act § 401(j)(6)(D). See also Rev. Unif. Sec. Act § 101(13)(vi).

(n31)Footnote 31. See, e.g., 6 Del Code Ann. § 7302(11)(d); Nev. Rev. Stat. § 90.280(6)(c); S.C. Code Ann. § 35-1-2013(f)(iv).

Connecticut and Massachusetts have adopted statutory exclusions from the definitions of "offer" and "sale" that are strikingly similar to the Securities Act of 1933 § 3(a)(10) transactional exemption for securities issued in reorganizations and exchanges with judicial or administrative approval.

Conn. Gen. Stat. Ann. § 36b-3(15)(g)(iv) excludes

[A]ny security which is issued in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash, where the terms and conditions of such issuance and exchange are approved by any state or federal court.

Mass. Gen. L. Ann., Ch. 110A, § 401(i)(6)(D) excludes

[A]ny act incident to a reorganization in which a security is issued in exchange for one or more outstanding securities, claims, or property interests, or partly in such exchange and partly for cash, if the terms and conditions of the issuance and exchange are approved, after a hearing upon their fairness at which all persons to whom it is proposed to issue securities in the exchange have the right to appear, by any court, any official or agency of the United States, or any state authority expressly authorized by law to grant such approval."

(n32)Footnote 32. *See, e.g.,* In the Matter of Brown Motors, Inc., [1982-1984 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,964 (Ga. Sec. Comm. 1984), where an advertisement placed in a trade publication of general circulation for the purpose of soliciting buyers of corporate stock constituted an offer to sell securities under the Georgia Securities Act.

But see Andrew Peck Assoc., Inc. v. Crease, [1982-1984 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,963 (Kan. D.C. 1984), where advertisements soliciting applications to open margin accounts with a brokerage firm that appeared in a publication directed to investors did not constitute offers to sell under the Kansas Securities Act where the name, quantity, price or other terms of the proposed agreement were not specified.

See § 3.01[1] supra.

(n33)Footnote 33. The states that include advertising in the definition do not define "offer" but use a broad definition of "sale" which includes offers to sell securities.

See, e.g., Ohio Rev. Code 1707.01(C)(1). But see n. 36 *infra*.

(n34)Footnote 34. Ch. 815, §§2.5; 2.5a: Ill. Comp. Stat.

(n35)Footnote 35. Ill. Admin. Code §130.210.

(n36)Footnote 36. *Ohio Rev. Code Ann. § 1707.01(C)(3):*

The use of advertisements, circulars, or pamphlets in connection with the sale of securities in this state exclusively to the purchasers specified in division (D) of section 1707.03 of the Revised Code is not a sale when the advertisements, circulars, and pamphlets describing and offering such securities bear a readily legible legend in substance as follows: "This offer is made on behalf of dealers licensed under sections 1707.01 to 1707.45 of the Revised Code, and is confined in this state exclusively to institutional investors and licensed dealers."

(n37)Footnote 37. *Ohio Rev. Code Ann. § 1707.01 (C)(4):* "The offering of securities by any person in conjunction with a licensed dealer, by use of advertisement, circular, or pamphlet is not a sale if such person does not otherwise attempt to sell such securities in this state."



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Blue Sky Regulation

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CHAPTER 3 "Offers" or "Sales" of Securities

1-3 Blue Sky Regulation § 3.04

§ 3.04 Identifying "Sellers"

In liability determinations under Blue Sky laws, administrators and courts look to activities of the parties to determine whether a sale is made and to determine who is the seller for purposes of liability.ⁿ¹ A comprehensive analysis of the question was undertaken in *Brown v. Cole*, a leading Texas case.ⁿ² The appellant in *Brown* offered a number of defenses against alleged violations of the Texas Securities Law contending that he was not the seller of securities. None was sustained by the court. No merit was found in the argument that since the appellant also purchased the securities, and lost his money along with the buyers, he was not the seller. The Texas court noted that a securities dealer could purchase part of his own offering and sell the balance to others. That a person purchases securities does not prevent him from being the seller of the same securities.ⁿ³ Of greater interest was the argument that the appellant was acting as an agent for the purchasers, not as their vendor. Here, the court looked at the appellant's activities. Important factors were that the subject of the securities transaction was proposed by appellant to the purchasers, the major contacts in purchasing the securities were with appellant, and, if not for appellant's efforts, the securities would not have been purchased by the respondents.ⁿ⁴ A third party had actually received the funds and transferred the securities, but this did not prevent the Texas court from finding more than one seller in a given transaction. A seller, said the court, "may be any link in the chain of the selling process."ⁿ⁵

A Louisiana appellate court offered this practical assessment of conduct amounting to an offer to sell or sale in *Godair v. Place Vendome Corporation of America*:ⁿ⁶

[W]e conclude that Essmeier "offered to sell" or "sold" the security to plaintiff. This finding is supported by the following facts: (1) he approached the plaintiff, stating that he represented Place Vendome; (2) he related to plaintiff all of the information concerning the project; (3) he asked plaintiff to invest in the project; (4) he got Thornton to phone plaintiff to give plaintiff additional information; (5) he went to plaintiff's place of business and received a cashier's check for \$100,000 from plaintiff; (6) he gave plaintiff a promissory note for \$200,000 in return for the cashier's check; (7) he delivered the check to Recile in Baton Rouge. Thus, Essmeier was actively involved in the disposition of the promissory note to plaintiff for value, i.e. \$100,000, and acted as a salesman of the security.

This fact assessment well illustrates the type of active role that will allow seller status to attach to a party who is not the actual seller in the sense of being one who passes title of securities, or who is not in direct privity with the buyer. Persons who knowingly facilitate a sale or the selling process may thus be subjected to primary liability for violations of Blue Sky laws, particularly registration related violations.

A more difficult question arises when a sale has been made, but the identity of the seller is challenged. In a California case,ⁿ⁷ decided under a former statute, a company argued that the sale was made by its president, and that the transaction was therefore exempt from the Blue Sky provisions. The court, looking to the activities of the parties, rejected this contention since the company: (1) contracted to sell the securities and (2) received and cancelled the president's stock and issued new shares to the purchasers.ⁿ⁸

Another factor that might be employed to determine whether an offer has been made is the intent of the parties. In one case in point, a California courtⁿ⁹ ruled that the intent of the alleged seller but not that of the buyer is critical. In this case, the defendant, charged with selling unregistered securities, argued that his vendee, a police officer investigating the defendant, never intended to consummate the sale. The court held that defendant's intent to sell the securities was the decisive factor and noted that, under the Blue Sky law, an offer or an attempt to sell securities is a sale.ⁿ¹⁰

FOOTNOTES:

(n1)Footnote 1. *See* Seaboard Planning Corp. v. Powell, 3 C.C.H. Blue Sky L. Rep. P 71,443 (Miss. Sup. Ct. 1978). Without participation in the wrongdoing (*e.g.*, inducement or knowledge), and in the absence of a principal-agent relationship, the issuer as such is not a statutory "seller" under the Mississippi Blue Sky law. More activity must be shown than a remote connection with the chain of distribution. *See also* State v. American Microtel, Inc., No. CV 93-21626 (Super. Ct. Ariz. 5/26/95) (memoranda informing investors of wireless cable enterprise and requesting payment constitutes offer).

(n2)Footnote 2. 155 Tex. 624, 291 S.W.2d 704 (1956) , *affg* 276 S.W.2d 369 (Tex. Civ. App. 1955) .

(n3)Footnote 3. 291 S.W.2d at 708 .

(n4)Footnote 4. 291 S.W.2d at 709 .

In a Texas case decided subsequent to *Brown* the question of agency as opposed to selling was also raised. In *Smith v. Smith*, 424 S.W.2d 244 (Tex. Civ. App. 1968) , the contending parties were brothers. The court still found that the activities involved caused a sale and not an agency. The court pointed out that the purchaser first became interested in the securities when solicited by his brother, all information relevant to the investment came from the brother through whom the purchase was made, the selling brother had taken initial steps to begin a business to sell generally the securities in question and a letter written by the selling brother contained a strong sales pitch without disclosing the names of any principals who could be contacted for investment.

See also In the Matter of Mistigull Jewelry Co., Inc., [1982-1984 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,485 (Ill. Sec. of State 1978) in which an officer of an issuing corporation was not allowed to deny his participation in the sale of unregistered securities on the basis of his status as an agent of the corporation. His telephone conversations with an investor culminated in an agreement to purchase stock, and this was sufficient to bring him within the "sale" provision of the statute. *But see* Bacon v. Smith, Barney, Shearson, Inc., Blue Sky L. Rep., 1996 CCH Decisions, 74,105 (D.N.H. 1996) (misrepresentation of tax consequences of closing IRA account which resulted in sale of stocks not advice given in connection with purchase or sale of security).

(n5)Footnote 5. 291 S.W.2d at 708 .

In *Dean v. State*, 433 S.W.2d 173 (Tex. Crim. App. 1968) , the person who signed the contract of sale was a seller although all representations relied on by purchasers concerning the security were made by others. Following *Brown*, n. 2 *supra* , it was determined that there can be more than one seller.

See also Gonia v. E.I. Hagen Co., 251 Ore. 1, 433 P.2d 634 (1968) .

(n6)Footnote 6. *La. App.* 93-1818, 648 So.2d 440, 446-447, 1994 *La. App.* LEXIS 3643 (*La. App.* 1994) .

1-3 Blue Sky Regulation § 3.04

(n7)Footnote 7. *Castle v. Acme Ice Cream Co.*, 101 Cal. App. 396, 281 P. 396 (1929) .

(n8)Footnote 8. *Id.*, 281 P. at 398 .

(n9)Footnote 9. *People v. Mills*, 148 Cal. App.2d 392, 306 P.2d 1005 (1957) . *See also* State of Iowa v. Diacide Distrib., Inc., Blue Sky L. Rep. (CCH) P 74,188 (Iowa 1999).

(n10)Footnote 10. 306 P.2d at 1015 .



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CHAPTER 3 "Offers" or "Sales" of Securities

1-3 Blue Sky Regulation § 3.05

§ 3.05 Offers and Sales in Cyberspace

The advent of the Internet as a tool for e-commerce has resulted in an explosion of online securities offerings. The proliferation of on-line "free" stock promotions, and regulatory responses to them, illustrate the breadth of the meaning of sale in the application of securities law protections. At the federal level, in a series of no-action letters the SEC has cautioned that the distribution of "free" stock to individuals who visit or register on Internet sites constitutes a sale of those shares within the purview of the federal securities laws where there is in fact something given up in order to obtain them, or when a valuable benefit accrues to the issuer in the distribution. Requiring cash payments to defray the cost of processing "free" shares, or requiring the purchase of a product or service,ⁿ¹ or even the simple requirement that an individual register on a company web site may create an event of sale.ⁿ² These considerations are no less meaningful in the application of state Blue Sky laws, and guide state regulators in their own aggressive monitoring of Internet "offering" communications that are clearly directed to residents.

Intermediaries likewise make extensive use of the Internet to advertise investment products and services. The scope and application of Blue Sky laws for the protection of investors in these areas must be balanced against the interest in facilitating electronic commerce and communication. States have responded with rules or policies aimed at furthering both objectives. Pennsylvania, for example, was the first state to develop an exemption for Internet offers, allowing an exemption if:

- (1) the Internet Offer indicates directly or indirectly that the securities are not to be offered to persons in the state;
- (2) an offer is not otherwise specifically directed to any person in the state by or on behalf of the issuer; and
- (3) no sales of the issuer's securities are made in the state as a result of the Internet Offer.ⁿ³

NASAA endorsed Pennsylvania's position, issuing a resolution encouraging state regulators to exempt Internet offers and using substantially similar language.ⁿ⁴ State responses are discussed in greater detail in Chapter 4.03[3] and extensively in Chapter 12--Blue Sky Laws and the Internet.ⁿ⁵

FOOTNOTES:

(n1)Footnote 1. American Brewing Co., SEC No Action Letter, [1999 Transfer Binder] Fed.Sec.L.Rep. (CCH) P 77,521 (Jan.27, 1999) ("Free" share of non-voting common stock for each case of issuer's beer purchased at retail would

constitute a sale).

(n2)Footnote 2. In *Vanderkam & Sanders*, SEC No Action Letter, [1999 Transfer Binder] Fed.Sec.L.Rep. (CCH) P 77,520 (Jan. 27, 1999), for example, a company proposal to operate and maintain an internet-based auto referral service in which shares of the company's common stock would be issued to any person who registered on the site was viewed by the SEC staff as an event of sale. There was no cash, property or services required to receive shares of the stock, which, when issued, would have been uncertificated and non-transferable. However, the company proposed to issue additional shares in exchange for referrals of others to its web site. The SEC staff was satisfied that the issuance of the shares in consideration of registration on or visit to the web site constituted a sale, and declined no-action advice that the company could proceed without compliance with the registration provisions of the Securities Act.

See also Andrew Jones, SEC No Action Letter, [1999 Transfer Binder] Fed.Sec.L.Rep. (CCH) P 77,565 (June 8, 1999) (Issuance of non-transferable free shares of common stock to the first one million people registering on a linked web site, and additional shares to persons who refer others to the web site would constitute an event of sale whether or not the distribution was through the issuer's web site).

(n3)Footnote 3. Pa. Code 203.190(a). *See also* Admin. Order, Pa. Sec. Comm. (9/2/97).

(n4)Footnote 4. The NASAA resolution encourages states to exempt Internet offers from their registration provision when

(A) the Internet offer indicates, directly or indirectly, that the securities are not being offered to residents of a particular state and

(B) an offer is not otherwise specifically directed to any person in any state by, or on behalf of the issuer of securities.

Resolution Regarding Securities on the Internet, adopted by NASAA 1-7-96. The Resolution further encourages states to allow sales that were the subject of an Internet offer if no sales of securities were made in the state until the offering was registered and declared effective and the final prospectus or Form U-7 was delivered to the investor prior to the sale, or the sales are exempt from registration. *Id.*

(n5)Footnote 5. *See also* Winn, Regulating the Use of the Internet in Securities Markets, 54 Bus. L. 443 (Nov. 1998); Coffee, Brave New World? The Impact(s) of the Internet on Modern Securities Regulation, 52 Bus. L. 1195, 1231 (Aug. 1997); Bertram, Offers and Sales of Securities on the Internet, 42 Practical Lawyer, No. 7, 23 (Oct. 1996).



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CHAPTER 4 State Investor Protection Authority

1-4 Blue Sky Regulation 4.syn

§ 4.syn Synopsis to Chapter 4: State Investor Protection Authority

§ 4.01 Introduction--The Scope of Jurisdiction under Blue Sky Laws

§ 4.02 The Impact of NSMIA on State Authority

[1] Regulation of Securities Offerings

[2] Intermediary Regulation

§ 4.03 Conflict Preemption of State Law

[1] Conflict Preemption

§ 4.04 Jurisdictional Predicates

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CHAPTER 4 State Investor Protection Authority

1-4 Blue Sky Regulation § 4.01

§ 4.01 Introduction--The Scope of Jurisdiction under Blue Sky Laws

In the preceding chapters the two essential predicates to the operation of state securities laws are identified: (1) the presence of a "security;" and (2) activity that triggers concern for investor protection. The latter is most often viewed in terms of whether there is (or is intended to be) an "offer" or "sale" of a security in the state, but should not be understood so narrowly. The jurisdiction of state securities regulators, and the availability of remedial provisions under Blue Sky laws generally, has historically extended well beyond the *distribution*, or capital formation, setting to encompass qualifications on, and the activities of, intermediaries such as dealers, salespersons, and investment advisers in a variety of market and transactional settings. Blue Sky laws are accorded the widest possible reach to effectuate their goal of investor protection. Thus, for example, in *Texas Capital Securities, Inc. v. Sandefer*,ⁿ¹ remedies under the Texas Blue Sky law were applied against a broker-dealer for securities transactions that occurred in the public secondary, *i.e.* trading, market. The court held that the Blue Sky law is not limited in application to initial, or primary, offerings, and that the rescission remedy should be available against any intermediary who forms a link in the chain of any selling process in which there is a violation of the law. Unlike its federal counterpart,ⁿ² said the court, the Texas Blue Sky remedy contains no limitation in scope that would prevent its application in secondary market settings.

In *People v. Napolitano* ⁿ³ New York's Blue Sky law--the "Martin Act"ⁿ⁴--was the basis for state prosecution of a defendant for conduct amounting to "insider trading." The law of insider trading has evolved almost exclusively under the antifraud provisions of the federal securities laws, most particularly section 10(b) of the Securities Exchange Act and SEC *Rule 10b-5*. Nevertheless, the Martin Act is a broad antifraud law, and in affirming the state convictions for insider trading under it the *Napolitano* court simply imported federal jurisprudence as defining the basis for conviction for the same conduct under it. The case illustrates an aggressive approach to enforcement under Blue Sky law antifraud provisions today that is in some ways a by-product of the redefinition of federal and state regulatory roles imposed by the National Securities Markets Improvement Act of 1996 ("NSMIA"),ⁿ⁵ which is examined more closely in

As discussed in *section 4.02* below, despite the enactment of NSMIA, the savings clauses of both the Securities Act of 1933 and the Securities Exchange Act of 1934 remain intact.ⁿ⁶ The scope of state investor protection authority and the availability of private remedies for antifraud violations were not affected. The legislative history of NSMIA itself makes congressional intent clear in regard to the continuing scope of investor protection under Blue Sky laws:

"It is also the Committee's intention not to alter, limit, expand or otherwise affect in any way any State authority or common law with respect to fraud or deceit, including broker-dealer sales practices, in

connection with securities and securities transactions."⁷

Consistent with the express reservation of powers in NSMIA and their historic mission, state regulators will broadly interpret and exercise the scope of their jurisdiction to protect against fraud, and state courts will likewise liberally define its limits. As a Utah appellate court observed in a pre-NSMIA setting:

[I]t is clear that Congress did not intend the Securities Exchange Act of 1934 to displace state law in the same area. It is also clear that Congress expressly gave the states the authority to regulate securities, especially securities that are being traded in a fraudulent manner ... It cannot be said that Utah's regulation of a fraudulent security does not at the same time fulfill the purposes and objectives of federal law.⁸

Apart from the broad reach of investor protection authority under Blue Sky antifraud provisions, a functional approach to state regulation means that *intermediary* regulation through licensing and enforcement is now, in many settings, the prime focus of state jurisdiction. In the assessment of intermediary activities under Blue Sky laws the starting point for determining the scope of state securities regulatory authority is in all cases the identification of an event or activity covered by the Blue Sky law. Despite whatever degree of uniformity has been achieved in state securities regulation through widespread adoption of the Uniform Securities Act in either its original or 1985 revised form, and today with the 2002 Uniform Act,⁹ there remain numerous and significant variants among the states which are a trap for the unwary. Consider, for example, the exemption from dealer licensing requirements allowed by Section 202 of the Revised Uniform Act in states adopting that version for broker-dealers where:

[T]he transactions effected by the broker-dealer in this State are exclusively with the issuer of the securities involved in the transaction, other broker-dealers licensed or exempt under this [Act], or financial or institutional investors.

Other states provide an exemption from dealer licensing if the dealer has no place of business in the state, and if transactions are effected exclusively with the issuer of the securities involved in the transactions or other broker-dealers registered or exempt in the state, but with no mention of transactions exclusively with "institutional investors." And in Ohio, although the Blue Sky law exempts offers and sales of securities to "institutional investors" from registration, dealer licensing is nevertheless expressly required even for those who effect transactions solely with such investors.¹⁰

These are critically important jurisdictional considerations for multi-state intermediary firms engaged, for example, in large private placements of senior or debt securities with major financial institutions. The compliance stakes are high, in that rescission remedies for transactions involving licensing violations are typically provided in addition to whatever administrative penalties may be imposed.

The offering and distribution of securities, and the activities of intermediaries, in Cyberspace present an entirely new set of challenges in defining the scope and application of state securities regulatory jurisdiction. Electronic offers of securities by issuers or intermediaries through the global medium of the Internet explode traditional notions of discrete territorial activity directed at or within investors of a particular state. Cyberspace jurisdictional issues thus drive an emergent emphasis on actual *sales* rather than traditional "offer" and solicitation activities as the trigger for application of state regulation. Here again, however, approaches among the states are not uniform. Moreover, where the jurisdictional focus shifts from pure distribution issues to anti-fraud protection, and given the fertile new ground for fraudulent schemes and investment scams that the Internet offers, state securities regulators have undertaken to expand their own resources and abilities to exercise the full scope of enforcement powers in this rapidly evolving technological environment.

The functional, or activity-oriented, scope of state Blue Sky jurisdiction also extends to corporate governance, through securities or corporate law provisions in various states relating to takeover attempts or so-called "control share" bids or

acquisitions. Though posing a federal constitutional quandary, and serious preemption issues, properly measured and applied state jurisdiction to regulate in this area is today for the most part upheld with decisions such as *WLR Foods, Inc. v. Tyson Foods, Inc.*,ⁿ¹¹ which recognize legitimate state interests in regulating relationships that affect corporations that are located within the state and are a product of its laws.ⁿ¹²

It is thus apparent that the limits of state securities regulatory authority face new tests. States themselves have acted to limit their own jurisdiction by excluding various types of *de minimis* activities within their boundaries from coverage under Blue Sky laws. By creating threshold levels applicable, for example, to activities of unlicensed securities salespersons employed by licensed dealer firms, states recognize situations in which there is no practical need for the exercise of jurisdiction beyond fraud-based enforcement powers. *De minimis* exceptions to the exercise of regulatory jurisdiction vary among the states, but impact both capital formation and intermediary activities.ⁿ¹³

Understanding the circumstances that define state securities regulatory authority is an essential predicate to understanding the operation of Blue Sky laws themselves. Accordingly, activities or events constituting jurisdictional predicates are examined more closely below. In doing so, the historic protective mission of Blue Sky laws is a paramount consideration because the *limits* on authority today are both explained and understood by it.

FOOTNOTES:

(n1)Footnote 1. 58 S.W.3d 760 , *reh. denied*, 2001 Tex. App. LEXIS 5004 (Tex. App. 2001) .

(n2)Footnote 2. Section 12(a)(2) of the Securities Act of 1933, 15 U.S.C. § 77l (a)(2), creates a rescission remedy for purchasers of securities offered or sold "by means of a prospectus or oral communication" containing an information failure. This provision in the federal statute has been held to mean that the remedy is available only in circumstances of an initial, or primary, offering of securities. See *Gustafson v. Alloyd Co.*, 513 U.S. 561, 115 S.Ct. 1061, 131 L.Ed.2d 1 (1995) .

(n3)Footnote 3. 282 A.D.2d 49, 724 N.Y.S.2d 702 N.Y. App. Div. LEXIS (App. Div. 1st Dept. 2001).

(n4)Footnote 4. N.Y. General Business Law, Art. 23-A.

(n5)Footnote 5. P.L. 104-290, 110 Stat. 3416 (1996). The National Securities Markets Improvement Act replaced, in its entirety, Section 18 of the Securities Act of 1933, 15 U.S.C. § 77r, and fundamentally altered the role of state Blue Sky laws by eliminating most state registration and qualification requirements for securities offerings that are national in character.

But see Kamen v. Lindly, 94 Cal. App. 4th 197, 114 Cal. Rptr. 2d 127 (Cal. App. 2001) (Availability of a private civil remedy for violation of the market manipulation provision of the California Blue Sky law denied on the basis of unusually strong persuasive federal precedent on construction of such provisions and the scope of liability under them).

See also *Daniel Boone Area School District v. Lehman Brothers, Inc.*, 187 F. Supp. 2d 400, 2002 U.S. Dist. LEXIS 2355 (W.D. Pa. 2002) , in which the court opined that civil remedies under the Pennsylvania Blue Sky law are limited to what is provided in the law, and that violations may not be civilly enforced through negligence actions).

The availability and scope of private remedies generally under Blue Sky laws is presented in depth in Chapter 15 *infra* . In the enforcement of Blue Sky laws the scope of state investor protection authority is broadly interpreted. These cases illustrate, however, that private rights of action do not necessarily enjoy the same degree of flexibility.

(n6)Footnote 6. State Blue Sky laws significantly predated the federal securities laws, and the creation of the federal regulatory scheme, with passage of the Securities Act of 1933 and the Securities Exchange Act of 1934, was not

intended to displace non-conflicting state jurisdiction. As section 28(a) of the Exchange Act, 15 U.S.C. 78bb(a), declares:

The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity... Nothing in this chapter shall affect the jurisdiction of the securities commissions (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder.

See also Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware, 414 U.S. 117, 94 S. Ct. 383, 38 L. Ed. 2d 348 (1973)

(n7)Footnote 7. H.R. Rep. No. 104-622, 104th Cong., 2d Sess. 34 (1996); *see also* IDS Bond Fund, Inc., v. Gleacher NatWest, Inc., CCH Blue Sky L.Rep. P 74,264, 2002 U.S. Dist. LEXIS 4073 (D. Minn. 2002) (No NSMIA preemption of state securities law fraud claims).

(n8)Footnote 8. *Johnson-Bowles Company, Inc. v. Utah Department of Commerce*, 829 P.2d 101, 109 , [1991-1993 Transfer Binder] CCH Blue Sky L. Rep. P 73,582, at 75,559-60 (Utah App. 1992), *cert. denied*, 843 P.2d 516 (Utah 1992) .

But see Dahl v. Charles Schwab & Co., 545 N.W.2d 918 (Minn. 1996) . In *Dahl* the Minnesota Supreme Court opined that state law may not be applied to the securities industry in a manner that is inconsistent with federal law. The court declined to permit application of state consumer protection laws to the disclosure of "payment for order flow" practices by securities broker-dealers. Application of stricter state law requirements, said the court, would be an obstacle to the accomplishment of federal regulatory purposes, have an adverse effect on securities markets nationwide, and conflict with the federal securities regulatory scheme.

See also Olde Discount Corporation v. Tupman, 1 F.3d 202 (3d Cir. 1993) , *cert. denied*. 510 U.S. 704 (1994) , in which the attempted exercise of jurisdiction by the Delaware Securities Commissioner to order rescission of security transactions on behalf of two broker-dealer customers through a state administrative proceeding was held to be precluded as being in conflict with rights secured to the broker-dealer under the Federal Arbitration Act.

(n9)Footnote 9. The 2002 Uniform Act is designed to modernize the Uniform Securities Act in light of NSMIA, significant recent changes in the technology of securities trading and regulation, and the increasingly interstate and international aspects of securities transactions. Unif. Sec. Act (2002), *Prefatory Note*. Although it is a new uniform act, the 2002 Uniform Securities Act contains several sections that are identical or substantively identical to sections of the original and/or revised acts. Here and throughout this treatise references are to the original and revised Uniform Acts as currently adopted in states, with further references to the 2002 Uniform Act where modifications or additions are noteworthy. The 2002 Uniform Act is reproduced in its entirety in the Appendix materials, at entirety in the Appendix materials, in Volume 2.

(n10)Footnote 10. *See Ohio Rev. Code § 1707.14(A)(2)*, which provides in pertinent part:

Notwithstanding the exceptions to licensure set forth in ... this section, no person other than an issuer selling its own securities shall engage in the business of selling securities to an institutional investor unless such person is licensed as a dealer.

(n11)Footnote 11. 65 F.3d 1172 (4th Cir. 1995) .

(n12)Footnote 12. State jurisdiction in the area of takeover bids and control share acquisitions is considered in

greater depth in § 4.04 *infra* .

State Blue Sky authority in matters of corporate governance extends in some states to proxy regulation. The Alaska Blue Sky law, for example, expressly prohibits misrepresentations in proxy solicitations, *see* Alaska Stat. § 25.55.160, and administrative regulations further prescribe its application to proxy statements, *see* 3 Alaska Admin. Code § 08.315(a). In *Meidinger v. Koniag, Inc.*, 31 P.3d 77, 2001 Alas. LEXIS 95 (Alaska 2001) , the Alaska Supreme Court affirmed an award of injunctive relief against a proxy solicitation involving a proxy statement containing materially false and misleading statements.

(n13)Footnote 13. As states limit the scope of securities regulation under Blue Sky laws tension arises over perceptions of what should be the proper scope of investor protection and the responsibility of state administrators in the exercise of their authority. In *First National Bank of the North v. Miller & Schroeder Financial, Inc.*, 709 N.W.2d 295 Minn. App. LEXIS (Minn. App. 2006), banks that had purchased defaulted debt securities claimed that the State of Minnesota was liable in tort because registration of the securities *by coordination* was "approved" by the state's securities administrator despite knowledge that the offering would not meet Minnesota merit-related registration requirements. The banks alleged that the administrator knew that the offering would not meet qualification requirements without including cash flow from borrowing.

Dismissal of the banks' claim against the state under the Minnesota Tort Claims Act was affirmed because the registration of securities for sale in Minnesota was an act of licensing or other authorization for which there is statutory immunity under the Tort Claims Act. The court held that the fact that a security was registered did not constitute a finding by the administrator that any materials filed by the issuer as part of the application was true, complete, and not misleading. While the focus of the decision was on the state's general authority in regard to licenses, permits or other authorization in connection with the registration of securities for sale, the practical issue was that the securities were registered by coordination, and the administrator did not apply standards that might otherwise apply if the registration were by qualification. The banks' claim against the state was in fact that a merit review standard had not been for their protection since the issuer could not fund its debentures. The outcome in *Miller & Schroeder Financial* turned on state immunity. It is clear, however, that the substantive challenge arose out of a perception of the scope of state investor protection authority in a changing regulatory environment.



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CHAPTER 4 State Investor Protection Authority

1-4 Blue Sky Regulation § 4.02

§ 4.02 The Impact of NSMIA on State Authority

[1] Regulation of Securities Offerings

NSMIA, the National Securities Markets Improvement Act of 1996, was passed "in order to promote efficiency and capital formation in the financial markets"ⁿ¹ and preempts state registration and qualification authority over certain securities offerings. As the U.S Court of Appeals for the Second Circuit has observed, NSMIA was enacted primarily to:

[p]reempt state "Blue Sky" laws which required issuers to register many securities with state authorities prior to marketing in the state. By 1996, Congress recognized the redundancy and inefficiencies inherent in such a system and passed NSMIA to preclude states from requiring issuers to register or qualify certain securities with state authorities.ⁿ²

After NSMIA, states may not directly or indirectly impose registration requirements, prohibit the offering or sale, impose conditions or additional disclosure requirements on the use of offering documents, proxy statements and other disclosure documents prepared by an issuer, or engage in merit regulation, with regard to four classes of "covered" securities. These are:

- (1) Securities listed or authorized for listing on the New York Stock Exchange or the American Stock Exchange, or listed on the National Market System of the NASDAQ Stock Market, or listed or authorized for listing on a national securities exchange which the Securities and Exchange Commission determines to have substantially similar listing standards, or securities equal in seniority or senior to securities described above;
- (2) Securities issued by an investment company registered under the Investment Company Act;
- (3) Securities offered or sold to a "qualified purchaser" as defined by the Commission; and
- (4) Securities offered or sold pursuant to certain exemptions under the 1933 Act,

1-4 Blue Sky Regulation § 4.02

including transactions exempt under Section 4(1)n3 (by persons other than an issuer, underwriter or dealer) and Section 4(3)n4 (dealer transactions) in securities of reporting issuers; transactions exempt under Section 4(4)n5 (brokers' transactions); transactions in securities exempt under Section 3(a)n6 (except for securities of religious or charitable organizations, securities issued in intrastate offerings and municipal securities offered in their home state); and securities offered and sold pursuant to exemptions by SEC rules and regulations issued under section 4(2) of the Securities Act.

States may continue to investigate and bring enforcement actions with respect to "fraud or deceit" or "unlawful conduct by a broker or dealer" in connection with these securities transactions. For securities offerings that would formerly have been subject to registration requirements, they may also require "notice filings" and filing fees (except relating to listed securities), and may suspend the offer or sale of securities within state borders for failure to file or to pay such fees.n7

The preservation of state authority in regard to fraud and intermediary activities is considerable. Nevertheless, an essential element in that preservation of authority is that it may not be exercised so as indirectly to impose conditions on the use of an issuer's offering documents, or to impose conditions based on the merits of an offering or issuer of a NSMIA covered security. However, in *IDS Bond Fund, Inc. v. Gleacher NatWest, Inc.*, n8 the court rejected an assertion that application of the antifraud remedy in the Minnesota Blue Sky law to private claims that an offering document contained false or misleading statements would necessarily constitute a NSMIA prohibited limitation or condition. Although antifraud claims made under the Blue Sky law would, if successful, impose limits on the use of the offering document by subjecting the defendants to damages for misstatements contained in it, the court found that such claims under state law posed no impediment to achieving the goal of NSMIA, and were expressly preserved.

A key consideration in *IDS Bond Fund* was that both state and federal securities laws prohibit fraud in the offer and sale of securities. Express preservation of antifraud authority aside, the application of an antifraud remedy under the state Blue Sky law is consistent with federal regulation. In contrast, a provision in the California Blue Sky law that placed limitations on the use of "penalty" bids in offerings of covered securities was held to be preempted by NSMIA in *Myers v. Merrill Lynch & Co.* n9 Because there was no such limitation imposed under the federal securities laws or SEC rules, the conflict between state and federal law resulted in NSMIA preemption.

The scope of NSMIA preemption of state authority has been examined most extensively in the critical area of offerings carried out pursuant to Rule 506 of SEC Regulation D under the Securities Actn10 Rule 506 of Regulation D was adopted under section 4(2) of the federal Securities Act--the federal "private offering" exemption.As such, securities offered and sold qualify as NSMIA covered securities, and state registration-related authority over them is preempted. But Rule 506 operates as a safe harbor to assure the validity of the section 4(2) exemption. As a safe harbor, Rule 506 and all of Regulation D of which it is a part mandate specific compliance requirements. The validity of a claimed Rule 506 exemption becomes critical in determining whether the securities offered are in fact NSMIA covered securities. Without the Rule 506 exemption, these offerings would not be covered securities, as NSMIA does not include stand-alone exempt offerings under section 4(2) within the definition of covered securities.

In NSMIA, Congress made no provision for any determination as to the validity of a claim that a security in an offering is, in fact, a covered security. Whether NSMIA preemption rests on actual validity of--versus claimed reliance on--the rule 506 exemption is critical in assessing the permitted scope of state authority to regulate offerings. State regulators and courts have challenged the existence of NSMIA preemption where there is merely claimed reliance on, and perhaps not actual compliance with, the Rule 506 exemption.

In 2005 the Alabama Supreme Court held that a registration-related claim under the Alabama Blue Sky law involving no fraud element was not preempted by NSMIA. In *Buist v. Time Domain Corp.*n11 the plaintiff purchased stock of a company in several transactions that were carried out in reliance upon the exemption from federal registration afforded by Rule 506 of Regulation D under the Securities Act of 1933. Securities offered in compliance with Rule 506 of

Regulation D are NSMIA "covered securities," and thus, state registration requirements are ostensibly preempted. However, the plaintiff in *Buist* alleged that the sales of stock were subject to the registration provisions of the Alabama securities law because the company did not have a valid federal exemption under Rule 506. Plaintiff argued that because the company did not prove that the sales to him complied the conditions and requirements of Rule 506, the securities were not NSMIA covered securities. The defendant company, on the other hand, urged that because it had undertaken the transactions in reliance upon Rule 506, and had in fact made the necessary Form D notice filing with the Alabama Securities Commission, NSMIA preempted state registration requirements without any further need for the seller to prove the federal exemption was available.

The trial court in *Buist* granted summary judgment to the defendant company, and its officers and directors who had also sold stock to the plaintiff. The lower court found no material issue of fact, and the record included evidence indicating that the company had made at least two Form D notice filings that the Alabama Securities Commission accepted as satisfying its requirements. The plaintiff's position that all requirements of Rule 506 and Regulation D were not followed, thus making the exemption unavailable and precluding NSMIA covered security status, was rejected.

The Alabama Supreme Court ultimately defined the central issue in the case as whether evidence indicating that all requirements of federal Rule 506 were satisfied is necessary to prove NSMIA preemption. The defendants had only presented evidence of compliance with Form D notice filing requirements, and plaintiff alleged that in fact the defendants had not complied with other requirements and could not claim the Rule 506 exemption. The Alabama Supreme Court agreed, to the extent of holding that the defendants, in order to avoid summary judgment, were required to submit evidence of compliance with all elements of Rule 506 and Regulation D, and not merely evidence of compliance with notice filing requirements. Under federal Rule 506, said the Court, the federal exemption and preemption under NSMIA are "functionally equivalent."¹² The Court stated:

Specifically, under the rule, the defendants can demonstrate that the [federal] Securities Act preempts the ASA because the transactions in question are exempt from the registration requirements of the Securities Act. The remaining question is whether evidence indicating that all of the requirements of Rule 506 were satisfied is necessary to preemption.¹³

The Court answered that question in the affirmative. Failure to comply with all requirements of Rule 506, said the Court, voids the federal exemption, and thereby eliminates the possibility of preemption. Summary judgment for the defendants was reversed, and the case remanded because:

[T]he exempt status of the sale of securities that deviates from any of the material commitments made in its Form D filing is repealed retroactively. Therefore, because Time Domain submitted no evidence indicating that its sales of securities were actually made in conformity with Regulation D, it did not make a prima facie showing that there was no genuine issue of material fact as to its exemption under Rule 506.¹⁴

The Alabama Supreme Court's holding in *Buist* that NSMIA did not preempt the plaintiff's state securities registration claims would presumably also permit a state administrator to examine the validity of the federal exemption in a Rule 506 offering in order to determine whether state registration requirements are preempted as to the particular offering. A state administrator, rather than the SEC, would be empowered to determine the validity of the federal exemption in order to determine whether an actual NSMIA covered security is involved in the offering. Such an exercise of state administrative authority over what are ostensibly covered securities under NSMIA, when there is no fraud involved, flies in the face of NSMIA's express preemption.

The Alabama court's approach had previously been rejected by federal courts for that very reason. In *Temple v. Gorman*¹⁵ and *Lillard v. Stockton*¹⁶ federal district courts concluded that private offerings made in reliance upon Rule 506 of federal Regulation D could not be subjected to state court registration requirements on grounds that the offerings did

not comply with federal Regulation D requirements. In *Temple* the court made clear: "Regardless of whether the private placement actually complied with the substantive requirements of Regulation D or Rule 506, the securities sold to Plaintiffs are federal 'covered securities' because they were sold pursuant to those rules."¹⁷ The court added:

Furthermore, any attempt by Florida to require registration of such securities or securities transaction would be preempted by NSMIA. Congress expressed its intent in NSMIA that federal regulations alone should govern the registration of national securities offerings. Where a Form D was filed with the SEC for a transaction that purported to merit an exemption from federal registration pursuant to Regulation D, Florida law could not require a duplicative registration or a transactional exemption from registration.¹⁸

The Alabama Supreme Court considered these federal decisions only to be persuasive authority with little analysis, and without any controlling effect. A subsequent Arkansas federal district court likewise concluded that NSMIA preemption of state authority is dependent upon the validity of the Rule 506 exemption.¹⁹ Recognizing that Congress did not by NSMIA completely preempt the field of securities regulation, the Arkansas federal court opined that the only way to assert federal preemption is to first show that the federal exemption from registration actually applies. Recitations in an agreement tracking the requirements of federal Regulation D were insufficient to show that the sales were in fact exempt. Therefore, state securities law claims were not preempted. The result was the same in *Grubka v. Webaccess International, Inc.*,²⁰ in which a Colorado federal district court held that registration claims asserted under the Colorado securities law would be preempted only if a defendant proved the validity of the federal exemption. Rejecting the contrary reasoning of *Temple v. Gorman*, the Colorado federal court concluded that the NSMIA definition of covered security is not satisfied simply because securities are sold pursuant to a putative federal exemption. The Court observed:

If Congress had intended that an offeror's representation of exemption should suffice it could have said so, but it did not. Such an intent seems unlikely, in any event; that a defendant could avoid liability under state law simply by disclaiming its alleged compliance with Regulation D is an unsavory proposition and would eviscerate the statute.²¹

The United States Court of Appeals for the Sixth Circuit echoed this reasoning in *Brown v. Earthboard Sports USA, Inc.*,²² and in *In re Blue Flame Energy Corp.*,²³ an Ohio appellate court upheld the authority of the Ohio Division of Securities to issue a cease-and-desist order finding that the respondents violated the Ohio Securities Law in the sale of unregistered securities that were claimed to be exempt under Rule 506. The Ohio court concluded that NSMIA cannot be read to allow an issuer to avoid state regulation or liability under state securities laws in regard to an offering simply by claiming compliance with Regulation D.²⁴ The weight of federal and state authority today clearly favors the exercise of state regulatory authority to determine the validity of a claimed Rule 506 exemption for purposes of NSMIA preemption.²⁵ Courts have likewise upheld state authority under the NSMIA "savings" clause²⁶ to exercise antifraud enforcement authority to deal with disclosures made in offering documents for covered securities.²⁷

As case law evolves, Practitioners must at least presume that state administrators and litigation plaintiffs will assert authority and, as commentators have counseled, it is essential to bear in mind that Rule 506 preemption from full state regulation can be lost if the private offering does not in fact comply with the specific requirements of the rule.²⁸

[2] Intermediary Regulation

NSMIA also impacts directly on state regulation of intermediary activities. For broker-dealers, federal law now limits state authority to impose requirements relating to such things as capital, margin, books and records, bonding and reports that are different from what is required by federal law. NSMIA does not eliminate state authority to regulate on these matters. It does, however, mandate that any state law dealing with them may not impose requirements that differ from or are in addition to those imposed under federal law.²⁹

1-4 Blue Sky Regulation § 4.02

NSMIA does not alter or limit the authority of states to require licensing of broker-dealers, or affect whatever standard may be applied in determining what may constitute transacting business. It does, however, prevent states whose contacts are *de minimis* from prohibiting an associated person of a broker-dealer from effecting transactions where, among other conditions, the associated person and the broker-dealer firm are already registered in a single state. Exchange Act section 15(h)(2) declares:

No law, rule, regulation, or order, or other administrative action of any State or political subdivision thereof may prohibit an associated person of a broker or dealer from affecting a ["described transaction"] for a customer in such state if--

(A) Such associated person is not ineligible to register with such State for any reason other than such a transaction;

(B) Such associated persons registered with a registered securities association [NASD] and at least one State; and

(C) The broker or dealer with which such person is associated is registered with such State.ⁿ³⁰

A "described transaction" for purposes of the limitation on jurisdiction is defined as one on behalf of a customer who has for at least 30 days maintained an account with the broker-dealer; is effected by an associated person who has a pre-existing service relationship of at least 14 days prior to the transaction; and the associated person is registered with a state in which the customer was resident or present for at least 30 consecutive days during the 1-year period prior to the day of the transaction. This provision is aimed at permitting a continuing service relationship with a transient or vacationing customer who is away from home for a period of time, as long as the associated person is registered in the state in which the customer permanently resides or was present for 30 days or more during the previous year. However, if the customer is present in another state for 30 days or more, or permanently changes his or her residence, the associated person will be subject to the jurisdiction of that new state and its registration/licensing requirements.

"Described transaction" also includes one executed on behalf of a customer who has been a customer of the broker-dealer for at least 30 days, by an associated person who has filed an application for registration in the state in which the transaction occurs. This provision anticipates situations in which an associated person executes a transaction for an existing customer in a state in which the associated person has made application for registration. The act provides a temporal window in relation to a pending application to register during which such associated persons may effect transactions.ⁿ³¹

Limiting the scope of state jurisdiction in this manner, NSMIA allocates authority away from states that do not have sufficient contacts to apply their laws. Such an allocation of authority is also accomplished in regard to investment advisers. NSMIA added new Section 203A(b)(1)(A) to the Investment Advisers Act of 1940ⁿ³² which provides that no state may impose license, registration, or qualification requirements on a federally registered investment adviser or investment adviser representative except in the case of a representative who has a place of business located in the state. While NSMIA also broadly reallocated federal and state regulatory authority over investment advisers generally so as to place principal authority with the states for regulation of investment advisers having assets under management of \$25 million or less,ⁿ³³ a national *de minimis* standard limiting that jurisdiction was also established. Section 222(d) of the Investment Advisers Actⁿ³⁴ declares that no state may impose registration, licensing or qualification requirements on an investment adviser that does not have a place of business in the state, and who has during the prior twelve month period had fewer than six clients who are residents of the state.ⁿ³⁵

In the same manner that NSMIA prohibits states from imposing qualification requirements relating to such things as

books and records that differ from or are in addition to federal requirements in regard to broker-dealers, it establishes like prohibition regarding investment advisers, but keying on the state of principal place of business rather than federal requirements. Sections 222(b) and (c) of the Investment Advisers Act³⁶ thus prohibit states from imposing or enforcing any law that imposes on an investment adviser books-and-records, net capital or bond requirements greater than those imposed by the state in which the adviser has its principal place of business.

FOOTNOTES:

(n1)Footnote 1. Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified as amended in scattered sections of 15 U.S.C.).

(n2)Footnote 2. *Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101, 109 (2d Cir. 2001) .

(n3)Footnote 3. 15 U.S.C. § 77d(1).

(n4)Footnote 4. 15 U.S.C. § 77d(3).

(n5)Footnote 5. 15 U.S.C. § 77d(4).

(n6)Footnote 6. 15 U.S.C. § 77c(a).

(n7)Footnote 7. The status of state registration requirements in the wake of NSMIA, and state registration requirements generally, are examined in Chapter 5, *infra* .

(n8)Footnote 8. CCH Blue Sky L.Rep. P 74,264, 2002 U.S. Dist. LEXIS 4073 (D. Minn. 2002) .

(n9)Footnote 9. 1999 U.S. Dist. LEXIS 22642 (N.D. Cal. 1999) , *aff'd*, 249 F.3d 1087 (9th Cir. 2001) .

(n10)Footnote 10. 17 C.F.R. § 230.506 (2008) ("Exemption for Limited Offers and Sales Without Regard to Dollar Amount of Offering").

(n11)Footnote 11. 926 So.2d 290, 2005 Ala. LEXIS 120 (2005) .

(n12)Footnote 12. 926 So.2d at 296 .

(n13)Footnote 13. *Id.*

(n14)Footnote 14. *Id.*, at 298 .

(n15)Footnote 15. 201 F. Supp.2d 1238 (S.D. Fla. 2002) .

(n16)Footnote 16. 267 F. Supp.2d 1081 N.D. Okla. 2003).

(n17)Footnote 17. 201 F. Supp.2d at 1244 .

(n18)Footnote 18. *Id.* See also, *Pinnacle Communications International, Inc. v. American Family Mortgage Corp.*, 417 F. Supp.2d 1073, 1087 (D. Minn. 2006) ("When an offering purports to be exempt under Regulation D, any allegation of improper registration is covered exclusively by federal law").

(n19)Footnote 19. *Hamby v. Clearwater Consulting Concepts, LLP*, 428 F. Supp. 2d 915 (E.D. Ark. 2006) .

(n20)Footnote 20. 445 F. Supp.2d 1259, 2006 U.S. Dist. LEXIS 44721 (D. Colo. 2006) .

(n21)Footnote 21. 2006 U.S. Dist. LEXIS 44721, at *29 .

(n22)Footnote 22. *481 F. 3d 901 (6th Cir. 2007)* .

(n23)Footnote 23. *871 N.E.2d 1227 (Ohio Ct. App. 2006)* .

(n24)Footnote 24. *Id.*, at 1244 .

(n25)Footnote 25. See Robert N. Rapp & Fritz E. Berckmueller, "Testing the Limits of NSMIA Preemption: State Authority to Determine the Validity of Covered Securities and to Regulate Disclosure," *63 Bus. Lawyer* 809 (May 2008).

(n26)Footnote 26. Securities Act § 18(c)(1), *15 U.S.C. § 77r(c)(1) (2000)*. The NSMIA "savings" clause is an express exception to preemption.

(n27)Footnote 27. See Rapp & Berckmueller, *supra*, at 827-835.

(n28)Footnote 28. See Hugh H. Makens, *Blue Sky Practice--Part I: Doing it Right*, SL075 ALI-ABA 549, 554 (Mar. 16, 2006).

(n29)Footnote 29. NSMIA amended Section 15 of the Securities Exchange Act of 1934, *15 U.S.C. § 78o*, by adding new subsection (h), "Limitations on State Law," which includes the provision that:

No law, rule, regulation, or order, or other administrative action of any State or political subdivision thereof shall establish capital, custody, margin, financial responsibility, making and keeping records, bonding or financial or operational reporting requirements for brokers, dealers, municipal securities dealers, government securities brokers, or government securities dealers that differ from, or are in addition to, the requirements in those areas established under this title. The Commission shall consult periodically the securities commissions (or any agency or office performing like functions) of the States concerning the adequacy of such requirements as established under this title.

(n30)Footnote 30. *15 U.S.C. § 78k(h) (2000)*.

(n31)Footnote 31. See generally H.R. Rep. No. 104-864, Joint Explanatory Statement of the Conference Committee, 104th Cong., 2d Sess. (Sept. 28, 1996).

(n32)Footnote 32. *15 U.S.C. § 80b-3a(b)(1)*.

(n33)Footnote 33. *15 U.S.C. § 80b-3a(a)*.

(n34)Footnote 34. *15 U.S.C. § 80b-22(d)*.

(n35)Footnote 35. Notwithstanding the allocation of authority and the imposition of a *de minimis* standard as part of NSMIA changes to investment adviser regulation, it is also clear that all state enforcement authority relating to fraud remains intact. Indeed, Section 203A(b)(2) of the Act, *15 U.S.C. § 80b-3a(b)(2)*, provides:

Nothing in this subsection shall prohibit the securities commission (or any agency or office performing like functions) of any State from investigating and bringing enforcement actions with respect to fraud or deceit against any investment adviser or person associated with an investment adviser.

(n36)Footnote 36. *15 U.S.C. § 80b-22(b)-(c)*.



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Blue Sky Regulation

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CHAPTER 4 State Investor Protection Authority

1-4 Blue Sky Regulation § 4.03

§ 4.03 Conflict Preemption of State Law

[1] Conflict Preemption

In the realignment of federal and state securities regulatory roles through NSMIA preemption of certain national market elements of Blue Sky laws, Congress carefully preserved state antifraud enforcement authority and most of the historic state function of licensing market intermediaries. In the assessment of NSMIA impact, the extent to which Congress preserved state authority is as significant as what was preempted. Moreover, NSMIA did not limit state common law fraud claims, or otherwise impinge upon such private rights of action and remedies available under state securities laws.ⁿ¹ "Savings" clauses in the federal securities laws and NSMIA make clear that there is no federal *field preemption* in the context of securities regulation.ⁿ²

However, the scope of investor protection under state securities laws may nevertheless be impacted by another form of legal preemption. The principle of *conflict preemption* operates where a federal statutory or regulatory scheme, although not displacing state law, supersedes it to the extent that it conflicts with federal law. Conflict preemption exists where a party's compliance with both federal and state law would be impossible, or where state law would pose an obstacle to the accomplishment of congressional objectives. In this context, federal regulations have no less preemptive effect than federal statutes.ⁿ³

The Eighth and Ninth Circuit U.S. Courts of Appeals have both applied the principle of conflict preemption to uphold dismissals of state law fraud claims arising out of "naked" short selling which drove down the market price for the stocks of two plaintiffs companies, and which the plaintiffs alleged was facilitated by a program operated by national "clearing agencies" registered under the federal Securities Exchange Act of 1934. Section 17A of the Exchange Actⁿ⁴ provides for the registration of "clearing agencies," which provide centralized clearance, settlement and transaction information for virtually all broker-to-broker equity, corporate bond, municipal and other securities transactions in the United States. These functions are centralized by the National Securities Clearance Corporation (NSCC) and Depository Trust Company (DTC), which are both subsidiaries of Depository Trust & Clearing Corporation (DTCC). Together, they operate a uniform national system for clearance and settlement of securities transactions.ⁿ⁵

NSCC also operates a "Stock Borrow Program" designed to electronically deal with temporary, short term failures to deliver stock that has been sold. The NSCC program allows it to facilitate settlement of transactions in which there has been a "fail-to-deliver" by "borrowing" the requisite number of shares, and delivering the "borrowed" shares to the

purchaser through the electronic settlement system. In this process, NSCC is a central counterparty, meaning that NSCC guarantees the transactions it processes by assuming the obligation of sellers to deliver shares. The process is seamless, and the buyer is credited with the shares never knowing that there has been a fail-to-deliver. It is intended to operate quickly, and temporarily, to permit timely settlement. NSCC obtains shares to cover a fail-to-deliver from lending its members. The Stock Borrow Program operates under rules adopted by NSCC and approved by the SEC under its statutory authority.

A "short" sale of securities occurs when the seller of shares does not at the time of the "short" sale own the shares being sold, and the seller must borrow shares to deliver on the settlement date. In most instances the short seller arranges to borrow the shares for delivery through a broker, and later purchases the identical shares to return to the broker, hoping that the price paid to "cover" the short sale is less than that received in making it. A "naked" short sale occurs when the seller not only does not own the shares being sold, but also does not borrow shares to deliver when due. Naked short sales thus trigger the NSCC Stock Borrow Program. Naked short selling may be deemed to be a fraudulent or manipulative practice where the naked short seller has no intention to obtaining sufficient shares to deliver on settlement date.

In *Pet Quarters, Inc. v. Depository Trust and Clearing Corp.*,ⁿ⁶ and *Whistler Investments, Inc. v. The Depository Trust and Clearing Corp.*,ⁿ⁷ plaintiffs were companies whose stock is publicly traded in the open market. Each company alleged that it had been victimized by "naked" short sellers, who drove down the market prices by selling shares without having stock available for delivery, and then intentionally failing to deliver. Both companies, in their separate actions, alleged that NSCC and its affiliates facilitated naked short selling by defects in the operation of the Stock Borrow Program. Whistler, for example, claimed that at times fails-to-deliver shares are not cured for long periods of time, and that the Stock Borrow Program creates more electronic shares in the marketplace, which in turn operates to depress the market price. Pet Quarters similarly claimed that defective methods of accounting for shares borrowed under the program allowed "phantom shares" in the market place, which diluted the value of its stock. Both made state tort law claims that included market manipulation, misrepresentation, breach of implied covenants and conspiracy. The district courts in both cases dismissed all claims on grounds of conflict preemption.

The dismissals in both *Pet Quarters* and *Whistler* were affirmed, as both the Eighth and Ninth Circuits concluded that state law challenges to the existence or operation of the Stock Borrow Program would conflict with the congressional directive evident in the adoption of Exchange Act section 17A. As the *Pet Quarters* court observed, in section 17A: "Congress directed the [SEC] to facilitate the establishment of a prompt, accurate national clearance and settlement system to protect investors and the public interest."ⁿ⁸ The SEC did so, said the court, when it approved the NSCC's creation of the Stock Borrow Program and the rules governing its operation. Thus, the court added:

To the extent that any of Pet Quarters's state law claims challenge this program or its rules, a favorable ruling on them would necessarily conflict with Commission regulation and control of the national securities clearing and settlement system and pose an obstacle to the congressional objectives in Section 17A.ⁿ⁹

The *Whistler* court likewise concluded that plaintiff's claims amounted to a direct challenge to the federally approved operation of the program, and conflicted with the SEC approval of its existence and operation.ⁿ¹⁰

Conflict preemption was also applied to bar claims under state law for practices that are specifically permitted by SEC rules. In *Guice v. Charles Schwab & Co.*,ⁿ¹¹ the New York Court of Appeals held that a state law challenge to order flow payment practices was preempted because the SEC had promulgated detailed rules addressing the precise timing, form and degree of disclosure required as to payment for order flow. In the end, it is not clear to what extent state law relating to fraud, manipulation and related conduct will be irreconcilable with obligations defined by federal law or the federal regulatory structure. In *Guice*, it appeared certain that permitting remedies under state law for practices that are expressly permitted under SEC rules presented a head-on conflict. On the other hand, obligations imposed under the

federal regulatory scheme may be entirely compatible with asserted obligations and remedies as a matter of late law as, for example, where federal regulations establish an applicable duty or standard of care upon which liability might be premised under the traditional statutory tort theory.

As a matter of state enforcement authority, it is certainly not clear after NSMIA to what extent the exercise of authority to investigate and address fraud--which is expressly preserved--could present the basis for challenge on conflict preemption grounds. NSMIA is a clear statement of congressional intent to preserve broad antifraud enforcement powers of state regulators. For that reason, the question of scope of authority is better addressed under NSMIA than separately considered in the context of conflict preemption. Both *Pet Quarters* and *Whistler Investments*, however, leave the door open to such a broader assessment.

FOOTNOTES:

(n1)Footnote 1. *See, eg., Zuri-Invest AG v. Natwest Fin., Inc.*, 177 F. Supp.2d, 189 (S.D.N.Y. 2001).

(n2)Footnote 2. Field preemption is based on the *Supremacy Clause of the U.S. Constitution*, and operates as an implied preemption of state law where a federal statutory or regulatory scheme is so pervasive in scope that it occupies the field, leaving no room for state action. *See Fid. Fed. Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. 141, 152-53, 102 S.Ct. 3014 (1982) .

(n3)Footnote 3. *Id.*, 458 U.S. at 153.

(n4)Footnote 4. 15 U.S.C. § 78q-1(a)(1)(A).

(n5)Footnote 5. The clearance and settlement process involves book-entry transfers of securities positions among participants in the system, and to beneficial owners of securities. Clearance and settlement takes place through NSCC, while book-entry transfers are effected among brokers' accounts at DTC.

(n6)Footnote 6. 559 F.3d 772 (8th Cir. 2009) .

(n7)Footnote 7. 539 F.3d 1159 (9th Cir. 2008) .

(n8)Footnote 8. 559 F.3d at 780 .

(n9)Footnote 9. *Id.*

(n10)Footnote 10. *See* 539 F.3d at 1167 .

(n11)Footnote 11. 674 N.E.2d 282 (N.Y. 1996) .



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CHAPTER 4 State Investor Protection Authority

1-4 Blue Sky Regulation § 4.04

§ 4.04 Jurisdictional Predicates

[1] Offer and Sale Activities

Armed with merit-based qualification criteria for securities offerings, state securities regulators historically functioned as gatekeepers. Without regard to the interstate character of any distribution, absent an exemption or, today, NSMIA "covered security" status, offers and sales within a particular state are permitted only upon advance approval of an administrator or pursuant to prescribed procedures. Likewise, the full range of enforcement powers under Blue Sky laws, which commonly includes cease-and-desist and civil injunctive authority, is premised upon a single act within a state amounting to a non-complying offer or sale.ⁿ¹ And private civil remedies for non-complying transactions, and for fraud, are likewise linked to a single jurisdictional predicate activity. The broad general definition of "offer" as encompassing every attempt to dispose of a security, or anything amounting to a solicitation of an offer to buy one,ⁿ² thus makes the particular notion of what constitutes an actual offer or sales related activity in a state a critical consideration where interstate transactions are contemplated. Moreover, as provided in the Uniform Act, state jurisdiction may be exercised on the basis of an offer or sale despite the fact that neither party to the transaction is actually present in the state. Section 414(c) of the Uniform Act, which prescribes the scope of the Act, declares:

For the purpose of this section, an offer to sell or to buy is made in this state, whether or not either party is then present in this state, when the offer (1) originates from this state or (2) is directed by the offeror to this state and received at the place to which it is directed (or at any post office in this state in the case of a mailed offer).ⁿ³

The drafters of the original Uniform Securities Act proceeded on the premise that the scope of individual state jurisdiction in interstate transactions should be made as explicit as possible, and that differences in construction and interpretation leading to conflict of laws problems should be minimized. Section 414 of the Act is thus a more or less comprehensive statement of criteria for determining when an offer is made in a state for purposes of jurisdiction under the Blue Sky law.ⁿ⁴ Uniform Act section 414 is preserved in the 2002 Uniform Act,ⁿ⁵ which the drafters describe as not only defining the application of the act to interstate, but also international transactions when only some of the elements of a violation occur in the state. As the drafters further point out, the law is now settled that a person may violate the law of a particular state without ever being within the state or performing each act necessary to violate the law within that state.ⁿ⁶

Although the mission of Blue Sky laws is protection of the citizens of the state, section 414 criteria manifest a decidedly

transactional focus. The jurisdictional predicate is not a function of an offer to a resident, but rather the act of originating an offer in or directing it into the state regardless of the citizenship or residence of the recipient. Because section 414 speaks in terms of offers as well as purchases and sale, there is no requirement that a transaction actually be completed in the state. It is also true that an offer originating in one state and directed into another is made in *both* states. The Blue Sky law of the originating state would apply under section 414(c)(1), and the law of the recipient state would apply under section 414(c)(2). This prevents a seller in one state from using that state as a base of operations for defrauding persons in other states. In practical terms there may be little concern for application of a Blue Sky law to such isolated transient events in a state as one might imagine, as, for example, an offer made during a meeting between two non-resident travelers in an airport transit lounge. However, the scope of jurisdiction under section 414 and all Blue Sky laws is defined so as to be certain that activity impacting the legitimate protective interests of the state and its citizens will not escape coverage.

Section 414 makes certain distinctions in the scope of jurisdiction under the Act depending upon the predicate conduct involved. The provisions governing fraud, registration of broker-dealers and agents, registration of securities, making unlawful statements to the effect that the administrator has recommended or approved of any registered seller or security, and civil liability apply to persons who sell or offer to sell when (1) an offer to sell (as defined above) is made in the state, or (2) an offer to buy is made and accepted in the state.ⁿ⁷ For an offer to buy to be "accepted" for purposes of jurisdiction under Section 414 means that acceptance of the offer is:

(1) communicated to the offeror in this state and (2) has not previously been communicated to the offeror, orally or in writing, outside this state; and acceptance is communicated to the offeror in this state, whether or not either party is then present in this state, when the offeree directs it to the offeror in this state reasonably believing the offeror to be in this state and it is received at the place to which it is directed (or at any post office in this state in the case of a mailed acceptance).

Uniform Act provisions relating to advisory activities, along with broker-dealer and agent licensing, apply to persons who buy or offer to buy when (1) an offer to buy is made in the state, or (2) an offer to sell is made and accepted in the state. The activity of intermediaries which serves as a jurisdictional predicate is considered later.ⁿ⁸ Here again, however, the transactional focus of the Act's approach is apparent. The jurisdictional premise is some purposeful undertaking which is either designed to produce or actually results in an investment decision within the protected borders. As will be seen, however, that focus is too narrow. The jurisdictional umbrella of Blue Sky laws is defined by the extent of activities which take place within a state that are so connected to offers and sales of securities that they supply a jurisdictional *nexus* without regard to whether actual residents of the states are the ultimately protected purchasers. This is the key consideration in understanding the extra-territorial impact of blue sky laws in interstate transactions. Certain principles of "long-arm" jurisdiction provide a starting point.

Conduct undertaken outside the borders of a state which has either purposeful or reasonably anticipated transactional consequences within a state has historically supported the exercise of long-arm personal jurisdiction by state courts. In *Cody v. Ward*,ⁿ⁹ for example, a California defendant who posted messages to an on-line service investment forum, purporting to provide reliable information concerning common stock of a video game company was held subject to suit by an investor in Connecticut. The Connecticut investor alleged that the defendant's on-line messages, and direct telephone follow-ups, concerning the company and its business prospects were fraudulent, leading to the investor's purchase of the company's stock and eventual loss of the funds invested. Upholding the exercise of personal jurisdiction over the out-of-state defendant the court opined that although he was not in Connecticut when the alleged misrepresentations were made, the defendant had purposefully communicated to the investor for the purpose of causing him to invest, and should have reasonably anticipated being sued in Connecticut if the plaintiff suffered the loss of his investment.ⁿ¹⁰

The protective mission of blue sky laws militates strongly in favor of such expansive assessments of the limits of jurisdiction. In *Bernie v. Waterfront Limited Dividend Housing Association*,ⁿ¹¹ the court upheld the application of the

Ohio Blue Sky law through the state's long-arm statute in circumstances in which the plaintiff Ohio resident learned of the investment opportunity during a trip to New York City and received offering materials during that trip. Once back in Ohio, the plaintiff initiated contact with representatives of the issuer in New York, and in response received further documents, mailed to him from New York, including subscription documents which the plaintiff then executed in Ohio, and thus committed himself to the purchase. On these facts, the court concluded that plaintiff had made a prima facie showing of jurisdiction and offered this insight into considerations overriding the fact that negotiation and solicitation of the investment occurred in New York:

With respect to whether Defendants purposefully availed themselves of the privilege of acting in Ohio or causing a consequence there, the court notes that the fact that much of the negotiation and solicitation of Plaintiff's investment occurred in New York is not as determinative of this issue as are the consequences of the contractual obligation in Ohio and the degree of interest which Ohio has in seeing that said obligations were faithfully executed... . The Ohio blue sky laws are evidence of Ohio's interest in protecting its citizens by making certain requirements of investment arrangements before they can be distributed in Ohio. Defendants, whether directly or through there agent, Continental, mailed a subscription agreement to Plaintiff in Ohio for his signature, *thus freely and intentionally encouraging and allowing an Ohio resident to make a substantial investment in Waterfront*.ⁿ¹²

Purposefully availing one's self of the "privilege" of entering a regulated securities market in a forum state was recognized as a proper basis for the exercise of regulatory jurisdiction under the New Jersey Blue Sky law in *Silverman v. Berkson*,ⁿ¹³ in which the state Supreme Court upheld extra-territorial subpoena authority of the Bureau of Securities. The court held that the agency may properly exercise its authority to compel attendance of out-of-state witnesses in an investigation where the witness is one who has engaged in purposeful conduct expressly aimed at regulated securities markets within the state.ⁿ¹⁴

Technological advances in communication among participants in national markets have added a further dimension in assessing the scope of state jurisdiction. E-mail and other electronic communications enable parties to conduct enormous volumes of business within a state without physically entering it. As an example, the New York Court of Appeals has held that so long as a party avails itself of the benefits of the forum state, has sufficient minimum contacts, and should reasonably expect to defend its actions there, the party may be subjected to jurisdiction in that state without ever being physically present. Thus, a Montana state agency that managed the investment program for public funds, the public retirement system and state compensation insurance funds was required to defend in New York when it broke a \$15 million investment transaction that had been negotiated and effected by e-mail. The Montana state agency, said the Court, was a sophisticated institutional trader that entered New York to transact business by knowingly initiating and pursuing a negotiation a transaction with a brokerage firm representative in New York that culminated in the sale. The agency should reasonably have expected to defend its actions in New York, particular given the fact that it had previously engaged in bond transactions with the same brokerage firm representative in New York, and had availed itself of the benefits of doing business there.ⁿ¹⁵

Long-arm jurisdiction cases are helpful in understanding the sense of *nexus*; between an offer or sale of securities and a state that is the essential jurisdictional predicate under Blue Sky laws. Activities having little or no relationship to the offer or sale of securities in a state will not support application of the Blue Sky law. *In re Revco Securities Litigation*ⁿ¹⁶ well illustrates the point. In *Revco* the court dismissed claims under the Ohio securities law where the subject purchase of securities of an Ohio issuer was by a New York investor through a Delaware intermediary, on the basis of information disseminated and representations made and received entirely outside of Ohio. Although the court considered a number of activities occurring in Ohio in regard to the issuing company, none of them were found to directly concern the sale of the securities to the New York investor. No sufficient nexus was shown between the subject sale of securities and the State of Ohio such that remedies under the Blue Sky law could properly be invoked.

On one hand, *Revco* stands simply for the point that no sale occurred within Ohio for purposes of the Blue Sky law. On

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the other hand, the broader notion of requisite *nexus* between the transaction and Ohio is much more meaningful, as other cases illustrate. In *Skurnick v. Ainsworth*, n17 for example, a New York licensed broker-dealer who received an order and payment for the purchase of securities mailed to New York by a Florida resident was held to have effected a sale in Florida for purposes of the Florida Blue Sky law. The broker had not solicited the Florida purchaser, and had acted only on the request of the purchaser. Nevertheless, the court found that the Florida statute unambiguously applied to activities of brokers outside the state who sell to persons within the state. Similarly, in *Ansbro v. Southeast Energy Group, Ltd.*, n18 although an agreement to purchase securities was executed in Indiana, the pre-agreement solicitation and meaningful communications were made from Illinois, where the agreement and payment were also sent. Those activities in Illinois were deemed to constitute sufficient nexus with Illinois to constitute a sale there for purposes of invoking the Blue Sky law.n19

In *Arizona Corp. Comm'n v. Media Products, Inc.* n20 the court added a further dimension to the nexus requirement in holding that the sale of securities by a foreign corporation whose base of operations was in that state would be a sale "from" the state for purposes of the Blue Sky law. The court determined that the securities were offered or sold from Arizona, even though: (1) all of the sales activities were conducted by out-of-state broker-dealers in states other than Arizona; (2) the offers to purchase were made and accepted out-of-state; and (3) no sale or offer of sale was made to any resident of Arizona.n21 The determining factors in favor of finding sales for purposes of the Blue Sky law included: (1) the issuer's principal place of business and base of operations was within the state; (2) the officers and directors resided in the state; (3) "selling agency agreements" that were material to the subject transactions were delivered to the company in the state; (4) Board of Directors meetings took place in the state; (5) the escrow agent bank was in the state; (6) stock certificates were delivered to the escrow agent versus payment at a closing in the state; and (7) stock certificates were prepared and issued by a transfer agent in the state. These factors, said the court, amounted to more than ministerial actions, and were sufficient to support application of the Blue Sky law to offers and sales that were thus made "from" the state.

To be sure, the *Media Products* court also opined that despite sufficient jurisdictional nexus, application of the Blue Sky law would impermissibly interfere with interstate commerce, an issue discussed further below. However, the jurisdictional nexus identified in sale-related activity and circumstances within the state is no less meaningful in understanding the scope of potential applications.n22

It is certain, however, that mere presence in a state, for example, by reason of incorporation, without activities connected to unlawful activity outside the state is not a sufficient basis on which to invoke jurisdiction of that state's Blue Sky law to address the out-of-state misconduct. In *Singer v. The Magnavox Company*, n23 the Delaware Supreme Court declined to extend coverage of that state's Blue Sky law to alleged fraud in connection with solicitation of proxies by a company incorporated in Delaware for a merger vote where all materials disseminated in connection with the transaction had a point of origin outside Delaware. The plaintiffs were not solicited in Delaware, and no part of the "sale" occurred there. The court observed that the Blue Sky law should not be read to apply merely because a corporation is incorporated in the state, and further declared:

We are not persuaded that because the corporate merger was held in Delaware this is a sufficient connection with the alleged fraud to permit plaintiffs to invoke the Act. That is simply too fragile a basis on which to establish subject matter jurisdiction over an alleged fraud in Pennsylvania or over a contract made in New York. And plaintiffs' arguments based on registration of the merger documents in Delaware ... and the statutory situs of the Magnavox stock in this state ... are equally tenuous and we reject them for the same reason.n24

Section 414 of the Uniform Act incorporates the notion of jurisdictional nexus in prescribing an offer or sale as occurring within a state when it *originates* from the state, and also in the provision declaring that an offer or sale may occur "whether or not either party is then present in this state." The latter clause is intended to cover the situation of an offeror or offeree who is absent from the state at the time the offer is made. For example: A is the offeror residing in

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State X. B is the offeree residing in State Y. If A placed an interstate phone call to B, there would be little doubt that the law of State X would be applicable since the offer originated from that State, and one state should not be used as a base of operations to defraud persons in other states.ⁿ²⁵ However, suppose that A travels to see B in State Y. Would the law of State X still be applicable? Under Section 414(c), the offer may still be deemed to have originated from State X. Under Section 414(c), the law of State Y would also apply since the offer originating in one state and directed to another is made in both states.ⁿ²⁶ The construction of Uniform Act section 414 also clearly contemplates that the Blue Sky law of more than one jurisdiction may be applied to a given transaction.ⁿ²⁷

To the extent that different private civil remedies may be available, it is useful to consider such possible applications of one state Blue Sky law to a transaction in another state based on isolated instances of travel or communication that result in or are connected with that transaction. However, the focus of Blue Sky laws on conduct or activity within the state that gives rise to concern for investor protection suggests that jurisdiction will in practical terms be determined based upon a course of conduct that, even if directed outside the state, has the realistic potential for impact within the state. In *Newsome v. Diamond Oil Producers, Inc.*,ⁿ²⁸ for example, the court applied the Oklahoma Blue Sky law to offers and sales made from Oklahoma facilities exclusively to residents of other states. Jurisdiction in regard to offers originating from the state, said the court, was clear, and thus:

Even when Defendants' assertions in regard to the location of offerees or purchasers are taken as true, the Act will apply *when any portion of the selling process of securities covered by the Act occurs in Oklahoma*. In this situation, the Act regulates Oklahoma promoters who sell only to residents of other states.ⁿ²⁹

Without regard to Section 414 of the Uniform Act, application of multiple Blue Sky laws to a single securities transaction has been upheld as a matter of legitimate state interests in regulating securities transactions. In *Chrysler Capital Corp. v. Century Power Corp.*,ⁿ³⁰ the court upheld the right of a plaintiff to sue under multiple state securities laws. Subsequently revisiting the issue on a request for reconsideration, the court underscored that a state's Blue Sky law may properly be applied when an issuer has performed significant actions within the state in connection with a transaction, although the transaction itself is consummated outside the state.ⁿ³¹ The controlling notion is that a state has a legitimate interest in preventing it from being used as a base of operations for marauders outside the state.ⁿ³²

That is not to say, however, that when there is *no* activity in a state that is meaningfully connected to or facilitative of conduct that takes place entirely in another state that jurisdiction under the first state's Blue Sky law may be asserted. As discussed earlier in *Singer v. Magnavox Co.*,ⁿ³³ for example, plaintiffs brought a class action alleging violations of the Delaware Blue Sky law, even though the activity violating the act occurred entirely in another state. The Delaware Supreme Court applied the general presumption that a law is not intended to apply outside the territorial jurisdiction of the state in which it is enacted, and refused to apply the Delaware Blue Sky law despite the fact that the company was incorporated in Delaware. State courts have consistently declined to apply Blue Sky laws on the basis of activity that occurs entirely in another state.ⁿ³⁴ Also as noted earlier,ⁿ³⁵ the application of Blue Sky laws on the basis of sales activity occurring outside the state may raise a federal constitutional question in regard to interference with interstate commerce. The application of multiple State Blue sky laws to single transactions has been considered in that context. In *Chrysler II* and other cases that considered such constitutional challenges, the arguments have been rejected on grounds that at least the antifraud protections of state Blue Sky laws are remedial, not preventative, and that they neither impose unreasonable burdens on interstate commerce or nor impede interstate transactions.

In interstate settings it is also recognized that state conflict of laws principles will generally not be applied to give effect to choice of law provisions contained in transaction documents or agreements where to do so would contravene public policy. Public policy in all states strongly favors regulation of securities transactions for the protection of investors under Blue Sky laws. In *Brenner v. Oppenheimer & Co., Inc.*,ⁿ³⁶ the Kansas Supreme Court refused to give effect to a customary choice of law provision in a brokerage agreement when the law of the chosen state would have prevented the assertion of a private right of action against the clearing broker defendant for participation in the sale of unregistered

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securities to Kansas plaintiffs. There was in this case a clear conflict in the laws of the two states on the issue. Because a strong public policy in favor of rigid governmental regulation of the sale of securities and protection of investors was clearly established, the Kansas Supreme Court held that the public policy exception to enforcement of a choice of law provision should be applied, and that the choice of law provision in the standard form agreement could not stand. A contractual provision, said the court, would not be allowed to negate Blue Sky laws enacted to the place the sales of securities under rigid regulation.ⁿ³⁷

Blue Sky laws do not often actually conflict as in *Brenner*. Moreover, it is widely recognized that the securities laws of two or more states may be applicable to a single transaction without presenting any conflict of laws question.ⁿ³⁸ Thus, courts do not often engage in traditional conflict of laws analysis. In most instances the only question is whether there is sufficient nexus between activities of defendants and the state asserting its jurisdiction under the Blue Sky law. Moreover, the express preservation of antifraud enforcement authority of the states in NSMIA leaves little doubt that states will continue to exercise regulatory power and make Blue Sky law remedies available on the basis of broadly defined jurisdictional predicates.

As discussed earlier, the Uniform Act also addresses jurisdictional predicates in terms of an offer being "accepted" in a state. Section 414(d) provides:

For the purpose of this section, an offer to buy or sell is accepted in this state when acceptance (1) is communicated to the offeror in this state and (2) has not previously been communicated to the offeror, orally or in writing, outside this state; and acceptance is communicated to the offeror in this state, whether or not either party is then present in this state, when the offeree directs it to the offeror in this state reasonably believing the offeror to be in this state and it is received at the place to which it is directed (or at any post office in this state in the case of a mailed acceptance).ⁿ³⁹

Acts constituting acceptance of an offer are significant when a seller receives an offer to buy, because under the Uniform Act the Blue Sky law of the *buyer's* state is applicable only if both offer and acceptance take place in the state where the buyer resides. If, for example, B in State Y calls A in State X, and B offers to buy securities, there is an offer which originated in State Y. However, if the offer is not then accepted and B subsequently visits A in State X, at which time A accepts the offer, then only the law of State X applies to the transaction. State X's law is applicable because the offer was made in the state (it was directed there) and it was accepted in that state. On the other hand, if A sends his acceptance to B in State Y, then State Y's blue sky law would be applicable since the offer originated from and was accepted in State Y.

In another example, if all negotiations leading to a sale take place in State X, merely the fact that the buyer makes her acceptance by mailing a check from State Y is not enough to bring State Y's law into operation.ⁿ⁴⁰ In addition, under the Uniform Act, where there is an offer to buy, the mere confirmation of sale or the delivery of securities by the seller does not render the buyer's state law applicable unless such confirmation or delivery constitutes acceptance.ⁿ⁴¹

Jurisdictional issues arising out of communications constituting offers of securities disseminated across state lines in conventional print and broadcast media are specifically addressed by the Uniform Act. Anticipating those situations in which material published or broadcast in one state finds its way into another, Section 414(e) provides:

An offer to sell or to buy is not made in this state when (1) the publisher circulates or there is circulated on his behalf in this state any bona fide newspaper or other publication of general, regular, and paid circulation which is not published in this state, or which is published in this state but has had more than two-thirds of its circulation outside this state during the past twelve months, or (2) a radio or television program originating outside this state is received in this state.ⁿ⁴²

The 2002 Uniform Act includes the same provision regarding print media.ⁿ⁴³ For broadcast media, however,

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modification of the original provision is more extensive, in order to more precisely define the meaning of "originating" when applied to a program, and also by introducing the notion of "other electronic communication" into consideration. Section 610(3) of the 2000 Act provides that a radio or television program, or other electronic communication is considered as having originated in the state if either the broadcast studio or the originating source of the transmission is located in the state, unless:

- (1) the program or communication is syndicated and distributed from outside this State for redistribution to the general public in this State;
- (2) the program or communication is supplied by a radio, television or other electronic network with the electronic signal originating from outside this State for redistribution to the general public in this State;
- (3) the program or communication is an electronic signal that originates outside this State and is captured for redistribution to the general public in this State by a community antenna or cable, radio, cable television or other electronic system; or
- (4) the program or communication consists of an electronic signal that originates in this State, but which is not intended for redistribution to the general public in this State.ⁿ⁴⁴

As for conventional print media situations, the typical approach under Blue Sky laws is illustrated in *Martin v. Steubner*.ⁿ⁴⁵ In that case defendants advertised in the Midwest edition of the *Wall Street Journal*, soliciting investors for a Minnesota real estate development. The plaintiff, an Ohio resident, became aware of the solicitation by reading the advertisement, which he answered by requesting more information. He received a reply addressed to him in Ohio, which he in turn followed up with a visit to the development in Minnesota. Ultimately, plaintiff made the investment and wired funds representing the purchase price from Ohio to a Minnesota bank. He received and signed the subscription agreement in Ohio. The Ohio Blue Sky law was held applicable for the protection of the Ohio purchaser, with the court endorsing the view that given the state's interest in protecting its citizens, the extension of requirements of the Blue Sky law was fair, and further, that ample contacts with the state supported the exercise of jurisdiction.ⁿ⁴⁶

State regulators assert jurisdiction in interstate offerings when an advertisement originates within the state, or when, as in *Martin*, it originates outside but is circulated in the state and inviting a response. In most cases of originating publications, dissemination of the advertisement to persons within the state will be apparent. However, as previously seen, an offer entirely to non-residents may nevertheless support application of the originating state law under the "marauding" notion where meaningful activities are in fact occurring in that state and there is fraudulent conduct.ⁿ⁴⁷

The Uniform Act, in Section 414(e)(1), addresses some of the thorny interstate publication issues regarding print media by providing:

An offer to sell or to buy is not made in this state when ... the publisher circulates or there is circulated on his behalf in this state any bona fide newspaper or other publication of general, regular, and paid circulation which is not published in this state, or which is published in this state but has had more than two-thirds of its circulation outside this state during the past twelve months ...

The Act thus affords relief for any advertisement in a regular newspaper or periodical by limiting jurisdiction only to the state in which it is published, and, because the place of publication of a nationally circulated periodical may be entirely fortuitous, jurisdiction will lie with the state where published only if at least one-third of the circulation is also in that state.ⁿ⁴⁸ Thus, a seller may place an advertisement in the national edition of the *New York Times* and have it freely circulated in all jurisdictions without the advertisement constituting an offer to sell securities in any jurisdiction other than the state of publication.

One must keep in mind, however, that the section 414(e) jurisdictional exclusion for what appears in newspapers or publications of general circulation attaches only to what is contained in that publication, as it is disseminated. While there may be no offer to sell or to buy simply by reason of the publication that comes to rest in a state, anything inviting action in response by a recipient, and follow-up activity associated with it, may well trigger application of the blue sky law. The cases previously considered in this chapter make clear that an advertisement disseminated into a state as part of a generally circulated publication can easily become an offer, and that the strong policy at work in the states will tilt every consideration in favor of finding a jurisdictional nexus where there is a reasonably anticipated next stage of activity as a result of the published matter.ⁿ⁴⁹

In the case of unintended circulation of a local publication beyond the state of its original publication, Uniform Act section 414(e)(1) provides that such ads are not offers in the states where the newspaper was not published.ⁿ⁵⁰ The Uniform Act treats advertisements in nationally circulated magazines the same as newspapers.ⁿ⁵¹

Section 414(e) invites certain critical inquiries concerning newspapers and magazines. For example, what is a "bona fide" newspaper? Would an advertisement in a newspaper that is distributed free qualify under section 414(e)(1)? There is some guidance in case law on the issue of bona fides, although not in this specific context. In *SEC v. Wall Street Transcript Corp.*,ⁿ⁵² the trial and appellate courts addressed the issue of a bona fide newspaper for purposes of the federal Investment Advisers Act. The lower court's approach was to compare characteristics of the subject publication--content, manner in which it is compiled, distribution system--with those of an acknowledged newspaper of general circulation. On appeal, however, the Second Circuit counseled that the content of a publication should be the focus. Content, said the court, should be evaluated in terms of what is or is not consistent with the purpose of the exclusion of a publication from regulatory coverage. Under that approach, even if the form and other characteristics match those of an acknowledged newspaper or generally circulated publication, the content could nevertheless render it within the scope of coverage. This assessment would be considerably easier, and more meaningful, in the context of investment adviser regulation than for the assessment of the more generalized issue of offers for purposes of Blue Sky laws. Still, between both approaches a notion of bona fides emerges that is at least helpful in making necessary judgments. A publication intended as, or emphasizing its role as, a medium for communication of investment opportunities, for example, would have to stand heavier scrutiny for an advertiser to claim relief under Uniform Act section 414(e).

Another inquiry invited by section 414(e) is the meaning of the word "general" as used in regard to circulation of a publication. Does, for example, "general" circulation in section 414(e)(1) mean large and diverse circulation or that the publication is available to anyone willing to pay the subscription price? Is a publication available on a paid subscription basis only to lawyers, for example, a publication with general circulation?

Use of print media in connection with the offer and sale of securities can present special issues where *third party* publications are involved. If a published third party report or other information piece is being used by the issuer or someone acting on behalf of the issuer to offer or sell securities, straightforward analysis under Uniform Act section 414 to determine the scope of the offering for purposes of state securities law jurisdiction is in order. It may be the case, however, that a more fundamental inquiry is necessary first to determine whether the third party publication is in fact a solicitation or advertisement. Some limited guidance in this inquiry is available in interpretative materials for SEC Regulation D under the Securities Act of 1933, which establishes safe harbors from federal registration requirements for certain types of limited offerings. "Manner of offering" limitations in Regulation D prohibit any form of general solicitation or general advertising.ⁿ⁵³ Where truly third party publications are involved, limited guidance available from the SEC suggests that the susceptibility to use by participants in an offering may determine whether the publication actually involves an offer within the scope of securities law coverage.ⁿ⁵⁴ For purposes of Blue Sky laws, any independent character of a third party publication would be lost where the facts demonstrate a significant degree of involvement by the issuer or a planned use of the information in support of solicitations.

Issues relating to third party communications are clearly not confined to print media. The rise in popularity of cable

television channels devoted exclusively to financial news and commentary has spawned questions concerning appearances on behalf of issuers, the independence of commentators, and other use of the medium in a manner that causes investor protection concerns. Radio and television generally advertising is covered by Uniform Act section 414(e)(2). For purposes of section 414(e)(2), a radio or television program originates in the state where the microphone or television camera is located, not in the state in which there is a relay station.ⁿ⁵⁵ But with broadcast media the question is essentially one of intent, or at least reasonable belief in the extent to which a broadcast message will be received in other states by persons who have the power to act on it. Apart from the issue whether a communication is amounts to an offer of securities, myriad possibilities associated with national, local or syndicated programming or advertisements invite jurisdictional issues under Blue Sky laws. Most, however, will be resolved in common sense applications based upon what the issuer or person acting on behalf of an issuer set out to accomplish with the communication and the choice of the medium.

In *Booth v. Verity, Inc.*, ⁿ⁵⁶ plaintiff stock purchasers alleged that non-resident senior executives and directors of the defendant corporation could be liable under Kentucky law for selling stock or stock options to Kentucky residents. Plaintiffs alleged that the individual defendants possessed the power and authority to control the contents of the company's presentations to security analysts and the general market. The complaint alleged that the company, whose shares traded in the Nasdaq Stock Market, disseminated false or misleading information that was subsequently reported in the financial press and analyst reports. Plaintiffs alleged that defendants also caused the information to be reported, and thus to reach them in Kentucky, over "the public airwaves, periodicals, telephone, the Internet and other sources."ⁿ⁵⁷ This, they alleged, amounted to defendants soliciting business in Kentucky, and thus satisfied the Kentucky long-arm statute. Although substantive claims were asserted under the Kentucky Blue Sky law, the threshold issue was determined by the court to be the scope of personal jurisdiction over the non-resident defendants.

Plaintiffs in *Booth* claimed that the individual defendants had purposefully reached out to them in Kentucky, and caused the sale of the securities to be made, with the resultant injury to Plaintiffs when the market price of the shares dramatically declined. They claimed that the defendants had done "everything within their respective powers to reach Plaintiffs in Kentucky."ⁿ⁵⁸ The court, however, rejected their jurisdictional assertions:

[T]hough Plaintiffs assert that the Defendant Directors sold stock to them in Kentucky, Plaintiffs have not alleged any act to accomplish this. Nor have Plaintiffs alleged any advertisement in Kentucky or even that they sold the stock or stock options directly to Plaintiffs. Purchasing securities in a secondary market located outside of Kentucky does not establish a contact with Kentucky. Nor is the mere ability to view a passive web page or a mass media report a contact with Kentucky rendering Defendants subject to jurisdiction of Kentucky courts.ⁿ⁵⁹

The court buttressed its conclusion with the Kentucky Blue Sky law provision declaring that an "offer to sell" does not occur in the state when it is made by means of a newspaper or radio broadcast originating outside the state.ⁿ⁶⁰ No facts were alleged to support a conclusion that the individual defendants had done anything purposefully to reach out to the plaintiffs in Kentucky, and claims under the Blue Sky law made against them were dismissed.

The jurisdictional assessment in regard to individual defendants in *Booth* well illustrates the notion of one purposefully acting to engage in conduct within the ambit of Blue Sky law protection. The knowing use of a medium of communication that reaches multiple states is not the same as the purposeful use of that medium to accomplish the offer or sale of securities. In this analysis the manner in which states have dealt with the truly unlimited medium of the Internet helps considerably in understanding and resolving jurisdictional issues that arise from the use of all media. Before considering that, however, *Booth* also highlights the fundamental notion of "transacting business" that is critical to application of state Blue Sky laws to activities of intermediaries.

[2] Intermediary Activities: "Transacting Business"

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Application of Blue Sky laws to intermediaries, particularly as to registration or licensing provisions, is a function of "transacting business" in the state. As a general matter, "transacts a business" has been held to mean "more than a trivial or *de minimis* business."ⁿ⁶¹

As applied specifically to the business of investment intermediaries, the scope of Blue Sky law jurisdiction is well illustrated by the decision in *Garretto v. Elite Advisory Services, Inc.*,ⁿ⁶² which upheld a claim of strict liability of an unlicensed investment adviser under the Wisconsin Blue Sky law. The defendant firm, a financial planning service company, was based in Illinois and engaged in business there as an investment adviser. Plaintiff and the defendant's representative held meetings in Illinois, leading to the plaintiff's execution, in Illinois, of an advisory agreement and commitment letter to participation in a particular investment offering then being formed. Plaintiff, a resident of Wisconsin, continued to communicate and correspond concerning the relationship and contemplated investments. Plaintiff ultimately sued the adviser to rescind his investment on grounds that the defendant firm had transacted business as an investment adviser in Wisconsin without being licensed as required by law.ⁿ⁶³

After concluding that the defendant firm's activities did, by definition, constitute transacting business as an investment adviser, the *Garretto* court further concluded that the activity fell within the scope of the Wisconsin Blue Sky law. Indeed, the court found that a "significant portion" of the adviser's conduct took place in Wisconsin, as follows:

Although all of the meetings between Garretto and Tomlinson appear to have taken place in Illinois, much of the exchange of information necessary in order to prepare a financial plan for Garretto and to execute plaintiff's investment in Elite Properties took place via telephone calls and letters to and from Garretto in Wisconsin... . These letters, together with the other correspondence and phone calls directed to Garretto at his Kenosha residence, reflect a course of conduct through which the defendants, to borrow a phrase commonly used in personal jurisdiction analysis, "purposefully established" and maintained contact with Wisconsin residents and procured their purchase of securities.ⁿ⁶⁴

Notably, the *Garretto* court flatly rejected a defense contention that the adviser had neither knowledge nor intent concerning the scope of its activities directed to the plaintiff in Wisconsin. The facts, said the court, left no issue whether the defendant transacted business there. The rescission remedy provided in the Wisconsin Blue Sky law for transactions in violation of the statute was thus appropriately applied.

The Uniform Act declares it is unlawful for any person to "transact business" in the state as a broker-dealer, agent of a broker-dealer or investment adviser unless registered under the Act.ⁿ⁶⁵ As *Garretto* illustrates, "transacting business" issues arise when an intermediary in one state has customers in another. For example, assume that a broker-dealer or investment adviser licensed in New York has a few customers who live in New Jersey or are vacationing in Florida. Must the intermediary be registered in either of these other states? The Uniform Act takes a realistic view of the problem by recognizing that it is quite likely that broker-dealers will have some customers in other states. As long as there are only a limited number of such customers in each state, there may be little need to require licensing for such a nominal business presence. The Uniform Act deals with the situation through key definitions. It thus excludes from the definition of "broker-dealer":

[a] person who has no place of business in the state if ... during any period of twelve consecutive months he does not direct more than fifteen offers to sell or buy into this state in any manner ... whether or not the offeror or any of the offerees is then present in this state.ⁿ⁶⁶

The Act likewise excludes from the definition of "investment adviser" any adviser who:

[h]as no place of business in this state if (A) his only clients in this state are other investment advisers, broker-dealers, banks, savings institutions, trust companies, insurance companies, investment companies ... pension or profit-sharing trusts, or other financial institutions or institutional buyers ... or

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(B) during any period of twelve consecutive months he does not direct business communications into this state in any manner to more than five clients other than those specified in clause (A), whether or not he or any of the persons to whom the communications are directed is then present in this state.ⁿ⁶⁷

The Uniform Act approach to limiting the scope of licensing jurisdiction for broker-dealers was adopted in nearly states, so as to make provision for some *de minimis* level of activity by an intermediary with no office in the state. That continues to be the case. However, Blue Sky laws were directly impacted by NSMIA in this regard, and have throughout the country been modified to satisfy NSMIA requirements generally, and to address the realities of an increasingly transient population specifically. It is for that reason that the 2002 Uniform Act, which amalgamates *post*-NSMIA exemptions from Blue Sky coverage, is most useful. Section 401 of the 2002 Uniform Act, in pertinent part, exempts broker-dealers from registration as follows:

(1) a broker-dealer without a place of business in this State if its only transactions effected in this state are with ...

(E) a bona fide preexisting customer whose principal place of residence is not in this State and the person is registered as a broker-dealer under the Securities Exchange Act of 1934 or not required to be registered under the Securities Exchange Act of 1934 and is registered under the securities act of the State in which the customer maintains a principal place of residence;

(F) a bona fide preexisting customer whose principal place of residence is in this State but was not present in this State when the customer relationship was established, if:

(i) the broker-dealer is registered under the Securities Exchange Act of 1934 or not required to be registered under the Securities Exchange Act of 1934 and is registered under the securities laws of the State in which the customer relationship was established or where the customer had maintained a principal place of residence; and

(ii) within 45 days after the customer's first transaction in this State, the person files an application for registration as a broker-dealer in this State and a further transaction is not effected more than 75 days after the date on which the application is filed, or, if earlier, the date on which the administrator notifies the person that the administrator has denied the application for registration or has stayed the pendency of the application for good cause;

(G) not more than three customers in this State during the previous 12 months, in addition to those specified in subparagraphs [above] if the broker is registered under the Securities Exchange Act of 1934 or not required to be registered under the Securities Exchange Act of 1934 and is registered under the securities act of the State in which the broker-dealer has its principal place of business ...ⁿ⁶⁸

Coordinate exemptions are provided for "agents" of broker-dealers exempt from registration in any state under these provisions,ⁿ⁶⁹ and the same approach is taken for investment advisers and their representatives.ⁿ⁷⁰ The full scope of exemptions from broker-dealer and investment adviser registration requirements is presented in Chapter 11 of this Treatise. It is important here, however, to understand that the notion of "transacting business" sufficient to trigger application of the Blue Sky law of a particular state to an intermediary is controlled by conduct and practices that have a meaningful nexus with the state. One normally thinks of activities amounting to the offer and sale of securities as triggering investor protection concerns. Clearly, however, the evolution of exemptions from the key definition of broker-dealer or investment adviser under the Uniform, Revised Uniform and now 2002 Uniform Acts discloses that there is a degree of such activity that does not trigger such concerns because of a limited nexus, particularly when the

intermediary involved is already subject to "home" state regulation.

There must be sufficient in-state conduct to support application of the Blue Sky law to an intermediary. In *First Providence Financial Group LLC v. Burke*, n71 administrative sanctions against a broker-dealer registered in Connecticut for employing unregistered agents were overturned. The Connecticut Uniform Securities Act prohibits the employment of unregistered agents, and there was no issue in the case that the broker-dealer did in fact employ agents not registered in the state. However, the broker-dealer did not maintain any office in Connecticut, and all of the activities of unregistered agents that were the subject of the administrative action took place outside Connecticut. The Connecticut registration requirement applied to persons who transacted business as an agent *in* the state. Because the activities constituting a violation of the Blue Sky law did not occur in the state, the court found that the Connecticut securities commissioner had no jurisdiction to revoke the broker-dealer's registration.

It may well be that a broker-dealer registered in one state that engages in acts or conduct in another state that, if conducted in its home state, would violate the Blue Sky law may be ultimately subjected to administrative sanctions under qualitative fitness standards that govern the registration process. However, cases such as *First Providence Financial Group* make clear that the meaning of "transacting business" as a threshold determination is not left to subjective judgments.

For all intermediaries, "transacting business" within a state may often be a difficult threshold issue. Broker-dealer and investment adviser definitions speak only generally in terms of transacting business, or "engaging in the business of ..." for purposes of triggering regulatory jurisdiction. In *Manns v. Skolnik*, n72 the respondent was the spouse of a lawyer who represented a client in connection with closing a real estate transaction. When she became aware that the client had received funds from the transaction which she wished to invest, respondent informed the individual concerning a foreign investment opportunity, and thereafter talked to the individual concerning its prospects and the fact that other people had invested. The individual ultimately tendered funds to the respondent for the investment, and executed an agreement in connection that the Indiana Securities Commissioner concluded was a security. Respondent was not a licensed broker-dealer, and was administratively sanctioned by the securities Commissioner. She challenged the jurisdiction of the Commissioner both as to subject matter and the claim that she violated the Blue Sky law by not being licensed. The sanction, however, was upheld.

Manns was not engaged in business as a broker-dealer, but for purposes of applying the Indiana Blue Sky law, she was held to have transacted business as such. Affirming the Commissioner's order, the court observed:

[T]he commissioner found that before [the investor] went to the bank to deposit the \$20,000, Manns told her about the Indonesian platinum transaction. Manns told [the investor] that she needed additional funds and additional investors, that the transaction would be profitable, and that she was trying to purchase samples of Indonesian platinum. As previously mentioned, the commissioner properly found the agreement to constitute a security.

Upon our review, we find that Manns' acts demonstrate an affirmative action to secure financing for the platinum transaction. Because the agreement constituted a security, we find that the evidence supports the commissioner's conclusion that Manns was trying to "effect the purchase" of a security for her own benefit and, therefore, that Manns offer and sale of the agreement violated the securities regulation.ⁿ⁷³

The notion of "transacting business" may fairly imply some degree of regularity in conduct or activities before state jurisdiction attaches. In *Musson v. Rice*,ⁿ⁷⁴ for example, an individual who sold three fractional interests in an oil well within a one week period was held not to be "engaged in the business of selling securities" for purposes of the Oklahoma Blue Sky law broker-dealer registration provisions. The Oklahoma Supreme Court opined that "engaged in the business" means the performance of acts which "occupy the time, attention and labor of persons for the purpose of

livelihood, profit or pleasure." This definition, said the court, emphasizes a certain regularity of activity. The doing of a single act pertaining to one's particular business will not be considered as carrying on, transacting, or doing business within the contemplation of the statute. The court added:

We refuse to hold that the legislature, in drafting the words "engaged in the business of effecting transactions in securities" would intend the seller in this case to fall within the definition of broker-dealer. The fractionalization and sale of a single \$43,000 interest in oil and gas does not ipso facto make one a broker-dealer engaged in the business of securities; had the legislature so intended, issuers would not be exempt from registration.ⁿ⁷⁵

This does not mean that a single transaction, or closed-end set, should never trigger jurisdiction. The broad objectives of blue sky laws would no doubt permit a "transacting business" conclusion where necessary to prevent fraud. Nevertheless, the exercise of jurisdiction over isolated intermediary activity by persons who should not be fairly characterized as actually engaging in business as such is problematic. The reasonable implication for the exercise of any state jurisdiction under blue sky laws is that there is a need for protection in the circumstances presented.

Where an intermediary firm is registered in a particular state, there is a persistent sub-issue of state jurisdiction in regard to activities of associated persons, representatives or salespersons. All states requiring licensing of broker-dealers also impose licensing requirements for sales or associated persons who transact business in the state. Multi-state customer bases, and the mobility of investment clients generally, add a further important dimension to blue sky law compliance. Servicing a single customer in a state typically triggers regulatory requirements applicable to the individual representative without regard to the qualification of the firm itself. As with offers of securities generally, the challenge of compliance with licensing requirements at both the firm and salesperson level in a Cyberspace environment is even more daunting.ⁿ⁷⁶

State *de minimis* exclusions or exemptions applicable to investment advisers are not available to broker-dealers and their associated persons. In the conventional multi-state securities industry environment the exercise of state jurisdiction over what amounts to *de minimis*; activity by an associated person of a firm that is itself licensed in the state makes little sense. Thus, in NSMIA Congress specifically limited the authority of states to impose regulation on associated persons of otherwise licensed broker-dealers when the activity of those associated persons in the state meets certain *de minimis* standards. NSMIA also allocates federal and state regulatory roles in regard to investment advisers. The result today is Blue Sky law provisions that are substantially reflected in the 2002 Uniform Act provisions discussed earlier.

Foreign transactions present a new set of challenges to the regulation of intermediary activities under the notion of "transacting business," particularly as a result of worldwide access to intermediaries and investors through the Internet. The drafters of the 2002 Uniform Act recognized the increasingly transnational nature of securities brokerage, and by section 401(d) of the Act established rulemaking authority for state administrators to permit transactions by a Canadian or other foreign broker-dealer with a person from the foreign country who is a resident of the state, or with a person in the state who established a broker-customer relationship with the foreign intermediary while being temporarily or permanently resident in the foreign country.ⁿ⁷⁷ The 2002 Uniform Act would not permit activities generally by a Canadian or foreign intermediary, but rather is limited to interactions with foreign nationals residing in a particular state. The drafters also make clear that to give effect to any action taken by rule or order under section 401(d) there must be a transaction exemption that will enable securities transactions to take place in customer accounts involving the foreign intermediary.ⁿ⁷⁸

The 2002 Uniform Act provision is the first large scale undertaking specifically to accommodate an aspect of cross-border offerings of financial products and services in Blue Sky laws, and the reality of worldwide Internet access. The role of state Blue Sky laws is no longer defined in terms of "national" financial markets, but rather global markets and global intermediary activities, and the scope of investor protection authority will be defined in a new paradigm.

[3] Cyberspace Issues

Internet Offers. Offers of securities made over the Internet add another dimension in assessing the scope of state jurisdiction and investor protection authority under Blue Sky laws. A communication made on the Internet is directed generally to anyone who has access to the Internet without regard to state, or indeed national, borders. In the case of Internet offerings the issue will typically not be one of definition--the "offer" will be plainly communicated. Rather, the question is whether the Internet disseminated offer will be deemed to have been made in a particular state for purposes of Blue Sky law compliance and state administrators' enforcement authority. The same is true for determining whether an intermediary is transacting business in a state simply because a web page is accessible.

Internet offerings are, of course, demonstrably "national," and today NSMIA materially circumscribes state jurisdiction over offerings that are national in character. However, NSMIA also defines such offerings ("covered securities") in terms that preserve considerable freedom of action for state regulators. Small entrepreneurial issuers most likely to utilize the Internet in seeking to minimize costs in capital formation will rarely be offering "nationally traded securities" under NSMIA. Such issuers may, of course, attempt to structure their offering to meet "qualified purchaser" criteria under NSMIA, or to qualify the offering for an available exemption under the Securities Act of 1933.ⁿ⁷⁹ But undertaking the latter NSMIA route to avoiding individual state registration and qualification procedures regarding an offering may itself involve state scrutiny of the manner of claiming the exemption,ⁿ⁸⁰ and also will not escape the antifraud enforcement and intermediary regulatory authority expressly preserved for the states by NSMIA.

As noted earlier, in the 2002 Uniform Securities Act, section 610(e) addressing offers communicated via broadcast media also covers offers by means of any "other electronic communication" originating outside a state and received in the state. This provision can fairly be deemed to cover Internet disseminated communications, although its application to offerings simply posted on an issuer web site is unclear.ⁿ⁸¹ In those states that have not adopted the 2002 Uniform Act regulators have primarily acted administratively to cement the position that an Internet communication designed to raise capital constitutes a general solicitation and an offer subject to their jurisdiction.

Pennsylvania first addressed the issue of Internet offers, approaching them with the assumption that an Internet communication originating outside the state has a nexus to persons within the state. Under this approach, an Internet offer is considered to be directed to every place that the offer could be viewed or downloaded, and thus, presumptively, directed to investors within the state for purposes of the Blue Sky law.

Implicit in any offer that is deemed to be subject to state jurisdiction, however, is the notion that it is a purposeful undertaking by the issuer or an intermediary in the state. Pennsylvania regulators recognized that Internet offers may not actually be intended to be offered in their state, and administratively promulgated the first form of a conditional exemption from registration and qualification for offerings made on the Internet.ⁿ⁸² The Pennsylvania exemption is conditioned upon: (1) the issuer representing that no offer or sale of securities in the state is intended; (2) that the issuer and any person acting on behalf of the issuer is not directing the offer to any person in the state; and (3) that no sales are made in the state as a result of the Internet offer. Notwithstanding the exemption from registration and qualification procedures, Pennsylvania expressly preserved its antifraud enforcement authority with respect to any Internet offer.

Other states followed the Pennsylvania lead in creating or interpreting administrative exemptions for Internet offers not intended to be offers in their state, and to enable issuers to comply by including relatively simple on-line exclusionary language. Ohio, for example, administratively adopted an exemption for Internet offers not specifically directed to any person in the state provided the offer "[i]ndicates, directly or indirectly, that securities are not being offered to any person in this state and the issuer does not otherwise attempt to sell securities in this state."ⁿ⁸³ That is accomplished quite simply, with the issuer either directly stating that residents of the state are not eligible to purchase securities being offered, or indirectly, by a stated limitation that the offer is directed only to persons elsewhere.

Other means of complying with "indication" requirements of Internet offer exemptions may also be available. PIN or

password protected access, or other gateway mechanisms, that prevent residents of a state from viewing or downloading a prospectus or subscription agreement, for example, may well eliminate an inadvertent invitation to send subscription funds. The principal concern is prevention of responsive action, whether it be communicating an expression of interest to an issuer or intermediary or actually subscribing or sending funds, by residents who receive the Internet communication.ⁿ⁸⁴

To address blue sky issues associated with Internet offers more comprehensively and uniformly among the states, the North American Securities Administrators Association (NASAA), in its 1996 "Resolution Regarding Securities Offered on the Internet," advocated two conditions to be imposed by states for exemption of Internet offers from registration and qualification provisions of Blue Sky laws. The NASAA Resolution prescribes these conditions:

- (1) The Internet Offer indicates, directly or indirectly, that the securities are not being offered to the residents of a particular state; and
- (2) An offer is not otherwise specifically directed to any person in a state by, or on behalf of the issuer of securities.ⁿ⁸⁵

The NASAA resolution further encourages states to take steps to allow sales of securities that were the subject of an Internet offer once there is compliance with applicable registration requirements or another exemption is available.ⁿ⁸⁶

Many states have by rules, administrative orders, or policy statements embraced, in whole or part, the NASAA Resolution.ⁿ⁸⁷ Others have adopted the Pennsylvania form of exemption which, although similar to the NASAA provision, differs in the treatment of a registration application made after an Internet offer.ⁿ⁸⁸ Whereas the NASAA form of exemption permits subsequent registration by an issuer without affecting the prior exemption for offers, the Pennsylvania approach conditions the Internet offer exemption on no sales being later made in the state as a result of it.

Other states deal with the issue informally, or in some cases by statute. Virginia, for example, has created a statutory exemption for: "Any offer that is communicated on the Internet, World Wide Web or similar proprietary or common carrier electronic system ..." provided there is compliance with administrative rules. By rule, the state imposes the following conditions: (1) The Internet offer is communicated by or on behalf of the issuer of the security; (2) The Internet offer indicates, directly or indirectly, that it is not directed specifically to the state; (3) An offer is not otherwise directed specifically to the state by or on behalf of the issuer; (4) Any order, offer to buy or subscription agreement received from a person in the state pursuant to the Internet offer is rejected; and (5) No sale pursuant to the Internet offer is made in the state without compliance with or another available exemption from registration provisions.ⁿ⁸⁹

While it is clear that states have approached activity in Cyberspace realistically, it is also clear that issuers and intermediaries must be keenly aware of the particular requirements of every state in which no offer is intended. With nearly all state policies on Internet offers now being based on either the NASAA or Pennsylvania exemption constructs, there is a degree of uniformity that permits confidence in approaching common compliance requirements such as the necessary indication or disclaimer in regard to securities not being offered to persons within a particular state.

Electronic screening, or "gateway" mechanisms, to prevent access to on-line offering materials by persons in states in which no offer is intended are demonstrably effective means of avoiding Blue Sky jurisdictional and compliance issues. The emergence of specialized service providers with software platforms for the facilitation of Internet offerings by issuers who might not otherwise attempt such on-line screening portends a much higher level of confidence in the offering process. Gateway programs utilizing advance registration, log-on and validation procedures for individuals wishing access to corporate listing areas or web sites allows for limiting any solicitation or viewing of an offering document to persons in states in which the offering has been approved or in which an exemption is applicable.ⁿ⁹⁰ Issuers can, of course, self-screen access to offering materials on their websites through questionnaire and password

mechanisms.

The foregoing discussion addresses circumstances in which an actual offer is made via the Internet in one or more states in which Blue Sky law jurisdiction and compliance requirements are assumed to attach. It must be remembered, however, that "offer" is a broadly defined term, and that communications disseminated via the Internet may be determined by state regulators to constitute an attempt to dispose or facilitate the disposition of a security, subjecting the issuer and any intermediary acting on its behalf to the full scope of enforcement authority. An undertaking by an issuer, for example, to utilize an Internet communication or web page posting to "test the waters" for a possible offering would itself by definition amount to an offer, and unless limited or restricted in accordance with controlling law and policy among the states, would violate blue sky laws. All states may permit Internet offers, but the permissive policies, rules, or exemptions are conditional. Any Internet communication which by definition is an "offer" must meet the conditions to avoid state jurisdiction attaching.

Intermediary activities. Web-based activity by intermediaries presents its own set of issues under the "transacting" business" or "engaging in business" triggers for licensing or registration requirements in Blue Sky laws. The Internet has produced a proliferation of websites, "platforms" and "portals" operated by intermediaries and designed to facilitate communication and dealing. These are considered in detail in Chapter 12--Blue Sky Laws and the Internet. The critical point in understanding the scope of jurisdiction under Blue Sky laws in regard to websites that are universally accessible is that states have accepted gateway or "firewall" technology as the means of assuring that purposeful, direct, communication with prospective customers or clients in a state will not occur unless the intermediary is licensed or exempt from licensing requirements in that state.

Websites operated by financial intermediaries are limited to the dissemination of general information on products and services, and do not involve either effecting or attempting to effect transactions in securities, or the rendering of personalized investment advice. A NASAA Model Interpretive Order concerning intermediaries using the Internet sets the parameters by which the use of the Internet will not be deemed to be "transacting business" within a state for purposes of licensing requirements. There are two elements. First, the website must carry a legend that makes clear that the intermediary may only transact business in a state in which it is licensed (or has been excluded from licensing requirements), and that there can be no individualized follow-up by the intermediary without compliance with the Blue Sky law. Second, the website must include a mechanism designed to assure that prior to any direct communication or individualized follow-up the intermediary must be qualified in the state.ⁿ⁹¹

Because these are licensing issues, the states continue to exercise the primary regulatory and investor protection function in regard to Web-based activities of intermediaries.ⁿ⁹² By preserving state authority in regard to intermediary licensing and antifraud enforcement, NSMIA assured that states will play the essential role in policing cyberspace activities because the Internet, from an investor protection perspective is only an intermediary tool. Federal enforcement authority is no less important, and clearly the SEC authority to regulate Web-based activities in regard to the offer and sale of securities under registration and antifraud provisions of the federal securities laws is meaningful. Nevertheless, intermediary activity as such remains the frontline concern of state regulators, whose challenge is today one of global proportions as an international intermediary community reaches out to potential investors and customers via the Internet.

FOOTNOTES:

(n1)Footnote 1. Constitutional aspects of state regulatory jurisdiction over transactions in financial products offered and sold by an out-of-state intermediary were considered in *Life Partners, Inc. v. Miller*, 420 F. Supp.2d 452 (E.D. Va. 2006) , in which application of the Virginia Viatical Settlements Act to the plaintiff viatical settlements provider was challenged. The plaintiff, a Texas company, negotiated a viatical settlement with a Virginia resident by telephone, and by sending several sales proposals to her. The agreement ultimately entered into provided, among other things, that the

transaction was entered into in Texas and was to be governed by and subject to the rules and regulations of the Texas Insurance Code. The agreement was executed by the viator in Virginia and returned to Life Partners in Texas, where it was signed on behalf of the company. Subsequently, the Virginia Bureau of Insurance investigated the transaction, and ordered that Life Partners show cause why it did not become licensed in Virginia prior to effecting the viatical settlement transaction.

In Life Partner's suit for a declaratory judgment that the Virginia Insurance Bureau had no constitutional authority to regulate the transaction at issue, the company alleged that there were no sufficient ties to Virginia, and that the agreement made clear that it was entered into in Texas and would be governed under Texas regulatory authority. It argued that to permit Virginia regulatory authority to be exercised would violate the dormant Commerce Clause of the U.S. Constitution. The argument was rejected, however, because (1) Virginia had a legitimate state interest in protecting its citizens; and (2) there were sufficient minimum contacts with Virginia to warrant compliance with its regulatory scheme. The viator resided in Virginia, and never left the state during negotiations leading up to the viatical settlement agreement. She placed and received calls in Virginia. She received multiple settlement agreements sent to her in Virginia for her review, and she signed the final agreement in Virginia. The court thus concluded that the viatical settlement agreement was not the product of a purely Texas based transaction, and that Virginia has regulatory jurisdiction. The choice-of-law provision in the agreement was deemed to have no effect on the scope of Virginia regulatory authority. Beyond the contacts and interest approach to assessing the scope of regulatory authority the court also concluded that the Virginia law regulated transactions evenhandedly, did not discriminate against interstate providers, and had only incidental effects on interstate commerce.

(n2)Footnote 2. *See* Uniform Act § 401(j)(2) ("Offer" or "offer to sell" includes every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security for value).

"A communication is an offer when its language can be expected to stimulate interest in the security and condition the public mind about the security." *State v. American Microtel, Inc.*, [1993-1994 Transfer Binder] CCH Blue Sky L. Rep. P 73,900, at 76,569 (Super. Ct. Ariz. 1994).

(n3)Footnote 3. Unif. Sec. Act §§ 414(a)-(e); *see also* Rev. Unif. Sec. Act § 801.

Among the states that have substantially adopted section 414(c) there are some subtle variations. Iowa, for example, provides that an offer directed into the state does not trigger application of the Act until the offer is actually received by the offeree in the state. Also, the provision in section 414(c) regarding delivery to a post office is eliminated, and in its place is a statement to the effect that for purposes of qualification of securities to be offered, "an offer to sell which is not directed to or received by the offeree in this state is not made in this state."

See also Pennsylvania: 70 Pa. Stat. § 1-702(b); California: Cal. Corp. Code § 25008(b), for further examples.

(n4)Footnote 4. Official Code Comment to Unif. Sec. Act §§ 414(a)-(f) (Section 414 "defines and delimits the application of the Act in interstate or international transactions with only some of their elements in the state").

(n5)Footnote 5. 2002 Unif. Sec. Act § 610.

(n6)Footnote 6. *Id.*, Official Comment 1.

(n7)Footnote 7. Unif. Sec. Act § 414(a).

See, e.g.:

California: Cal. Corp. Code § 25008(a) applies when the offer to buy is accepted in the state. However, it need not be made there. If both purchaser and seller are domiciled in California the statute applies

when the security is delivered to the purchaser in the state.

Massachusetts: Mass. Gen. L. Ann., Ch. 110A, § 414(a).

Michigan: Mich. Comp. Laws § 451.814(a).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:30(I).

New Jersey: N.J. Rev. Stat. Ann. § 49:3-51(a).

Some states have modified the Uniform Act provision by making all portions of the statute that concern sales or offers to sell applicable whenever the offer to sell is made in the state or whenever the offer to buy is made and accepted in the state.

See, e.g.:

Pennsylvania: 70 Pa. Stat. § 1-702(a).

(n8)Footnote 8. *See § 4.04[2] infra.*

(n9)Footnote 9. *954 F. Supp. 43 (D. Conn. 1997) .*

(n10)Footnote 10. The court's conclusion that personal jurisdiction was properly exercised in *Cody* did not rest on whether the defendant's on-line postings were alone sufficient. To the contrary, the court declined to decide whether such electronic messages themselves amounted to purposeful contact with Connecticut, since there were also direct telephone contacts with and personal e-mail messages to the plaintiff investor. However, the extent to which on-line or Internet posting activity generally can, or should, support the exercise of state securities regulatory jurisdiction is considered briefly in § 4.03[3], and in depth in Chapter 12, *infra* .

(n11)Footnote 11. *614 F. Supp. 651 (S.D. Ohio 1985) .*

(n12)Footnote 12. *Id.*, at 654 (emphasis added).

(n13)Footnote 13. *141 N.J. 412, 661 A.2d 1266 (1995) .*

(n14)Footnote 14. *See also* *Brown v. Investment Management and Research, Inc.*, [1995-1996 Transfer Binder] CCH Blue Sky L. Rep P 74,112 (S.C. 1996), in which personal jurisdiction under the South Carolina Blue Sky law was upheld against non-resident defendant sellers of securities on the basis of an agency relationship with persons within the state who in fact interacted directly with investors.

(n15)Footnote 15. *Deutsche Bank Securities, Inc. v. Montana Board of Investments*, 7 N.Y.3d 65, 818 N.Y.S.2d 164, 850 N.E.2d 1140 (2006) .

Cyberspace issues and challenges in the context of jurisdictional predicates for the application of Blue Sky laws are considered in more detail in § 4.03[3], *infra*.

(n16)Footnote 16. [1991-1993 Transfer Binder] CCH Blue Sky L. Rep. P 73,609 (N.D. Ohio 1991).

(n17)Footnote 17. *591 So.2d 904 (Fla. 1991) .*

(n18)Footnote 18. 658 F. Supp. 566 (N.D. Ill. 1987) .

(n19)Footnote 19. See also *Green v. Weis, Voisin, Cannon, Inc.*, 479 F.2d 462 (7th Cir. 1973) (where all preliminary steps in connection with sale of unregistered corporate stock were taken in Illinois; confirmations and stock certificates were delivered in Illinois to Illinois residents, there were "sales" in Illinois that properly triggered the Illinois Securities Act, even though, underwriter's checks were forwarded to New York offices and deposited in New York bank account, and confirmations and stock certificates were issued from New York); *Kries v. Mate's Investment Fund, Inc.*, 473 F.2d 1308 (8th Cir. 1973) (where private citizen in Missouri sent check to investment company in New York requesting that company sell him shares, and where company sent back confirmation of purchase to buyer in Missouri, both offer and acceptance occurred in Missouri and triggered application of Missouri Blue Sky law); *Shapple v. State*, 520 S.W.2d 766 (Tex. Crim. App. 1974) (criminal conviction under Texas Blue Sky law upheld: offer to sell securities made via telephone negotiations between appellant seller in Scottsdale, Arizona and buyer in Texas governed by Texas law, under which appellant was not a licensed dealer); *Ah Moo v. AG Becker Paribas, Inc.*, 857 F.2d 615, 620 (9th Cir. 1988) (Hawaii's securities act applies if there was physical nexus between sale or offer to sell and state of Hawaii); *Sullivan v. Metro Productions, Inc.*, 150 Ariz. 573, 724 P.2d 1242 (Ariz. App. 1986) , cert. denied sub nom., *Miller v. Sullivan*, 479 U.S. 1102, 107 S. Ct. 1334, 94 L. Ed. 2d 185 (1987) (promotion of videotape investment contract by California based defendants resulting in execution of contracts in Arizona upon advice of accountant induced by defendants to recruit investors in Arizona, and subsequent down payment in Arizona, amounted to sufficient contacts under Arizona Blue Sky law); *Oil Resources, Inc. v. State of Fla. Dept. of Banking & Fin., Div. of Sec.*, 583 F. Supp. 1027, 1030 (S.D. Fla. 1984) , aff'd, 746 F.2d 814 (11th Cir. 1984) (Florida statute preventing sale of securities in or from offices in state to persons outside state did not violate Commerce Clause); *In re Benjamin Cablevision Programming Inv.*, 114 Ill. 2d 150, 102 Ill. Dec. 296, 499 N.E.2d 1309 (Ill. 1986) (sale occurred in Illinois statute when defendant, a limited partnership established under laws of Illinois with principal place of business there, sold limited partnership interest to plaintiff pursuant to solicitations directed to him in California and plaintiff mailed subscription agreement and check to defendant in Chicago).

But see *Jasper v. Zara*, 595 So.2d 1075 (Fla. App. 1992) (New York-based financial planner not subject to Florida jurisdiction for telephone advice to Florida resident who called him in New York).

(n20)Footnote 20. 158 Ariz. 463, 763 P.2d 527 (Ariz. App. 1988) .

(n21)Footnote 21. *Id.*, at 529 .

(n22)Footnote 22. See also *In re Benjamin Cablevision Programming Inv.*, 114 Ill. 2d 150, 102 Ill. Dec. 296, 499 N.E.2d 1309 (Ill. 1986) (sale occurred under Illinois statute when defendant, a limited partnership established under laws of Illinois with principal place of business there, sold limited partnership interest to plaintiff pursuant to solicitations directed to him in California and plaintiff mailed subscription agreement and check to defendant in Chicago: court found defendant's execution of agreement and cashing of check in state could constitute acceptance of plaintiff's offer to purchase securities and created physical nexus to Illinois); *In re Activision Sec. Litig.*, 621 F. Supp. 415 [1984-1985 Transfer Binder] CCH Blue Sky L. Rep.P 72,218, at 71,123 (N.D. Cal. 1995) (jurisdictional requirement met when offering emanated from California headquarters and acceptances were directed there); *Martin v. Steubner*, 485 F. Supp. 88 (D.C. Ohio 1979) , aff'd, 652 F.2d 652 (6th Cir. 1981) , cert. denied, 454 U.S. 1148, 102 S. Ct. 1013, 71 L. Ed. 2d 302 (1982) (out-of-state seller's mailing of two letters and subscription agreement into Ohio for investor's signature constituted sale in Ohio); *Enntex Oil & Gas Co. (of Nevada) v. State*, 560 S.W.2d 494 (Texas Civ. App. 1977) ; *Rio Grand Oil Co. v. State*, 539 S.W.2d 917, 55 O.&G.R. 499 (Texas Civ. App. 1976) (Texas Securities Act applied to solicitation of offers to buy and to sales made by phone and by mail from Texas to out-of-state residents); *State v. Hayes*, 305 So.2d 819 (Fla. App. 1975) (Florida Blue Sky law applied to the offer and sale of securities by defendants from within Florida to out-of-state residents).

(n23)Footnote 23. 380 A.2d 969 (Del. 1977) , overruled on other grounds sub nom, *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) .

(n24)Footnote 24. *Id.*, at 982 .

(n25)Footnote 25. Official Code Comment to Unif. Sec. Act §§ 414(a)-(f); *see also* Official Code Comment to Rev. Unif. Sec. Act § 801. These provisions continue unchanged in section 610 of the 2002 Uniform Act.

(n26)Footnote 26. *Id.*

(n27)Footnote 27. *Id.*

The phrase "whether or not either party is then present in this state" also applies when the offeree is temporarily absent from the state. If A mails a written offer to sell to B in State Y, State Y's law would apply even if B is not then present in the state to receive the offer when it arrives.

Another problem that may arise is solved by the parenthetical phrase at the end of Section 414(c), which deems an offer to be made in the state when it arrives at a post office located in the state. If offeror A in State X mails the offer to offeree B in State Y while B is temporarily living in State Z, and the offer is then forwarded to B by the post office, it is the law of State Y, and not State Z, that will apply. This prevents entrapment of innocent persons who have no reason to believe that an offer will be forwarded into another state whose Blue Sky laws may not have been complied with.

(n28)Footnote 28. [1982-1984 Transfer Binder] CCH Blue Sky L.Rep. P 71,869 (Okla. Dist. Ct. 1983).

(n29)Footnote 29. *Id.*, (emphasis added); *see also McCullough v. Leede Oil & Gas, Inc.*, 617 F. Supp. 384 (W.D. Okla. 1985) .

(n30)Footnote 30. [1991-1993 Transfer Binder] CCH Blue Sky L. Rep. P 73,632 (S.D.N.Y. 1992).

See also Lintz v. Carey Manor, Ltd., 613 F. Supp. 543 (W.D. Va. 1985) ; *Barnebey v. E.F. Hutton & Co.*, 715 F. Supp. 1512 (M.D. Fla. 1989) .

(n31)Footnote 31. *Chrysler Capital Corp. v. Century Power Corp.*, 800 F. Supp. 1189 (S.D.N.Y. 1992) ("Chrysler II").

(n32)Footnote 32. *Id.*, *Chrysler II*, 800 F. Supp. at 1192 .

(n33)Footnote 33. N. 51, *supra*.

(n34)Footnote 34. *See, e.g., Allen v. Oakbrook Securities Corp.*, 763 So.2d 1099 (Fla. App. 1999) (Florida Blue Sky law not applicable to sales of securities that took place entirely in other states despite the fact that the securities consisted of stock in a company which as incorporated in Florida and had its principal place of business there); *Cors v. Langham*, 683 F. Supp. 1056 (E.D. Va. 1988) (Complaint did not state a claim under Maryland Blue Sky law when all acts complained of took place in Virginia); *McCullough v. Leede Oil & Gas, Inc.*, 617 F. Supp. 384 (W.D. Okla. 1985) .

(n35)Footnote 35. *See Arizona Corp. Comm'n v. Media Products, Inc.*, n.48, *supra* , and accompanying text.

(n36)Footnote 36. 273 Kan. 525, 2002 Kan. LEXIS 133, 44 P.3d 364 (Kan. 2002) .

(n37)Footnote 37. *Id.*, 44 P.3d at 377.

The principle that an otherwise proper application of a Blue Sky law based upon activities having a nexus to the state cannot, as a matter of public policy, be avoided through private agreements is widely recognized. *See Eisenbaum v. Western Energy Sources, Inc.*, 218 Cal. App. 3d 314, 267 Cal. Rptr. 5 , [1990-1991 Transfer Binder] CCH Blue Sky L.

Rep. P 73,246 at 74,580 (Cal. Ct. App. 1990) (parties may not waive application of California law to transaction by private agreement); *Hall v. Orange County*, 758 F.2d 421, [1982-1984 Transfer Binder] CCH Blue Sky L. Rep. P 71,929 at 70,341 (Cal. Ct. App. 1983) (same); *Getter v. R.G. Dickinson & Co.*, 366 F. Supp. 559 (S.D. Iowa 1973) (stock purchase agreement provided New York law would apply; court held that the Iowa Securities Act applied to the sale); *Boehnen v. Walston & Co., Inc.*, 358 F. Supp. 537 (D.S.D. 1973) (customer agreement provided for New York law to apply; court held that New York law does not govern and South Dakota law would apply if evidence at trial shows a solicitation in South Dakota). Whether a choice of law provision would be enforced has been viewed as a question of whether the plaintiffs waived the protection of the blue sky law that would apply to the transaction, in favor of the law specified in the choice of law provision of the agreement between the parties. Waiver as a defense to civil liability under Blue Sky laws is discussed in Chapter 15 *infra*.

(n38)Footnote 38. See *Barnebey v. E.F. Hutton & Co.*, 715 F. Supp. 1512, 1533 (M.D. Fla. 1989) ; *Simms Inv. Co. v. E.F. Hutton & Co., Inc.*, 699 F. Supp. 543, 545 (M.D.N.C. 1988) ; *Lintz v. Carey Manor, Ltd.*, 613 F. Supp. 543 (W. D. Va. 1985) .

(n39)Footnote 39. Unif. Sec. Act § 414(d). This provision has been substantially adopted in the following states:

California: Cal. Corp. Code § 25008(b) (provision deletes the portion of § 414(d) that requires acceptance not to have been previously communicated to the offeror, orally or in writing outside the state).

Connecticut: Conn. Gen. Stat. § 36-33(d).

Massachusetts: Mass. Gen. L. Ann., Ch. 110A, § 414(d).

Michigan: Mich. Comp. Laws § 451.814(d).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:30 (IV).

New Jersey: N.J. Rev. Stat. Ann. § 49:3-51(d).

Pennsylvania: 70 Pa. Stat. § 1-702(c) (Uniform Act provision has been modified; for scope of modification, see notation following the Iowa citation, *supra*).

Some states have adopted the language of the Revised Act, *see, e.g.*:

New Mexico: N.M. Stat. Ann. § 58-13-B-54(D).

Rhode Island: R.I. Gen. Laws § 7-11-801(d).

(n40)Footnote 40. Official Code Comment, Unif. Sec. Act § 414(a)-(f); *see also* Rev. Unif. Sec. Act § 801 and Official Code Comment.

(n41)Footnote 41. *Id.*

(n42)Footnote 42. Unif. Sec. Act § 414(e). This provision has been substantially adopted in the following states:.

California: Cal. Corp. Code § 25008(c).

Massachusetts: Mass. Gen. L. Ann., Ch. 110A, § 414(e).

Michigan: Mich. Comp. Laws § 451.814(e).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:30(v).

New Jersey: N.J. Rev. Stat. Ann. § 49:3-51(e).

Pennsylvania: 70 Pa. Stat. § 1-702(d) (statute omits the provision regarding a newspaper or other publication that is published in the state but has had more than two-thirds of its circulation outside the state during the preceding twelve months).

(n43)Footnote 43. 2002 Unif. Sec. Act § 610(e).

(n44)Footnote 44. *Id.*, § 610(e)(1)-(4).

(n45)Footnote 45. 652 F.2d 6th Cir. 1981), *cert. denied*, 452 U.S. 1148, 102 S. Ct. 1013, 71 L. Ed. 2d 302 (1982).

(n46)Footnote 46. *See also Ledgebrook Corporation v. Lefkowitz*, 77 Misc. 2d 867, 354 N.Y.S.2d 318 (N.Y. Sup. Ct. 1974) . In *Ledgebrook*, New York's Martin Act was held to apply to an advertisement for the sale of out-of-state condominiums placed in the *New York Times*, *New York Law Journal*, and *Herald Statesman* (published in Yonkers, N.Y.) on thirty occasions. The ads, each with the disclaimer: "This does not constitute an offer where an offer may not legally be made," were deemed to be public offers' in New York for purposes of the New York law.

(n47)Footnote 47. On the other hand, if a publication is demonstrably disseminated entirely outside the state of origination, it is well to keep in mind that individual states may as a matter of policy or administrative regulation exempt it from coverage. California, for example, exempts any offer or sale of a security by or through a licensed broker-dealer to an out-of-state resident so long as the sale is not in violation of that purchaser's home state law. *See Cal. Code of Regs. tit. 10, § 260.105.2* (out of state sales and sales to broker-dealers).

(n48)Footnote 48. Official Code Comment, Unif. Sec. Act § 414(a)-(f).

(n49)Footnote 49. Another caveat is in order. Although an advertisement itself may not be an offer to sell securities within a state, the person placing the ad may still have to comply with the securities and broker-dealer registration requirements of a state in which the advertisement appears if, for example, one of the newspaper's readers responds to the ad by making an offer to purchase the securities and the seller communicates acceptance to the offeror in the offeror's home state. *See* Unif. Sec. Act § 414(a)(2).

(n50)Footnote 50. *See* Unif. Sec. Act § 414(e)(1).

(n51)Footnote 51. Some national newspapers and magazines are published in regional editions, with national ads and regional ads. How separate editions are treated for the purpose of section 414(e) of the Uniform Act is important in those states where the circulation of the regional edition outside the state is insufficient to exempt the ad from local regulation. In California, for example, "in the case of a newspaper or magazine which publishes a separate edition circulated in this State which does not carry the same advertising as that of other editions of the same publication, such separate edition shall be considered a separate newspaper or magazine from other editions of the same publication with respect to any advertisement which is not to be carried in all editions of the newspaper or magazine." *Cal. Code of Regs. tit. 10, § 260.008*; Rev. Unif. Sec. Act § 801(f).

(n52)Footnote 52. 294 F. Supp. 298 (S.D.N.Y. 1968) , *rev'd*, 422 F.2d 1371 (2d Cir.1970) .

(n53)Footnote 53. See Rule 502(c), 17 C.F.R. § 230.502(c).

(n54)Footnote 54. See Securities Act Rel. No. 33-6455 (Mar. 10, 1983); see also Alma Securities Corp., SEC No Action Letter, 1982 SEC No-Act LEXIS 2647 (Aug. 2, 1982); Oil and Gas Investor, SEC No Action Letter, 1983 SEC No-Act LEXIS 2788 (Sept. 9, 1983).

(n55)Footnote 55. Official Code Comment, Unif. Sec. Act § 414(a)-(f).

(n56)Footnote 56. 124 F. Supp.2d 452, 2000 U.S. Dist. LEXIS 18684 (W.D. Ky. 2000) .

(n57)Footnote 57. *Id.*, 124 F. Supp.2d at 458.

(n58)Footnote 58. *Id.*

(n59)Footnote 59. *Id.*, at 459 .

(n60)Footnote 60. Ky. Rev. Stat. § 292.313.

(n61)Footnote 61. *United States v. Schwartz*, 464 F.2d 499, 506 (2d Cir.) , cert. denied, 409 U.S. 1009, 93 S. Ct. 443, 34 L. Ed. 2d 302 (1972) .

(n62)Footnote 62. 793 F. Supp. 796 (N.D. Ill. 1992) .

(n63)Footnote 63. Like all states requiring licensing of investment advisors, the former Wisconsin law provides: "[i]t is unlawful for any person to transact business in [Wisconsin] as an investment adviser unless so licensed or licensed as a broker-dealer ... " Wisconsin has since adopted the 2002 Uniform Securities Act. Nothing in this provision has changed, however. See Wis. Stat. § 551.403(1).

(n64)Footnote 64. 793 F. Supp. at 806 .

(n65)Footnote 65. Unif. Sec. Act § 201; see also Rev. Unif. Sec. Act §§ 201, 203; 2002 Unif. Sec. Act. §§ 401, 403.

(n66)Footnote 66. Unif. Sec. Act § 401(c).

(n67)Footnote 67. Unif. Sec. Act § 401(f); see also Rev. Unif. Sec. Act § 204 (establishing the criteria as an exemption from investment adviser licensing requirements rather than a definitional exclusion in the manner of the Uniform Act); 2002 Unif. Sec. Act § 403(a).

(n68)Footnote 68. 2002 Unif. Sec. Act § 401(b)(E)-(G).

(n69)Footnote 69. *Id.*, § 402(b)(2).

(n70)Footnote 70. *Id.*, §§ 403(b), 404(b).

(n71)Footnote 71. CCH Blue Sky L. Rep. P 74,243, 2001 Conn. Super. LEXIS 3287 (Conn. Super. Ct. 2001) .

(n72)Footnote 72. 666 N.E.2d 1236 (Ind. Ct. App. 1996) .

(n73)Footnote 73. 666 N.E.2d at 1247.

See also *Kinsela v. Dept. of Finance*, 117 Idaho 632, 790 P.2d 1388 (1990) . Defendant sought to avoid application of the Idaho blue sky law provisions governing investment advisers by claiming that in simply giving advice, rather than actually offering or selling securities, he did not transact business within the purview of intended regulation. The

adviser relied on an administrative regulation defining "transacting business" as including only the sale of or contract to sell securities, which conflicted with the statutory definition of investment adviser. The Idaho Supreme Court dismissed the argument, and dismissed the notion that an administrative regulation could be read as overriding the statute.

(n74)Footnote 74. 1987 OK 66, 739 P.2d 1004 (Okla. 1987) .

(n75)Footnote 75. 739 P.2d at 1006 .

See also *Heligman v. Otto*, 161 Mich. App. 735, 411 N.W.2d 844 (Mich. Ct. App. 1987) , in which the court offered this additional assessment of the key notion:

We agree that in order for a person to be engaged in the business of effecting transactions in securities or commodity contracts under the Uniform Securities Act, he must have performed such transactions often enough to demonstrate that they are in fact a part of his or her business. We do not believe that the Legislature intended to impose the registration requirements applicable to broker-dealers upon individuals who, as did Otto in this case, facilitate a single commodity contract without making any profit thereon and apparently without the intent of participating in such transactions in the future. 161 Mich. App. at 741 .

(n76)Footnote 76. The manner of controlling access to Internet offers is discussed briefly in § 4.03[3], *infra* , and in more detail in Chapter 12. The same technology also permits limiting interactions between investors and individual sales or associated persons of broker-dealer firms only to those states in which the person is registered. See, e.g., Investment Management & Research, Inc., No Action or Interpretive Letter, Illinois Securities Dept. (Sept. 25, 1996) (gateway designed to be exclusive means of accessing a web site would only permit access to individuals residing in states in which the representative is registered).

See also "Interpretive Order Concerning Certain Broker-Dealers, Their Agents and Investment Advisers Who Use the Internet for Information Distribution on Products and Services," Michigan Corporation, Securities and Land Development Bureau (Sept. 24, 1997) (legending Internet communications and requiring mechanisms to ensure that interactions between prospective customers do not trigger licensing requirements and involve only dissemination of information on products and services).

(n77)Footnote 77. The 2002 Uniform Act provision is aimed at particular situations in which (1) a citizen of a foreign country temporarily resides in the state and for whom there is a bona fide pre-existing customer relationship with the foreign intermediary; or (2) the foreign citizen resident in the state has a self-directed retirement investment account in the foreign county; or (3) an individual present in the state has a pre-existing broker-customer relationship that arose while that individual was temporarily or permanently resident in a foreign country. 2002 Unif. Sec. Act § 401(d)(A)-(C).

(n78)Footnote 78. Official Comment 8, 2002 Unif. Sec. Act § 401(d).

(n79)Footnote 79. "Covered securities" under NSMIA, and the dual roles of state and federal regulation in regard to registration and qualification of securities offerings generally are discussed in depth in Chapter 5--Securities Registration, *infra*.

(n80)Footnote 80. State regulators can be expected, for example, to scrutinize offeree qualifications or subscription limitations contained in an Internet communicated offer that are designed to secure exemptions relating to "accredited investors." The issue becomes one of disclosure, that is, whether actual qualifying criteria for accredited investor status are presented in the offer or subscription information so as to permit the determination to be made.

(n81)Footnote 81. The Revised Uniform Act language covering "electronic communications" is carried into the

2002 Uniform Act as section 610(e), and the Official Comment makes clear that references to electronic means of communication in the Act is coextensive with computer or other information technology. Official Comment, § 610, 2002 Unif. Sec. Act.

(n82)Footnote 82. 64 Pa. Code Regs. § 203.190 ("Certain Internet Offers Exempt").

(n83)Footnote 83. *Ohio Admin. Code, Rule 1301:6-3-03 (D)(9)*. As with the Pennsylvania exemption, availability is also conditioned on no sales being made in the state as a result of the Internet offer unless registered or otherwise qualified for an exemption.

(n84)Footnote 84. *See, e.g., In re Millennium Interactive Technologies Corp., Emergency Cease and Desist Order*, No. 98 E 043 (Kansas Sec. Comm'r., Aug. 7, 1997) (an Internet offer limited to "qualified investors" only included information concerning how to obtain the prospectus, and led at least one Kansas resident to respond and request additional information concerning the investment).

See also In re The Gambler, Inc., Summary Order to Cease and Desist, No. 9612-09 (Pa. Sec. Comm., Jan. 15, 1997) (Internet offer of stock through an advertisement that did not directly or indirectly indicate that the securities were not being offered in Pennsylvania, coupled with telephone follow-up and facsimile transmission of documents in reply to an e-mail inquiry by a Pennsylvania resident).

(n85)Footnote 85. "Resolution Regarding Securities Offered on the Internet," CCH NASAA Reports P 7040 (Jan. 7, 1996).

(n86)Footnote 86. *Id.*

(n87)Footnote 87. Those states embracing the substance (with minor variations in some instances) of the NASAA Resolution by administrative orders or other formal statements include: Alabama, California, Connecticut, Florida, Idaho, Iowa, Kansas, Massachusetts, Michigan, Minnesota, Mississippi, Montana, Nebraska, Nevada, New Jersey, New York, North Carolina, North Dakota, Ohio, Rhode Island, South Carolina, Vermont, Washington, West Virginia, Wisconsin and Wyoming.

(n88)Footnote 88. States following the Pennsylvania example include: Alaska, Indiana, Maryland, South Dakota, Texas and Utah.

(n89)Footnote 89. *21 Va. Admin. Code § 5-40-110* (1997).

(n90)Footnote 90. *See, Internet Capital Corporation, SEC No Action Letter* (Available Dec. 24, 1997) (Website able to limit access to offering documents only to persons in states where approved); *IPONET, SEC No Action Letter* (Available July 26, 1996) (Qualification of accredited or other eligible investors utilizing a password protected web page).

(n91)Footnote 91. *Interpretive Order Concerning Broker-Dealers, Investment Advisers, broker-Dealer Agents and Investment Adviser Representatives Using the Internet for General Dissemination of Information on Products and Services*, CCH NASAA Reports P 2191 (Apr. 23, 1997). The NASAA Model Interpretive Order and approaches among the states are considered in detail in Chapter 12, *infra*.

(n92)Footnote 92. In regard to investment advisers, NSMIA established a dual scheme under which certain advisers, based on size criteria, are federal covered advisers subject to registration with the SEC, and only to "notice" filing requirements under state Blue Sky laws. However, investment adviser representatives, or agents, remain fully subject to licensing or registration requirements imposed by state laws, regardless of the status of the adviser itself as a federal covered adviser. The dual regulatory scheme applicable to investment advisers is discussed in Chapter 11, *infra*.



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Blue Sky Regulation

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CHAPTER 4 State Investor Protection Authority

1-4 Blue Sky Regulation § 4.05

§ 4.05 State Jurisdiction Over Takeovers and Contests for Corporate Control

Following passage of the federal Williams Act (Sections 13 and 14 of the Securities Exchange Act of 1934) in 1968, a large majority of states enacted laws regulating hostile takeover bids for corporations having prescribed jurisdictional ties to the state. Most commonly, the application of state takeover laws was predicated upon the corporation being incorporated in the state, or having its principal place of business or substantial assets there. The so-called "first generation" of state laws in this area was decidedly anti-takeover, imposing significant burdens on the process of unfriendly offers and interjecting state administrative authority, all in a manner that departed from the disclosure and timing provisions of the federal securities law provisions.ⁿ¹

From the outset, the extension of state jurisdiction by anti-takeover laws raised serious federal constitutional issues and questions of federal preemption. The Supreme Court first reached the merits of these issues in *Edgar v. MITE Corp.*,ⁿ² in which the court held the notice and hearing provisions of the Illinois Business Take-Over Act unconstitutional under the Commerce Clause. A plurality of Justices also found that the Illinois statute frustrated the objectives of federal law and should be invalidated by reason of federal preemption. The Illinois statute applied to every tender offer for a corporation of which ten percent of the shares were owned by persons located in the state, or which met two of three conditions: (1) organization under Illinois law, (2) principal executive office in Illinois, or (3) at least ten percent of stated capital and paid-in surplus represented in Illinois. The Supreme Court invalidated the statute since it overburdened interstate commerce in relation to local interests served, especially by allowing a state official to block a nationwide tender offer.ⁿ³

The decision in *Mite* sounded the death-knell for "first generation" state anti-takeover laws. In *Hyde Park Partners, L.P. v. Connolly*,ⁿ⁴ for example, the First Circuit, upheld a post-*Mite* preliminary injunction against the enforcement of the Massachusetts Take-Over Bid Regulation Act.ⁿ⁵ The Massachusetts statute required a prospective offeror to make an advance disclosure of intent to seek control of a target company prior to acquiring five percent of its stock. A penalty provision imposed a one year moratorium on making a takeover bid after failure to disclose control intent. The First Circuit agreed that enforcement of the provision violated the federal Commerce clause, and on application of a balancing test relative to local benefits. The court also concluded that the Massachusetts provision conflicted with the objectives of the federal Williams Act, despite the fact that a bidder could comply with both sets of requirements. According to the court, the provision intruded upon the careful balance struck by Congress between providing disclosure to investors and enabling tender offers by:

1-4 Blue Sky Regulation § 4.05

(1) depriving a purchaser intent on acquiring control of the right to increase its stake beyond 5% before disclosing the existence of such toehold by the end of ten days, and

(2) assisting incumbent management by giving more time to prepare defensive maneuvers.ⁿ⁶

Numerous federal and state cases with the same result followed, each striking down first generation anti-takeover laws on Commerce Clause and preemption grounds. States would not be permitted to extend their jurisdiction to interdict tender offers even if enforcement was sought solely as to offers to and purchases from residents of the state.ⁿ⁷

This does not mean, however, that state regulators may exercise no authority in regard to takeover bids. States may continue to impose filing and review requirements to the extent consistent with federal Williams Act processes and objectives, and which are not unduly burdensome to interstate commerce.ⁿ⁸ As a practical matter, however, the surviving vestiges of first generation state anti-takeover authority have little impact.

In the wake of *Mite* a new, second, generation of state laws emerged which have passed federal constitutional muster, and which provide a meaningful role for state law processes, if not administrative authority, in contests for corporate control. Second generation statutes fall under various descriptive titles. Most commonly they are referred to as "business combination," "interested shareholder," or "control share acquisition" laws. "Business combination" (or sometimes also titled "merger moratorium") statutes typically prohibit various forms of corporate transactions between a subject corporation and an "interested shareholder" for a specified period unless the transaction is approved by management; by shareholders under defined voting requirements; or in some cases unless fair price requirements are met. "Control share acquisition" laws control such transactions by mandating shareholder votes, but stripping voting rights from one who accumulates specified levels of shares of the company through means such as tender offers.ⁿ⁹ Their validity today is largely the result of the U.S. Supreme Court revisiting the subject of the proper scope of state authority in *CTS Corp. v. Dynamics Corp. of America*,ⁿ¹⁰ which upheld Indiana's "control share acquisition" statute.ⁿ¹¹

In *CTS* the Supreme Court upheld an Indiana law providing that an acquirer of more than twenty percent of shares of an issuer organized in Indiana may not vote those shares without first obtaining the approval of a majority of all disinterested shareholders. The court opined that the law did not conflict with the Williams Act or offend the Commerce Clause. The law did not discriminate against out-of-state offerors, was firmly rooted in state power to regulate voting rights in domestic corporations, and did not present a risk of inconsistent regulation among different states. Rather, said the court, it was a legitimate attempt to set conditions for acquisition of control of publicly traded companies incorporated in the state and to protect the voice of shareholders in the affairs of those companies.ⁿ¹² The scope of state authority was explained by the Supreme Court as follows:

Every State in this country has enacted laws regulating corporate governance. By prohibiting certain transactions, and regulating others, such laws necessarily affect certain aspects of interstate commerce. This necessarily is true with respect to corporations with shareholders in States other than the State of incorporation. Large corporations that are listed on national exchanges, or even regional exchanges, will have shareholders in many States and shares that are traded frequently. The markets that facilitate this national and international participation in ownership of corporations are essential for providing capital not only for new enterprises but also for established companies that need to expand their businesses. This beneficial free market system depends at its core upon the fact that a corporation--except in the rarest situations--is organized under, and governed by, the law of a single jurisdiction, traditionally the corporate law of the State of its incorporation.ⁿ¹³

The fact that the burden of state regulation falls on some interstate companies does not by itself establish a claim that it discriminates against or unacceptably interferes with interstate commerce. In the Supreme Court's view, any impact of

the Indiana statute on interstate commerce was consistent with Indiana's legitimate interests in regulating its domestic corporations. The Court considered the statute to be non-discriminatory. It had the same effects on tender offers whether or not the offeror is a domiciliary or resident of Indiana. Further, the court noted, the statute pursued the legitimate objective of protecting the shareholders of Indiana corporations by affording them an opportunity, when a takeover offer is made, to decide collectively whether that change would be desirable--a power that may be especially beneficial where a hostile tender offer may coerce shareholders into tendering their shares. Finally, unlike the Illinois statute considered in *MITE*, the Indiana statute applied only to corporations that have a substantial number of shareholders in Indiana. As a result, every application of the statute would affect a substantial number of Indiana residents, whom Indiana has a legitimate interest in protecting.ⁿ¹⁴

Unlike the first generation state laws considered in *Kidwell*, *MITE*, and their progeny, Indiana's regulatory scheme did not involve any process of filing with or approval by the State. Instead, Indiana's statute relied on the processes of corporate suffrage. The Indiana law provides that:

(1) the acquirer of "control shares" in an Indiana corporation covered by the statute,ⁿ¹⁵ is not entitled to vote those shares unless the exercise of its voting privileges is approved by a majority of the issuer's shareholders;

(2) the shareholders' determination is made at the next regularly scheduled shareholders' meeting, or at a special meeting. The acquirer can require the issuer's management to convene such a special meeting within 50 days by filing an acquiring person's statement with the issuer and agreeing to pay the expenses of the meeting;

(3) if the shareholders do not vote to restore voting rights, the issuer may, but is not required to, redeem the control shares from the acquirer at fair market value;

(4) if the acquirer fails to file the acquiring person's statement with the issuer, the issuer may, if its by-laws or articles of incorporation provide, redeem the shares at any time after 60 days after the acquirer's last acquisition.ⁿ¹⁶

Some twenty-six states have enacted control share acquisition statutes.ⁿ¹⁷ Thirty-five have enacted some form of business combination statute, and a substantial number among them have both. There are other hybrid approaches as well. In the wake of *CTS* these various second generation state laws have been upheld against constitutional challenges. In *WLR Foods, Inc. v. Tyson Foods, Inc.*,ⁿ¹⁸ for example, the court upheld each of Virginia's second generation anti-takeover laws in the face of federal preemption and Commerce Clause attacks. The state, said the court, "[h]as a clear interest in regulating the relationships that affect the corporations that are located within its territory and are a product of its own laws."ⁿ¹⁹ The court held that the Virginia laws--which include both a control share acquisition law and a business combinations law--do not offend the Commerce Clause because they do not discriminate against interstate commerce and, to the extent there is a burden on interstate commerce, it is justified by the legitimate interest of the state in regulating its corporations.ⁿ²⁰

To be sure, the path to upholding second generation state laws has not been without twists and turns. Discriminatory statutes creating the risk of inconsistent regulation have fared no better in the post-*CTS* era than before. In *Campeau Corp. v. Federated Department Stores, Inc.*,ⁿ²¹ for example, the court struck down the Ohio "Foreign Business Acquisitions Act," which regulated acquisitions of Ohio corporations by certain statutorily defined foreign corporations. The statute required foreign businesses to file an "application for approval of an acquisition," but did not impose the same requirement on either similarly situated offerors incorporated in the United States or foreign offerors already having a substantial interest in Ohio. Similarly, in *Tyson Foods, Inc. v. McReynolds*,ⁿ²² the Sixth Circuit held Tennessee provisions aimed at takeovers by foreign corporations to be in violation of the Commerce Clause because,

among other things, they represented direct regulation of foreign corporations and deterred nationwide tender offers. In addition, control share acquisition statutes have not escaped scrutiny. In *Luxottica Group S.p.A v. United States Shoe Co.* n23 the court held provisions of the Ohio control share acquisition statute which had the effect of disenfranchising certain shareholders to be unconstitutional where the process applied in determining which shares were eligible to vote meant that a tender offer could not be completed within the period prescribed by the federal Williams Act.n24

Scope of coverage issues will also arise. In *Kaplan v. Booth Creek Ski Group, Inc.*, n25 the New Hampshire Supreme Court held that state's Security Takeover Disclosure Actn26 did not apply to a statutory merger. Unlike a tender offer in which shareholders are asked to tender their shares directly to an acquiring entity, in a statutory merger the board of directors of each corporation must adopt a plan of merger, which is then submitted for shareholder approval. Thereafter, the transaction is accomplished by a stock-for-stock exchange or payment of other specified consideration. In *Kaplan* the court determined that because in a statutory merger the acquiring company does not directly solicit tenders of securities, but rather enters into a negotiated plan of merger there is no need for protection afforded by the Takeover Disclosure Law. Instead, the issue, if any, is the fiduciary duty of the board of directors to the shareholders in negotiating the best transaction and approving the plan. Thus, said the court, applying the Takeover Act to such transactions would not further the Act's central purpose of protecting shareholders.

Such continuing assessments notwithstanding, the second generation state laws governing takeovers are now solidly a part of the regulatory landscape. The contours of state jurisdiction are today shaped by what the U.S. Supreme Court articulated as the states' legitimate interest "in defining the attributes of shares in its corporations and in protecting shareholders."n27 States may legislate for the governance of the corporations they create, and so long as their laws do not discriminate against out-of-state interests, and do not undermine operation of federal regulation of tender offers, those laws will stand.

FOOTNOTES:

(n1)Footnote 1. Most of these statutes protected incumbent management in ways not contemplated by the Williams Act. Documents were usually required to be filed with the state and sent to the target anywhere from ten to sixty days preceding the offer, with disclosures that were frequently more detailed than those called for by the Williams Act. Commonly, the state required an administrative hearing on the bid before letting it proceed. Tender offers were, however, exempted by a number of states if the target's management recommended acceptance.

(n2)Footnote 2. 457 U.S. 624, 102 S. Ct. 2629, 73 L. Ed. 2d 269 (1982) .

The first significant constitutional challenge to state anti-takeover legislation was raised in *Great Western United Corp. v. Kidwell*, 577 F.2d 1256 (5th Cir. 1978) , rev'd for improper venue, 443 U.S. 173, 99 S. Ct. 2710, 61 L. Ed. 2d 464 (1979) , in which the Fifth Circuit held the Idaho anti-takeover law invalid under the Commerce Clause of the U.S. Constitution, and as being preempted by the Williams Act. The U.S. Supreme Court reversed on procedural grounds and did not reach the constitutional and preemption issues. See *Leroy v. Great Western United Corp.*, 443 U.S. 173, 99 S. Ct. 2710, 61 L. Ed. 2d 464 (1979) . In the wake of *Kidwell* courts split on the constitutional issues. See generally; 1 Lipton & Steinberger, *Takeovers and Freezeouts* § 5.02[2] (Law Journal Seminars-Press 1997).

(n3)Footnote 3. 457 U.S. at 643, 102 S. Ct. at 2641 .

(n4)Footnote 4. 839 F.2d 837 (1st Cir. 1988) .

(n5)Footnote 5. Mass. Ann. Laws Ch. 110C, §§ 1 through 13.

(n6)Footnote 6. But see *Nomad Acquisition Corp. v. Damon Corp.*, 701 F. Supp. 10 (D. Mass. 1988) (Tender offeror failed to show irreparable harm from application by target company of the Massachusetts control share

acquisition statute--a form of "second generation" anti-takeover law discussed further below).

(n7)Footnote 7. *Martin Marietta Corp. v. Bendix Corp.*, 690 F.2d 558 (6th Cir. 1982) (enforcement of antifraud provisions of Michigan statute held unconstitutional even if applied only to prevent purchases by Michigan residents).

(n8)Footnote 8. *Cardiff Acquisitions, Inc. v. Hatch*, 751 F.2d 906 (8th Cir. 1984) (state officials may require disclosures in addition to those required by the Williams Act so long as they are purely factual and not judgmental in nature, are not inconsistent with the Williams Act, and do not unduly burden interstate commerce).

But see Batus, Inc. v. McKay, 684 F. Supp. 637 (D. Nev. 1988) (state law mandating completion of a tender offer within 60 days was preempted by the Williams Act).

(n9)Footnote 9. "Business combination" laws have on occasion been characterized as "third generation" state anti-takeover laws, see *Amanda Acquisitions Corp. v. Universal Foods Corp.*, 877 F.2d 496 (7th Cir. 1989) .

(n10)Footnote 10. 481 U.S. 69, 107 S. Ct. 1637, 95 L. Ed. 2d 67 (1987) .

(n11)Footnote 11. *Ind. Code § 23-1-42-1 et seq.*

(n12)Footnote 12. 481 U.S. at 85-86 .

(n13)Footnote 13. 481 U.S. at 89-90 .

(n14)Footnote 14. *Id.*, at 93-94 .

(n15)Footnote 15. Control shares are defined as shares acquired that would bring the acquirer's voting power to or above any of three thresholds: 20%, 33 1/3%, or 50%. *Ind. Code 23-1-42-1*. The statute applies to any corporation that has 100 or more shareholders, has its principal office or substantial assets in Indiana, and has either (1) more than 10% of its shareholders resident in Indiana, (2) more than 10% of its shares owned by Indiana residents, or (3) ten thousand shareholders resident in Indiana. *Ind. Code 23-1-42-4(a)*.

(n16)Footnote 16. See *Ind.Code § 23-1-42-1-23-1-42-11*.

(n17)Footnote 17.

Arizona: Ariz. Rev. Stat. Ann. § 10-2741-2743.

Connecticut: Conn. Gen. Stat. § 33-840-845.

Delaware: 8 Del. Code Ann. § 203.

Florida: Fla. Stat. Ann. Ch. 607.0902.

Georgia: Ga. Code Ann. §§ 14-2-111, 14-2-1131-1133.

Idaho: Idaho Code § 30-1701-1710.

Illinois: 805 ILCS 5/7.85, 5/11.75 (2006).

Indiana: Ind. Code §§ 23-1-43-1-23-1-43-24.

Kansas: Kan. Stat. Ann. § 17-12, 100-104.

Kentucky: Ky. Rev. Stat. Ann. §§ 271B.12-200-271B.12-230.

Louisiana: La. Rev. Stat. Ann. § 12:132-134.

Maine: 13A Me. Rev. Stat. Ann. § 611-A.

Maryland: Md. Code Ann., Corps. & Ass'ns § 3-701-709.

Massachusetts: Mass. Ann. Laws, Ch. 110C, §§ 1 through 13.

Michigan: Michigan Comp. Laws §§ 450.1775-1784.

Minnesota: Minn. Stat. Ann. § 302A.673.

Mississippi: Miss. Code Ann. § 79-25-1-9.

Missouri: Mo. Rev. Stat. § 351.459.

Nebraska: Neb. Rev. Stat. §§ 21-2431-2453.

Nevada: Nev. Rev. Stat. §§ 78.411-444.

New Jersey: N.J. Rev. Stat. §§ 14A:10A-1-10A6.

New York: N.Y. Bus. Corp. L. § 912.

North Carolina: N.C. Gen. Stat. §§ 55-9-01-05.

Ohio: Ohio Rev. Code §§ 1701.831-.832.

Oklahoma: 18 Okla. Stat. § 1090.3.

Oregon: Ore. Rev. Stat. §§ 60.825-.971.

Pennsylvania: 15 Pa. Cons. Stat. §§ 2551-2556.

Rhode Island: R.I. Gen. Laws Ann. §§ 7-5.2-1-8.

South Carolina: S.C. Code Ann. §§ 35-2-101-226.

South Dakota: S.D. Codified Laws §§ 47-33-1 through 47-33-19.

Tennessee: Tenn. Code Ann. §§ 48-35-201-209.

Virginia: Va. Code Ann. §§ 13.1-725-727.1.

Washington: Wash. Rev. Code §§ 23B.19.010-.050.

Wisconsin: Wis. Stat. §§ 180.1130-1150.

Wyoming: Wyo. Stat. Ann. §§ 17-18-101-403.

(n18)Footnote 18. 65 F.3d 1172 (4th Cir. 1995) .

(n19)Footnote 19. *Id.*, at 1182 .

See also *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496 (7th Cir.) , cert. denied, 493 U.S. 955, 110 S. Ct. 367, 107 L. Ed. 2d 353 (1989) (Wisconsin business combination statute upheld).

(n20)Footnote 20. See also *BNS, Inc. v. Koppers Co.*, 683 F. Supp. 458 (D.Del. 1988) (upholding Delaware business combination law); *RP Acquisitions Corp. v. Staley Continental, Inc.*, 686 F. Supp. 476 (D. Del. 1988) .

(n21)Footnote 21. 679 F. Supp. 735 (S.D. Ohio 1988) .

(n22)Footnote 22. 700 F. Supp. 906 (M.D. Tenn. 1988) , *aff'd*, 865 F.2d 99 (6th Cir. 1989) .

(n23)Footnote 23. 919 F. Supp. 1085 (S.D. Ohio 1995) .

(n24)Footnote 24. But see *United Dominion Industries, Inc. v. Commercial Intertech Corp.*, 943 F. Supp. 857 (S.D. Ohio 1996) (Ohio statute upheld where process associated with "interested share" determinations could be accomplished within time frame mandated by the Williams Act).

(n25)Footnote 25. 147 N.H. 202, 785 A.2d 412, 2001 N.H. LEXIS 199 (N.H. 2001) .

(n26)Footnote 26. N.H. Rev. Stat. Ann. ch. 421-A.

(n27)Footnote 27. *CTS Corp. v. Dynamics Corp. of America*, *supra*, 481 U.S. at 94.



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CHAPTER 4 State Investor Protection Authority

1-4 Blue Sky Regulation § 4.06

§ 4.06 Challenges of Functional Regulation

Spawned by the stock market crash of 1929 and the ensuing Great Depression, New Deal-Era legislative initiatives in fairly short order produced the Securities Act of 1933, the Securities Exchange Act of 1934, and the Banking Act of 1933, the latter being better known as the Glass-Steagall Act.ⁿ¹ The Glass-Steagall Act mandated separation of commercial banking from investment banking, and confined banks to business activities that were scrutinized and regulated by designated banking authorities. At the same time, the Securities and Exchange Commission (SEC) was established to regulate securities distributions, trading markets and other aspects of securities transactions by issuers and intermediaries. Later, in 1945, Congress passed the McCarran-Ferguson Act,ⁿ² which provided for state regulatory authority over the insurance industry. Overall, the federal legislative approach to regulation of financial institutions and intermediaries was based on the separate and distinct activities of each of these segments of the financial services industry--banking, insurance and securities--and the desire to place each segment under the authority of regulators having specialized expertise.

The Depression-Era regulatory scheme was based on the distinct separation of activities within what steadily evolved in later decades as a true financial services industry. The 1930's bright lines between banking, securities and insurance activities were increasingly blurred. As financial institutions were driven by competition and a relaxing regulatory environment, banks offered securities brokerage and other investment-related services through "Section 20" subsidiaries,ⁿ³ broker-dealers created money-market funds into which they could sweep accounts, take deposits and allow check-writing, and insurance companies offered variable annuity products with investment features akin to and directly competitive with mutual funds. In time, the concept of "functional" regulation fully emerged, by which particular segments of business activity within a single institution became subject to regulation by the subject matter, or functional, expert in regard to that business segment.

The evolution of functional regulation was not without some resistance. In the insurance industry, for example, the scope of authority of securities regulators over variable annuity insurance products was ultimately determined in the United States Supreme Court. In *SEC v. Variable Annuity Life Ins. Co. of America (VALIC)*,ⁿ⁴ the Supreme Court held that variable annuities, in which all investment risk fell on the purchaser, are not "insurance," and are subject to regulation as securities. Subsequently, in *SEC v. United Benefit Life Ins. Co.*,ⁿ⁵ the Supreme Court held that so-called "flexible fund" annuities, which were structured to include an increased level of risk to the company in order to address the holding in *VALIC*, were also securities and subject to regulation as such.ⁿ⁶ Similarly, for thrift institutions, the Supreme Court determined in 1967 that "withdrawable capital shares" issued by a savings and loan institution were

securities for purposes of the antifraud provisions of the federal securities laws.ⁿ⁷

Throughout the evolutionary process in which functional regulation came into its own, state securities regulators maintained their historic focus on the licensing of investment professionals, registration of securities offerings, and vigorous enforcement. The melding of securities, banking and insurance products and services, however, progressively changed the landscape of the financial services marketplace. With the enactment of the Gramm-Leach-Bliley Act of 1999 (GLBA)ⁿ⁸ the change was fully consummated. GLBA, among other things, repealed key provisions of the Glass-Steagall Act, and ushered in major changes in the businesses that financial organizations are permitted to conduct, how they may conduct them, and how they are regulated. GLBA permitted the affiliation of banks with securities firms and insurance companies, and significantly reduced the restrictions on the activities conducted by those entities. Bank affiliates, for example, are no longer prohibited from engaging in the full range of securities activities, including organizing, sponsoring, and distributing mutual funds.

GLBA established functional regulation as the norm in the new financial services marketplace. Thus, bank regulators continue to regulate banking activities, securities regulators continue to regulate securities activities, and state insurance regulators continue to regulate insurance activities. GLBA required for the first time, however, that the separate functional regulators undertake to coordinate examinations, engage in information-sharing, and consult with each other prior to promulgating regulations that would apply across business lines. To effectuate functional regulation GLBA also removed the prior exemption of banks from the definitions of "broker" or "dealer" under the federal securities laws,ⁿ⁹ and provided for the creation of functionally regulated subsidiaries, specifically including a broker-dealer, investment adviser, investment company, or an insurance agency or company. In doing so, it supports the conduct of brokerage activities by banks through "Third Party Brokerage Arrangements" under which a bank may have a contractual relationship with a registered broker-dealer for providing securities brokerage and related services.

The role of state securities regulation in the new financial services environment is unchanged and, indeed, is firmly fixed after GLBA as a matter of functional regulation. State securities commissions continue to have regulatory authority over sales practices and licensing of intermediaries. Nevertheless, the new challenge for state regulators in functional regulation is also clearly apparent, as Blue Sky laws must now be administered and enforced in cooperation with banking and insurance counterparts. State regulators have thus entered into new information-sharing agreements with other functional regulators,ⁿ¹⁰ and are more focused on consistency and uniformity. In that regard, section 608 of the 2002 Uniform Act sets the stage:

Objective of uniformity. The administrator shall, in its discretion, cooperate, coordinate, consult, and, subject to Section 607, share records and information with the securities regulator of another State, Canada, a Canadian province or territory, a foreign jurisdiction, the Securities and Exchange Commission, the United States Department of Justice, the Commodity Futures Trading Commission, the Federal Trade Commission, the Securities Investor Protection Corporation, a self-regulatory organization, a national or international organization of securities regulators, a federal or state banking and insurance regulator, and a government law enforcement agency to effectuate greater uniformity in securities matters among the federal government, self-regulatory organizations, States, and foreign governments.ⁿ¹¹

The challenge for Blue Sky administrators in functional regulation is largely one of communication and cooperation. As discussed more fully elsewhere in this Treatise,ⁿ¹² state securities regulators increasingly demonstrate the view that the scope of investor protection under Blue Sky laws encompasses the integrity of national markets for securities that are sold locally, and the conduct of intermediaries in those markets that impacts public investors. There have been remarkable examples of cooperative enforcement initiatives--best illustrated by the 2002 formal inquiry into market practices concerning research analysts jointly conducted by the SEC, self-regulatory organizations, the New York Attorney General, NASAA and a number of states. The challenge in functional regulation after GLBA, however, is more subtle. Regulatory efficiency is at stake. Regulatory objectives must mesh, such that, for example, regulation for

investor protection is not inconsistent with prudential regulation of an umbrella financial institution.

While the distinct role of Blue Sky regulation is unchanged in the post-GLBA functional regulation era, the scope of state investor protection authority is a matter for continuous redefinition. It will also be the subject of continuing tension. A significant number of states, for example, do not provide for functional regulation by securities commissioners of intermediaries selling variable annuity products despite the fact that they have long been determined to be "securities"ⁿ¹³ under the federal securities laws. On the other hand, insurance and securities regulators have worked together in many states to coordinate the regulation of viatical settlement contracts. Additionally, the National Association of Insurance Commissioners and NASAA have jointly established an Enforcement Coordination Subgroup in order to increase communication and cooperation between state insurance and securities regulators in areas of regulatory overlap. Functional regulation today is a dynamic process in which the scope of regulatory authority is molded to permit the most efficient achievement of objectives in a multi-jurisdictional setting.

FOOTNOTES:

(n1)Footnote 1. Banking Act of 1933, Pub. L. No. 33-66, 48 Stat. 162 (1933) (codified in scattered sections of 12 U.S.C.).

(n2)Footnote 2. *15 U.S.C. § 1012, et seq.*

(n3)Footnote 3. Section 4(c)(8) of the Bank Holding Company Act of 1956, *12 U.S.C. § 1843(c)(8)*, permitted bank holding companies to invest in and control any company the activities of which the Federal Reserve Board determined to be "so closely related to banking [or to managing or controlling banks] as to be a proper incident thereto." Through an interpretation of section 4(c)(8) and section 20 of the Glass-Steagall Act, the Federal Reserve permitted bank holding companies to engage in securities activities through so-called "Section 20" subsidiaries.

(n4)Footnote 4. *359 U.S. 65, 79 S.Ct. 618, 3 L.Ed. 2d 640 (1959)* .

(n5)Footnote 5. *387 U.S. 202, 87 S.Ct. 1557, 18 L.Ed. 2d 673 (1967)* .

(n6)Footnote 6. *See also NationsBank of North Carolina, N.A. v. Variable Annuity Life Ins. Co., Inc., 513 U.S. 251, 115 S. Ct. 810, 130 L. Ed. 2d 740 (1995)* , in which the Supreme Court upheld a ruling of the Comptroller of the Currency that interpreted certain provisions of the National Bank Act as prohibiting banks from selling insurance to classify variable annuities as investments rather than insurance.

(n7)Footnote 7. *Tcherepnin v. Knight, 389 U.S. 332, 88 S. Ct. 548, 19 L. Ed. 2d 564 (1967)* .

(n8)Footnote 8. Pub. L. 106-102, 113 Stat. 134 (Nov. 12, 1999).

(n9)Footnote 9. To effectuate this change at the state level, the 2002 Uniform Securities Act likewise eliminates the exclusion contained in both the Uniform and Revised Uniform Acts from the definition of broker-dealer for a bank, savings institution or trust company. Although certain exclusions based on they type or extent of securities activity are allowed in conformity with GLBA, under the 2002 Uniform Act banks, savings institutions, and other depository institutions are be required to register under section 401 and generally, like all other broker dealers, to be subject to regulatory and liability provisions of the Act.

(n10)Footnote 10. *See NASAA Vision Statement, "The New Economy and State Securities Regulation," CCH NASAA Reports, P 19,005 (Sept. 19, 2000).*

(n11)Footnote 11. 2002 Unif. Sec. Act § 608(a).

(n12)Footnote 12. *See* Chapter 14, "Administration and Enforcement."

(n13)Footnote 13. The tension on this particular matter of Blue Sky law coverage is such that the 2002 Uniform Act incorporates optional language for those state that wish variable insurance products to be included in the definition of security, *see* 2002 Unif. Sec. Act § 102 (28)(B).



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CHAPTER 5 Securities Registration

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CHAPTER 5 Securities Registration

1-5 Blue Sky Regulation § 5.01

§ 5.01 In General

[1] Introduction

For more than sixty years the process of creating securities and their distribution into the hands of the investing public was carried out under a system of dual federal and state regulation. From the outset, however, the philosophical underpinnings and the approach of state and federal securities laws fundamentally differed. State Blue Sky laws were the product of early 20th Century Populism, and, with pure paternalistic motives, were enacted to prevent investors from losing their assets in fraudulent or highly speculative schemes and "to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures."¹

The notion of merit regulation of the distribution of securities became central in state securities regulation. Registration and "qualification" processes under most Blue Sky laws were designed to position a regulatory authority between issuers and potential investors for the purpose of determining essential fairness and, fundamentally, to make a determination whether citizens should be permitted even to consider the offering. For the most part, Blue Sky law registration requirements were thus aimed at creating information for submission to and review by regulators, and only secondarily focused on the dissemination of information to potential purchasers.²

In contrast, the registration mechanisms of the federal securities laws, all of which spring from Section 5 of the Securities Act of 1933,³ are "disclosure" oriented; that is, they prescribe the creation and dissemination of structured information to potential investors in the distribution process. Congress eschewed the paternalistic philosophy of Blue Sky regulation in favor of a system in which the central feature is a "registration" statement comprised primarily of the prospectus, a structured disclosure document that is reviewed by the Securities and Exchange Commission, but for the manner and completeness of its disclosure content rather than substantive fairness or merit of the offering. As a reviewing authority, the SEC is concerned with the adequacy and accuracy of information contained in the issuer's registration statement, of which the main part is the prospectus that will be distributed to prospective and actual purchasers of the covered securities. Although the SEC may, under the mantle of full disclosure, impose requirements intended to illuminate substantive aspects of an offering in a manner that suggests fairness concerns or heightens attention on particular risks, under the federal regulatory scheme, the SEC does not purport to judge the merit or worth of the offered securities.

Meaningful attempts were made to meld federal and state regulatory schemes relating to registration of securities

offerings that are national in character. For example, states adopted provisions for registration by "coordination," when the offering also involved the issuer filing a registration statement with the SEC under the Securities Act of 1933. Registration by this method avoids duplication in submissions between federal and state agencies, and streamlines the reviewing process at the state level. Many states also adopted outright exemptions from Blue Sky registration and qualification requirements for securities listed or approved for listing on principal national securities exchanges and the National Market System tier of the Nasdaq Stock Market. Despite these efforts, the dual regulation of securities offerings in a national market setting was seen as raising the cost of capital for issuers without any apparent corresponding incremental benefit in the protection of investors. Duplicative regulation in the registration process was challenged as costly, and the validity of merit regulation itself was questioned. These concerns were ultimately addressed with enactment of The National Securities Markets Improvement Act of 1996 ("NSMIA"),ⁿ⁴ which realigned state and federal roles in regard to registration requirements, and reallocated regulatory responsibility between state and federal authorities based upon the nature of a securities offering.

NSMIA fundamentally altered the role of Blue Sky regulation by eliminating most state registration and qualification requirements for offerings that are: (a) national in character; or (b) for which a uniform national policy or rule for an exemption is appropriate.⁵ By creating classes of "covered securities,"ⁿ⁵ federal law now restricts state regulatory authority principally to the context of smaller regional, and intrastate offerings, but preserves broad enforcement authority with respect to fraud or deceit, and to unlawful conduct of broker-dealers.

Most states base their registration requirements on the original Uniform Securities Act, and, after NSMIA, on the 2002 Uniform Securities Act, which has been adopted in several states and is under active consideration in others.ⁿ⁶ⁿ⁷ The 2002 Uniform Act was drafted to fully reflect NSMIA. Blue Sky laws in states that have not adopted the 2002 Uniform Act have been amended to deal with basic NSMIA preemption, although in most instances there remain provisions that no longer have relevance after NSMIA. Nevertheless, there remains in every state some provision for registration, if not qualification, of securities offerings. Registration under Blue Sky laws remains an essential consideration for "intrastate" offerings exempted from federal registration requirements, and for offerings carried out pursuant to Rules 504 and 505 of Regulation D under the Securities Act of 1933, neither of which involve NSMIA covered securities.ⁿ⁸ More broadly, real estate programs, equipment leasing programs, oil and gas offerings, and other partnership and non-corporate offerings, as well as corporate offerings in a variety of non-exempt settings that do not involve NSMIA "covered" securities continue to be subject to registration and qualification requirements, including merit review in those states that apply it.

[2] Registration Requirements

Section 301 of the 2002 Uniform Securities Act prescribes the baseline, post-NSMIA registration requirement that is part of all state securities laws. Section 301 provides in pertinent part:

It is unlawful for a person to offer or sell a security in this State unless:

- (1) the security is a federal covered security;
- (2) the security, transaction, or offer is exempted from registration under Sections 201 through 203; or
- (3) the security is registered under this [Act].ⁿ⁹

"Sale" under the 2002 Uniform Act is broadly defined to include every disposition of a security or interest in a security for value, and every attempt to offer or dispose of, to solicit an offer to buy, a security or interest in a security for value.ⁿ¹⁰ Whether "offer" and "sale" are defined together or separately, the breadth of their definition is no different

among all state securities laws. The registration requirement is triggered by any attempt to dispose, or solicitation of an offer to buy, for value, of a security for which no exemption is available.ⁿ¹¹ As presented in the State Guides, some states make specific provision for "testing the waters,"ⁿ¹² or permit other pre-filing activity that would otherwise trigger registration requirements. However, there is no uniformity among the states in making such allowances.

[3] Notice Filing

Where "covered" securities are involved in an offering, NSMIA precludes state registration and qualification requirements. However, NSMIA expressly permits state to require "notice" filings, and, to the extent that the covered securities are not listed securities, to assess filing fees.ⁿ¹³ The permitted notice filing may include the requirement to file any document filed with the SEC, as well as to file annual or periodic reports of the value of securities sold or offered for sale in the state. Section 302 of the 2002 Uniform Securities Act carries this authority into operation as follows:

(a) [Required filing of records.] With respect to a federal covered security, as defined in Section 18(b)(2) of the Securities Act of 1933..., that is not otherwise exempt under Sections 201 through 203, a rule adopted or order issued under the [Act] may require the filing of any or all of the following records:

(1) before the initial offer of a federal covered security in this State, all records that are part of a federal registration statement filed with the Securities and Exchange Commission under the Securities Act of 1933 and a consent to service of process ... signed by the issuer and the payment of a fee of \$[];

(2) after the initial offer of the federal covered security in this State, all records that are part of an amendment to a federal registration statement filed with the Securities and Exchange Commission under the Securities Act of 1933; and

(3) to the extent necessary or appropriate to compute fees, a report of the value of the federal covered securities sold or offered to persons present in this State, if the sales data are not included in records filed with the Securities and Exchange Commission and payment of a fee of \$[].ⁿ¹⁴

The 2002 Uniform Act permits state administrators to issue "stop orders" suspending an offering in the event there is a failure to comply with the notice filing or fee requirements. The stop order authority relating to non-payment of notice filing fees, however, does not extend to offerings involving listed securities.ⁿ¹⁵

States adopting the 2002 Uniform Act have for the most part adopted section 302 verbatim, although in most cases adding a provision for waiver of the requirements by rule or an order issued by the administrator.ⁿ¹⁶ Notice filing provisions in other states vary somewhat as to form and mechanics. In all cases, however, as specifically permitted under NSMIA, state administrators may issue stop orders or suspend the offering of covered securities when notice filing requirements are not satisfied.

FOOTNOTES:

(n1)Footnote 1. *1 Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 815, 13 Cal. Rptr. 186, 361 P.2d 906 (1961); see also *People v. Baumgart*, 218 Cal. App. 3d 1207, 267 Cal. Rptr. 534 (Ct. App. 1990) (main object of securities law is to protect public against imposition of unsubstantial, unlawful, and fraudulent stock and investment schemes and to promote full disclosure of all information necessary to make informed and intelligent investment decisions); *Crater v. International Resources, Inc.*, 92 Ohio App. 3d 18, 633 N.E.2d 1212 (Ohio Ct. App. 1993) (purpose of registration statute is to protect public "from its own stupidity, gullibility and avariciousness"); *Grand Prairie Sav. & Loan Assoc.*

v. *Worthen Bank & Trust Co., N.A.*, 298 Ark. 542, 769 S.W.2d 20 (Ark. 1989) (purpose of state act is remedial and intended to prevent fraudulent practices and activities from becoming a burden on unsophisticated investors and the general public).

(n2)Footnote 2. The philosophy of merit regulation, and its implications in practice, is considered specifically in Chapter 6 of this Treatise. As discussed further there, even before the major federalism adjustments that have now curtailed the role of merit regulation, merit regulation was not universally applied among the states.

(n3)Footnote 3. 15 U.S.C. § 77e (2000).

(n4)Footnote 4. P.L. 104-290, 110 Stat. 3416 (1996). NSMIA replaced, in its entirety, Section 18 of the Securities Act of 1933, 15 U.S.C. § 77r (2000). NSMIA is introduced in § 1.02[4], *supra*, and its impact on various aspects of state securities regulation is addressed throughout this Treatise, *see, e.g.*, § 4.02 ("The Impact of NSMIA on State Authority").

(n5)Footnote 5. NSMIA defines four categories of covered securities:

(1) *Nationally Traded Securities*. These securities comprise those listed or authorized for listing on the New York Stock Exchange, the American Stock Exchange, or which are listed or will upon completion of the offering be listed for trading in the National Market System tier of the Nasdaq Stock Market, or any national securities exchange designated by the SEC as having listing standards substantially similar to the named markets.

(2) *Securities issued by an investment company registered or filing for registration under the Investment Company Act of 1940*. There is exclusive federal jurisdiction with regard to investment company securities.

(3) *Securities sold to "Qualified Purchasers."* Any security will be a covered security for purposes of the preemption of state regulation if it is offered and sold to persons who are defined by the SEC to be "qualified purchasers." NSMIA itself prescribes no criteria for defining the class of persons who will be deemed qualified. It does, however, expressly permit the SEC to classify buyers by reference to types of securities being offered, "consistent with the public interest and the protection of investors." Acting under that authority, the Commission has proposed a rule that would confer qualified purchaser status on any "accredited investor" as that term is defined in Rule 501(a) under the Securities Act. The list of accredited investors in Rule 501(a) includes individuals meeting certain net worth or income levels.

(4) *Securities involved in transactions exempt under certain federal Securities Act provisions*. NSMIA extends the "covered security" umbrella over a broad range of exempt securities or transactions under Sections 3 and 4 of the Securities Act of 1933. With the exception of Securities Act section 3(a)(4) (eleemosynary issuer), section 3(a)(10) (securities issued in exchange transactions pursuant to judicially or administrative fairness proceedings), section 3(a)(11) (intrastate offerings), and municipal securities offered and sold in the state in which the issuer is located, all other securities exempt under section 3(a) of the Securities Act are covered securities.

(n6)Footnote 6. The 2002 Uniform Securities Act is discussed throughout this Treatise. It has been adopted in Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Maine, Michigan, Minnesota, Mississippi, Missouri, New Mexico, Oklahoma, South Carolina, South Dakota, U.S. Virgin Islands, Vermont and Wisconsin.

(n7)Footnote 7. The full text of the original Uniform Act, the Revised Uniform Act, and the 2002 Uniform Act, is reprinted in Volume 2, at page UA-1 *et seq. infra*.

(n8)Footnote 8. Rule 504, 17 C.F.R § 230.504, provides an exemption from federal registration requirements for limited offers and sales of securities not exceeding \$1,000,000. There are general conditions to be met under Regulation D. However, a compliant Rule 504 offering does not involve NSMIA "covered" securities, and thus remains fully subject to state registration and qualification requirements. This is also the case with offerings carried out in compliance with Rule 505 of Regulation D, 17 C.F.R. § 230.505, which provides an exemption from federal registration for offerings up to \$5,000,000 to an unlimited number of accredited investors and up to 35 other persons who meet certain sophistication or wealth standards. Through widespread adoption of the Uniform Limited Offering Exemption, most states accommodate Rule 505 offerings with an exemption from state requirements as well when ULOE criteria are met.

Securities offered and sold pursuant to Rule 506 of Regulation D, 17 C.F.R. § 230.506, are NSMIA covered securities, Rule 506 provides a federal exemption for offers and sales of securities without regard to the dollar amount of the offering, provided the general conditions of Regulation D are satisfied and specific conditions of Rule 506 dealing with the number and nature of purchasers are also met. States have nevertheless asserted authority to determine the validity of the federal Rule 506 exemption in order to determine whether NSMIA covered securities are in fact involved in an offering that would otherwise be subject to state requirements for registration or an available exemption. See Rapp & Berckmueller, "Testing the Limits of NSMIA Preemption: State Authority to Determine the Validity of Covered Securities and to Regulate Disclosure," 63 *Bus. Lawyer* 809 (May 2008).

(n9)Footnote 9. 2002 Unif. Sec. Act § 301.

(n10)Footnote 10. 2002 Unif. Sec. Act § 102(26).

(n11)Footnote 11. The meaning of "offer" and "sale" of securities in the application of Blue Sky laws is considered in detail in Chapter 3, *supra*.

(n12)Footnote 12. See, e.g., Alaska, 3 AAC § 08.087; Virginia, 21 VAC 5-40-70. In most instances these provisions permit solicitations of interest before the filing of a registration statement to the extent that an issuer may make an "offer," but not a sale, for the sole purpose of receiving a prospectus if certain conditions are met. Conditions on "testing the waters" focus on the nature of the issuer involved, the proper qualification of agents making the solicitation, the manner of making solicitations, and the use of a prescribed legend on soliciting materials. In most cases an advance filing of a solicitation of interest form with the administrator is required, and there is a filing fee.

(n13)Footnote 13. See Securities Act of 1933 § 18(c)(2), 15 U.S.C. § 77r(c)(2) (2000). Listed securities are specifically excluded from state authority to impose filing fees. However, there is no exclusion from any state notice filing requirement.

(n14)Footnote 14. 2002 Unif. Sec. Act § 302(a).

A notice filing under this provision is effective for one year commencing on the later of the notice filing or the effectiveness of the offering filed with the SEC. The notice filing may be renewed. *Id.*, § 302(b).

(n15)Footnote 15. See 2002 Unif. Sec. Act § 302(d).

(n16)Footnote 16. See, e.g., Wisconsin, Wis. Stat. § 551.302(5).



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Blue Sky Regulation

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CHAPTER 5 Securities Registration

1-5 Blue Sky Regulation § 5.02

§ 5.02 Types of Registration

Blue Sky laws commonly provide three alternative forms for the registration of securities. They are: (a) Registration by *notification* (referred to in some Blue Sky laws as registration by "description" or "filing"), a procedure generally reserved for higher quality issues; (b) Registration by *coordination*, a method used when the issue is also being registered with the Securities and Exchange Commission; and (c) Registration by *qualification*, the method that is the most demanding for the issuer. Each of these is considered in further detail below.

[1] Registration by Notification

Registration by notification is the simplest method of registration. As the name implies, compliance is accomplished via registration forms which need only contain basic identifying and descriptive information concerning the issuer and the offering of securities involved. Typical content requirements are set out in Section 302 of the original Uniform Securities Act Act,ⁿ¹ which has been adopted in the majority of states that retain a provision for this type of registration.ⁿ²

Nomenclature may differ. California, for example, provides for "qualification by notification."ⁿ³ Other state provide for registration by "description."ⁿ⁴ However labeled, the availability of registration by notification is conditioned upon meeting certain criteria. This simplified form of compliance with state registration requirements is reserved for comparatively high quality securities, as measured by prescribed characteristics of the issuer.ⁿ⁵ The original Uniform Act thus provides that to qualify for registration by notification, an issuer must have been in continuous operation for at least five years; must not have defaulted in the payment of principal, interest, or dividends of any security during the preceding three fiscal years; and must have had average earnings of at least five percent on its common shares. Particular states may impose other qualifying transactional criteria, such as limiting the number or purchasers, or the extent of commissions, or providing for escrow of funds, or other requirements relating to use of an offering document.ⁿ⁶

By meeting these qualitative criteria (and demonstrating so on the face of the registration form) an issuer is permitted to file a much simpler form of registration statement, containing only certain basic identifying information and other items describing the character of its business, the security involved, the proposed offering terms, a description of any stock options, and financial data under certain conditions. A copy of any prospectus or other sales literature must be submitted with the registration statement.

An important advantage of registration by notification beyond the simplicity of the process, is its speed. The original Uniform Act provides that unless there is a stop order in effect, a registration by notification is automatically effective on the second full business day after the filing, or at such earlier time the Administrator determines. Some states vary the effective date provision. Alabama, for example, provides that the registration is effective on the fifth, rather than the second, full business day after filing,ⁿ⁷ while Michigan provides for effectiveness on the twentieth day.ⁿ⁸ However specified in the statutes, effective dates are not necessarily automatic, and careful attention must be paid to administrative rules or interpretations. In Ohio, for example, by statute a registration by description is complete upon certified mailing of the complete registration statement and requisite fee to the administrative agency.ⁿ⁹ Administrative rules governing registration by notification or description often provide for review of such registration statements, and admonish issuers not to proceed until that additional processing is completed and an acknowledgment is issued.ⁿ¹⁰ In addition, all state agencies are authorized to suspend effectiveness of a registration statement.ⁿ¹¹

Variations among the states include the qualifying period of time that an issuer must have been in business before registration by notification is possible. The original Uniform Act, for example, provides a five-year prerequisite. Texas, on the other hand, provides that securities issued by corporations that have been in operation for not less than *three* years may register their securities by notification.ⁿ¹² Other variations involve restrictions on use of the notification procedure by the type of security being offered. Minnesota, for example, provides that only tax-exempt industrial revenue bonds and securities issued by nonprofit organizations may be registered by notification.ⁿ¹³ The same is true in New Hampshire.ⁿ¹⁴

Such variations notwithstanding, registration by notification is generally available for all types of comparatively higher quality securities, as measured by qualifying characteristics of the issuer, and otherwise controlled, if at all, by limitations on the offering or the selling process. This, and any, type of state registration is nevertheless subject to suspension, or a "stop order," issued by the administrator if it fails to meet qualifying requirements, or, as set out in Section 306 of the original Uniform Act, if it is determined that the offering works, tends to work, or would work a fraud upon purchasers.ⁿ¹⁵ Merit, or fairness, criteria of individual states may thus be applied.

The 2002 Uniform Securities Act eliminated registration by notification, with the drafters noting that it was little used, and that the notice filing requirement for federal covered securities essentially replaces the need for registration by notification.ⁿ¹⁶ Nevertheless, in many of the states that have not adopted the 2002 Uniform Act, registration by notification, or an analog, remains an available form of registration.

[2] Registration by Coordination

Registration by coordination is available under Blue Sky laws when a registration statement for the same offering has been filed with the SEC under the Securities Act of 1933. Federal-state coordination permits the issuer to avoid duplication and to use substantially the same materials in complying with registration requirements at both levels. The procedure is set out in original Uniform Act Section 303,ⁿ¹⁷ and is carried into the 2002 Uniform Act, also as section 303. It is available in most states.ⁿ¹⁸ Registration by coordination avoids duplication by federal and state agencies. The information required to be filed with the various states is essentially the same as that filed with the SEC, including the prospectus and such other documents as may be requested by a particular state administrator. A uniform application to register securities, Form U-1, is used in the process.ⁿ¹⁹

The key element of registration by coordination is the registration statement relating to the same offering of the same securities that is filed under the Securities Act of 1933. Compliance with state submission requirements is entirely premised upon the federal process. As noted above, Form U-1 is available for use, although individual states prescribe their own submission requirements and the content of forms. Generally, registration by coordination at the state level entails submission of all documents filed with the SEC as part of the federal registration statement, along with certain other documents such as the articles of incorporation, any agreement among underwriters, any indenture or other

instrument governing the issuance or terms of the particular security, and a specimen of the security.ⁿ²⁰

As part of the federal registration statement, a prospectus containing specified financial statements must also be submitted. Item 16(b) of Form S-1, "Financial Statements," governs what financial information must be included in this section of the prospectus: a balance sheet, an income statement, and a statement of source and application of funds.ⁿ²¹ The form and content of these financial statements are in turn determined by Regulation S-X under the Securities Act.ⁿ²²

Each of the states permitting registration by coordination requires that a certain number of copies of the prospectus filed under the Securities Act of 1933 accompany the state registration. Although the number of copies of this prospectus requested by the Commissioner may vary,ⁿ²³ All but one stateⁿ²⁴ require that they be the latest or final copy of the prospectus and any amendments thereto. Under the Uniform Act, registration by coordination in a state automatically becomes effective when the federal registration becomes effective if (1) no stop order is in effect; (2) the registration has been on file with the state commissioner for ten days; and (3) a statement of the maximum and minimum proposed offering prices and the maximum underwriting discounts has been on file for two days. Some states vary the requirement for the time in which the registration statement must have been on file.ⁿ²⁵ Others vary the time in which pricing data must be on file.ⁿ²⁶ In all cases, however, the registrant must notify each state's administrator of the federal statement's effectiveness, and must file a post-effective amendment containing the information and documents that were filed with the SEC as the "price amendment," to the registration statement.ⁿ²⁷

Since the adoption of SEC Rule 430A under the Securities Act of 1933,ⁿ²⁸ the process of a traditional "price amendment" for a federal registration statement has been eliminated. The form of prospectus filed as a part of the federal registration statement that is declared effective may omit price and underwriting information. Rule 430A prescribes that such information is now supplied to the SEC by filing the final prospectus. Since there is no longer a need for a federal "price amendment," the original Uniform Act provision for post-effective submission of that specifically identified information as a condition to effectiveness at the state level should be satisfied by submission of the final prospectus. Most states provide needed flexibility in this process by expressly allowing for waiver by the administrator of the time requirements for which information must be on file, and also for interaction with the administrator in order to avoid gaps in the effective dates of federal and state registrations.ⁿ²⁹ In any case, if the registrant fails to file the required notification of federal effectiveness and make whatever post-effective amendment is necessary at the state level, the administrator may enter a stop order retroactively denying or suspending effectiveness until compliance at the state level is complete.

"Shelf" Registration. SEC Rule 415 under the Securities Act,ⁿ³⁰ which permits the registration of securities to be offered and sold on a delayed or continuous basis in the future ("shelf registration"), raises special questions for state registration by coordination.ⁿ³¹ For example, Section 305(i) of the original Uniform Securities Act provides that a registration statement remains effective for a period of one year from its effective date, or such longer period during which the offering is actually being made by an underwriter. The effective periods for registration statements in particular states vary. Shelf registrations, however, clearly contemplate that potentially longer periods of time will be involved. To deal with such issues many states have adopted specific procedures for the shelf registration by coordination for debt and equity securities that are registered with the SEC for primary offerings under Rule 415, if not otherwise exempt under state law.ⁿ³² Generally, the shelf registration statement filed with the SEC is annexed to Uniform Form U-1, "Uniform Application to Register Securities," and filed with the appropriate fee with the state administrator.ⁿ³³ Further filings must be made relating to particular offerings, and as each offering of securities (or "takedown") covered by the registration statement is offered for sale and sold, the registrant will be required to file prospectus supplements or post-effective amendments to the registration statement, or both types of filings.

[3] Registration by Qualification

Registration by qualification is the most demanding method of state registration. In the post-NSMIA regulatory

environment, and given the pre-existing alternative for registration by coordination where broad scale offerings are involved, registration by qualification will be relied upon most often for "intrastate" offerings exempt from federal registration by Securities Act Section 3(a)(11), and also for limited offerings of securities pursuant to SEC Rules 504 and 505 of Regulation D, which are not deemed to be covered securities for purposes of federal preemption under NSMIA, and which are not typically exempted from state registration requirements.ⁿ³⁴ Original Uniform Act Section 304 sets out this alternative, which is carried into the 2002 Uniform Act. The original Uniform Act provision for registration by qualification has been adopted by a majority of states,ⁿ³⁵ and non-Uniform Act states have essentially the same provisions and requirements. Any security may be registered by qualification, whether or not another type provisions and requirements. Any security may be registered by qualification, whether or not another type of registration is available. As a practical matter, registration by qualification is used by an issuer when no other less demanding form is available.

Registration by qualification involves the submission of numerous categories of information and documents that must accompany each such application. As spelled out in the original Uniform Securities Act, these include:

- (1) Basic information about the issuer and any subsidiaries, if any, the character and location of its business, and the general competitive conditions in the industry;
- (2) Personal data about corporate officers and their security holdings including a description of any material interest or transaction effected between the issuer and the officer for a period of three years;
- (3) Remuneration paid to corporate officers during the previous twelve months;
- (4) Details relating to capitalization and long term debt; information about the securities such as price, estimated underwriting and selling discounts or commissions;
- (5) Cash proceeds expected from the offering, and the proposed use of such proceeds; a description and amount of any stock options;
- (6) Copies of any material contracts made otherwise than in the ordinary course of business;
- (7) Pending litigation;
- (8) Copies of any prospectus or sales literature to be used;
- (9) A copy of the security being registered;
- (10) An opinion of counsel as to the legality of the security being offered;
- (11) Consents from any professional, *e.g.*, accountant, engineer, if such person is named as having prepared or certified a report used in the registration process;
- (12) A balance sheet and profit and loss statement; and
- (13) Any additional information required by the Administrator.ⁿ³⁶

The majority of states mandate all of the Uniform Act categories of information and documents for registration by qualification. Some, however, require more or less information, depending most commonly on whether the state engages in merit review of registration statements. Merit review of registration statements involves the application of qualitative standards to the offering, and a determination by the administrator whether to permit in the state based on a

statutory standard and particular guidelines applicable in the state.ⁿ³⁷

Although registration by qualification is the most burdensome form of registration under Blue Sky laws, it may be the only alternative for smaller, localized distributions. So as not to unduly impede capital formation, a NASAA sponsored modification of the procedure for small company offerings has been widely adopted. For eligible issuers, the Small Company Offering Registration ("SCOR") is made on Form U-7. It is a registration by qualification, but the information requirements specified in Form U-7, particularly for financial statements, are significantly lessened. SCOR registrations are discussed further in *section 5.02[4][d] below*.

A registration by qualification becomes effective when the Administrator so orders,ⁿ³⁸ although the 2002 Uniform Act illustrates a commonly adopted approach of automatic effectiveness within a stated time period unless action is taken by the administrator.ⁿ³⁹

[4] Other Types of Registration

Among states that have not adopted a version of the Uniform Act, or that vary to one degree or another the nomenclature or substance of registration alternatives, there are functional equivalents of the simplified notification or coordination registration processes. There are also variants available in some states for particular types of offerings. Non-Uniform Act types of registration are discussed below.

[a] Registration by "Filing"

This simplified method of registration is based on section 302 of the Revised Uniform Securities Act, which takes the place of registration by notification.ⁿ⁴⁰ As illustrated in Rhode Island, the procedure is separate from registration by coordination and authorizes the registration of certain securities for which a statement has been filed under the 1933 Act, whether or not they would be eligible for filing under the registration by coordination or registration by qualification provisions of the Blue Sky law,ⁿ⁴¹ provided certain conditions are satisfied. These include certain residency and duration of business operations requirements, registration under Section 12 of the Securities Exchange Act of 1934, a minimum net worth, and other criteria designed to demonstrate that the issuer is a seasoned company with substantial marketplace information and activity.ⁿ⁴²

[b] Registration by "Description"

As an available method of simplified registration in Arizona,ⁿ⁴³ North Dakota,ⁿ⁴⁴ and Ohio,ⁿ⁴⁵ registration by description is similar to registration by notification. In Arizona, for example, the registration by description is available if the issuer has been in continuous operation for a minimum three-year period and has shown specified net earnings for recent reporting periods. The statute requires that the registration statement specify the name and address of both the person doing the filing and of the issuer and the title, amount, and price of the securities being offered. Further, financial data, *i.e.*, balance sheet and profit and loss statements, and a prospectus, if one was filed in conjunction with a federal filing, must be submitted. A registration statement filed in Arizona pursuant to the description method becomes effective when filed.

[c] Registration by "Announcement"

This procedure is available only to non-issuers in North Dakota.ⁿ⁴⁶ It is available for securities "that have been outstanding and in the hands of the public for not less than one year as a result of prior original registration,"ⁿ⁴⁷ or for securities of life insurance companies that have been in continuous operation for twenty years. The announcement that must be filed with the North Dakota Commissioner of Securities by a registered dealer must contain the name and address of the issuer and a description of the security being offered. In addition, the issuer must mail a current balance sheet to the Commissioner. The effective date of such registration is the date of the filing of the announcement.

[d] Small Company Offering Registration (SCOR)

As a less burdensome form of registration by qualification, SCOR registrations are made on Form U-7, the "Small Company Offering Registration Form." The procedure is intended to foster capital formation by smaller enterprises and to encourage investment. Small issuers raising small amounts capital face special problems not faced by issuers raising larger amounts, and with NASAA sponsorship, states have recognized that the standards appropriate to registrations of larger offerings may be unduly burdensome when applied to small offerings. The optional method of a SCOR registration is thus intended to reduce costs and burdens of raising capital for small business without sacrificing investor protection, and to maximize the amount of offering proceeds available to the SCOR issuer for investment in the business.

SCOR is intended to allow small companies to conduct limited offerings. For qualifying issuers the information requirements of Form U-7, particularly the financial statement requirements, are much less burdensome. Virginia, for example, provides that financial statements included in the application for registration need not be audited if the issuer meets certain qualifying criteria. The issuer may not previously have sold securities through an offering involving general solicitation, and must not previously have been required under any federal or state securities law to submit audited financial statements in connection with any sale of its securities.ⁿ⁴⁸ All states also limit SCOR availability by the size of the offering, most commonly specifying that the aggregate offering price of the securities offered may not exceed \$1,000,000, with some provision for integration of prior offerings within a particular time period in making that calculation. Thus, for example, in Washington, the aggregate offering price of the securities offered may not exceed \$1,000,000 less the aggregate offering price of all securities sold by the issuer within the twelve months before the start of the offering, as well as during the offering in reliance on an exemption from the federal securities laws.ⁿ⁴⁹

Consistent with its purpose and the fact that the Form U-7 format will not provide adequate disclosure for certain issuers, SCOR registration is also generally limited to certain types of issuers, or is deemed to be unsuitable for certain issuers without permission of the administrator. As illustrated again in Washington, a SCOR issuer must be a corporation or centrally managed limited liability company, and must not have a complex capital structure.ⁿ⁵⁰ These restrictions (and several others) on SCOR availability are all part of the NASAA *Statement of Policy Regarding Small Company Offering Registrations*,ⁿ⁵¹ which explains that SCOR registration is designed to provide uniform treatment of small company offerings which are exempt from federal registration under Rule 504 of Regulation D, Regulation A, or section 3(a)(11) of the Securities Act of 1933. Thus, in addition to all other requirements, the Policy Statement requires that SCOR offerings be conducted in compliance with those federal provisions. However, it also makes clear that state administrators are free to waive any standard in the Policy Statement, and impose substantive conditions not contained in the Policy Statement. Most states embracing SCOR have adopted the NASAA Policy Statement. Others simply make Form U-7 generally available, relying on the form itself as setting out the instructions for availability.ⁿ⁵²

Interstate use of Form U-7 and SCOR registration has been significantly advanced through state initiatives to allow coordinated review through regions of the country. The process of coordinated review of SCOR registrations, and other programs for coordinated review of equity offerings on a regional basis is discussed more fully in Chapter 6. Coordinated review for SCOR registrations means that a lead reviewer represents all of the states in a particular region, thus streamlining the process and reducing the costs of capital formation for smaller issuers.

[e] Registration in New York: The Martin Act

While traditional regulation of securities offerings under Blue Sky laws is based on the registration of securities, and in some cases the merit review of offerings, regulation of securities offerings in New York is primarily accomplished through regulation of those persons who engage in the process of offering and selling securities. The Martin Actⁿ⁵³ regulates persons engaged in the business of selling securities to the public. "Registration" principally focuses on registration of the intermediaries who carry out offerings, and issuers engaged in the sale of their own securities. That is not to say, however, that the Martin Act has no traditional registration elements. Intrastate offerings, along with real

estate and theatrical syndication offerings involve procedures akin to traditional securities registration. Intrastate offerings, are governed by Section 359-ff of the Martin Act, and specific regulations under it which comprise the New York Intrastate Financing Act.ⁿ⁵⁴ In addition to enumerated disclosure requirements, the regulations provide for exemptions based upon offerings to special classes of investors, including related or sophisticated persons, promoter groups, and small offerings of specialized securities such as employee stock purchase plans or investment clubs.ⁿ⁵⁵

Intrastate public offerings--principally consisting of those carried out pursuant to Rule 504 of Regulation D under the federal Securities Act of 1933,ⁿ⁵⁶ which involve general solicitations and where resales will not be restricted, are fully subject to state regulation. In New York, intrastate offerings are subject to "registration," although the registration filing consists of a disclosure document that satisfies content requirements. Section 359-ff of the Martin Act makes it unlawful for any person to offer or sell securities in an intrastate offering unless an "offering prospectus" which makes full and fair disclosure of all material facts is first filed by the issuer. The offering prospectus must include, without limitation, a description of the securities offered and terms of the offering, the nature of the issuer's business, the purpose of the offering and the application of proceeds by the issuer. It must also contain background information regarding management, and any pending material litigation. Specified financial statements of the issuer are also required.ⁿ⁵⁷ A prospectus is required for intrastate offerings, and New York Form INTRASTATE-1 is prescribed for that purpose.

No registration in New York is required with respect to intrastate offerings that are subject to an effective registration statement filed with the U.S. Securities and Exchange Commission pursuant to the federal Securities Act of 1933, or for an offering which otherwise qualifies for an exemption from federal registration under any securities or transaction exemption other than section 3(a)(11) (the intrastate offering exemption) of the federal Securities Act of 1933. Intrastate offerings by issuers whose securities are registered under the federal Securities Exchange Act of 1934 are likewise exempt from filing in New York. Certain other securities that are subject to regulation under other provisions of New York law are also exempt.ⁿ⁵⁸

Other than specific provisions for intrastate offerings, filing requirements for securities offerings in New York are built around a "State Notice" and a "Further State Notice" to be filed by broker-dealers who engage in the offering.⁹ These requirements prohibit a broker or dealer from buying or selling, or offering to buy or sell, securities until the dealer or broker identifies itselfⁿ⁵⁹ and, in the case of a "Further State Notice," the dealer must provide the name of the security and the name of the issuer of the securities to be sold.ⁿ⁶⁰ These simple filings are built around the more substantial filing requirement--the "Broker-Dealer Statement"--for broker-dealers who engage in the offer and sale of securities.

[f] Multijurisdictional Disclosure System Offerings

Many states participate in the SEC Multijurisdictional Disclosure System ("MJDS") to facilitate cross border offerings by certain Canadian issuers.ⁿ⁶¹ The MJDS allows qualifying Canadian issuers to file their Canadian registration and disclosure documents with the SEC, and to register by filing in the states in which the offering will be made.ⁿ⁶² In order to harmonize state registration procedures with the MJDS, state requirements regarding content and time-on-file for eligible offerings are modified.

FOOTNOTES:

(n1)Footnote 1. *See also* Rev. Unif. Sec. Act § 302, which has substituted a "registration by filing" procedure for the Uniform Act notification procedure. States that have adopted this method, with some additional local requirements, include Rhode Island, *see R.I. Gen. Laws § 7-11-302*.

(n2)Footnote 2. *See, e.g.:*

Alaska: Alaska Stat. § 45.55.080.

California: Cal. Corp. Code § 25112.

Kentucky: Ky. Rev. Stat. § 292.350.

Maryland: Md. Code Ann. § 11-502.

New Jersey: N.J. Stat. Ann. § 49:3-61.2.

(n3)Footnote 3. *See Cal. Corp. Code Section 25112.*

(n4)Footnote 4. *See:*

North Dakota: N.D. Cent. Code § 10-04-07.

Ohio: Ohio Rev. Code Ann. § 1707.08.

(n5)Footnote 5. In Kentucky, for example, the following securities may be registered by notification:

(a) Any security whose issuer and any predecessors have been in continuous operation for at least five (5) years if:

1. There has been no default during the current fiscal year or within the three (3) preceding fiscal years in the payment of principal, interest, or dividends on any security of the issuer (or any predecessor) with a fixed maturity or a fixed interest or dividend provision; and

2. The issuer and any predecessors during the past three (3) fiscal years have had average net earnings, determined in accordance with generally accepted accounting practices, which are applicable to all securities without a fixed maturity or a fixed interest or dividend provision and which equal at least five percent (5%) of the amount of securities without a fixed maturity or a fixed interest or dividend provision outstanding at the date the registration statement is filed (as measured by the maximum offering price or the market price on a day selected by the registrant within thirty (30) days before the date of filing the registration statement, whichever is higher, or if there is neither a readily determinable market price nor an offering price, book value on a day selected by the registrant within ninety (90) days of the date of filing the registration statement), or if the issuer and any predecessors have not had any securities without a fixed maturity or a fixed interest or dividend provision outstanding for three (3) full fiscal years, equal at least five percent (5%) of the amount (as measured by the maximum public offering price) of such securities which will be outstanding if all the securities being offered or proposed to be offered (whether or not they are proposed to be registered or offered in this state) are issued;

(b) Any security registered for nonissuer distribution if any security of the same class has ever been registered under this chapter or a predecessor law, or the security being registered was originally issued pursuant to an exemption under this chapter or a predecessor law or, if previously publicly offered and sold, was not offered and sold within this state.

Ky. Rev. Stat. § 292.350.

(n6)Footnote 6. *See, e.g.:*

Arizona: Ariz. Rev. Stat., Art. 6, §§ 44-1871 through 44-1878 (additional information filing requirements and provision for escrows or impoundment of funds in certain cases).

see also.:

Maryland: Md. Code. Ann. § 11-502(c) (requiring use of a prospectus containing specified information).

(n7)Footnote 7. *Ala. Code § 8-6-5(c).*

(n8)Footnote 8. *Mich. Comp. Laws § 451.702(c).*

For other state variations on the effective date provision, *see:*

California: Cal. Corp. Code § 25112(c) (10th day).

Maryland: Md. Code Ann. § 11-502(d)(1) (10th day).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:12(III) (5th day).

Texas: Tex. Rev. Civ. Stat. Ann. § 581-7(B)(2)(b) (5th day).

(n9)Footnote 9. *Ohio Rev. Code Ann. § 1707.08.*

(n10)Footnote 10. *Ohio Admin. Code § 1301:6-3-06(B).*

(n11)Footnote 11. *See* Unif. Sec. Act § 306(a) (power to issue a stop order denying effectiveness to, or suspending or revoking effectiveness of, any registration statement where appropriate in the public interest or in other circumstances involving deficiencies).

(n12)Footnote 12. *Tex. Rev. Civ. Stat. § 581-7(B)(1).*

(n13)Footnote 13. *Minn. Stat. Ann. § 80A.09(1).*

(n14)Footnote 14. *N.H. Rev. Stat. Ann. § 421-B:12(I).*

(n15)Footnote 15. Suspension of registration and related powers and considerations applicable to all registrations are more fully considered in § 5.07 *infra* .

(n16)Footnote 16. 2002 Unif. Sec. Act § 302, Off. Comment 1.

(n17)Footnote 17. *See also* Rev. Unif. Sec. Act § 303.

(n18)Footnote 18. *See, e.g.:*

Alaska: Alaska Stat. § 45.55.090.

California: Cal. Corp. Code § 25111.

Illinois: Ill. Comp. Stat., ch. 815, § 5A.

Massachusetts: Mass. Gen. Laws Ann., ch. 110A, § 302.

New Jersey: N.J. Stat. Ann. § 49:3-61.1.

Ohio: Ohio Rev. Code Ann. § 1707.091.

Pennsylvania: 70 Pa. Stat. § 1-205.

Here again, nomenclature may vary. Florida incorporates the procedure into its provision for registration by notification. *See Fla. Stat. § 517.082(2).*

(n19)Footnote 19. A copy of Form U-1 is included at UF-1 *infra*.

(n20)Footnote 20. *See* Unif. Sec. Act § 303(b)(2).

(n21)Footnote 21. In some instances, Form S-1 requires the filing of consolidated financial statements. *See* Instructions As To Financial Statements, Part B, Form S-1.

(n22)Footnote 22. 17 C.F.R. pt. 210.

(n23)Footnote 23. *See, e.g.:*

California: Cal. Corp. Code § 25111 (1 copy).

Massachusetts: Mass. Gen. Laws Ann. ch. 110A, § 302 (3 copies).

Ohio: Ohio Rev. Code Ann. § 1707.091 (3 copies).

Texas: Tex. Rev. Civ. Stat. Ann. § 581-7C (3 copies).

(n24)Footnote 24. *Pennsylvania: 70 Pa. Stat. § 1-205 (2 copies of the preliminary prospectus accepted).*

(n25)Footnote 25. *See, e.g.:*

Michigan: Mich. Comp. Laws § 451.703(c)(2) (twenty days).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:13(III)(b) (twenty days).

(n26)Footnote 26. *See, e.g.:*

Delaware: 6 Del. Code Ann. § 7305(c)(3) (must be on file at time of federal effectiveness).

Virginia: Va. Code Ann. § 13.1.509(C) (three days).

(n27)Footnote 27. Unif. Sec. Act § 303(c).

(n28)Footnote 28. *17 C.F.R. § 230.430A*. Rule 430A provides in pertinent part:

The form of prospectus filed as part of a registration statement that is declared effective may omit information with respect to the public offering price, underwriting syndicate (including any material relationships between the registrant and underwriters not named therein), underwriting discounts or commissions, discounts or commissions to dealers, amount of proceeds, conversion rates, call prices and other items dependent upon the offering price, delivery dates and terms of the securities dependent on the offering date ...

(n29)Footnote 29. *See, e.g.:*

Rhode Island: Gen. Laws R.I. Sec. 7-1-303(f),(g).

(n30)Footnote 30. *17 C.F.R. § 230.415*.

(n31)Footnote 31. Rule 415 is available for the following securities offerings:

- secondary offerings;
- securities offered pursuant to dividend or interest reimbursement or employee benefit plans;
- securities underlying options, warrants, or rights issuable upon conversions;
- securities pledged as collateral;
- depository shares evidenced by American Depository Receipts registered on Form F-6; and
- mortgage-related securities.

Rule 415 is also available to the following securities if the securities were registered in an amount which, at the time the registration statement became effective, were reasonably expected to be offered and sold within two years from the initial effective date of the registration:

- securities issued in connection with business combination transactions;
- securities, the offering of which will be commenced promptly, be made on a continuous basis, and may continue for over thirty days from the date of initial effectiveness; and
- securities to be registered, or qualified to be registered on S-3 or F-3 (forms of registration statements typically used by issuers widely followed by professional security analysts).

For a more detailed discussion of Securities Act Rule 415, see Federal Securities Act of 1933 § 7A.03[4] (Matthew Bender).

(n32)Footnote 32. *See, e.g.:*

California: Release 70-C. An abbreviated registration procedure is available for primary delayed or

continuous offerings of securities registered by a Securities Act Form S-3 registrant. It is not available for traditional shelf offerings. The procedure requires the filing of an application for qualification by coordination to be filed at the same time, but ordinarily not later than two business days after, a shelf registration statement is filed with the Commission. 1 Blue Sky L. Rep. (CCH) P 12,560.

Florida: Rule 3E-800.001, Dep't Banking & Fin., Div. Sec. Shelf registrations on a Notification Registration Application are to be filed with a copy of the initial registration statement, written consent to service of process, and payment of a fee. Prospectus supplements for each subsequent takedown are to be filed during the permit period. 1A Blue Sky L. Rep. (CCH) P 17,497.

Illinois: Securities Department Special Bulletin No. 52, December 20, 1984. Shelf offerings made by a single issuer can be registered under a single application, and the effectiveness coincides with the federal registration provided the necessary documents and fees are filed. Registration is valid for one year and may be renewed before expiration. Offerings by a series of issuers must be registered under separate applications with separate fees. 1A Blue Sky L. Rep. (CCH) P 23,214.

Texas: Securities Rule § 113.11. Texas permits registration by coordination of securities under SEC Rule 415. Each series or takedown requires separate registration except when it is disclosed in the prospectus that neither the security nor the selling method may be varied from one series or takedown to the next or, in the case of certain debt offerings, by substantial issuers that are eligible to use SEC Form S-2 or S-3. 3 Blue Sky L. Rep. (CCH) P 55,590A.

(n33)Footnote 33. A copy of Form U-1 is reproduced at UF-1 *infra*.

(n34)Footnote 34. Rule 504 creates an exemption from federal registration for limited offerings and sales of securities not exceeding \$1 million, where conditions are met. Rule 505 operates likewise for offerings up to \$5 million. Both provisions, however, are grounded in Section 3(b) of the Securities Act, and are thus outside the definition of NSMIA covered securities. State law private or limited offering exemptions key on Section 4(2) of the Securities Act, and thus Rule 504 and 505 offerings remain subject to state registration requirements, although exemptions may nevertheless be available.

(n35)Footnote 35. *See, e.g.:*

Alaska: Alaska Stat. § 45.55.100.

California: Cal. Corp. Code § 25113.

Florida: Fla. Stat. Ann. § 517.081.

Illinois: Ill. Comp. Stat., ch. 815, § 5/5B.

New Jersey: N.J. Stat. Ann. § 49:3-61.

(n36)Footnote 36. Unif. Sec. Act § 304(b).

(n37)Footnote 37. Merit review of securities offerings is thoroughly considered in Chapter 6, *infra*.

(n38)Footnote 38. Unif. Sec. Act § 304(c).

(n39)Footnote 39. 2002 Unif. Sec. Act § 304(c). As adopted in Tennessee, for example:

A registration statement under this section shall become effective twenty (20) days following filing unless the commissioner by order specifies an earlier effective days, or he may by order defer the effective for any reason shown to be in the public interest and necessary for the protection of investors. *Tenn. Code Ann. Sec. 48-2-106(c)*.

In this process the administrator is empowered to delay effectiveness, and to act on any request by the registrant that effectiveness be delayed. This process allows for completion of administrative review and interaction between the registrant and the administrator in addressing any concerns, particularly in those states that engage in merit review. The simpler "when the Administrator so orders" approach of the Uniform Act practically allows for the same interactive process, but without the mandate of prescribed time limits and procedures that are meaningful to issuers.

(n40)Footnote 40. Rev. Unif. Sec. Act § 302.

(n41)Footnote 41. *R.I. Gen. Laws § 7-11-302*.

(n42)Footnote 42. See Official Code Comment to Rev. Unif. Sec. Act § 302.

(n43)Footnote 43. *Ariz. Rev. Stat. Ann. § 44-1871*.

(n44)Footnote 44. *N.D. Cent. Code § 10-04-07*.

(n45)Footnote 45. *Ohio Rev. Code Ann. § 1707.08*.

(n46)Footnote 46. *N.D. Cent. Code § 10-04-07.1*.

(n47)Footnote 47. *Id.* § 10-04-07.1(1).

(n48)Footnote 48. Va. Corp. Comm. Rules, Rule 21 VAC 5-30-90(B).

(n49)Footnote 49. Wa. Admin. Code § WAC 460-17A-030(2)(e).

(n50)Footnote 50. Wa. Admin. Code § WAC 460-17A-030(2)(a).

(n51)Footnote 51. CCH NASAA Reports P 413 (Apr. 28, 1996).

(n52)Footnote 52. See, e.g.:

Texas: Tex. Admin. Code, Sec. 133.33(9).

A SCOR Issuer's Manual--*NASAA Small Company Offering Registration Manual*--is available to guide companies in determining availability and in the registration process itself, see CCH NASAA Reports P 415.

(n53)Footnote 53. N.Y. Gen. Bus. Law, Ch. 20, Art. 23-A (McKinney 1996).

(n54)Footnote 54. 13 N.Y.C.R.R. Part 80.

(n55)Footnote 55. 13 N.Y.C.R.R. § 80.8.

(n56)Footnote 56. 17 C.F.R. § 230.504.

(n57)Footnote 57. Gen. Bus. Law § 359-ff.1.

(n58)Footnote 58. *See* Gen. Bus. Law § 359-ff.5.

(n59)Footnote 59. *Id.* § 359-e2.

(n60)Footnote 60. *Id.* § 359-e8.

(n61)Footnote 61. *See, e.g.:*

Connecticut: Reg. Conn. State Agencies § 36b-31-19d.

(n62)Footnote 62. *See* 1 CCH Blue Sky L. Rep. P 6371.



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Blue Sky Regulation

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CHAPTER 5 Securities Registration

1-5 Blue Sky Regulation § 5.03

§ 5.03 The Registration and Offering Process

Blue Sky laws make it unlawful for any person to offer or sell a security in the state unless (1) it is registered; (2) either the security or the transaction is exempt from registration; or (3) it is a federal covered security.ⁿ¹ As triggering events, definitions of the terms "offer" and "sale" are critical and must be carefully considered in the planning process for creating and distributing securities. They are specifically considered elsewhere in this text.ⁿ² Equally important, however, are Blue Sky law prescriptions of "scope" of coverage, most often as stated in section 414 of the Uniform Act, to encompass any offer or sale that originates within the state.ⁿ³ Although these provisions are most prominent in assessing jurisdiction of state administrators over out-of-state communications directed into a state, as shown below their effect in the application of registration requirements where offers and sales are directed entirely outside a state is no less significant.

The practical scope of state authority under baseline registration requirements is not defined by whether securities are actually offered and sold in the state, but rather by whether the state has a legitimate interest within its boundaries that is impacted by one who engages in non-fraudulent offers and sales securities from that state, even if entirely to outsiders. In *A.S. Goldman & Company, Inc. v. New Jersey Bureau of Securities*,ⁿ⁴ the authority of the state administrator to enforce the registration requirement of the New Jersey securities law was upheld against a U.S. constitutional challenge by a New Jersey-based underwriter planning to engage in an initial public offering of securities, registered in other states, to persons outside New Jersey. Because the securities were not registered or exempt from registration in New Jersey, the Bureau of Securities sought, and obtained, a cease and desist order prohibiting the underwriting firm from, among other things, offering or selling the subject securities in *or from* that state to any members of the public.

Arguing that the New Jersey order violated the Commerce Clause of the U.S. Constitution, the underwriter claimed in federal court that New Jersey had no authority under its Blue Sky law to interdict the sale of securities outside its borders. The district court concluded that absent fraud, New Jersey had no interest in regulating transactions outside its borders, and that the attempt to mandate registration in these circumstances constituted an excessive burden on interstate commerce relative to any local benefit. However, on appeal by the administrator the Third Circuit U.S. Court of Appeals reversed. The Court of Appeals opined that state authority to require registration of securities offered and sold from the state furthers a legitimate interest, and is not an impermissible burden on commerce. Particular state interests involved, said the court, are: (1) preventing New Jersey companies from offering suspect securities to outsiders helps preserve the reputation of legitimate securities issuers in the state; and (2) protecting New Jersey residents from dubious securities that might enter the state in secondary market transactions. As to the latter, the Court declared:

The risk is particularly great because a broker-dealer such as Goldman could otherwise delay or even avoid the Bureau's scrutiny through an initial sale to a cooperative party outside New Jersey. Because there is no filing requirement for secondary transactions, Goldman could arrange to "sell" to a friendly out-of-state party, immediately buy back the security, and then sell it freely to New Jersey residents using possibly questionable sales practices ... New Jersey's most effective means of preventing such an undesirable result would be to block the initial public offering.ⁿ⁵

In *A.S. Goldman* the Third Circuit took comfort from the historical fact that commerce clause and other constitutional challenges to Blue Sky laws have generally been rejected. Nevertheless, upholding authority under Blue Sky laws to impose registration requirements on securities offered wholly outside the state on the assumption that they could come back into the state through unregulated secondary transactions tests the limits of state authority in the post-NSMIA regulatory environment. That said, however, the case underscores the significance of Blue Sky registration requirements, and demonstrates that in the absence of a NSMIA covered security, those requirements will be applied to whatever extent is reasonably necessary to achieve their protective purpose. Against that backdrop, essential considerations bearing upon the registration process are presented below.

[1] Who Must Register

Section 305(a) of the original Uniform Securities Act provides that "[a] registration statement may be filed by the issuer, any other person on whose behalf the offering is to be made, or a registered broker-dealer."ⁿ⁶ The reference to "any other person on whose behalf the offering is made is designed for non-issuer distributions. "Secondary" offerings by controlling persons or affiliates of an issuer, venture capitalists and others seeking liquidity in an investment position. The drafters also explained that the provision for a registered broker-dealer to file a registration statement makes it possible for a local intermediary to file independently of the issuer or an underwriter. This may be meaningful in situations involving federal/state registration by coordination in circumstances in which the issuer or underwriter chooses not to register in a particular state in which another intermediary wishes to make the offering and establish a market for the securities.ⁿ⁷

Some states technically vary the basic provision. Several states, for example, have modified the basic provision to specify that securities may be registered by the issuer or a registered dealer, thus eliminating the broader "any other person" of the Uniform Act. States with such language include Florida, Texas, and Louisiana.ⁿ⁸ Most, however, have substantially adopted the language of the original Uniform Act.ⁿ⁹

Some states modify the basic provision with different rules concerning the proper party for registering an issue for each different type of registration that is provided. In Arizona, for example, an issuer must file a registration by qualification, whereas either the issuer or a dealer may file a registration by description.ⁿ¹⁰ North Dakota permits either the issuer or a registered dealer to file a registration by description or by qualification.ⁿ¹¹ However, only a dealer may file a registration by announcement (notification) statement.ⁿ¹² In Alabama, the issuer, "any other person," or a dealer may file a registration by notification, coordination, or qualification.ⁿ¹³ Ohio permits an issuer, a majority of the incorporators prior to the election of officers, or licensed broker-dealers to file a registration by description.ⁿ¹⁴ Only the issuer or a licensed broker-dealer, however, may file a registration by qualification.ⁿ¹⁵

Some states more clearly contemplate secondary distributions by security holders. Oregon's broad statute, for example, allows registration by the issuer or any other person on whose behalf the offering is to be made, or a registered broker-dealer, and/or the owner of the securities.ⁿ¹⁶ Illinois provides that applications for registration by coordination or qualification may be filed by the issuer, a controlling person, or a registered dealer.ⁿ¹⁷ California eliminates the broker-dealer as one who may register, limiting the filing in an issuer transaction to the issuer and in a non-issuer transaction to "the person on whose behalf the offering is being made or by the issuer on behalf of such person."ⁿ¹⁸ On the other hand, in Tennessee, only the issuer or a broker-dealer may file a registration statement,ⁿ¹⁹

Such variations among the states that control who may register securities for an offering, or the type of registration available to a particular person, illustrate the significance and desirability of contractual provisions providing for securities registration rights in finance and investment relationships. A contract right to compel an issuer to file a registration statement for the eventual offering and sale of securities acquired and held by a significant investor, or to assure a "piggyback" registration right in the event the issuer files a registration statement for its own offering, are thus common, particularly in venture capital relationships. Liquidity considerations associated with any significant minority position likewise compel concern for both the availability of registration, and its concomitant expense.

[2] Qualification to Do Business

A corollary compliance consideration for a corporate issuer that undertakes to offer securities within a state other than its state of incorporation is whether doing so constitutes "doing business" in the state. If so, the issuer will first have to "qualify" with the Secretary of State or similar administrator in charge of corporate registration. In most states the offering and sale of securities by a foreign corporation does not constitute doing business for purposes of qualification requirements.ⁿ²⁰ The rationale behind this view is that selling stock or stock subscriptions is preliminary to the actual conduct of business. Further, if the issuing corporation ceases its acts within the particular jurisdiction upon the completion of the sale of its stock and conducts no further business dealings within the state, then no business, *i.e.*, the customary acts that constitute doing business by a corporation, has been transacted, and the foreign corporation need not qualify. There is a separation between activity involved in the offer and sale of securities, which is regulated under the Blue Sky law, and carrying on actual business activity in the state, for which qualification is necessary. Foreign corporations may do one or the other, or both, but are subject to applicable requirements independently.

A minority view, adopted in only a few states, holds that the sale of stock does constitute doing business, and that a foreign corporation must qualify to do business in the state prior to or in connection with an offering.ⁿ²¹ Lastly, courts in several jurisdictions have held that a foreign corporation selling stock *plus* transacting some other corporate activity constitutes doing business in the state.ⁿ²²

[3] Documents to Be Filed

Although content and materials required to be filed as part of a registration varies from state to state, in all cases some form of registration statement is required, and the Blue Sky laws in all states specify essential content. The original Uniform Securities Act provides:

Every registration statement shall specify (1) the amount of securities to be offered in this state; (2) the states in which a registration statement or similar document in connection with the offering has been or is to be filed; and (3) any adverse order, judgment or decree entered in connection with the offering by the regulatory authorities in each state or by any court or the Securities and Exchange Commission.ⁿ²³

Variations among states involve expansion of the baseline content requirement. In Pennsylvania, for example, every registration statement must also include the names of any underwriters and broker-dealers selling or offering the securities for sale in the state.ⁿ²⁴

The basic form of registration statement under Blue Sky laws is Form U-1--"Uniform Application to Register Securities."ⁿ²⁵ All states have adopted Form U-1, although requirements for submission of additional information and materials vary. In the federal/state regulatory environment NSMIA, the challenge of dealing with variations in submission requirements is substantially diminished by federal preemption of state registration requirements for offerings of NSMIA covered securities. Equity offerings of a national character are likely to fall within the "nationally traded securities" classification of covered securities. However, in those circumstances in which state registration requirements continue to apply, in addition to whatever basic form is involved, there are rules requiring the filing of

prospectuses, consents to service of process,ⁿ²⁶ and other materials including surety bonds, sales literature, additional financial data, periodic reports, corporate resolutions authorizing the offering, bylaws, underwriting documents, opinions of counsel, specimen stock certificates, and miscellaneous other documents. Particular elements of commonly required submissions are considered further below.

[a] The Prospectus

As a structured disclosure document containing material facts about the issuer, its business and the securities being offered for sale, the prospectus has always played a central role as a matter of federal law governing the distribution of securities. In state securities regulation the mandated use of a structured disclosure document (whether identified as a prospectus, offering circular or memorandum) has evolved into an important element of the registration and qualification processes. A 1987 North American Securities Administrators Association (NASAA) amendment to section 304 of the Uniform Act added a specific provision empowering the state administrator to require as a condition of registration by qualification that a prospectus containing designated parts of the information specified to be included in a registration statement be sent or given to every person to whom a written offer is made, and prior to or concurrently with confirming any sale. States embracing the NASAA amendment include Michigan, which, for registrations by qualification, declares:

The administrator may by rule or order require as a condition of registration under this subsection that a prospectus be sent or given to each person to whom an offer is made. The administrator may by rule or order fix the requirements as to the use, content, revision and supplementation of the prospectus.ⁿ²⁷

Although a "prospectus" is most often thought of in terms of a structured disclosure document presenting a description of a new security issue supplied to prospective purchasers and giving detailed information concerning the company's business and financial standing, its character as a matter of law is much broader. In practice it is in fact *any* written or broadcast communication which "offers" a security for sale, or which confirms a sale. The Uniform Act defines "offer" or "offer to sell" as including: "every attempt to offer to dispose of, or solicitation of an offer to buy, a security or interest in a security for value."ⁿ²⁸

The primary section of the original Uniform Act dealing with the prospectus is Section 304(d), which states that in a registration by qualification procedure, the state administrator may require that a prospectus be provided to each person to whom an offer is made. In addition, Section 303, which deals with registration by coordination, requires that copies of the latest form of prospectus filed by the issuer under the federal act be included.ⁿ²⁹ Although not prescribed in terms of a prospectus, a filing is also required for registration by notification. This includes "a description of the security being registered ... and the information and documents specified in clauses (8), (10), and (12) of Section 304(b)."ⁿ³⁰ Documents specified in section 304(b) include a copy of any prospectus, pamphlet, circular, form letter, advertisement, or other sales literature to be used in connection with the offering. Many states have expressly added to their simplified notification or description registration procedures the requirement that prospectuses or offering documents be filed with the basic form.ⁿ³¹

The specific information required to be included in a prospectus varies from state to state, but commonly includes general information about the issuer; expected use of proceeds of the offering; summary of earnings; capitalization; history and business, including employee relations; property of the issuer; competitive conditions in the industry; management and control, including remuneration of officers and directors; outstanding options or warrants; capital stock being registered; long-term debt being registered; other securities (if not capital stock or long-term debt) being registered; rights of shareholders; principal holders of securities; parents of issuer; escrow provisions; underwriting or plan of distribution; pending legal proceedings; opinion of counsel with respect to the legality of the offering; and miscellaneous financial statements.ⁿ³²

Some states prescribe content by incorporating requirements under federal law. Thus, a prospectus meeting the requirements of the Securities Act of 1933 Act is deemed to satisfy the state's requirements.ⁿ³³

For qualified small corporate offerings, most states have approved the use of the NASAA Form U-7 registration statement (the "SCOR Form") as the prospectus.ⁿ³⁴ Form U-7 is a simplified registration statement designed to promote uniformity among the state for smaller offerings. In these offerings the SCOR form itself becomes the main disclosure document. It prescribes certain categories of information to be included in all filings in a structured format. Importantly however, Form U-7 also requires information concerning other material factors concerning a particular company and its business. Issuers must add such specific material disclosures to the Form U-7 format. Specific additional documents or exhibits may also be required as part of the filing.ⁿ³⁵

[b] Consent to Service of Process

The Uniform Act provides that every issuer that proposes to offer a security must file an irrevocable consent appointing the state's administrator to be the issuer's attorney "to receive service of any lawful process in any non-criminal suit, action or proceeding ... which arises under this act or any rule or order hereunder after the consent has been filed."ⁿ³⁶ Every state that provides for registration of securities before their issuance and sale within that state, has, somewhere within its statute or regulations, a similar provision for consent to service of process. The majority of states have adopted the original Uniform Act's language essentially verbatim.ⁿ³⁷ In these states, every applicant for registration under the Act, including broker-dealers acting on a "firm commitment" basis,ⁿ³⁸ and every issuer, resident or non-resident, that has employed a "broker-dealer" or other party in an agency capacity (*e.g.*, a "best efforts" underwriting)ⁿ³⁹ must file this consent to service of process with the state's administrator. In each instance, it is the "principal" party involved in the registration that is required to file the consent to service of process. However, whether it be the applicant or the issuer, a person who has filed such a consent in connection with a previous registration need not file another.ⁿ⁴⁰

A minority of states requires *non-resident issuers only* to file the consent (*i.e.*, even if a registered broker-dealer is acting on a firm commitment basis, the actual issuer still must submit its own consent to service of process). However, this may be mitigated by limiting the type of registration to which this rule applies.ⁿ⁴¹ In these states that limit the application of this rule to a particular form of registration, broker-dealers, acting on a firm commitment basis, are free to file the required consent for those types of registration not covered by the statute and thus eliminate the need for the issuer also to file.

A third group of states provides that no additional consent to service of process need be filed if the applicant is a corporation organized under the laws of that state *or* is a registered broker-dealer in the stateⁿ⁴² acting on a firm commitment basis. Thus, even if the issuer is a non-resident, it need not file an additional consent to service of process, provided that a registered broker-dealer is the applicant for the registration.

[c] Surety Bonds

It is not common for states to require the issuer to post surety bonds in connection with the registration of securities.ⁿ⁴³ However, in line with the original Uniform Securities Act policy relating to intermediaries,ⁿ⁴⁴ some states require registered broker-dealers, their agents, and investment advisers to post bonds in varying amounts as a requirement for licensing.ⁿ⁴⁵ Thus, to the extent that any offering is undertaken with the involvement of regulated intermediaries, the offering is, in effect, conditioned on those intermediaries' compliance with all licensing and registration provisions, including whatever surety or fidelity bond may be required in the conduct of their activities. Investor protection from issuer abuses contemplated under Blue Sky laws in the offering setting is directly achieved through other mechanisms such as required escrow or impoundment of proceeds of an offering and other administratively imposed requirements designed to enforce the quasi-fiduciary responsibilities of promoters.

[d] Registration Forms

Every state prescribes the use of certain registration forms depending upon the type of registration involved. Collaborative efforts to bring uniformity among states for the benefit of issuers produced a series of uniform forms now in widespread use. These include: (1) Form U-1, Uniform Application To Register Securities; (2) Form U-2, Uniform Consent to Service of Process; (3) Form U-2a, Uniform Form of Corporate Resolution; (4) Form U-SB, Uniform Surety Bond; and (5) Form U-7, The Small Corporate Offering Registration Form.ⁿ⁴⁶

Form U-1, approved by NASAA in 1962, is used in those situations in which a registration statement has been filed with the Securities and Exchange Commission. Thus, this form is specifically applicable to a registration by coordination. However, even in those states that make no provision for registration by coordination, Form U-1 is specified as the basic form of registration statement to be filed for all forms of registration with the exception of qualified SCOR offerings.ⁿ⁴⁷ And Form U-1 is widely available, if not prescribed, as the basic form of registration statement to be filed by issuers seeking registration by qualification.ⁿ⁴⁸ Some states accept not only Form U-1, but also provide for their own forms for each type of registration. Other states, such as Colorado, accept Form U-1 but also prescribe an additional "Application for Registration of Securities," which is basically a one page form with supplemental pages for the form specifically applicable to registration by coordination, qualification, or notification.

The Uniform Consent to Service of Process (Form U-2) is a written authorization by a corporation appointing the state securities administrator as agent to receive process on behalf of the corporation. Form U-2A, the Uniform Form of Corporate Resolution is submitted on behalf of a corporation that authorizes the corporate officers to perform any acts they deem necessary in order to meet the registration requirements of any particular state. Form U-SB, the Uniform Surety Bond is a standardized form to implement the Uniform Act requirement for the posting of bonds by registered broker dealers.ⁿ⁴⁹

Form U-7 is the Small Corporate Offerings Registration Form, or "SCOR Form," and is limited to certain qualifying small corporate offerings exempt under provisions of the Securities Act of 1933. The procedure provides for use of a disclosure document arranged in a question and answer format, which was adopted by the North American Securities Administrators Association ("NASAA") in 1989. Use of the fifty-question Form U-7 results in lower costs for issuers, and by mandating the use of "plain English," is intended to provide investors with an offering document that is clear and easily understood. In many instances, states require use of Form U-7 in conjunction with Form U-1, as the Form U-7 is a disclosure document delivered in the offering process, while Form U-1 is more precisely the application document.

[e] Financial Statements

In most instances, when a Blue Sky law requires a financial statement to accompany the registration application for a proposed offering,ⁿ⁵⁰ one or more of the following must be submitted: a balance sheet, an income statement, and an analysis of surplus. The 2002 Uniform Securities Act reflects the requirement in most states, requiring for registration by qualification:

[A] balance sheet of the issuer as of a date within four (4) months before the filing of the registration statement; a statement of income and changes in financial position for each of the three fiscal years preceding the date of the balance sheet and for any period between the close of the immediately previous fiscal year and the date of the balance sheet, or for the period of the issuer's and any predecessor's existence if less than three years; and, if any part of the proceeds of the offering is to be applied to the purchase of a business, the financial statements that would be required if that business were the registrant. ... ⁿ⁵¹

The balance sheet is a summary of the financial position of an enterprise as of a particular date. In form, it is expressed in the basic accounting equation "Assets = Liabilities + Shareholders Equity." With allowances for any adjustments in

valuation, the balance sheet reveals the consequences that would result from the immediate liquidation of the business on a given date, if the amount realized on the sale of the assets were to equal their book value (*i.e.*, their initial or net costs, less depreciation). Thus, the balance sheet reveals, in essence, what is owned, what is owed, and the source of funds used for acquisitions.

The financial statement of greatest interest to people who deal with any business enterprise is the income statement. While the balance sheet is equivalent to a snapshot glimpse of a company's financial condition at one *point* in time, the income statement is designed to reveal the financial results of business activity over a given period of time. Although the income statement may vary in content and form, depending on the company's operation and for whom the statement is being prepared, its purpose is to reveal the profit or loss as a result of operations over the accounting period.ⁿ⁵² This is achieved by setting forth in the income statement the amount and sources of revenue for the period, with the corresponding costs and expenses deducted. Thus, despite differences in content, all income statements begin with gross sales or operating income and end with net income or loss.

An "analysis of surplus" is usually integrated with either the balance sheet or the income statement. However, it may be issued independently.

Requirements for financial statements in the registration process may vary not only by state, but also as to the type of registration involved and the nature of the issuer. Requirements for registration applicable to ongoing business concerns differ from those for promotional or developmental enterprises. In addition, it must be remembered that state administrators are usually given broad, discretionary powers to alter general rules. This discretionary authority is most consistently employed for registration by qualification, although it could be equally utilized for any type of registration statement. Against this backdrop, particular common considerations for financial statement requirements associated with each type of registration are discussed below.ⁿ⁵³

[4] Conditions of Registration

As reflected in the 2002 Uniform Securities Act, states may impose certain conditions of registration. Most commonly, a requirement for escrow of securities issued to promoters proceeds of an offering, and impoundment of proceeds of the offering in the state pending receipt by the issuer of a specified amount of proceeds from sales of the securities. Section 305(f) of the 2002 Uniform Act is representative of many such provisions:

[Escrow and impoundment.] A rule adopted or order issued under this [Act] may require as a condition of registration that a security issued within the previous five years or to be issued to a promoter for a consideration substantially less than the public offering price or to a person for a consideration other than cash be deposited in escrow; and that the proceeds from the sale of the registered security in this state be impounded until the issuer receives a specified amount from the sale of the security either in this State or elsewhere. The conditions of any escrow or impoundment required under this subsection may be established by rule adopted or order issued under this [Act], but the administrator may not reject a depository institution solely because of its location in another State.ⁿ⁵⁴

As also illustrated in the 2002 Uniform Act, states may, as a condition of registration, require that the securities be sold only by a specified form of subscription or sales contract, and that a signed or conformed copy of each contract be filed, or preserved for a period specified by rule or order.ⁿ⁵⁵ Both of these provisions for conditions on registration were included in the original Uniform Act as well, and they are common in Blue Sky laws or regulations.ⁿ⁵⁶ Additionally, in states which engage in merit review of registrations by qualification, a specific NASAA Guideline on the impoundment of proceeds is in place.ⁿ⁵⁷

[5] Effective Date of Registration

The original Uniform Act, with its three methods for the registration of securities, also has three separate provisions relating to the time when a filed registration statement is effective. Section 302 of the Act provides that a registration by notification becomes effective "[i]f no stop order is in effect and no proceeding is pending under Section 306 ... at [three o'clock Eastern Standard time] in the afternoon of the second full business day after the filing of the registration statement or the last amendment, or at such earlier time as the Administrator determines."ⁿ⁵⁸ As for registration by coordination, section 303 declares that a registration becomes effective:

[A]t the moment the federal registration statement becomes effective if all the following conditions are satisfied: (1) no stop order is in effect and no proceeding is pending under Section 306; (2) the registration statement has been on file with the Administrator for at least ten days; and (3) a statement of the maximum and minimum proposed offering prices and the maximum underwriting discounts and commissions has been on file for two full business days or such shorter period as the Administrator permits by rule or otherwise and the offering is made within those limitations.ⁿ⁵⁹ Finally, for registration by qualification, section 304 of the Act simply provides that a registration by qualification becomes effective "when the Administrator so orders."ⁿ⁶⁰

Nearly every state has followed the Uniform Act registration by notification provision quite closely, with only a few modifications. Some states, for example, deal differently with the time of effectiveness under a registration by qualification. Under the Uniform Act, a registration by qualification becomes effective when ordered by the Administrator. The 2002 Uniform Act, however, reflects common provisions among the states providing that such a registration becomes effective on the thirtieth day after filing (or such earlier date as the commissioner may determine).ⁿ⁶¹ This statutory approach illustrates what is commonly involved in all registration by qualification situations, whether formally prescribed in the statute or simply as a matter of practice. Interaction between administrators and registrants will normally identify any areas of concern in the review process and prompt cooperative action to delay effectiveness while those concerns are addressed. Administrators in all states have ultimate authority to initiate stop order proceedings regardless of any provision for automatic effectiveness, and some have specific delaying authority as illustrated in the 2002 Uniform Act:

The administrator may delay effectiveness once for not more than 90 days if the administrator determines that the registration statement is not complete in all material respects and promptly notifies the registrant of the determination. The administrator may delay effectiveness for a single period not to exceed 30 days if the administrator determines that delay is necessary or appropriate.ⁿ⁶²

Delays outside or beyond the scope of these provisions are addressed and imposed by way of stop orders.

[6] Period of Registration

The original Uniform Act declares:

Every registration statement is effective for one year from its effective date, or any longer period during which the security is being offered or distributed in a non-exempted transaction by or for the account of the issuer or other person on whose behalf the offering is being made or by any underwriter or broker-dealer who is still offering part of an unsold allotment or subscription taken by him as a participant in the distribution, except during the time a stop order is in effect under Section 306. ... ⁿ⁶³

Most states have adopted the Uniform Act effective period of registration provision.ⁿ⁶⁴ Variations include provision for renewal registrations in the event securities registered for sale are not sold within twelve months and the issuer desires to continue the offering.ⁿ⁶⁵ Other states provide that registration remains in effect for the indefinite period during which the securities are being offered or distributed in a nonexempt transaction by or for the account of the issuer, or by an underwriter or broker-dealer who continues to offer part of an unsold allotment or subscription taken as a participant in the distribution.ⁿ⁶⁶ Still other states provide for effectiveness until revoked by the administrator, terminated by the

registrant, or both.ⁿ⁶⁷

[7] Filing Fees

All states require that every person filing a registration statement must pay a filing fee,ⁿ⁶⁸ but the amount is left for determination in each state. Some states have a fixed fee; the majority, however, have adopted the Uniform Act language providing for a fee based on a percentage of offering price, with a typical statute requiring a fee of one-tenth of one percent of the aggregate price.ⁿ⁶⁹ Further, if a particular state has more than one method of registration, there generally is a different fee requirement for each type offered.

[8] Advertising Requirements and Restrictions

Most states have, in either their statutes or by rules, some requirement relating to pre- or post-registration advertising. Requirements vary considerably. The original Uniform Act addresses advertising in Section 403, declaring that:

The Administrator may by rule or order require the filing of any prospectus, pamphlet, circular, form letter, advertisement, or other sales literature or advertising communication addressed or intended for distribution to prospective investors, including clients or prospective clients of an investment adviser unless the security or transaction is exempted by Section 402.ⁿ⁷⁰

In Alabama, all advertising and sales literature must be authorized in writing by the Securities Commissioner before it can be used in newspapers or other public communication.ⁿ⁷¹ Alaska has adopted the Uniform Act language nearly verbatim, and has in addition adopted certain requirements and restrictions by rule. Specifically, the rule provides, in part, that a copy of all proposed advertising material be submitted to the administrator at least five days before its dissemination, and, if not disallowed within five days from filing, the use of such material will be permitted. The rules then lay out a series of specific prohibitions, such as "distribution of any non-factual or inaccurate data or material by words, pictures, charts, graphs or otherwise, based on conjectural, unfounded, extravagant, or flamboyant claims, assertions, predictions, or excessive optimism."ⁿ⁷² Arizona requires the filing of any proposed advertising at least three days before its use. The rule also contains several proscriptions; for example, no advertisement shall contain any "statement or inference that the securities offered are without risk, that dividend returns are assured, or that failure or loss is not possible."ⁿ⁷³ In addition, the Arizona rule establishes certain requirements as to contents and form of all advertising matter.ⁿ⁷⁴ The Arkansas statuteⁿ⁷⁵ is much like the Uniform Act provision; however, Arkansas' regulationsⁿ⁷⁶ require filing at least five days prior to use and contain certain exceptions to the filing requirement and certain specified prohibitions. One prohibition, for example, is for:

[a]ny package or bonus deal, prize, gift, gimmick or similar inducement, combined with or dependent upon the sale of some other product, contract or service, unless such unit or combination has been fully disclosed and specifically described and identified in the application as the security being offered.ⁿ⁷⁷

California prohibits the publication of any advertisement concerning a security unless a copy is filed three days prior to its use.ⁿ⁷⁸ However, the statute also provides exceptions. For instance, California permits certain published advertisements by licensed broker-dealers if they are not effecting a transaction in the security as an underwriter or other participant for the issuer.ⁿ⁷⁹ Florida regulations forbid the use of deceptive or misleading sales material, require filing at least ten days prior to publication, and require written authorization by the state before publication or circulation (unless FINRA-approved or in conformance with 1933 Act requirements, or limited to certain factual price and identifying particulars).ⁿ⁸⁰ In Hawaii, regulations concerning advertising are sparse, simply stating that all security-related advertisements must be filed at least two days prior to their proposed use.ⁿ⁸¹

The Massachusetts statute echoes the Uniform Act provision but excludes the final phrase pertaining to clients of an investment adviser.ⁿ⁸² The regulations provide that any person, including a broker-dealer, its agent, or an issuer's

agent, other than an issuer of a security, must file any sales literature used in connection with the offer or sale of security in the Commonwealth.ⁿ⁸³ One copy must be filed with the director before or simultaneously with the first use of the sales literature.ⁿ⁸⁴ However, the regulations exempt the issuer of any non-exempted security issued or guaranteed by the Commonwealth or any subdivision from filing sales literature.ⁿ⁸⁵ Pennsylvania has no formal filing requirement, but restrictions apply to the kind of advertising literature used,ⁿ⁸⁶ and specifically as to the advertising of securities issued by governments, governmental agencies, and political subdivisionsⁿ⁸⁷ and securities issued or guaranteed by banks or credit unions.ⁿ⁸⁸

FOOTNOTES:

(n1)Footnote 1. *See* 2002 Unif. Sec. Act § 301.

(n2)Footnote 2. The meanings of "offer" and "sale" for all purposes under state Blue Sky laws are discussed in ch.3 *supra*.

(n3)Footnote 3. Identifying the "Scope of the Act," section 414(c) of the original Uniform Act provides:

For purposes of this section, an offer to sell or buy is made in this state, whether or not either party is then present in this state, when the offer (1) originates from this state or (2) is directed by the offeror to this state and received at the place to which it is directed (or at any post office in this state in the case of a mailed offer).

(n4)Footnote 4. *163 F.3d 780 (3d Cir.) , cert. denied, 528 U.S. 868 (1999) .*

(n5)Footnote 5. *163 F.3d at 788-89 .*

(n6)Footnote 6. Unif. Sec. Act § 305(a); *see also* 2002 Unif. Sec. Act § 305(a).

(n7)Footnote 7. Unif. Sec. Act § 305(a), Official Code Comment.

(n8)Footnote 8.

Florida: Fla. Stat. Ann. § 517.081(2).

Texas: Tex. Rev. Civ. Stat. Ann. § 581-7.

(n9)Footnote 9.

Alaska: Alaska Stat. § 45.55.110(a).

Massachusetts: Mass. Gen. Laws Ann., ch. 110A § 304(a).

New Jersey: N.J. Stat. Ann. § 49:3-62(a).

Pennsylvania: 70 Pa. Stat. 1-207(a).

(n10)Footnote 10. *Ariz. Rev. Stat. Ann. §§ 44-1892, 44-1872.*

(n11)Footnote 11. *N.D. Cent. Code § 10-04-07, 10-04-08.*

(n12)Footnote 12. *Id.* § 10-04-07.1.

(n13)Footnote 13. *Ala. Code* § 8-6-8(a).

(n14)Footnote 14. *Ohio Rev. Code Ann.* § 1707.08.

(n15)Footnote 15. *Id.* § 1707.09.

(n16)Footnote 16. *Or. Rev. Stat.* § 59.065(1); *Or. Admin. Rule* 441-65-010.

(n17)Footnote 17. *Ill. Comp. Stat.*, ch. 815, § 5/5.

(n18)Footnote 18. *Cal. Corp. Code* § 25115.

(n19)Footnote 19. *Tenn. Code Ann.* § 48-2-107(a).

(n20)Footnote 20. *See, e.g.:*

Michigan: Edward v. Ioor, 205 Mich. 617, 172 N.W. 620, 621 (1919) .

Georgia: Gold v. Pioneer Fund, Inc., 107 Ga. App. 855, 132 S.E.2d 144 (Ct. App. 1963) .

Kansas: Scrivner v. Twin Americas Agric. & Indus. Dev., Inc., 1 Kan. App. 2d 404, 573 P.2d 614 (Kan. Ct. App. 1977) ; *Home Lumber Co. v. Hopkins*, 107 Kan. 153, 190 P. 601 (1970) .

Missouri: Meir v. Crossley, 305 Mo. 206, 264 S.W. 882 (1974) .

(n21)Footnote 21. *See, e.g.:*

Rhode Island: White v. Shiller Chemicals, Inc., 379 F. Supp. 101 (D.R.I. 1974) , *aff'd*, 503 F.2d 1396 (1st Cir. 1974) .

Wisconsin: Kappus v. Western Hills Oil, Inc., 24 F.R.D. 123 (E.D. Wis. 1959) .

(n22)Footnote 22. *See, e.g.:*

Minnesota: Atkinson v. U.S. Operating Co., 129 Minn. 232, 152 N.W. 410 (1915) .

Pennsylvania: Sampson-Miller Associated Cos. v. Washington Home, Inc., 303 F. Supp. 739 (D. Pa. 1969) .

Washington: Banker's Holding Corp. v. Maybury, 161 Wash. 681, 297 P. 740 (1931) .

(n23)Footnote 23. *Unif. Sec. Act* § 305(c).

(n24)Footnote 24. *Pa. Stat. Ann. Sec.* 207(b).

(n25)Footnote 25. Form U-1 is reproduced at UF-1 *infra*.

(n26)Footnote 26. The consent to service of process typically requires the filing of a consent appointing the

Secretary of State as the lawful representative to receive lawful process. *See* § 5.03[3][b] *infra*.

(n27)Footnote 27. *Mich. Comp. Laws § 451.704(d)*. By rule, Michigan prescribes a specific form (form PI) for a prospectus to be used for securities registered by qualification, requiring that it be filed with the administrator, and that it be sent or given to each prospective purchaser within a reasonable time before a commitment to purchase is made. Revision and supplementation requirements are also included. *See Mich. Admin Code R 451.704.1*.

(n28)Footnote 28. Unif. Sec. Act § 401(j)(2).

In this context, a prospectus is synonymous with an advertisement that offers any security for sale or confirms the sale of any security. *See, e.g., Cal. Corp. Code § 25002* (defining "advertisement" as "any written or printed communication or any communication by means of recorded telephone messages or spoken on radio, television, or similar communications media, published in connection with the offer or sale of a security").

(n29)Footnote 29. Unif. Sec. Act § 303(b)(1).

(n30)Footnote 30. Unif. Sec. Act § 302(b)(4), (5).

Those documents specified in § 304(b) include information on the offering price (the basis if other than cash); a description of any stock options or other security options outstanding, or to be created in connection with the offering; and a copy of any prospectus, pamphlet, circular, advertisement, etc. intended as of the effective date to be used in connection with the offering.

(n31)Footnote 31. *See, e.g.:*

Alabama: Code Ala. § 8-6-5(b)(9) (Copy of an offering circular or prospectus to be used in connection with the offering).

North Carolina: N.C. Gen. Stat. § 78A-25(b)(5) (Copy of any prospectus and other offering materials).

(n32)Footnote 32. *See e.g.:*

Delaware: Del. Sec. Reg. Rule 6(A), Schedule A.

Hawaii: Haw. Sec. Reg. 16-38-9.

Illinois: Ill. Comp. Stat. Ch. 815, § 5B(3).

New Mexico: Sec. Div. Rule 86-5.14.

(n33)Footnote 33. *See, e.g.:*

Alaska: Alaska Admin. Code § 3 AAC 08.120.

Florida: Fla. Sec. Reg. 3E-700.002.

New Jersey: N.J. Reg. § 13:47A-10.3.

Ohio: Ohio Rev. Code Ann. § 1707.09.

(n34)Footnote 34. *See, e.g.:*

New Hampshire: Sec. 421-B:15-a.

Ohio: Rule 1301:6-3-09.

(n35)Footnote 35. *See, e.g.:*

Washington: Washington Regs. WAC 460-17A-060 (Documents to be filed with administrator by SCOR registrant).

The availability of Form U-7 is also generally conditioned on adherence to the NASAA Statement of Policy regarding Small Company Offering Registrations. These requirements are discussed in *section 5.02[4][d], supra*.

(n36)Footnote 36. Unif. Sec. Act § 414(g); *see also* 2002 Unif. Sec. Act § 611. All state consent forms, including Form U-2, the Uniform Consent to Service of Process, are reproduced in Parts III and IV *infra*.

(n37)Footnote 37. *See, e.g.:*

Alaska: Alaska Stat. § 45.55.980(g).

Massachusetts: Mass. Gen. Laws Ann., ch. 110A, § 414.

New Jersey: N.J. Reg. § 13:47A-7.1.

(n38)Footnote 38. The underwriter or broker-dealer that is operating on a "firm commitment" basis obligates *itself* to purchase the security from the issuer or from selling security holders. It then distributes the security to the public. Under these circumstances, the term "applicant" under the original Uniform Securities Act and those state statutes similarly worded includes the underwriter, and it must then file the consent to service of process.

(n39)Footnote 39. "Best efforts" underwritings are those in which the underwriter or broker-dealer merely agrees to use its best efforts to market the security for a commission without obligating itself to make the sales. This is the type of underwriting referred to in Section 414(g) of the original Uniform Securities Act when it states that the issuer "proposes to offer a security ... through any person acting on an agency basis in the common-law sense."

(n40)Footnote 40. *See, e.g.,* Unif. Sec. Act § 414(g).

(n41)Footnote 41. *See, e.g.:*

Arizona: Ariz. Rev. Stat. Ann. § 44-1892 (applies only to registration by qualification).

Hawaii: Haw. Rev. Stat. § 485.12 (applies to registration by coordination and qualification).

New York: N.Y. Gen. Bus. L. § 352-a.

Texas: Tex. Rev. Civ. Stat. Ann. § 581-8.

(n42)Footnote 42. *See, e.g.:*

Arizona: Ariz. Rev. Stat. Ann. § 44-1872 (applies only to registration by description).

California: Cal. Corp. Code § 25165.

Ohio: Ohio Rev. Code Ann. § 1707.11 (this jurisdiction only has this exception for an incorporated or unincorporated issuer; no exception is provided for registered broker-dealers).

(n43)Footnote 43. *But see* Ga. Code § 10-5-6(b)(1).

(n44)Footnote 44. Unif. Sec. Act § 202.

(n45)Footnote 45. *See, e.g.:*

California: Cal. Corp. Code § 25.216(e).

Michigan: Mich. Comp. Laws § 451.602(e).

See also Form U-SB, the Uniform Surety Bond.

(n46)Footnote 46. All uniform forms are reproduced in Volume 2 *infra*.

(n47)Footnote 47. *See, e.g.:*

Arizona: Statements of Policy, Form U-1 Registration Applications, 1 *CCH Blue Sky L.Rep.* P 9616 (Ariz. Corp. Comm. Apr. 3, 1987).

Vermont: Policy Statement No. S-91:1, Securities Filing Requirements, 3A *CCH Blue Sky L.Rep.* [par] 58,415 (Sec. Div. Mar. 1, 1994 as amended).

(n48)Footnote 48. *See, e.g.:*

West Virginia: Comm. Sec. Admin. Regs. Sec. 14.03.

(n49)Footnote 49. *See* Unif. Sec. Act § 202; § 5.03[3][c] *supra* .

(n50)Footnote 50. Although Form U-1 is widely utilized as the basic form of registration statement under Blue Sky laws, it does not include any requirement for *audited* financial statements. As will be seen, however, states impose their own requirements in this area and others. While Form U-1 sets basic requirements, individual states prescribe other categories or forms of information necessary for whatever type of registration and review is involved. This is particularly evident in the manner in which financial statement requirements vary among the states.

(n51)Footnote 51. 2002 Unif. Sec. Act § 304(b)(17).

(n52)Footnote 52. The accounting period for which the profit or loss is computed on a published income statement is generally the fiscal year of the company, although interim statements are often required for both internal use and for submission as quarterly reports under blue sky regulations. *See, e.g., Fla. Stat. Ann. § 517.081(1)(e)*. The fiscal year may be coextensive with the calendar year or, if the operating cycle of the company is terminated at a time other than December 31, with some other twelve month period. For a discussion of the propriety of adding "forward looking" information to the financial statements, *see* Massachusetts Blue Sky Policy Statement, Mass. Securities Quarterly Spring 1987, CCH Blue Sky L. Rep. P 31,616. Such information is permitted in Massachusetts only upon full disclosure in the offering documents of the underlying assumptions, and a showing "either that the assumptions are reasonable or that the intended offeree is fully capable of understanding and evaluating the information." *Id.*

(n53)Footnote 53. In all considerations of financial statement requirements in the registration process, references to "certified," financial statements are commonly grounded in the requirement, as Hawaii illustrates, that:

Financial statements as required hereunder shall be prepared, audited and certified by independent certified public accountants or licensed independent public accountants in accordance with generally accepted accounting procedures and practices, applied on a consistent basis. If a report contains exceptions of a material nature it will not be considered to be certified. Haw. Regs., 16-38-11.1.

(n54)Footnote 54. 2002 Unif. Sec. Act § 305(f); *see, e.g., Kansas: Kan. Stat. Ann. § 17-12a305 (f)*.

(n55)Footnote 55. 2002 Unif. Sec. Act § 305(g).

(n56)Footnote 56. *See, e.g.:*

Kentucky: Ky. Rev. Stat. § 292.3803(a)-(b).

(n57)Footnote 57. *See, e.g.:*

Massachusetts: Code Mass. Regs. § 13.305(A).

(n58)Footnote 58. Unif. Sec. Act. § 302(c); *see also* 2002 Unif. Sec. Act § 303(e).

(n59)Footnote 59. Unif. Sec. Act. § 303(c); *see also* Rev. Unif. Sec. Act § 303(c).

(n60)Footnote 60. Unif. Sec. Act § 304(c).

(n61)Footnote 61. 2002 Unif. Sec. Act § 304(c).

(n62)Footnote 62. 2002 Unif. Sec. Act § 304(d).

(n63)Footnote 63. Unif. Sec. Act § 305(i).

See also 2002 Unif. Sec. Act § 305(h).

(n64)Footnote 64. *See, e.g.:*

Florida: Fla. Stat. Ann. § 517.07.

New Jersey: N.J. Stat. Ann. § 49:3-62(g).

Pennsylvania: 70 Pa. Cons. Stat. § 1-207(j).

Texas: Tex. Rev. Civ. Stat. Ann. §§ 581-7(B)(2)(b), 581-7(c)(3).

(n65)Footnote 65. *See, eg.:*

Georgia: 10 Code Ga. Ann. § 10-5-6(i).

(n66)Footnote 66. *See, e.g.:*

Delaware: Del. Code Ann. § 7307(d).

(n67)Footnote 67. *See, e.g.:*

Alabama: Ala. Code § 8-6-8(f).

Virginia: Va. Code Ann. § 13.1-511.

Washington: Wash. Rev. Code. § 21-20.260.

(n68)Footnote 68. Unif. Sec. Act § 305(b).

(n69)Footnote 69. Unif. Sec. Act § 305(b).

(n70)Footnote 70. Unif. Sec. Act § 403. This provision was carried into the 2002 Uniform Act as part of its antifraud provisions, *see* 2002 Unif. Sec. Act § 504 ("Filing of Sales and Advertising Literature").

(n71)Footnote 71. Ala. Reg. Rule 830-X-2.06 (however, so called "tombstone ads" are exempted from this rule).

(n72)Footnote 72. Alaska Admin. Code tit. 3, § 3 AAC 08.900(2)(F). The rules also provide that the following forms and types of advertising are permitted without the necessity for filing or the prior authorization of the administrator:

(1) So-called "tombstone" advertising, containing no more than the following information:

- (i) name and address of issuer;
- (ii) identity or title of security;
- (iii) per unit offering price, number of shares and amount of the offering;
- (iv) brief, general description of business;
- (v) name and address of underwriter, or address where offering circular or prospectus can be obtained; and
- (vi) date of issuance;

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- (2) Dividend notices, proxy statements and reports to shareholders including investment company quarterly and semi-annual reports;
- (3) Sales literature, advertising or market letters prepared in conformity with the applicable regulations and in compliance with the filing requirements of the SEC, NASD, or a recognized national securities exchange;
- (4) Factual or information letters, bulletins or releases, similar to "news letters," relating to issuer's progress or activities, status of the offering or current financial condition; and
- (5) Dissemination of any data incorporated in the offering circular or prospectus, so long as the use of such material out of context does not tend to detract from, distort, supersede or express a different meaning than the representations or disclosures contained therein.

Id. § 3 AAC 08.900(3).

(n73)Footnote 73. Sec. Reg. § R14-4-103(B)(2). *See also* State of Arizona v. English, 3 CCH Blue Sky L. Rep. P 73,853 (Ariz. Sup. Ct. 1992), in which the court held that using promotional material advertising low risk and high return on investment violated Arizona Blue Sky antifraud provisions. In Arizona, a self-addressed stamped envelope must accompany the advertising material for acknowledgment. Ariz. Blue Sky Policy Statement, CCH Blue Sky L. Rep. P 9617 (Apr. 3, 1987). If the material does not conform to the state's standards, a letter indicating the areas of noncompliance will be sent to the issuer within three days after receipt of the material. *Id.*

(n74)Footnote 74. Sec. Reg. § R14-4-103(C)-(F).

(n75)Footnote 75. *Ark. Code Ann. § 23-42-502.*

(n76)Footnote 76. *See generally* Ark. Sec. Rule 502.

(n77)Footnote 77. Ark. Sec. Reg. Rule 502.03(G).

(n78)Footnote 78. *Cal. Corp. Code § 25300(a).*

(n79)Footnote 79. *Id.*, § 25300(b).

(n80)Footnote 80. Fla. Sec. Reg. § 3E-100.007.

(n81)Footnote 81. Haw. Sec. Reg. § 16-38-18.

(n82)Footnote 82. Mass. Gen. Laws Ann., ch. 100A, § 403 (statute additionally prohibits the administrator from requiring affirmative approval or filing of sales literature before its use or requiring issuers outside the Commonwealth to file such literature).

(n83)Footnote 83. Mass. Sec. Reg. 14.403(A).

(n84)Footnote 84. Mass. Sec. Reg. 14.403(A).

(n85)Footnote 85. Mass. Sec. Reg. 14.403(A). For the definition of "sales literature," *see* Mass. Sec. Reg. 14.403(C)).

(n86)Footnote 86. Pa. Sec. Reg. § 606.031.

The Pennsylvania Securities Commission has issued a media guide on illegal securities advertisements to Pennsylvania newspapers, magazines and other periodicals, as well as radio and television stations. The guide explains in general language how to recognize securities advertisements and those that are potentially illegal. *See* 3 CCH Blue Sky L. Rep. P 48,680V.

(n87)Footnote 87. Pa. Sec. Reg. § 606.033.

(n88)Footnote 88. *Id.* § 606.034.



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Blue Sky Regulation

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CHAPTER 5 Securities Registration

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§ 5.04 Registration of Non-Issuer Transactions

[1] Generally

Non-issuer transactions fall into two general categories: (1) "resale" transactions; and (2) "secondary" distributions. Resale transactions involve persons purchasing securities of an issuer in an offering that is either registered or exempt under provisions of state and federal law who then resell those securities. In practical terms there is a two step process here. By one means or another securities have come into the hands of an investor, who then proceeds independently to resell them. Although most easily understood in terms of resales in relation to a primary offering by the issuer, it is important to keep in mind that registration issues associated with non-issuer transactions are entirely independent from the circumstances under which a non-issuer acquired the securities, and whether or not, or to what extent, registration or other state regulation was involved in the process whereby securities reached the hands of one who seeks to dispose of them by resale. "Secondary" distributions are those in which securities held by a non-issuer are offered and sold by control persons or affiliates of the issuer in circumstances indistinguishable from a primary offering, and in which the concerns for investor protection are the same.

For the most part, state Blue Sky laws provide exemptions applicable to "resale" transactions by non-issuers. The most common examples are those contained in section 402(b) of the original Uniform Securities Act, which exempts:

- (1) Any "isolated" non-issuer transaction;
- (2) Any non-issuer sale of an outstanding security that is "manualized," that is, the issuer is listed in a recognized securities manual containing certain basic management and financial data; and
- (3) Any non-issuer transaction effected by or through a registered broker-dealer pursuant to an unsolicited order or offer to buy.ⁿ¹ State exemptions applicable to listed or traded securities are likewise equally available for non-issuer transactions.

As a matter of federal law in the non-issuer setting, NSMIA eliminates state jurisdiction over non-issuer, or resale, transactions in many instances. A "covered security" under the act includes any security involved in a transaction federally exempt under sections 4(1) and 4(3) of the Securities Act so long as the issuer is a reporting company under provisions of the Exchange Act. In addition, transactions exempt under Section 4(4) are all deemed covered securities.

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The combination of these federal transactional exemptions will blanket many transactions by non-issuers and eliminate any question concerning registration requirements under state securities laws.

The second classification of non-issuer transactions, "secondary distributions," is a more difficult matter under state Blue Sky laws. "Secondary distribution" is not a defined term as a matter of state or federal securities laws. It is, however, a transaction whose characteristics are such that the non-issuer, who may be a control person of the issuer, or is perhaps a very large holder disposing of a substantial block of securities in an underwritten offering involving all of the mechanics and processes of a primary offering, is a person not entitled to claim an exemption at the federal level under section 4(1) of the Securities Act for a transaction not involving "an issuer, underwriter or dealer." A key consideration is the presence of an "underwriter," which, under federal law, is defined to include:

[a]ny person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct participation in any such undertaking, or participates in or has a participation in the direct or indirect underwriting of any such undertaking As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.ⁿ²

Thus, one who is a non-issuer, but who is nevertheless a statutory' underwriter cannot claim the federal Securities Act section 4(1) exemption, and may also be a statutory "issuer," impacting the availability of exemptions for others engaging in resales of securities acquired from her. At the state level, the non-issuer's reliance on an "isolated transaction" exemption in circumstances involving the presence of a control person "issuer" and a statutory "underwriter" becomes problematic.

Blue Sky laws, and their transaction exemptions, historically did not focus on secondary distributions or the basic question of when or if registration is required. Indeed, drafters of the original Uniform Act cogently identified the problem:

Perhaps the most difficult aspect of the area of securities registration, and often the most ambiguous under the present statutes, is the application of the registration provisions to secondary distributions or other transactions not involving the issuer of the security. In many statutes it is difficult or impossible to say with any certainty when registration is required in such a case; who must or may register; how many units of the security should be registered; who may sell once a registration becomes effective; and, as a result, who is civilly liable.ⁿ³

It is clear that a registration statement may be filed not only by an issuer, but also any person on whose behalf an offering is to be made.ⁿ⁴ Moreover, the 2002 Uniform Act recognizes that in the case of a non-issuer distribution, information or a record otherwise required of an issuer may not be required unless it is known to the person filing the registration statement, or to the person on whose behalf the distribution is to be made, or unless it can be furnished by those persons without unreasonable effort or expense.ⁿ⁵ There is no simple answer, however, to the question whether a non-issuer transaction is subject to registration requirements, except to say that it must be registered unless an exemption is available. As a general matter, the focus will be on the "isolated non-issuer transaction" exemption found in one form or another in all Blue Sky laws.ⁿ⁶ However, as explained in Official Comments to the 2002 Uniform Securities Act, the exemption does not cover sales by a person or a group in circumstances that constitute a "distribution" as that term is used for purposes of the federal securities laws, or are too frequent to be considered "isolated" under the relevant state law.ⁿ⁷

Secondary distributions are subject to registration requirements because they raise the same concerns and investor protection needs as a primary distribution by an issuer. Blue Sky laws will apply, and the array of "issuer" exemptions available in state laws are not available to non-issuers or for non-issuer distributions. There are, however, various

transactions exemptions from registration requirements specifically for non-issuers in addition to the isolated transaction exemption. These non-issuer exemptions generally address transactions by a non-issuer by or through a registered (or exempt) broker-dealer in securities meeting particular criteria. For example, section 202(2) of the 2002 Uniform Securities Act reflects a common exemption in Blue Sky laws for nonissuer transactions by or through a broker-dealer registered or exempt from registration in a security of a class that has been outstanding in the hands of the investing public for at least 90 days, where certain qualifying criteria concerning the issuer, the security, or the transaction are met.ⁿ⁸ One criterion, for example, is that the security is sold at a price reasonably related to its current market price. Another is that there is current publicly available business and financial information concerning the issuer.ⁿ⁹

"Class" Registration. Section 305(i) of the original Uniform Securities Act established the concept of "class" registration of securities specifically to address non-issuer transactions. It provides in pertinent part:

All outstanding of the same class as a registered security are considered to be registered for the purpose of any non-issuer transaction (1) so long as the registration statement is effective and (2) between the thirtieth day after the entry of any stop order suspending or revoking the effectiveness of the registration statement under section 306 (if the registration statement did not relate in whole or in part to a non-issuer distribution) and one year from the effective date of the registration statement.ⁿ¹⁰

Class registration under section 305(i) or an equivalent is carried into most Blue Sky laws,ⁿ¹¹ and in a simplified form, is also part of the 2002 Uniform Act.ⁿ¹² The principal effects of class registration are support the secondary trading market, and avoiding the prospect of finding a secondary distribution in the aftermarket triggering registration requirements. There is a fundamental issue, however, when and to what extent particular non-issuer sales would not be considered to be a secondary distribution subject to registration requirements. The Uniform Act provisions for class registration come in the context of setting the effective period of a registration statement, which in most cases is one year unless extended by order. Thus, the flexibility for non-issuer transactions afforded by class registration is necessarily limited only to the period during which the registration is effective. Moreover, the statutory underwriter concept is not abrogated by these provisions and in any given set of circumstances at any time, a non-issuer transaction may be deemed to be a secondary distribution subject to registration requirements as a matter of federal or state securities laws.ⁿ¹³

[2] Particular Requirements

As a general rule, there is not much difference between procedures applicable to a primary registration and those for a secondary registration. However, under the Uniform Act, if the non-issuer registration is by qualification, the registrant is relieved from filing otherwise required information "unless it is known to the person filing the registration statement or to the persons on whose behalf the distribution is to be made, or can be furnished by them without unreasonable effort or expense."ⁿ¹⁴

A similar rule is applicable to any periodic reports that may be required to keep information in the application current.ⁿ¹⁵ The provision is intended to apply to the non-issuer seller who is not in possession of audited financial statements and other information normally required to be filed. If the non-issuer applicant is in a control relationship with the issuer, or such person otherwise has access to required information, then the phrase "without unreasonable effort or expense" is not applicable. This particular provision has been substantially adopted in a number of states.ⁿ¹⁶

Recognizing the special circumstances that may often be involved with non-issuer registrations, North Carolina includes a special registration procedure for non-issuer sellers known as registration by announcement.ⁿ¹⁷ The procedure is applicable only for securities "that have been outstanding and in the hands of the public for not less than one year as a result of prior original registration,"ⁿ¹⁸ or for securities of life insurance companies that have been in continuous operation for twenty years. The announcement that must be filed with the North Dakota Commissioner of Securities by

a registered dealer must contain the name and address of the issuer and a description of the security being offered. In addition, the issuer must mail a current balance sheet to the Commissioner. The effective date of such registration is the date of the filing of the announcement.

Non-issuer distributions of securities are in practice most often accomplished through so-called "piggy-back" arrangements by which shares offered and sold by an individual or institutional holder are included in a registration statement for securities being offered by the issuer. In any situation in which securities are offered and sold by one party as part of a registration undertaken by another, there is a risk to the secondary offeror/seller that the party on whom he or she has piggy-backed might voluntarily withdraw the registration. Such an action would automatically affect non-issuer sellers who have placed reliance for their own sales on the fact that the securities are registered. Non-issuer sellers unaware of the withdrawal could find themselves in violation of law and open to otherwise unwarranted civil liability. To guard against such an occurrence, the original Uniform Act provides:

A registration statement may not be withdrawn for one year from its effective date if any securities of the same class are outstanding. A registration statement may be withdrawn otherwise only in the discretion of the Administrator.ⁿ¹⁹

Similar protection for a non-issuer distribution has been offered in a number of states that allow non-issuers to sell securities registered by another person.ⁿ²⁰

Some special consideration is necessary in regard to secondary offerings of interests or participations in oil, gas, or mining titles or leases or in payments out of production under such titles or leases, all of which are specifically defined to be securities.ⁿ²¹ Under the Uniform Act, these securities are deemed not to have an issuer as such.ⁿ²² Consequently, the offer and sale of these interests are always considered non-issuer transactions both in the Uniform Act and in the states adopting the provision.ⁿ²³ The position in these states may have a practical bearing on securities that may be registered by notification.

As is discussed in more detail earlier,ⁿ²⁴ Registration by notification is a simplified registration procedure generally applicable when an issuer has a proven record of earnings and no default in payments due on any senior securities. Under the Uniform Securities Act, non-issuer distributions may be eligible for registration by notification if the same class of securities was previously registered or was originally issued pursuant to an exemption.ⁿ²⁵ However, because oil, gas, and mineral interests have no issuer, under ordinary circumstances, all such distributions would be eligible for registration by notification by non-issuers.ⁿ²⁶ As a result, the Uniform Act specifically excludes the eligibility of non-issuer distributions of such securities from registration by notification.ⁿ²⁷ This position has been adopted by most of the states that declare that there is no issuer for these securitiesⁿ²⁸ and by a few states that do not statutorily consider such interests as having no issuer.ⁿ²⁹

FOOTNOTES:

(n1)Footnote 1. Unif. Sec. Act § 402(b)(1)-(3).

(n2)Footnote 2. Securities Act § 2(11), 15 U.S.C. § 77b(11).

(n3)Footnote 3. Draftsmen's commentary to Unif. Sec. Act. §§ 305(i), 305(j).

(n4)Footnote 4. Unif. Sec. Act § 305(i); *see also* 2002 Unif. Sec. Act § 305(a).

(n5)Footnote 5. 2002 Unif. Sec. Act § 305(e).

(n6)Footnote 6. *See* 2002 Unif. Sec. Act § 202(1).

(n7)Footnote 7. 2002 Unif. Sec. Act § 202(1), Off. Comment No.2.

(n8)Footnote 8. 2002 Unif. Sec. Act § 202(2).

(n9)Footnote 9. *Id.*, § 202(2)(D).

(n10)Footnote 10. Unif. Sec. Act § 305(i).

The original Uniform Act provision protects investors in a primary distribution by allowing such investors to sell securities so purchased even though a stop order has been issued against further sales of the original issue. If a stop order is entered against the seller of the original issue, all trading, including non-issuer trading, in that security must cease immediately. However, after thirty days, during which time it is presumed that the public has become aware of the stop order and the reason for it, non-issuer trading may resume and continue until one year from the date the registration of the original issue became effective. This rule applies only to registration statements filed in connection with a primary distribution. If the registration statement in effect is for a secondary distribution and a stop order is issued, all trading must stop and may not continue unless the order is vacated or modified by the administrator.

(n11)Footnote 11. *See, e.g.:*

Kentucky: Ky. Rev. Stat. 292.380(6).

Massachusetts: G.L. Mass. Sec.304(g).

In states adopting this particular Uniform Act provision, it seems that administrators would give their respective state statutes the same interpretation as given in the various commentaries to the Uniform Act. A few states have opted not to adopt the Uniform Act provision, but the position of these states is still reasonably clear. These statutes provide, in effect, that all outstanding securities of the same class as a registered security are considered registered for the purpose of non-issuer transactions or distributions.

A comparable California provision allows non-issuer distributions to be made without registration if they fall within the terms of a transactional exemption. *Cal. Corp. Code § 25104(h)*. Generally, a distribution of securities of the same class may be made without registration if a primary registration statement became effective within eighteen months prior to the non-issuer offer or sale. If the non-issuer sales are of a class of securities registered pursuant to a primary registration of securities issued in a reorganization or recapitalization, or if the sales are of a class of securities previously registered for purposes of a non-issuer distribution, then the registration must have become effective within twelve months prior to the offer or sale. The exemption applies to non-issuer distributions meeting the following conditions:

Any offer or sale of a security if a qualification under chapter 2 (commencing with Section 25110) of this part for any securities of the same class has become effective within 18 months or longer period as the Commissioner may order provided that each consecutive order shall be for no more than six months, prior to such offer or sale or if a qualification under chapter 3 (commencing with Section 25120) or chapter 4 (commencing with Section 25130) of this part for any securities of the same class has become effective within 12 months prior to such offer or sale, provided no order under Section 25140 or subdivision (a) of Section 25143 is in effect under this division with respect to such qualification, and, provided further, that this exemption does not apply to such securities offered pursuant to a registration under the Securities Act of 1933 or pursuant to an exemption under Regulation A [Reg. § 230.252] under that act if the aggregate offering price of the securities offered under such exemption exceeds fifty thousand dollars (\$50,000). The commissioner may, by rule or order, withhold this exemption with respect to securities qualified only pursuant to a limited offering qualification.

(n12)Footnote 12. 2002 Unif. Sec. Act § 305(h) ("For the purposes of a nonissuer transaction, all outstanding securities of the same class identified in the registration statement as a security registered under this [Act] are considered to be registered while the registration statement is effective").

(n13)Footnote 13. *See also* 70 Pa. Stat. § 1-207(j):

The fact that a registration statement has been effective in this State with respect to any security does not permit sales of securities of the same class by the issuer or an affiliate of the issuer if such person did not file the registration statement, unless a separate registration statement is filed and declared effective with respect thereto, or an exemption from registration is available ...

(n14)Footnote 14. Unif. Sec. Act. § 305(f); *see also* Rev. Unif. Sec. Act § 305(g).

(n15)Footnote 15. *Id.*

(n16)Footnote 16. *See, e.g.:*

Alaska: Alaska Stat. § 45.55.110(f).

Massachusetts: Mass. Gen. Laws Ann., ch. 110A, § 304(f).

North Carolina: N.C. Gen. Stat. § 78A-28(f).

See also Cal. Corp. Code § 25131(d) (applicable to non-issuer registration by notification).

(n17)Footnote 17.

North Dakota: N.D. Cent. Code § 10-04-07.1.

(n18)Footnote 18. *Id.* § 10-04-07.1(1).

(n19)Footnote 19. Unif. Sec. Act. § 305(i); 2002 Unif. Sec. Act § 305(h).

(n20)Footnote 20. States providing such protection include Alaska, Massachusetts, and New Jersey.

Other states that permit non-issuer sales when any registration statement is in effect have adopted a provision to the effect that post effective withdrawal will be allowed only with the consent of the administrator. *See Va. Code Ann. § 13.1-511.*

Many states, while requiring non-issuer registration, do not make their position clear as to when such persons are required to register the securities they wish to sell. Of these states, a few have adopted a provision that disallows post effective withdrawals without the consent of the administrator. *See, e.g.:*

Delaware: 6 Del. Code Ann. § 7307(d).

Pennsylvania: 70 Pa. Stat. § 1-207(j).

(n21)Footnote 21. Unif. Sec. Act § 401(l).

(n22)Footnote 22. Unif. Sec. Act § 401(g)(2).

The term "issuer" when applied to factional interests in oil, gas or other mineral leases, rights or royalties means the person who first divides the interest sold into fractional interests and each fractional interest holder who subsequently divides and conveys the interest. *Ill. Adm. Code tit. 14 § 130.205*.

(n23)Footnote 23. *See, e.g.:*

New Jersey: N.J. Stat. Ann. § 49:3-49(h)(2).

(n24)Footnote 24. *See § 5.02[1], supra.*

(n25)Footnote 25. Unif. Sec. Act § 302(a)(2); *see also* Rev. Unif. Sec. Act § 302 ("registration by filing").

(n26)Footnote 26. Official Comment to Unif. Sec. Act. § 302(a).

(n27)Footnote 27. Unif. Sec. Act § 302(a)(2). This issue would not arise in states adopting the Rev. Unif. Sec. Act approach, as the owners offering such interests are deemed to be issuers.

(n28)Footnote 28. *See, e.g.:*

Alaska: Alaska Stat. § 45.55.080(a)(2).

Maryland: Md. Code Ann. § 11-502(a)(2).

Michigan: Mich. Comp. Laws § 451.702(a)(2).

(n29)Footnote 29. *See, e.g.:*

Alabama: Ala. Code § 8-6-5(a)(2).



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CHAPTER 5 Securities Registration

1-5 Blue Sky Regulation § 5.05

§ 5.05 Withdrawal or Abandonment of Registration

For a variety of reasons, although most often in the face of either insufficient investor interest or in anticipation of unfavorable action by the administrator on a pending registration, an issuer or offeror may seek to abandon or withdraw the registration. Once filed, a registration statement under any of the available procedures may not simply be withdrawn, but is rather contingent on the approval of the administrator. In Illinois, for example:

Any application for registration or any amendment or exhibit thereto may be withdrawn, prior to registration, upon application, if the Secretary of State, finding the withdrawal consistent with the public interest and the protection of investors, consents thereto. The application for the consent shall be signed and shall state fully the grounds upon which made. The examination fee paid upon the filing of the application will not be returned. All papers comprising the application for registration or amendment, with the exception of the application form and correspondence, will be removed from the files of the Secretary of State and destroyed unless the applicant has requested return of the papers required to be retained by this Part. The application form will be plainly marked with the date of the giving of the consent, and in the following manner: "Withdrawn upon the request of the applicant, the Secretary of State consenting thereto."¹

However stated, in all states a registration statement may be withdrawn only in the discretion of the administrator. While most often a withdrawal would occur prior to the effectiveness of a registration, permission to withdraw after effectiveness will be made subject to appropriate undertakings for appropriate notifications, the cancellation of any subscriptions and return of any purchase payments. Specific requirements in some states include notification to all persons making a market in the issuer's securities.

Withdrawal in some instances occurs by operation of law, as a registration statement is presumed to be withdrawn if the registrant takes no affirmative action to complete the registration within a prescribed period of time.² More often, however, inaction and the passage of time in the registration process is treated as an abandonment. Thus in Maryland, for example, a registration statement that has not been made effective within one year from the date of initial filing may be deemed by the Commissioner as abandoned.³ The principal danger in abandonment of a registration is that the administrator may proceed to issue an adverse order, with consequences extending to registrations pending in other states either at the time or at some time in the future. Orders amounting to a denial of effectiveness, even on the basis of abandonment, may adversely impact the issuer's ability to meet qualifying criteria in the same or other states for

subsequent or related registrations. Thus, withdrawal of the registration will normally be the most desirable course in the face of obstacles to effectiveness in a particular state. Post-effective withdrawals will be closely scrutinized.

FOOTNOTES:

(n1)Footnote 1.

Illinois: Ill. Adm. Code tit. 14, § 130.538.

(n2)Footnote 2. *See, eg.:*

Kentucky: Ky. Admin Regs. Rule 808 KAR 10:050 (No action to consummate the registration for a period in excess of ninety days).

(n3)Footnote 3. *Ann. Code Md. § 11-508(c).*



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CHAPTER 5 Securities Registration

1-5 Blue Sky Regulation § 5.06

§ 5.06 Post Effective Filing Requirements and Amendments

[1] Reporting Requirements

Completion of the registration process does not end the process of compliance with filing requirements. As a general matter, states require post-effective periodic reports, which detail the progress and status of sales within the state, to be filed. Section 305(j) of the original Uniform Act provides:

So long as a registration statement is effective, the Administrator may by rule or order require the person who filed the registration statement to file reports, not more often than quarterly, to keep reasonably current the information contained in the registration statement and to disclose the progress of the offering.ⁿ¹

States adopting this or similar provisions require issuers to submit sales reports on a monthly, quarterly, or annual basis.ⁿ² In addition to sales reporting requirements, many states require that when sales within a state are completed the issuer must file a termination report specifying the date the offer terminated and statistics concerning the results of the offering. Alabama is typical:

Any issuer, whose securities have been registered by qualification ... who has completed the sale of the securities so registered, or who desires to discontinue the sale of said registered securities, and who desires to be discharged from further supervision of the commissioner or from further compliance with the Alabama securities law, may file with the commissioner a notice in writing to such effect, and the commissioner may thereupon enter an order canceling the registration of such securities, and such issuer shall thereupon be discharged from filing any financial report except as the commissioner may require up to and including the date of the filing of said notice as hereinabove provided. No such notice may be filed within one year after the effective date of the registration statement if any securities of the same class as those registered are outstanding.ⁿ³

Some states empower the administrator to extend post-effective filing or reporting requirements for additional periods of time beyond that otherwise provided. These types of requirements, and discretion built into their application, illustrate one mechanism by which controls and conditions may be imposed in particular situations to meet concerns of administrators in assuring that issuers of securities offered and sold in the state remain faithful to represented undertakings and their intended enterprise in seeking capital.

[2] Amendments

Blue Sky laws widely contemplate post-effective amendments to registrations for the purpose of increasing the securities specified as proposed to be offered. The Uniform Act originally addressed post-effective amendments as an accommodation to investment companies (mutual funds) that continually offer their securities. The Uniform Act thus provides for a registration statement relating to a security issued by an investment company, or unit investment trust, to be amended after its effective date in order to add securities simply by paying an additional fee.ⁿ⁴

The provision for post-effective amendment of a registration is not restricted to mutual funds. As reflected in section 305(j) of the 2002 Uniform Act, any registration statement may be amended after its effective date.ⁿ⁵ Thus, for example, in Maryland, a registration statement relating to any security registered by notification, coordination or qualification may be amended after its effective date so as to increase the securities proposed to be offered.ⁿ⁶ Amendments under these provisions require an additional filing fee, calculated in the manner specified for offerings generally, and become effective upon an order of the administrator if the excess securities have not yet been sold. In the case of securities that are sold in an amount in excess of the amount or number specified in an effective registration statement, states may provide for effectiveness of an amendment covering those securities as of the date of sale if time limitations and fee requirements are met.ⁿ⁷ In any case, amendments may expressly be conditioned on the offering price and underwriters' commissions and discounts remaining unchanged from those previously reported.ⁿ⁸

Although not always addressed in terms of amendments to a registration, states commonly require attention to the accuracy of information contained in a registration statement throughout the effective period of an offering, and make provision for correction or updating of information. As discussed in *section 5.06[2]* below, stop orders suspending or revoking a registration may be issued based upon the completeness and accuracy of the registration statement as of its effective date. Drafters of the 2002 Uniform Securities Act explained:

A registration statement must be kept current with changing developments until the effectiveness date, but a registration statement is not required to be amended after the effective date except to correct inaccuracies or deficiencies which existed as of the effective date. An administrator, however, separately may require ... periodic reports or amendments to keep reasonably current the information contained in the registration statement.ⁿ⁹

Louisiana addresses the point by providing for supplementation of a prospectus, a procedure common used:

Any prospectus forming a part of a registration statement which has become effective ... may be supplemented without amending such registration statement by adding information regarding factual developments which occurred after the effective date of such registration statement and by deleting statements of fact which may be misleading or immaterial.ⁿ¹⁰

The prospectus, as supplemented, must be filed, may be used five business days after filing, or a shorter time as the commissioner may allow. The supplementing process is commonly referred to as "stickering" a prospectus, as the means of supplementation is most often by attaching or "stickering" the information to the prospectus rather than making substantive changes to the body of the document in use.

FOOTNOTES:

(n1)Footnote 1. Unif. Sec. Act § 305(j); *see also* 2002 Unif. Sec. Act § 305(i).

(n2)Footnote 2. *See, e.g.:*

Alaska: Alaska Stat. § 45.55.110(j); Alaska Sec. Reg. § 08.230.

California: Cal. Corp. Code §§ 25145, 25146. See also Cal. Sec. Rule 260.146, which requires registrants through open qualification to submit semi-annual financial reports within 120 days after the end of their fiscal year and within 90 days after the end of the first six months of their fiscal year. Issuers exempted by *Cal. Corp. Code § 25146* and issuers filing reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 are exempted from these requirements.

Kentucky: Ky. Rev. Stat. Ann. § 292.380(7).

Massachusetts: Mass. Gen. Laws Ann., ch. 110A, § 304(h) (secretary may require the filing of such reports).

New Jersey: N.J. Stat. Ann. § 49:3-62(h); N.J. Sec. Reg. § 13:47A-6.3.

Pennsylvania: 70 Pa. Stat. § 1-207(K); see also Pa. Reg. § 207.110 (reports of receipts and expenditures of proceeds are to be filed within 30 days after each three-month period from the effective date of the offering; a complete balance sheet and profit and loss statement are required for the termination period of the offering).

(n3)Footnote 3. *Ala. Code § 8-6-8(h).*

See also:

Delaware: Del. Sec. Reg. Rule 7(e):

If an offering of securities registered by coordination has been completed the person who filed the registration statement may be relieved of filing further reports by notifying the Commissioner in writing of the fact that the offering has been completed.

(n4)Footnote 4. *Unif. Sec. Act. § 305(k).*

(n5)Footnote 5. *2002 Unif. Sec. Act § 305(j).*

(n6)Footnote 6. *Ann. Code Md. § 11-510.*

(n7)Footnote 7. *See, e.g.:*

Michigan: Mich. Comp. Laws § 451.705(j).

(n8)Footnote 8. *See:*

Indiana: Ind. Code § 23-2-1-6(m).

(n9)Footnote 9. *2002 Unif. Sec. Act. § 305, Off. Comment (3).*

(n10)Footnote 10. *La. Rev. Stat. § 51:706 (J)(2).*



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CHAPTER 5 Securities Registration

1-5 Blue Sky Regulation § 5.07

§ 5.07 Administrative Authority

[1] Denial, Suspension and Revocation of Registration

The historic mission of Blue Sky laws has always been grounded in the gatekeeper's role, and intercession of state administrators to prevent the offering of unsound or fraudulent securities. State authority to deny, suspend or revoke the registration of securities is a significant element of the Blue Sky registration process. Section 306 of the 2002 Uniform Securities Act exemplifies the basic authority that is in place in all states:

(a) **[Stop orders.]** The administrator may issue a stop order denying effectiveness to, or suspending or revoking the effectiveness of, a registration statement if the administrator finds that the order is in the public interest and that:

(1) the registration statement as of its effective date or before the effective date in the case of an order denying effectiveness, an amendment under Section 305(j) as of its effective date, or a report under Section 305(i), is incomplete in a material respect or contains a statement that, in the light of the circumstances under which it was made, was false or misleading with respect to a material fact;

(2) this [Act] or a rule adopted or order issued under this [Act] or a condition imposed under this [Act] has been willfully violated, in connection with the offering, by the person filing the registration statement; by the issuer, a partner, officer, or director of the issuer or a person having a similar status or performing a similar function; a promoter of the issuer; or a person directly or indirectly controlling or controlled by the issuer; but only if the person filing the registration statement is directly or indirectly controlled by or acting for the issuer; or by an underwriter;

(3) the security registered or sought to be registered is the subject of a permanent or temporary injunction of a court of competent jurisdiction or an administrative stop order or similar order issued under any federal, foreign, or state law other than this [Act] applicable to the offering, but the administrator may not institute a proceeding against an effective registration statement under this paragraph more than one year after the date of the order or injunction on which it is based, and the administrator may not issue an order

1-5 Blue Sky Regulation § 5.07

under this paragraph on the basis of an order or injunction issued under the securities act of another State unless the order or injunction was based on conduct that would constitute, as of the date of the order, a ground for a stop order under this section;

(4) the issuer's enterprise or method of business includes or would include activities that are unlawful where performed;

(5) with respect to a security sought to be registered under Section 303, there has been a failure to comply with the undertaking required by Section 303(b)(4);

(6) the applicant or registrant has not paid the filing fee, but the administrator shall void the order if the deficiency is corrected; or

(7) the offering:

(A) will work or tend to work a fraud upon purchasers or would so operate; [or]

(B) has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, or promoters' profits or participations, or unreasonable amounts or kinds of options[; or

(C) is being made on terms that are unfair, unjust, or inequitable].n1

Section 306(a)(7) above presents the common provisions in Blue Sky laws for both merit and disclosure-based regulation of offerings. NSMIA preempted state authority in regard to merit regulation of offerings of "covered securities," but states remain free to engage in the process with respect to other offerings. Even before NSMIA, however, not all states engaged in merit review of offerings.n2 A significant number of states chose instead to evaluate only disclosure associated with an offering rather than its qualitative characteristics and elements. That continues to be the case today with respect to offerings of securities that are not NSMIA covered securities. Nevertheless, all Blue Sky laws contain some broadly stated fraud-based or fairness standard as the basis for administrative authority to deny, suspend or revoke registration regardless of what approach is taken in the review of an offering.

Post-NSMIA, state administrators retain general antifraud enforcement authority over securities offerings whether or not a NSMIA covered security is involved. However, the states' retained antifraud enforcement authority does not preserve authority to regulate the registration or offering process for NSMIA covered securities by imposing requirements concerning the content of prospectuses or offering documents, or otherwise imposing procedures for review that operate to control content. This is a matter of NSMIA "use" preemption relating to offering documents, and is discussed in further detail later in this chapter.n3

The power to *suspend* the offer or sale of securities within a state, without regard to the security's NSMIA "covered" status, is expressly preserved in regard to the failure of an issuer to make any required filing, or to pay any requisite fee. Except where NSMIA covered securities falling under the classification of "nationally traded securities" are involved, states may require notice filings and assess fees in connection with an offering in the state. Enforcement authority in regard to these permitted requirements is the power to suspend the offering.n4

[a] Standards--Generally

Where NSMIA covered securities are not involved, state authority in regard to registration or qualification of securities for offer and sale is unfettered, and state powers remain defined by the statutes. Depending on the type of registration involved, a registration statement may become effective upon filing, or be subject to review, including the full scope of

merit review, prior to effectiveness. In any case, once effective, a registration statement is subject to suspension and/or revocation under a variety of circumstances and upon application of varying standards.

The standards for suspension or revocation of an effective registration are, at the baseline, the same as those applied for denying qualification where an offering is subject to pre-effective merit review. Orders suspending or revoking the effectiveness of a registration are, however, reviewable in accordance with the applicable provision of a state's administrative procedures act or code, and thus involve not only the baseline standards, but also the manner and process by which the discretion exercised in applying them is undertaken.ⁿ⁵

As illustrated by section 307 of the 2002 Uniform Securities Act discussed above, standards applied in the process are formulated in varying ways among the states. Many state standards sound in "fraud," others speak in terms of degrees of "fairness," and still others speak of what is or is not "fair, just and equitable." In discussing the basis on which a state's administrator decides whether or not to grant an issuer the right to sell its securities within the state, or make a determination that it should be terminated, several general groupings of states can be made, but with hybrid standards some states fall into more than one group.

First, there are states where an application for registration will be denied or an already effective registration statement will be suspended or revoked if the administrator finds that a denial, suspension, or revocation would be in the public interest and that any or all of the following apply: (1) the registration statement is incomplete or contains any false or misleading facts; (2) the issuer or any controlling person willfully violated the blue sky law; (3) the security is subject to an administrative stop order or a judicial injunction; (4) the issuer's method of business is illegal; (5) the offering has worked or tended to work a fraud upon the public; (6) there is an unreasonable amount of discounts, commissions, or options connected with the offering; (7) if sought to be registered by notification, it is not eligible; (8) if sought to be registered by coordination, the necessary undertaking has not been obtained; or (9) the proper filing fee has not been paid.ⁿ⁶

Another group of states can be referred to as the "fair, just, and equitable" states.ⁿ⁷ This group includes California,ⁿ⁸ Florida,ⁿ⁹ North Dakota,ⁿ¹⁰ Oregon,ⁿ¹¹ Tennessee,ⁿ¹² and Texas.ⁿ¹³ In these states, a registration statement will be denied or suspended (or more practically, the administrator will permit the issuer to modify the offering so as to meet that state's standards) if the offering is not fair, just, or equitable.

The categories of information required and the state standards for the denial, suspension, or revocation of registration based upon the proffered data vary widely. States employing a fraud standard permit denial, suspension, or revocation of registration if the offering would tend to work a fraud upon purchasers,ⁿ¹⁴ although, as with the Uniform Act, this particular fraud-based standard is part of a series of disqualifying criteria, including such things as illegality and unreasonable intermediary compensation.ⁿ¹⁵

Merit regulation states employ any number of qualitative grounds available to the administrator on which to authorize stop orders or denials, revocations, or suspensions of registration. The language often used is "unfair, unjust or inequitable."ⁿ¹⁶ The mid-ground rests with states that have adopted the language of § 306(a)(2)(F) of the Uniform Act as their prime standard,ⁿ¹⁷ and focus their attention on whether the offering involves "unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation."ⁿ¹⁸

[b] Particular Standards

In Chapter 6, the subject of "merit regulation" is considered in depth, including qualitative standards applied throughout the states in regard to particular aspects of an offering. However, as an introduction to that extensive analysis, and in order to fully understand the process of Blue Sky registration and the exercise of authority in regard to denial, suspension or revocation, it is useful here to examine the bases for administrative action, and some of the particular standards on which it is premised.

The standards applied by state administrators demonstrate two basic patterns. First, there are generic rules dealing with such things as promotional shares, excessive warrants and options, non-voting common stock or common stock with disproportionate voting rights, or preferred stock dividend and debenture interest coverage, as well as debt securities generally. Second, there are separate guidelines to address specific classes of issues or offerings, such as real estate, oil and gas, cattle feeding or equipment leasing. In all cases, standards applied in individual states are characterized as guidelines, particular to the state. However, in an effort to bring some uniformity and greater certainty in application, such guidelines and statements of policy have been promulgated by the North American Securities Administrators Association (NASAA), and have been widely adopted, in one form or another, among the states.ⁿ¹⁹ As an example, NASAA adopted a statement of policy aimed specifically at debt securities, which provides in part as follows:

.....

A public offering of debt securities may be disallowed by the Administrator if the Issuer's adjusted cash flow for the last fiscal year or its average adjusted cash flow for the last three (3) fiscal years prior to the public offering was insufficient to cover its fixed charges, meet its debt obligations as they became due, and service the debt securities being offered.ⁿ²⁰

Some states have regulations containing specific standards that are applied by the administrator in determining whether to grant an initial application for registration or cancel an existing registration.ⁿ²¹ Many of the standards are quite similar to one another, and thus an examination of a few representative provisions is illustrative of their application in practice.

The regulations pertaining to registration standards in Missouriⁿ²² address nearly twenty considerations that may form the basis of the administrator's determination to deny, suspend, or revoke a registration. This list includes: (1) commissions and expenses; (2) offering price; (3) options and warrants; (4) cheap stock; (5) promoters' equity investment; (6) escrow requirements; (7) impoundment requirements; (8) voting rights; (9) preferred stock and debt securities; and (10) transactions with officers, directors, or employees. Consider how just these ten considerations are applied:

(1) Commissions and expenses that have been or are to be paid in connection with the offering of a security must be reasonable and must not exceed specified percentages.ⁿ²³

(2) The offering price for the securities must bear a reasonable relationship to the established market price (if there is an established market price).ⁿ²⁴

(3) Options or warrants granted or reserved to persons other than pro rata to all of the securities' purchasers must be reasonable in number and method and must "not exceed a number equal to 15% of the number of shares to be outstanding upon completion of the offering." There are also other restrictions that include when the options or warrants may be exercised, their initial exercise price in terms of their public offering price, and the fact that they may be issued only by a relatively small company in its promotional stage or one that lacks public ownership.ⁿ²⁵

(4) Cheap stock, also called promotional securities, is sold to promoters or underwriters for an amount less than the public offering price or for a consideration other than cash. The sale of such securities must fall within certain conditions, and the Administrator may require a certain percentage of shares to be held in escrow subject to staggered release dates.ⁿ²⁶

(5) The equity investment of the promoters of an issuer in the promotional or developmental stage must equal at least 10% of the aggregate public offering.ⁿ²⁷

(6) Stock that is required to be placed in escrow must be deposited into a bank or with an individual approved by the commissioner, and the deposit is subject to the approval of the Commissioner.ⁿ²⁸

(7) Proceeds from the sale of securities that are required to be impounded must be deposited into a bank or with an individual approved by the commissioner, and the deposit is subject to the approval of the commissioner.ⁿ²⁹

(8) Unless justified, the offering cannot include a class of securities that either has no voting rights or has less than equal voting rights.ⁿ³⁰

(9) If preferred stock is being offered, the issuer's net earnings for its last year or average of its last three years must be sufficient to cover proposed dividends; if debt securities are being offered, the cash flow of the issuer for its last year or average of its last three years must be sufficient to cover all debt service requirements.ⁿ³¹

(10) Unless justified, loans to officers, directors, or employees made out of the ordinary course of business, or remuneration paid to officers, directors, or employees from the proceeds of an offering or that fail to meet other conditions are looked upon with disfavor by the commissioner.ⁿ³²

California applies meaningful state standards dealing with such prominent regulatory concerns in an offering as selling expenses, offering price, options or warrants, promotional securities or preferred stock.ⁿ³³ In an offering in California, an issuer of securities may only incur those expenses that are reasonably necessary for the sale and issuance of the securities. "Selling expenses," including commissions, are deemed reasonable if they do not exceed fifteen percent of the aggregate offering price and are computed only on that portion actually paid to the issuer.ⁿ³⁴ As for offering price, although it is stated that the Commissioner will not consider the fairness of the offering price, there is an exception to this rule. If the offering price, when compared to the price at which securities of the same class have recently been sold to others, would make these latter securities promotional shares, resulting in unreasonable promoter's profits or participations, an examination by the Commissioner will result.ⁿ³⁵ In all other instances, securities must be sold at a price that is fair to the issuer and the purchasers.ⁿ³⁶

Options, warrants or similar rights involved in an offering receive special attention because of the dilutive effect they may have on existing shareholders or those purchasers who do not receive the rights on a pro rata basis. With regard to options, and with the exception of sales to existing shareholders on a pro rata basis,ⁿ³⁷ California limits the number of options (including warrants and similar rights) to thirty percent of the outstanding shares of the issuer.ⁿ³⁸

As in Missouri and other states, California limits the amount of promotional securities or "cheap stock."ⁿ³⁹ There is a presumption that for "unseasoned companies," the amount of promotional shares that is reasonable is limited to twenty-five percent of all common shares issued and proposed to be issued by the corporation.ⁿ⁴⁰

Lastly, the California regulations provide that common shares and similar equity securities should *normally* carry equal voting rights on all matters, where such vote is permitted by applicable law.ⁿ⁴¹ A class of securities, however, can be created without voting rights if the holders of the class are provided with reasonable representation on the board of directorsⁿ⁴² and afforded other protective measures.ⁿ⁴³

Other state standards focus on protection of investors in developmental or start-up situations. Florida, for example,

requires the proceeds from the sale of developmental or promotional securities to be escrowed for a period of time.ⁿ⁴⁴ The escrow agent in all instances must be a commercial bank or trust company, and all checks, drafts, or money orders for the period during which the securities are escrowed are to be made payable to this agent.ⁿ⁴⁵ Another guideline used in Florida, as well as in other states, is commonly referred to as the "promoters' equity investment ratio." Unless the promoters' equity investment is equal to a given percentage, the new issue will be disallowed registration. In Florida, in offerings where the issuer is in the promotional or development phase, registration will be denied unless the equity investment by promoters or insiders is at least fifteen percent of the total equity investment resulting from the sale of the entire offering.ⁿ⁴⁶

Finally, Florida limits the sale or issuance of nonvoting common stock, preferred stock, and debt securities. Nonvoting common stock will not be permitted unless notice is given to the prospective buyer that he will not be entitled to vote the shares, the corporation seeking to register these securities has been in business for at least two years, and dividend rights on voting stock and nonvoting stock are equal.ⁿ⁴⁷ Issuers in the promotional or developmental phase will likewise not ordinarily qualify to issue preferred shares or debt securities because of the amount of earnings required by the regulations.ⁿ⁴⁸

Demonstration of compliance with qualifying criteria or standards is a part of the registration process. Registration by qualification involves forms and submission requirements setting out information upon which the applicable qualitative standards may be applied. However, the burden of compliance is continuing. If, for example, an escrow arrangement for offering proceeds or for promoters shares is made, but not implemented or maintained fully in accordance with the requirement or undertaking, administrative power to suspend or revoke the registration will be exercised. The effectiveness of a registration, whatever type may be involved, is conditional. The forms involve less burdensome submission requirements, but the power of an administrator to suspend or revoke is no different, and the general standards for doing so, applied in hindsight, are no less meaningful. Where particular standards are applied ahead of effectiveness, however, the continuing burden of compliance must be a key concern of issuers.

[2] NSMIA "Use" Preemption: Offering Documents

NSMIA limitations on state authority in registration or qualification of transactions involving covered securities also extends to any state regulation of the use of an offering document prepared by or on behalf of the issuer. The principal impact of "use" preemption is to prohibit state requirements for content, and to eliminate any qualification role in the offering process through controls on the use of an offering document. "Offering document" is defined in NSMIA by reference to the definition of "prospectus" in section 2(10) of the Securities Act of 1933.ⁿ⁴⁹ It also incorporates communications determined or permitted by SEC rules as not constituting an offer of a security.ⁿ⁵⁰ Thus, communications excluded from the definition of "prospectus" via SEC Rules 134 or 135ⁿ⁵¹ are immune from state regulation other than the retained investigative and enforcement authority with respect to fraud.ⁿ⁵²

The impact of NSMIA use preemption is well illustrated by the declaratory statement of the Head of the Florida Department of Banking and Finance that the state's offering circular requirements for certain municipal bond issues are preempted. In *Petition for Declaratory Statement of the City of Chicago, Illinois* ⁿ⁵³ the administrator concluded that Florida's regulatory requirements for disclosing information in an offering circular for new bonds concerning a default on bonds previously issued by the municipality were inapplicable to the new bonds. The new bonds, general airport refunding bonds, proposed for offer and sale by the City of Chicago in Florida were deemed to be NSMIA covered securities, and thus under NSMIA section 18(a)(2)(a) Florida could not impose any content conditions or limitations on an offering document prepared by or on behalf of the issuer. The administrator concluded:

Section 19(a) of the Securities Act of 1933 exempts a covered security from state laws, rules and regulations (unless the regulating state is also the state of incorporation of the issuer) that directly or indirectly, limit or impose conditions on the use of any offering statement that is prepared by or on behalf of the issuer of the covered security.ⁿ⁵⁴

The scope of state authority over offering documents is also prescribed by the NSMIA mandated authority of the SEC to define the meaning of the key qualifying term. By rule, the SEC has determined that for purposes of section 18(d)(1) of NSMIA an offering document is "prepared by or on behalf of the issuer" if the issuer or an agent of the issuer authorizes the document's production, *and* approves the document before its use.ⁿ⁵⁵ The scope of agency of an issuer in regard to preparation of an offering document is surely broad enough to cover materials prepared by officers, directors, controlling persons generally, as well as underwriters, attorneys, accountants and any others who have normal or delegated responsibility for the preparation of materials or parts of documents. However, documents prepared and circulated without issuer authorization are not covered offering documents under NSMIA.

[3] Review of Denial, Suspension, or Revocation of Registration

Administrative action taken in regard to a registration will produce an order which is reviewable after it is made final or which may be challenged before it becomes final. The suspension of a registration, for example, although it may be done summarily under most statutes, is subject to proper notice requirements and to challenge through an administrative hearing procedure.ⁿ⁵⁶ Those hearings will generally be controlled by the particular state's administrative procedures act, although the Blue Sky law or regulations may dictate the form and content of notices issued in regard to suspension or other orders. Summary suspensions or "initial" orders do not become final until completion, or waiver, of the hearing process. Through that process it may also be shown why no order should issue, and the administrator may rescind or revoke any initial order.

The denial or postponement of effectiveness of a registration statement likewise involves orders which fall within the administrative hearing process and are initially reviewable in this manner. As seen above, denials of effectiveness of registration statements are often referenced under the heading of stop orders, with the Uniform Act declaring, for example: "The [Administrator] may issue a stop order denying effectiveness to ... any registration statement" ⁿ⁵⁷ The "stop order" or suspension process is obviously most efficient in regard to those types of registration which allow for automatic effectiveness. A registration by qualification entails an actual order for effectiveness, the denial of which is treated no differently for purposes of the right to be heard in an administrative review procedure.

Blue Sky laws specifically provide for judicial review of a *final* order of denial, suspension, or revocation of a registration statement as a part of providing for review of any order of an administrator. The original Uniform Act, for example, provides in section 411:

Any person aggrieved by a final order of the [Administrator] may obtain a review of the order in the [insert name of appropriate court] by filing in court, within sixty days after entry of the order, a written petition praying that the order be modified or set aside in whole or part ⁿ⁵⁸

The final order limitation on seeking judicial review means that orders, such as stop orders, that are summarily issued must first be reviewed through whatever administrative process is established. Failure to do so precludes any judicial review through application of the exhaustion of administrative remedies principle generally, and particular state law provisions.ⁿ⁵⁹

The standard procedure is to file an appeal in the appropriate court within the time allotted. It must be cautioned, however, that unless ordered by the reviewing court, a judicial appeal does not operate as a stay of the original order. Furthermore, notice of the pending judicial review must be served on the appropriate party defendant (namely, the Administrator), and in some cases, a bond must be posted to assure faithful prosecution of the appeal.

As would be expected, courts give considerable deference to the securities' administrator's experience and discretionary powers in issuing any final order from which an appeal is taken.ⁿ⁶⁰ Indeed, in some instances statutes themselves so mandate. In West Virginia, for example, while a reviewing court has the power to affirm, modify, enforce, or set aside

the commissioner's order, "[t]he findings of the commissioner as to the facts, if supported by competent, material and substantial evidence, are conclusive."n61

FOOTNOTES:

(n1)Footnote 1. 2002 Unif. Sec. Act § 306.

(n2)Footnote 2. "Merit review" of securities offerings by states is considered separately in Chapter [(" "], *infra*.

(n3)Footnote 3. *See* § 5. [], *infra*.

(n4)Footnote 4. Securities Exchange Act Section 18(c)(3) provides:

Nothing in this section shall prohibit the securities commission (or any agency or office performing like functions) of any State from suspending the offer or sale of securities within such state as a result of the failure to submit any filing or fee required under law and permitted under this section.

(n5)Footnote 5. *See* § 5.05[4] *infra*.

(n6)Footnote 6. Unif. Sec. Act § 306(a); *see also* Rev. Unif. Sec. Act § 306(a). States that have enacted, in whole or in part, such a statute include:

Alaska: Alaska Stat. § 45.55.120.

Connecticut: Conn. Gen. Stat., ch. 672a, § 36b-20.

Delaware: 6 Del. Code Ann. § 7308.

Hawaii: Haw. Rev. Stat. § 485-13.

Massachusetts: Mass. Gen. Laws Ann., ch. 110A § 305.

Pennsylvania: 70 Pa. Cons. Stat. § 1-208.

Washington: Wash. Rev. Code § 21.20.280.

Other states have adopted an abbreviated version of the Uniform Securities Act provision. *See, e.g.*, Ga. Stat. Ann. § 10-5-7(a)(5); *see also* Ill. Comp. Stat. ch 815. § 5/11(E) (nonuniform state but similar in formulation of fraud language).

(n7)Footnote 7. *See also* Rev. Unif. Sec. Act § 306(a) (offers states an election to adopt "fair, just and equitable" language in lieu of "tending to work a fraud" language in Unif. Sec. Act § 306(a)(2)(E)).

(n8)Footnote 8. *Cal. Corp. Code § 25140(a)(2).*

(n9)Footnote 9. *Fla. Stat. Ann. § 517.111(1)(i).*

(n10)Footnote 10. *N.D. Cent. Code § 10-04-09.*

(n11)Footnote 11. *Or. Rev. Stat. § 59.105(1)(a).*

(n12)Footnote 12. *Tenn. Code Ann. § 48-2-112(a).*

(n13)Footnote 13. Tex. Rev. Civ. Stat. Ann. § 581-7(C)(2); *see In re Plantation Oil, Inc.*, [1982-1984 Transfer Binder] CCH Blue Sky L. Rep. P 71,870 (Texas State Securities Board 1983), in which the Commissioner denied an application for registration of securities for a prospective offering after determining that the offering could not be considered fair, just, or equitable because:

- (1) the plan of business failed to provide safeguards against conflicts of interest between management and investors where fiduciary relationship existed;
- (2) the requisite state-registered dealer was not involved; and
- (3) deficiencies in disclosure would tend to work a fraud on purchasers.

(n14)Footnote 14. *See, e.g., Md. Code Ann. Corps. & Ass'ns § 11-511(a)(5); Va. Code Ann. § 13.1-513(a)(7).*

(n15)Footnote 15. *See* Unif. Sec. Act § 306(a). Note that in addition to the particularized standards for denial, suspension, or revocation of a registration statement, the Uniform Act also broadly prohibits fraud via Section 101, a state law analog to SEC *Rule 10b-5* under the Securities Exchange Act of 1934, 17 C.F.R. § which declares:

It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly,

- (a) to employ any device, scheme, or artifice to defraud,
- (b) to make any untrue statement of a material fact or to omit 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, or
- (c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.

As one criterion for denial, suspension, or revocation of a registration set out in Section 306, the Uniform Act declares that an order may issue on a finding that "any provision of this act ... has been willfully violated in connection with the offering." Unif. Sec. Act § 306(a)(2)(B).

(n16)Footnote 16. *See, e.g., Fla. Stat. § 517.111(1)(a)-(j)* (which, among other grounds, authorizes denial, revocation, or suspension if the offer is not "fair, just or equitable" or if the issuer has "demonstrated any evidence of unworthiness"); *Or. Rev. Stat. § 59.105(1)(a)-(h)* (grounds include issuer in unsound financial condition; offer generates unreasonable amounts or kinds of commissions).

(n17)Footnote 17. Unif. Sec. Act § 306(a)(2)(F).

(n18)Footnote 18. *See, e.g., Conn. Gen. Stat. § 36b-20; Pa. Cons. Stat. § 1-208(a)(V); Unif. Sec. Act § 306(a)(2)(F); Rev. Unif. Sec. Act § 306(a)(6).*

(n19)Footnote 19. 1 CCH Blue Sky L. Rep. P 6211; CCH NASAA Reports PP 351-3802.

(n20)Footnote 20. CCH NASAA Reports PP 1221-1227. The NASAA guideline for public offerings of debt securities also includes the requirement for a "Trust Indenture," which must incorporate specific provisions designed to interpose an indenture trustee between the issuer and purchasers to protect the rights of purchasers in the event of certain circumstances or transactions.

(n21)Footnote 21. *See, e.g.:*

Alaska: Alaska Sec. Reg. Art 2, §§ 3AAC 08.130 through 3 AAC 08.220.

California: Cal. Sec. Reg. art. 4, Rule 260.140 *et seq.*

Florida: Fla. Sec. Reg. §§ 3E-700.005 *et seq.*

Oregon: Or. Rev. Stat. § 59.105(1)(a).

Texas: Tex. Sec. Reg. Ch.117 (real estate programs); Ch.119 (cattle feeding programs); Ch.121 (oil and gas programs).

(n22)Footnote 22. *Mo. Code Regs. tit. 15, §§ 30-52-030 et seq.*

(n23)Footnote 23. *Mo. Code Regs. tit. 15, § 30-52.040.* Missouri has adopted the NASAA Policy Statement Regarding Selling Expenses and Securities Holders. *See* CCH NASAA Reports P 3671. of the registration rules. Those issues disallowed registration upon application of the above criteria confirmed what had been suspected; namely, that underwriters charged higher commissions and incurred greater expenses for selling securities that were considered less desirable. Consequently, there was some justification in using this yardstick for reliability of performance.

(n24)Footnote 24. *Mo. Code Regs. tit. 15, § 30-52.050.*

(n25)Footnote 25. *Mo. Code Regs. tit. 15, § 30-52.060.*

The "same conditions apply to options or warrants by selling shareholders, unless evidence indicates that the selling shareholders are so separated from the issuer and so lacking in control of the issuer as to require different treatment." *Mo. Code Regs. tit. 15, § 30-52.060(1)(d)(8).* *See also* CCH NASAA Reports PP 2801-2807, Statement of Policy Regarding Options and Warrants.

(n26)Footnote 26. *Mo. Code Regs. tit. 15, § 30-52.070.* Missouri has adopted the NASAA Statement of Policy Regarding Promotional Shares. *See* CCH NASAA Reports PP 3201-3205.

The rationale for this standard is to assure that the promoters actually contribute a reasonable value for their stock. If the promoter's contribution is not in the form of tangible assets, the issuance of cheap stock can only be justified in terms of intangibles that lead to the issuer's subsequent successful operation. This, in turn, explains why the Commissioner, as in Missouri and elsewhere, may require that excessive cheap stock be escrowed under terms that will permit its release if and when justified by the issuer's performance.

(n27)Footnote 27. *Mo. Code Regs. tit. 15, § 30-52.080.* Missouri has adopted the NASAA Statement of Policy Regarding Promoter's Equity Investment, CCH NASAA Reports PP 3102-3104.

(n28)Footnote 28. Former *Mo. Code Regs. tit. 15, § 52.090.* Missouri rescinded its regulation in favor of the NASAA Policy. *See* CCH NASAA Reports PP 3203-3205. Other states have retained similar language. *See Alaska Admin. Code tit. 3, § 08.180.*

(n29)Footnote 29. *Mo. Code Regs. tit. 15, § 30-52.100:*

(1) Proceeds from the sale of registered securities which are required to be impounded (Section 409.305(f)(2)) shall ordinarily be impounded in accordance with the following provisions:

(A) An impoundment depository may be a bank or trust company or other person satisfactory to the commissioner.

(B) The impoundment shall be covered by agreement which shall be executed subject to the written approval of the commissioner, in substantially the format, and in accordance with such terms as the commissioner may determine.

(C) The form of impoundment agreement may be obtained from the commissioner upon request

(n30)Footnote 30. *Mo. Code Regs. tit. 15, § 30-52.110:*

(1) Unless preferential treatment as to cumulative dividends and liquidation is provided with respect to the publicly offered securities or the differentiation is otherwise justified, the offering or proposed offering of equity securities of an issuer having more than one class of equity securities authorized or outstanding shall not include a class of equity securities which has no voting rights, or has less than equal voting rights in proportion to the number of shares of each class outstanding and in proportion to the par value or fair value of each class outstanding, on all matters including the election of members to the board of directors of the issuer.

(n31)Footnote 31. *Mo. Code Regs. tit. 15, § 30-52.120.*

(n32)Footnote 32. *Mo. Code Regs. tit. 15, § 30-52.130.* Missouri has adopted the NASAA Statement Regarding Loans and Other Material Affiliated Transactions. NASAA Reports (CCH) PP 371-376.

(n33)Footnote 33. *Cal. Code Regs. tit. 10, § 260.140.*

(n34)Footnote 34. *Cal. Code Regs. tit. 10, § 260.140.20:*

"Selling expenses," as used in this Article, means the total underwriting and brokerage discounts and commissions (including fees of the underwriters' attorneys paid by the issuer) paid in connection with the offering plus all other expenses actually incurred by the issuer relating to printing, engraving, mailing, salaries of employees while engaged in sales activity, charges of transfer agents, registrars, trustees, escrow holders, depositories, and engineers and other experts, expenses of qualification of the sale of the securities under Federal and State laws, including taxes and fees, and any other expenses actually incurred by the issuer and directly related to the offering and sale of the securities, but excluding accountants' and the issuer's attorneys' fees and options to underwriters.

(n35)Footnote 35. *Cal. Code Regs. tit. 10, § 260.140.50.*

(n36)Footnote 36. *Id.* In determining whether the price is fair, predominant weight will be given to the following:

(a) If securities of the same class are publicly traded on an active market of substantial depth, the recent market price of such securities;

(b) If securities of the same class have not been so publicly traded, the price at which securities of reasonably comparable corporations (if any) in the same industry are being traded, subject to appropriate adjustments for the dissimilarities between the corporations being compared.

Id.

(n37)Footnote 37. *Cal. Code Regs. tit. 10, §§ 260.140.40, 43* (sales made to shareholders on a pro rata basis may be not more than 15% below the preexisting market price and still be presumptively reasonable).

(n38)Footnote 38. *Cal. Code Regs. tit. 10, § 260.140.45* (30% figure is exclusive of shares subject to promotional waivers).

(n39)Footnote 39. *Cal. Code Regs. tit. 10, § 260.140.30*:

"Promotional shares" means any securities which are (a) issued in consideration for services rendered in connection with the founding or organizing of a business enterprise, or (b) issued to a promoter in consideration for any tangible or intangible property, such as patents, copyrights or goodwill, to the extent that the value has not been satisfactorily established, or (c) issued to a promoter in the recent past or proposed to be issued at a price substantially lower than the price at which other securities of the same class or substantially similar class have been or are to be sold without any change in the conditions of the market or in the circumstances of the issuer which would justify such different price.

(n40)Footnote 40. *Cal. Code Regs. tit. 10, § 260.140.31*.

This regulation does allow, however, for the issuance of additional promotional shares in light of the services rendered and other consideration given to the corporation by the promoters, the nature and circumstances of the business enterprise being promoted, and the identity of the investors.

(n41)Footnote 41. *Cal. Code Regs. tit. 10, § 260.140.1*.

(n42)Footnote 42. *Cal. Code Regs. tit. 10, § 260.140.2*.

(n43)Footnote 43. *Cal. Code Regs. tit. 10, § 260.140.3*.

These protective measures include a provision that: the dividends on such shares be cumulative; a prohibition of dividends on common stock during the existence of any arrears on the preferred shares; an appropriate requirement for the approval by the vote or written consent of a specified percentage of preferred shareholders of any adverse change in the rights of such preferred shares; and appropriate dividend restrictions on common stock. *Id.*

(n44)Footnote 44. Fla. Sec. Reg. § 3E-700.009.

(n45)Footnote 45. *Id.*

(n46)Footnote 46. Fla. Sec. Reg. § 3E-700.005.

An exception to this rule is permitted, however, when the net worth of the issuer is in excess of \$100,000 and the offering is supported by the firm commitment of an underwriter registered under the Securities Exchange Act of 1934. *Id.*

(n47)Footnote 47. Fla. Sec. Reg. § 3E-700.006.

(n48)Footnote 48. Fla. Sec. Reg. § 3E-700.010. An issuer of preferred stock or debt securities must have, after provision for federal income taxes determined in accordance with generally accepted accounting principles, earnings, for both the last and current fiscal years, excluding extraordinary items, sufficient to pay dividends or interest, respectively, on the securities to be offered to the public. *Id.*

(n49)Footnote 49. Section 18(d)(1)(A) of NSMIA provides that offering document "has the meaning given the term 'prospectus' in Section 2(10), but without regard to the provisions of subparagraphs (A) and (B) of that section." In pertinent part, Securities Act section 2(10) defines a prospectus as:

[Any] prospectus, notice, circular, advertisement, letter or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security.

(n50)Footnote 50. Section 18(d)(1)(B) declares that offering document also includes "a communication that is not deemed to offer a security pursuant to a rule of the Commission."

(n51)Footnote 51. SEC Rule 134 under the Securities Act permits the creation and use of certain written materials after the filing of a registration statement under Section 5 of the Act, but prior to the effective date. Rule 135 permits a pre-filing notice of a public offering. The content of all forms of communications permitted under these rules is limited by the rules. The permitted communications are, by virtue of authority granted to the SEC in Section 2(10) of the Act, excluded from the definition of "prospectus."

(n52)Footnote 52. In practice, there may be uncertainty over state authority in situations involving documents that may, under the U.S. Supreme Court decision in *Gustafson v. Alloyd Co.*, 513 U.S. 561, 115 S. Ct. 1061, 131 L. Ed. 2d 1 (1995), not be prospectuses, and thus not "offering documents" within the NSMIA definition. In *Gustafson*, the Court opined that, at least for purposes of a private remedy for fraud contained in the Securities Act of 1933, a written communication that is for all practical purposes a "prospectus" is not a prospectus in a non-public, exempt, offering of securities. Such an offering may well involve a covered security under Section 18(b)(3) or (b)(4)--as, for example, an offering carried out pursuant to SEC Rule 506 under the Securities Act--and utilize a disclosure document. Under *Gustafson*, however, if the disclosure document in a non-public offering setting is excluded from the definition of "prospectus," it is also excluded from the definition of "offering document" for purposes of the "use" preemption of state authority under NSMIA.

(n53)Footnote 53. File No. 2848-S-8/99, 1999 Fla. Sec. LEXIS 119 (Fla. Dept. Banking and Finance, Div/ Sec. Nov. 1, 1999).

(n54)Footnote 54. *Id.*

(n55)Footnote 55. Securities Act Rule 146(a), 17 C.F.R. § 230.146(a).

(n56)Footnote 56. *See, e.g.*, Unif. Sec. Act §§ 204(c), (f).

(n57)Footnote 57. Unif. Sec. Act § 306(a).

(n58)Footnote 58. Unif. Sec. Act § 411; Rev. Unif. Sec. Act § 711(b).

See also:

Alaska: Alaska Stat. § 45.55.940.

California: Cal. Corp. Code § 25609.

Florida: Fla. Stat. Ann. § 517.241.

Massachusetts: Mass. Gen. Laws Ann., ch. 110A, § 411.

(n59)Footnote 59. *See, e.g.:*

Minnesota: Minn. Stat. Ann. § 80A.24(2).

Orders of the division are subject to judicial review ... but orders originally entered without a hearing may be reviewed only if the party seeking review has requested a hearing within the time provided [for administrative review]. Wis. Stat. § 551.61(5).

(n60)Footnote 60. *See, e.g., Fehrman v. Ohio Dept. of Commerce, 2001 Ohio 4225, 141 Ohio App. 3d, 503, 751 N.E.2d 1089 (10th Dist. App. 2001).*

(n61)Footnote 61. Code W. Va. § 32-4-411(a).



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Blue Sky Regulation

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CHAPTER 5 Securities Registration

1-5 Blue Sky Regulation § 5.08

§ 5.08 Uniformity, cooperation and coordination

The 2002 Uniform Securities Act is grounded in three general policies to be taken into account by state securities regulators in carrying out the public interest:

- (1) Maximizing effectiveness of regulation for the protection of investors;
- (2) Maximizing uniformity in federal state and regulatory standards; and
- (3) Minimizing burdens on the business of capital formation, without adversely affecting essentials of investor protection.n1

Among the subjects specifically targeted by the drafters of the 2002 Uniform Act for cooperation and coordination in regard to registration of securities are:

- (a) Establishing or employing one or more designees as a central depository for registration and notice filings;
- (b) Developing and maintaining uniform forms;
- (c) Coordinating registrations; and
- (d) Formulating common systems and procedures.n2

NSMIA redefined federal and state regulatory roles so as to eliminate much of state authority in regard to registration of securities which are, or are traded in markets that are, national in character. Yet at the same time, NSMIA underscored the role of the states in protecting investors through registration requirements that remain fully operational at local and state levels, and indeed, without any limitations at all where non-covered securities are involved. Non-exempt offerings of securities that are not NSMIA covered securities--oil and gas interests, real estate programs, cattle feeding programs, for example--remain subject to state registration requirements and, where applicable, merit review. Uniformity, cooperation and coordination in state registration processes in connection with such offerings thus continue to be important policy objectives. State securities regulators, particularly in combined efforts through NASAA--the North

American Securities Administrators Association--have achieved significant uniformity in forms,ⁿ³ and in standards applied in merit review. Through the development of uniform forms, the creation of coordinate registration programs procedures at the regional level and uniform statements of policy,ⁿ⁴ states have in fact taken significant steps to enforce uniformity in the registration of securities offerings. Much has been accomplished in reducing the burden of compliance at all levels without compromising investor protection.

FOOTNOTES:

(n1)Footnote 1. 2002 Unif. Sec. Act § 608(b).

(n2)Footnote 2. *Id.*, § 608(c).

(n3)Footnote 3. One of the most significant innovations, for example, has been the creation of a simplified registration form for small businesses. This is known as the Small Corporate Offering Registration form ("SCOR" or the Uniform Form 7) which has been adopted or recognized and accepted in 47 states. The principal innovation of this form is its question and answer format that permit a business person to fill in the blanks, file it with a state securities administrator and, upon approval, use it as a disclosure document in a public offering.

(n4)Footnote 4. Programs and mechanisms already in place for coordinated regional review of securities offerings are discussed in Chapter 6.



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CHAPTER 6 Merit Regulation

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§ 6.01 Introduction

[1] Merit Regulation in Historical Context

In Chapter 5, the historic paternalistic mission of state Blue Sky laws to protect individual investors through the process of merit regulation was introduced in the context of registration and qualification requirements for the offer and sale of securities. Simply put, merit regulation under Blue Sky laws involves the interpositioning of an administrator between the issuer of a security and the investing public, with the administrator acting as gatekeeper and opining, on qualitative grounds, whether a particular security may be offered for sale in the state. Such assessments are anchored in variously worded statutory "fairness" standards that are applied without regard to the extent of information disclosure that may be made to prospective purchasers in the offering process.ⁿ¹

In one form or another, these standards are contained in virtually every state securities law and set the basis upon which an administrator may deny, suspend, or revoke the effectiveness of a registration statement. Section 306 of the 2002 Uniform Securities Act, for example, provides that the administrator may deny, suspend, or revoke the effectiveness of a registration statement when it is in the public interest to do so, and upon grounds that include the offering "will work or tend to work a fraud upon purchasers or would so operate."ⁿ² Beyond broadly worded statutory standards, however, a significant number of states adopted particular standards for merit regulation of securities offerings. The authority of states to act in this regard was a central feature of the dual federal-state securities regulatory scheme that came with the enactment of the federal Securities Act of 1933 and the Securities Exchange Act of 1934, which expressly preserved protections afforded to investors by state Blue Sky laws by adding savings clauses to the federal statutes.

The founding premises for merit regulation of securities offerings are simple enough:

- (1) Public investors have inadequate access to information on which to make an informed judgment;
- (2) Even when they have all the facts, the average public investor is not capable of properly evaluating them; and
- (3) Some securities or their terms are inherently unfair or fraudulent, and no amount of disclosure will correct those attributes.ⁿ³

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That is to say, requiring only disclosure to investors of the terms of an offering does not go far enough to protect them from overreaching and unfairness. Thus, merit regulation has been described in contemporary terms as a regulatory system that allows administrators to deny registration to a securities offering unless the substantive terms of the offering and associated transactions: (1) ensure a fair relation between promoters and public investors; and (2) provide public investors with a reasonable relation of risk to return.ⁿ⁴

While all states have registration procedures (absent an available exemption), not all of them engage in merit review, and the states that do are not uniform in the extent to which their Blue Sky administrators actually do so. The 1986 ABA Report found that 39 states provided, in one form or another, for merit regulation of securities offerings.ⁿ⁵ Among these, some 20 were in more recent years described as "traditional" merit review jurisdictions, providing for evaluation of securities registrations on the basis of some variant of fairness and equity to investors.ⁿ⁶

States making no provision for traditional merit review opted for the federal model, by which administrators review the adequacy of disclosures and are empowered to deny qualification, but do not make qualitative assessments. The Maryland statute is typical. For registration of securities by qualification, the Maryland Blue Sky law and implementing regulations require disclosure of extensive information in a registration statement and prospectus (the use and dissemination requirements for which are also prescribed) filed with the Commissioner.ⁿ⁷ Subject to stop order authority of the Commissioner, a registration statement becomes effective upon the order of the Commissioner. Stop order authority provides for denial, suspension, or revocation of the registration on a finding, among others, that the registration statement is incomplete in a material respect, "or contains a statement that was, in the light of the circumstances under which it was made, false or misleading with respect to a material fact."ⁿ⁸ Stop order authority is also specified in circumstances in which an offering has worked, tended to work, or would work a fraud upon purchasers.ⁿ⁹ However, there are no qualitative standards prescribed for making such determinations.ⁿ¹⁰

Over time, states thus became identified as either "merit" or "disclosure-only" states. Merit review states exercised authority to reject an offering for reasons, as simply stated in practical terms, that it was a bad investment. Disclosure states prohibited fraud and in most cases mandated the dissemination of structured disclosure documents, but did not exclude offerings on substantive terms. Yet, as capital and financial markets evolved on an ever-growing national, and indeed global, basis, the wisdom of merit regulation of securities offerings by states became a leading policy debate concerning United States securities regulation. In the context of this debate, states themselves substantially limited the scope of merit regulation of securities offering through enactment of an array of exemptions from registration requirements that recognized the national character of certain securities offerings, or the fact that some types of limited or private offerings carried out in conformity with federal requirements did not need the protection of state merit review. Thus, for example, a "marketplace" or "listed securities" exemption from state securities registration was universally adopted to exclude most larger scale public offerings from the merit review process.ⁿ¹¹ For most private offerings that satisfied the requirements of SEC Regulation D under the Securities Act of 1933,ⁿ¹² the Uniform Limited Offering exemption (ULOE) promulgated by the North American Securities Administrators Association (NASAA) in 1983 was adopted to provide an exemption from state registration requirements for qualifying limited offerings. States adopted other "merit safe harbors" and other provisions designed to lessen the burden of merit regulation in circumstances in which the need for merit review was significantly diminished or nonexistent. As discussed in Chapter 5, to a significant degree, states likewise adopted provisions for registration by "coordination," by which state requirements for registration were substantially reduced for securities issuers that also file a registration statement under the federal Securities Act of 1933.

Many states providing for merit review also elected to limit that authority or significantly streamline its exercise through the adoption of "merit safe harbors." By such fast-track provisions, offerings that meet conditions of the safe harbor are, presumptively, deemed to meet the applicable fairness standard, or whatever particular standard is applied to any aspect of an offering.ⁿ¹³ Streamlined, coordinated, merit review procedures were also established to make the process for multistate qualification of offerings by smaller issuers, or those offerings which are undertaken pursuant to a registration statement filed with the SEC pursuant to the Securities Act of 1933, more efficient.ⁿ¹⁴

Nevertheless, fundamental tensions between state and federal securities laws regarding securities offerings that are national in character persisted, and with the National Securities Markets Improvement Act of 1996 ("NSMIA"), Congress restructured the dual federal-state scheme of securities regulation in the United States. A key aspect of NSMIA is the limitation of merit regulation by states. NSMIA preempted state merit regulation when securities being offered and sold are "covered securities" as defined by NSMIA.ⁿ¹⁵

[2] Contemporary Relevance of Merit Regulation

Well before NSMIA, the role of merit regulation in the landscape of securities regulation in the United States had been substantially reduced. The number of offerings actually subjected to merit review under state Blue Sky laws had dramatically declined, as the vast majority of securities sales were carried out in reliance upon available exemptions from registration. Merit review was applied to a relatively narrow class of offerings, primarily those by small businesses and new ventures seeking to raise relatively small amounts of money. This diminished, but continuing, role focused on small business may be seen as entirely consistent with the historic mission of merit regulation. Merit review is appropriate, and indeed necessary, for investor protection in connection with small business offerings that are not subject to the discipline and scrutiny markets and intermediaries. On the other hand, state registration on merit review may be seen as impeding the flow of capital to small businesses by, among other things, imposing high costs on small issuers when there is an increasing need for equity investment to support new ventures, small business generally, and job creation that results. The principal benefits of merit review are the prevention of fraud and a reasonable assurance of investor protection against substantively flawed investment offerings. But it is not clear in today's capital markets and regulatory setting how effective, or necessary, merit review actually is in the prevention of fraudulent or insubstantial and excessively risky offerings. What is clear, however, is that there have been fundamental changes in securities and capital markets, not the least of which is the integration of regional, national, and global financial markets that quite simply changed the paradigm of state securities regulation.

NSMIA stripped the states of merit regulatory authority over all categories of federal covered securities. Nevertheless, while the definition of "covered securities" under NSMIA is broad, state authority to engage in merit regulation of securities offerings not involving covered securities remains unaffected. State authority with respect to intrastate offerings, or localized offerings that are ineligible for Rule 506 of Regulation D, for example, remains intact. States may also continue to require registration, and engage in merit review, of public offerings by non-bank, non-governmental issuers whose securities are not listed or to be listed on a NSMIA-covered marketplace.ⁿ¹⁶

In practical terms, this translates into securities including: (a) securities quoted in the Nasdaq Capital Marketⁿ¹⁷ or the NASD over-the-counter Bulletin Board; (b) securities quoted in the over-the-counter "pink sheets"; (c) securities listed on exchanges other than the New York or American Stock Exchanges, or the top tiers of the Nasdaq Stock Market; (d) various securities of non-listed issuers, such as asset-backed and mortgage-backed securities; (e) private placements of securities under section 4(2) of the Securities Act of 1933 that do not meet the requirements of Rule 506 of Regulation D; and (f) securities issued in exempt offerings under Regulation A and Rules 504 and 505 of Regulation D. Among these categories, NASAA has identified offerings of so-called "small cap" securities--those registered with the SEC and the states that are typically traded in the Nasdaq Capital Market tier, on certain regional exchanges, and on the NASD over-the-counter "Bulletin Board"--as particularly needing the scrutiny of merit regulation, and for which there is empirical evidence of the "value added" through application of substantive state review standards.ⁿ¹⁸

It is for small business issuers that state merit regulation authority after NSMIA has its greatest impact. In most cases, only Rule 506 of Regulation D under the federal Securities Act will present a realistic opportunity to engage in an offering of covered securities, and thus avoid state qualification requirements.ⁿ¹⁹ However, Rule 506 has its own set of qualifications and restrictions on its use, and may not be well suited to the needs of a small business issuer in particular circumstances. A private placement transaction carried out in reliance on section 4(2) of the federal Securities Act of 1933 outside of Rule 506 of Regulation D, and offerings pursuant to Rule 505 of Regulation D, or SEC Regulation A

offerings, are not NSMIA covered transactions. While there may be a coordinate state exemption from registration and qualification requirements for some of these offerings, they are not uniform among the states. Offerings by small business issuers made in reliance upon Rule 504 of Regulation D likewise remain fully subject to state merit regulation unless there is an available exemption.ⁿ²⁰

Many states offer small business issuers the opportunity to carry out securities offerings under SCOR--Small Corporate Offering Registration--procedures. This simplified form of registration for qualifying issuers utilizing Form U-7 substantially lessens the burden and expense of registration by qualification procedures that would otherwise apply. However, SCOR is not an exemption from registration, and in those state that engage in merit review, a SCOR registration remains fully subject to that process. "Intrastate" offerings, unless they meet an applicable *de minimis* issuer exemption, will also be subject to state registration, and applicable merit review standards. For the small issuer that is either unable or unwilling to proceed under Rule 506 of Regulation D, the challenge of individual state compliance with available exemptions, or regular qualification and merit review procedures, thus remains.ⁿ²¹

To be sure, for offerings of all securities that remain subject to Blue Sky registration and qualification requirements there are mechanisms in place to smooth the qualification process. An SEC study undertaken in 1997 found that states have taken a number of significant actions to increase uniformity in regulating offerings of such securities that are not NSMIA "covered securities." Examples noted by the SEC include: (1) a uniform registration statement for offerings exempt at the federal level and a regional state review program for this form; and (2) statements of policy on several matters that enhance uniformity in review among the states.ⁿ²² These mechanisms do nothing for the small business issuer that seeks to avoid any interdiction by states in capital formation, but they are meaningful for multi-state smaller offerings that remain subject to registration requirements, and for which greater speed and uniformity is needed.ⁿ²³ Thus, while it is true that after NSMIA merit regulation in the broadest sense may be seen as a thing of the past, for small business capital formation in particular, it is still an absolutely relevant consideration. Merit review standards or guidelines have, for the most part, not been changed to accommodate small issuers, and it is essential therefore that they be understood and appreciated in advance so that an offering can be structured at the outset so as to minimize the burden and cost that the qualification process will entail in those states where merit review is a part of the regulatory process.

In sum, the relevance of state merit regulation after NSMIA is confined primarily, but importantly, to small business offerings undertaken outside of Rule 506 of Regulation D under the federal Securities Act. Nevertheless, the continued authority for merit regulation of securities offerings that are not excluded by so-called "marketplace preemption," that is, the offer and sale of securities that are not eligible for listing in a NSMIA covered exchange or market, is meaningful and encompasses a broader set of offerings that are undertaken pursuant to federal registration, which may or may not be registered by coordination at the state level, but which are subject to merit review in any event. It is also true that all federally exempt intrastate offerings are subject to state merit regulation, and that certain municipal securities offered in the state where the issuer is located may also be subject to merit regulation, although in most instances a state exemption would be available depending upon the particular type of security involved.

FOOTNOTES:

(n1)Footnote 1. In its 1986 "Report on State Merit Regulation of Securities Offerings," 41 *Bus. Lawyer* 785, 795 (May 1986), an Ad Hoc Subcommittee of the ABA State Regulation of Securities Committee offered, in response to the question what is merit regulation?, the following: There is no accepted definition of merit regulation. It has been variously defined as "a composite of substantive standards" as a "discretionary power" allowing the administrator "to pass on the investment merits of an issue of securities proposed to be offered to the public" as a device "which attempts to lessen the investment risks for investors in newly promoted firms" and as a "quality of issue assessment ... based on a comparison of regulatory standards to the corresponding values of the issue."

The Ad Hoc Subcommittee Report is referenced throughout this chapter as the "ABA Report."

(n2)Footnote 2. 2002 Unif. Sec. Act § 306(a)(7)(A). Two additional, but optional, provisions in section 306 empower the administrator to act if the offering has been or would be made with unreasonable amounts of underwriters' and sellers' commissions or other unreasonable compensation; or if the offering is being made on terms that are unfair, unjust, or inequitable. *See* 2002 Unif. Sec. Act. §§ 306 (a)(7)(B)-(C). These standards built into the 2002 Uniform Act and state Blue Sky laws generally, are discussed further in § 6.03[2].

(n3)Footnote 3. From the earliest days, the purpose of Blue Sky laws was seen as "to protect the public against imposition of unsubstantial schemes and the securities based upon them." *Merrick v. N. W. Halsey & Co.*, 242 U.S. 568, 61 L. Ed. 498, 37 S. Ct. 227 (1917).

(n4)Footnote 4. *See* ABA Report, *41 Bus. Lawyer* at 829.

By rule, Tennessee defines baseline merit review in terms incorporating modern financial economic principles, as follows:

All securities covered by this rule shall be offered upon such terms and conditions that the potential rewards to the investors and to the promoter or issuer of the securities bear a reasonable relation to the risks assumed by each. Tenn. Rule 0780-4-2-.06, 3.

(n5)Footnote 5. *ABA Report*, *41 Bus. Lawyer* at 788-89.

(n6)Footnote 6. *See* 1 Louis Loss & Joel Seligman, *Securities Regulation* 112 (3d ed. 1998).

Those identified as "traditional" states include:

Arizona: Ariz. Rev. Stat. §§ 44-1921(3),(4)

Arkansas: Ark. Code Ann. § 23-42-405(a)(2)(E)(ii)

California: Cal. Corp. Code § 25,140(a)(2)

Colorado: Col. Sec. Act § 11-51-306(b)

Florida: Fla. Stats. § 517.111(l)

Iowa: Code of Iowa § 502.306(1)(g)-(h)

Kansas: Kan. Stat. Ann. §§ 17-12a306

Maine: Maine Rev. Stat. Ann. § 16306(G)

Michigan: Mich. Comp. Laws § 451.706(a)(5)

Minnesota: Minn. Stat. § 80A.13(l)(6)

Missouri: Mo. Rev. Stat. §§ 409.3-306(a)(7)

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Nebraska: Rev. Stat. Neb. § 8-1109.01(2)

New Hampshire: N.H. Rev. Stat. Ann. § 421-B16(I)(b)(7)

North Dakota: N.D. Cent. Code § 10-04-09(1)

Ohio: Ohio Rev. Code § 1707.13

Oregon: Or. Rev. Stat. §§ 59.105(2)(a), (b)

Texas: Vernon's Tex. Civ. Stats. § 581-23(A)

Virginia: Code of Va. § 13.1-513(a)(5)

(n7)Footnote 7. Md. Code Ann. § 11-504.

(n8)Footnote 8. *Id.*, § 11-511.

(n9)Footnote 9. *Id.*, § 11-511(5).

(n10)Footnote 10. Examples of other disclosure jurisdictions include Connecticut, Delaware, Illinois, New Hampshire, North Carolina, and Wisconsin.

Wisconsin is an example of the contemporary shift among states away from merit regulation. Effective January 1, 1997, Wisconsin repealed its entire array of merit standards, in favor of a disclosure-based system for registration by qualification. *See* Wis. Admin. Code Ch. DFI-Sec. 3. Note, however, that a number of published fairness standards which have included within them disclosure aspects have been specifically adopted in Wisconsin for use in evaluating the adequacy of disclosure. Wisconsin formally adopted several Statements of Policy promulgated by the North American Securities Administrators Association (NASAA) to the extent they require disclosures regarding certain matters, but not as setting any standards on which to assess the merits of the offering.

(n11)Footnote 11. The critical element in the availability of the marketplace exemption was satisfaction of marketplace *listing* requirements, which are themselves qualitative standards. In 1990, NASAA, the principal national securities exchanges and NASD (which was at the time the operator of the Nasdaq Stock Market) entered into a Memorandum of Understanding providing for a common set of minimum listing standards. *See* "Memorandum of Understanding: The Uniform Model Marketplace Exemption from State Securities Exemption Requirements," *NASAA Reports (CCH)* P 2351, at 1391 (July 1990).

(n12)Footnote 12. Regulation D is comprised of Rules 504-506 under the Securities Act of 1933; *see* 17 C.F.R. §§ 230.504-.506. These provisions, and the entire set of federal exemptions for limited or private offerings, are discussed in detail in Chapter 8 .

(n13)Footnote 13. *See, e.g., Cal. Corp. Code § 25140(d)* (The price at which a security is offered shall not be considered unfair whenever the security is the subject of a firm commitment underwriting, publicly offered for cash, pursuant to a registration statement filed under the Securities Act of 1933).

Merit safe harbors are considered in more detail in § 6.03 .

(n14)Footnote 14. The uniform "Small Corporate Offering Registration" (SCOR), and the "Coordinated Equity Review" (CER) program for offerings that are also the subject of a federal registration, are considered further in § 6.03.

(n15)Footnote 15. As addressed throughout this Treatise, section 18(b) of the Securities Act of 1933, added by NSMIA, establishes four types of "covered securities" as to which state merit regulatory is preempted:

- (1) Securities listed or authorized for listing on the New York Stock Exchange (NYSE); the American Stock Exchange (Amex); the Nasdaq National Market System (NMS) tier; or other securities exchanges registered with the SEC (or any tier market) if the SEC determines by rule that their listing standards are substantially similar to those of the NYSE, Amex, or Nasdaq NMS; and any security of the same issuer that is equal in seniority or senior to any security listed on the NYSE, Amex, or Nasdaq NMS;
- (2) Securities issued by an investment company registered with the SEC under the Investment Company Act of 1940;
- (3) Securities offered or sold to "qualified purchasers," as that term may be defined by the SEC; and
- (4) Securities issued under specified exemptions in the Securities Act of 1933, as follows: (A) Sections 4(1) (transactions by persons other than an issuer, underwriter, or dealer); and 4(3) (dealers after specified periods of time in relation to an offering), when the issuer is reporting to the SEC under sections 13 or 15(d) of the Act; (B) Section 4(4) (unsolicited brokerage transactions); (C) Securities offered and sold pursuant to Securities Act exemptions in Section 3(a), with the exception of the charitable issuer exemption in section 3(a)(4), the exchange exemption in Section 3(a)(10), the intrastate exemption in Section 3(a)(11), and the municipal securities exemption in Section 3(a)(2), but only as to the offer or sale of such a security in the state in which the issuer is located; and (D) Securities issued in compliance with SEC rules under Section 4(2) of the Securities Act of 1933.

(n16)Footnote 16. In the wake of NSMIA, the North American Securities Administrators Association (NASAA) identified the securities remaining open to merit regulation under Blue Sky laws as follows:

- (1) Certain equity securities registered with the SEC and the states;
- (2) Smaller offerings generally exempt from federal registration but registered with the states;
- (3) A narrow "band" of often illiquid securities registered with both the SEC and the states; and
- (4) Securities offered in certain types of non-public offerings exempt from SEC and state registration.

NASAA "Submission for Mandated Study Under NSMIA on the Uniformity of State Regulatory Requirements for Securities and Securities Transactions That Are Not Covered Securities," *CCH NASAA Reports* P13,047, at 13,118 (Aug. 22, 1997) (hereinafter the "NASAA Uniformity Submission").

(n17)Footnote 17. The Nasdaq Capital Market tier is the former Nasdaq "SmallCap" market. Also, the former top tier of the Nasdaq Stock Market--the National Market System (NMS) tier--is today divided into two top tiers, the Nasdaq Global Select Market and the Nasdaq Global Market. Listing standards for Nasdaq Global Market securities are equivalent to those formerly applied to NMS securities. For Global Select securities, the standards are higher. Both of the new top tiers of Nasdaq will satisfy the NMS requirement for covered security status under NSMIA.

(n18)Footnote 18. *Id.*

Substantive review standards cited by NASAA as being commonly applied in regard to these offerings to prevent the promotion of fraudulent or inequitable issues are merit standards going to: (1) excessive underwriting commissions and

offering expenses; (2) "cheap stock"; (3) the inclusion of unequal voting rights; (4) loans and affiliate transactions; and (5) the presence of excessive options and warrants.

(n19)Footnote 19. "Covered security" status for purposes of NSMIA preemption of state registration and qualification requirements that would otherwise be applicable to an offering made under Rule 506 may depend upon the actual validity of the Rule 506 exemption rather than simply invoking or claiming it for an offering. In *Buist v. Time Domain Corp.*, 926 So. 2d 290 (Ala. 2005), the Alabama Supreme Court held that an offering made pursuant to Rule 506 of Regulation D must actually comply with Rule 506 conditions in order for the securities to constitute NSMIA "covered securities." The Court rejected the assertion that as long as one offers and sells securities *in reliance upon* Rule 506, the securities are covered securities and NSMIA preemption applies. The same conclusion was reached in *Grubka v. WebAccess Int'l, Inc.*, 445 F. Supp. 2d 1259 (D. Colo. 2006), and *Blue Flame Energy Corp. v. Ohio Dep't of Commerce, Div. of Sec.*, 2006 Ohio 6892 (Ct. App. 2006), in which the courts held that NSMIA expressly preempts state laws from regulating the issuance and sale of those securities that are actually exempt under Rule 506.

After, NSMIA states retain the authority to require notice filings and fee payments for Rule 506 offerings. Thus, armed with the fundamental requirement for actual compliance with the requirements of Rule 506, a state administrator may examine Rule 506 notice filings and the offering for compliance, exercising full regulatory authority, *i.e.*, finding a registration violation in the event the Rule 506 exemption is determined by the administrator to be invalid.

(n20)Footnote 20. As a practical matter, a small business issuer offering securities in reliance upon Rule 504 of Regulation D would expect to comply with applicable state registration and qualification requirements in order that the securities being offered and sold would not be deemed to be "restricted" securities as a matter of the federal securities laws. SEC Rule 504 provides that securities sold pursuant to the Rule are restricted, and thus subject to certain resale limitations *unless* they were acquired in a state-registered offering or state accredited investor offering. *See* Rule 504(b)(1), 17 C.F.R. § 230.504(b)(1); Rule 502(d), 17 C.F.R. § 230.502(d). "Restricted" securities are subject to resale limitations imposed under SEC Rule 144(k) under the Securities Act of 1933, 17 C.F.R. § 230.144(k), which permits resales free of all restrictions by non-affiliates of the issuer after a two-year holding period.

(n21)Footnote 21. *See also* Rutherford B. Campbell, Jr., "The Impact of NSMIA on Small Issuers," 53 *Bus. Lawyer* 575 (Feb. 1998).

(n22)Footnote 22. "Report on the Uniformity of State Regulatory Requirements for Offerings of Securities That Are Not 'Covered Securities' " (SEC Oct. 1997).

(n23)Footnote 23. For multi-state offerings of non-covered securities, "Coordinated Equity Review" (CER or "CR-EQUITY") provides a uniform procedure designed to coordinate the registration process among states in which the issuer seeks to sell its securities. In addition to creating uniformity in review standards, CER is designed to expedite the registration process, saving the issuer time and money. CER is discussed fully in § 6.03.



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CHAPTER 6 Merit Regulation

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§ 6.02 Merit Regulation: A Process Overview

[1] Generally

States providing for merit regulation authorize administrators to evaluate the quality of securities proposed to be offered, and to prohibit those which are seen as defective. Normally, this process operates under the registration by "qualification" provisions discussed in Chapter 5,ⁿ¹ on the basis of determining what is "fair, just, and equitable" to investors or determining whether the terms of a security or offering will "tend to work a fraud" or whether such terms are "grossly unfair."ⁿ² Mechanically, the process is accomplished by disclosure of information to the administrator in prescribed filings and submissions.ⁿ³ All states have adopted Form U-1 as the uniform form of registration statement in this process, and most have likewise adopted Form U-7 for use by qualifying SCOR or other small business issuer offerings. Form U-7 is a simplified question and answer format submission that also serves as the structured disclosure document for dissemination to prospective investors. Once submitted to the administrator, the Blue Sky law in each state prescribes the timing and conditions for effectiveness.ⁿ⁴ For an offering subject to merit review, the timing will normally be adjusted by request of the issuer to provide sufficient time for completion of the process. Failure of the issuer to make such a request would, in most cases, lead to an order by the administrator delaying effectiveness.

Among the states that engage in merit regulation of securities offerings, the fairness objective and focus of administrators in merit reviews are common threads. Common areas of focus by state administrators in the merit review process include:

- Offering price
- Promoter or "cheap" stock
- Promoters' equity investment
- Escrow or restrictions on cheap stock
- Impound of funds
- Options and warrants

- Underwriting expenses and commissions
- Offering expenses generally
- Capital structure of the issuer
- Rights of investors
- Conflicts of interest
- Preferred dividends and debt coverage
- Sinking fund provisions
- Indentures and protective covenants generally
- Issuer's plan of business
- Issuer's financial condition.

Today, states engaging in merit review of securities offerings apply policy statements, or guidelines, promulgated and published by the North American Securities Administrators Association, Inc. (NASAA). The NASAA Statements of Policy provide a more or less common anchor for merit assessment of a wide variety of offerings and particular considerations attendant to them. NASAA Statements of Policy range from the broad guideline regarding "unsound financial condition,"ⁿ⁵ to quite specific, detailed prescriptions for particular types of offerings.ⁿ⁶

Ideally, the publication of NASAA policies means that issuers and intermediaries have a common frame of reference, and approach the qualification process with a significantly higher degree of confidence. NASAA Statements of Policy and guidelines have been adopted, although in varying versions, in a large number of states.ⁿ⁷ The effort to achieve uniformity and predictability in merit review standards through the NASAA statements of policy and guidelines has achieved some degree of success in such areas as cheap stock, dilution, promoters' equity participation, options and warrants, offering expenses and other areas of common concern that principally impact companies in the promotional or developmental stage, and their promoters.ⁿ⁸ Nevertheless, the guidelines do supply comprehensive criteria with which to evaluate particular types of offerings, as for example "real estate programs," or "direct participation programs" in general, and on which to make broader qualitative judgments on common matters such as underwriting expenses, disclosure guidelines, or dishonest or unethical business practices. Merit standards in all of these areas, whether grounded in NASAA policies or independently prescribed in particular states, are more specifically considered in § 6.02[2].

[2] Merit Standards

For offerings that remain subject to merit regulation in the wake of NSMIA, reviewing states continue to carry out the process through the application of merit standards or guidelines. In most cases, as with states that have adopted the original Uniform Securities Act, the starting point is the general statement of authority to deny, suspend, or revoke a registration statement on fraud or fairness grounds, and the particular statutory grounds that are provided. In the exercise and extension of that authority, states then proceed in the application of particular merit standards. Growing acceptance of the 2002 Uniform Securities Act has not fundamentally altered the sources and use of state merit standards. The 2002 Uniform Act, however, eliminates most of the specific statutory standards and powers of the original Uniform Act, leaving state authority to be defined in terms of a broadly stated fraud standard. This section examines the principal sets

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of standards available or in use in those circumstances in which state authority remains intact.ⁿ⁹ These standards derive from the Uniform Securities Act, the 2002 Uniform Securities Act, NASAA Statements of Policy, or the standards of individual states historically applied. Each category is considered further below.

[a] The Uniform Securities Act The original 1956 version of the Uniform Securities Act is the basis for a majority of state Blue Sky laws. In Uniform Act states that have preserved merit regulation, the specific standards set out in the Act itself are the starting point from which other particular merit standards or guidelines may be derived or added. Each of these statutory standards is considered further below.

[i] Escrow of Cheap Stock. Under Uniform Act § 305(g)(1), securities registrations by qualification or coordination may require the escrow of "cheap stock"--securities issued up to three years prior to the registration where a substantial difference exists between the insider or promoter price and that paid by the public. The section provides a similar requirement where the insider or promoter paid for securities with consideration other than cash. The conditions of the escrow are left to the discretion of the administrator.

[ii] Impound of Proceeds. Under Uniform Act § 305(g)(2), the proceeds from the sale of securities registered by qualification or notification may be impounded by the administrator until a specified amount of funding is obtained from the sale of the securities registered. The conditions of the impound are left to the discretion of the administrator.

[iii] Illegal Business. Under Uniform Act § 306(a)(D), the administrator may prevent the sale of securities when it is determined that the enterprise, or method of business of the issuer is illegal where it is to be performed.

[iv] Commissions and Expenses. Under Uniform Act § 306(a)(F), the administrator can prevent the offering of securities where it is determined that the commissions and expenses associated with the offering are excessive or unreasonable. Such expenses are defined as underwriter and seller discounts, commissions, promoters profits or participation, and options.

[v] Options. The issuance of unreasonable amounts of options may prevent the offering under Uniform Act § 306(a)(F).

[vi] Advertising and Sales Material. Uniform Act § 403 requires the filing of all advertising and sales material. That section, when combined with the authority of the administrator under Uniform Act § 412(a),ⁿ¹⁰ allows the prevention of securities sales based on the material utilized. The administrator is afforded, therefore, the ability to pass judgment on these materials.

[b] The 2002 Uniform Securities Act

The 2002 Uniform Securities Act has been adopted by several states and is under consideration in several others. It addresses state Blue Sky regulatory authority after NSMIA, and is designed to harmonize state investor protection goal with the national character of financial and capital markets that gave birth to the NSMIA federal "covered security." To that end, the 2002 Uniform Act retains only two merit regulation provisions.ⁿ¹¹ Both are prescribed as part of the administrator's authority to deny, suspend, or revoke the effectiveness of a registration statement. First, section 306(a)(7)(A) permits the exercise of merit regulatory authority if "the offering will work or tend to work a fraud upon purchasers or would so operate."ⁿ¹² Secondly, the administrator may deny effectiveness if:ⁿ¹³

[T]he offering has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, or promoters' profits or participations or unreasonable amounts or kinds of options.

Section 306 of the 2002 Uniform Act also includes a bracketed, optional, merit regulatory provision where "the offering is being made on terms that are unfair, unjust, or inequitable."ⁿ¹⁴

Although these general merit review provisions are included in the 2002 Uniform Act, the Act is also clear that to the extent practicable, an administrator must, by rules or orders, publish standards that provide notice of conduct that violates the generally stated section 306(a)(7) standards.ⁿ¹⁵ In all of this there is, of course, the over-arching objective of the 2002 Uniform Act to promote uniformity and cooperation among state, federal, and self-regulatory organizations.ⁿ¹⁶ Well before NSMIA, Statements of Policy or Guidelines formulated by the North American Securities Administrators Association (NASAA) were developed for this purpose, and have worked well to promote not only uniformity but also to provide fair and objective notice of the standards to which issuers will be held. The NASAA Statements of Policy and Guidelines (most often referred to as the NASAA "Guidelines") thus continue to function in response to the mandate for notice and objectivity in the 2002 Uniform Act, as well as continuing to play a critical role in the continuing merit regulatory processes in states operating under prior versions of the Uniform Act or independently of it. The NASAA Guidelines are discussed in detail below.

[c] NASAA Statements of Policy: General Application NASAA--the North American Securities Administrators Association--was founded in 1918 as the National Association of Securities Administrators. The name of the organization was changed to the North American Securities Administrators Association (NASAA) in 1957. Today, NASAA is an organization of state securities regulators from the United States, Canada, Mexico, Puerto Rico, and the U.S. Virgin Islands.

NASAA adopts "Statements of Policy," which are defined as:ⁿ¹⁷

Statements of general purpose and prospective applicability to implement, interpret or prescribe model laws, regulations, forms, or policies pertaining to investor protection and securities regulation, including statements regarding the registration of securities, registration and business practices of securities industry and investment advisory licensees, and enforcement of anti-fraud laws, for implementation among jurisdictions of the North American Securities Administrators, Inc.

NASAA policies, or "guidelines," do not become policies of the states until, and unless, they are adopted by individual states as rules or regulations. As will be seen below, NASAA policies may be adopted selectively, or not at all.

In 1997, NASAA undertook to promote uniformity and facilitate implementation of the Coordinated Equity Review Program (CER)ⁿ¹⁸ by revising its Statements of Policy that have general application to NSMIA non-covered equity securities offerings, and adding three new ones. The policies of general application to equity offerings are as follows:

[i] Promotional Shares. The revised NASAA policy authorizes the escrow, or "lock-in," of some or all promotional shares as a condition for qualification of the offering. Promotional shares are those issued to a "promoter," which by definition, includes officers and directors, and others who receive five percent or more of the securities as consideration for services and/or property. The extent of the escrow or lock-in arrangement that may be required is determined by a prescribed calculation, as is the extent of any release of shares from the escrow or lock-in.ⁿ¹⁹

[ii] Promoters' Equity Investment. This revised NASAA policy mandates specific, and significant, percentage components of promoter's investment in the "aggregate public offering" price of the securities. The policy requires that the promoters' investment must constitute at least ten percent of the first \$1 million of the aggregate public offering, seven percent of the next \$500,000, five percent of the next \$500,000, and two and one-half percent of the balance over \$2 million.ⁿ²⁰

[iii] Options and Warrants. This revised NASAA policy limits the amount of options and warrants issued or reserved for issuance within one year following the offering generally to 15% of shares of the issuer outstanding plus the shares being offered. Exclusions permit some degree of flexibility in the calculation of the numbers of options and warrants being issued, but the limitation is otherwise straightforward.ⁿ²¹

[iv] Impoundment of Proceeds. The revised NASAA policy covering impoundment of proceeds declares that, if determined necessary by an administrator, the entire proceeds of an offering may be impounded in an escrow or trust account under the terms of an "Impoundment Agreement." The agreement controls the terms and conditions of the impoundment, most importantly, including the release of the impounded proceeds to the issuer. The policy statement does not prescribe any standards or conditions for determining the necessity of an impoundment.ⁿ²²

[v] Unsound Financial Condition. This newly adopted policy statement grants authority to an administrator to deny qualification where the financial statements of an issuer have a "going concern" qualification by the auditor, or where certain other indicia of an unsound condition are present. The latter include an accumulated deficit, negative shareholders equity, an inability to meet current obligations, and negative cash flow. There are no other standards prescribed. However, the policy statement does include mechanisms, including specific disclosure requirements, for permitting qualification upon satisfaction of the administrator that conditions will improve.ⁿ²³

[vi] Underwriting and Selling Expenses. This revised Statement of Policy imposes limits on underwriting commissions, options, warrants, and selling expenses generally. Underwriting expenses may not exceed seventeen percent (17%) of the gross proceeds of the offering. The total of direct and indirect selling expenses are limited to twenty percent (20%) of the gross proceeds of the offering. The latter includes some, but not all, of the items that would comprise underwriting expenses, thus providing some flexibility in making the percentage calculations. The policy statement prescribes calculations for warrants and options in determining the amount of underwriting expenses, and sets certain further conditions on the use of options and warrants in regard to underwriters.ⁿ²⁴

[vii] Preferred Stock. This revised Statement of Policy permits an offering of preferred stock to be disallowed when it is determined by the administrator that the issuer has insufficient earnings to meet its fixed charges and preferred stock dividends. Alternative "adjusted net earnings" or "cash analysis" methodologies are prescribed for making the determination. The policy is expressly stated as not being applicable to offerings of convertible preferred stock having certain preference characteristics that make it superior in right to payment of dividends, interest, and liquidation proceeds to other convertible debt or preferred stock held by promoters.ⁿ²⁵

[viii] Loans and Affiliated Transactions. With this Statement of Policy, administrators are empowered to disallow an offering in circumstances in which there will be loans outstanding to the issuer or its affiliates after the offering, or where the issuer intends to make loans or loan guarantees on behalf of promoters. Provision is made for permitting certain loans outstanding at the time of the offering that represent advances for travel and other ordinary business and operating expenses. And certain issuers whose primary business is making loans are also permitted to have loans outstanding where conditions are met such that the existence of such loans in the ordinary course of a commercial lending business is apparent. Otherwise, subject to waiver authority by the administrator, all loans existing at the time of registration must be repaid.ⁿ²⁶

[ix] Specificity in Use of Proceeds. This Statement of Policy imposes particular disclosure requirements in regard to the issuer's use of proceeds of an offering. It is not a qualitative standard as such, but rather, mandates the manner and extent of disclosure as a condition to qualification of an offering. The policy statement requires that the prospectus contain a tabular presentation of estimated cash proceeds of the offering, the purposes for which the proceeds will be used, the amount to be used for each purpose, and the order of priority in usage. The issuer must also include information explaining other sources of funds for the same purposes and the relative role of offering proceeds versus other sources in regard to those purposes.

Although the use of proceeds in the Statement of Policy is a disclosure provision, it also prescribes a qualitative standard in stating that an issuer normally may not reserve more than fifteen percent (15%) of the proceeds of an offering for working capital or general corporate purposes. If the issuer requires greater flexibility in the use of proceeds, the Statement of Policy mandates further disclosure.ⁿ²⁷

[x] Unequal Voting Rights. Although it was not one revised or newly adopted by NASAA in conjunction with

implementation of CER, the Statement of Policy regarding unequal voting rights is one of general application to corporate equity offerings. Under it, an administrator may deny qualification if the shares being offered have less than equal voting rights, unless they are given preferential treatment as to dividends and liquidation or the disparity in voting rights is justified to the satisfaction of the administrator. If there is to be a disparity in voting rights, the Statement of Policy provides for prominent disclosure in the issuer's offering circular or prospectus.ⁿ²⁸

[xi] Corporate Securities Definitions. As noted earlier, this Statement of Policy supplies the common definitions for use in all of the NASAA policies of general application. The definitions policy statement expressly provides for its application to each of the Statements of Policy discussed above. Of particular significance in the definitions policy statement is the broad definition of "promoter," as well as "promotional shares," "promoters' equity investment," "affiliate," and the earnings definitions that are central to certain of the policy statements.ⁿ²⁹

These are the NASAA Statements of Policy by which participating states in the CER program agree that corporate equity offerings will be reviewed. All of them, however, are also available to non-participating CER states, and for application to offerings not submitted for CER review. However, as with every NASAA Statement of Policy, each of the policies of general application contains the proviso that nothing contained in it shall prevent the securities administrator of a state from applying a different standard.

[d] Particular NASAA Statements of Policy.ⁿ³⁰ NASAA Statements of Policy intended for specific applications are examined in more detail below. Note that in most instances, the contents of particular NASAA Statements of Policy are, by design, referred to in the policy as "guidelines." The distinction indicates that while applications not conforming to the stated standard are disfavored, where good cause is shown, "guidelines" may be modified or waived by the administrator.

[i] Oil and Gas Programs. NASAA guidelines for oil and gas programs, originally adopted in 1976 and last amended in 1991, are generally aimed at programs in the form of limited partnerships.ⁿ³¹ However, they are also intended for application by analogy to programs in other forms.

The guidelines first provide thirty (30) definitions applicable to oil and gas programs. They then impose sponsor requirements in the areas of experience and net worth, set requirements for tax rulings or opinions, program investment, reports, and fiduciary duty. Brokerage commissions are required to be only in cash. Warrants or options to broker/dealers are possible in the case of a firm underwriting. Sales material must be provided to the securities administrator in advance of use.

A number of suitability standards are prescribed for participants. These include standards regarding a purchaser's level of understanding regarding risks and particular characteristics of the offering and the sponsor. Minimum income and net worth standards are prescribed depending upon whether the program is an income or drilling program, and the particular characteristics of each type of program. For example, for drilling programs which do not provide the participant with statutory protection against unlimited liability, each participant must have a minimum net worth of \$225,000 or \$100,000 for the current year and for each of the two previous years. Alternatively, the suitability standard may be satisfied by a participant with minimum net worth in excess of \$1,000,000, or minimum net worth of \$500,000, and minimum annual gross income of \$200,000.

Organization and offering expenses must be reasonable. The total, plus management fees cannot exceed fifteen percent (15%) of the initial subscriptions, and all commissions must be paid in cash. Additional standards are set in the area of sponsor or affiliate compensation. The reimbursement of sponsors and affiliates for program expenses is also addressed as are transactions with affiliates and conflicts of interest. The rights and obligations of participants are covered in the policy statement, as are standards regarding \$1,000,000 minimum program capital and minimum disclosure requirements.

[ii] Church Bonds.ⁿ³² The current NASAA guidelines for offerings of church bonds were adopted in 2002. Although church bonds are generally exempt from federal registration, that is not the case in most states, and a considerable number of states have adopted the NASAA policy, or similar policy, regarding these issues.ⁿ³³

The standards are intended to be useful in determining the ability of the individual church issuing bonds to repay the bonds, and to insure full and adequate disclosure. The guidelines prescribe offering circular and trust indenture requirements. In addition, the total debt of the church at completion of the offering is not to exceed four times the church revenues of the last 12 months. These revenues are exclusive of nonrecurring bequests and other extraordinary items.

[iii] Real Estate Investment Trusts. The current NASAA guidelines for real estate investment trusts were adopted in 1993. These complex guidelines spell out requirements for REIT sponsors, advisors, trustees, and affiliates--all in the context of 31 defined terms. Real estate investment trusts must have no less than three trustees, each elected by shareholders, with a term not greater than one year. Rights and obligations of shareholders generally are prescribed, with specific attention to governance and a range of shareholder protective provisions that include special protections in "roll up" situations. Indeed, this NASAA Statement of Policy involves principally the imposition of a governance structure rather than a measure of the fairness of particular terms of an offering. It is unique among the NASAA Statements of Policy in that regard.

The policy statement provides that the trustees are obligated to evaluate the performance of advisors prior to entering into or renewing advisory contracts. The compensation to be provided for advisory services is also prescribed as a trustee responsibility. Fees, compensation, and expenses of the REIT generally are addressed, with limits being imposed. Total operating expenses, for example, shall (in the absence of a satisfactory showing to the contrary), be considered excessive if they exceed, in any fiscal year, the greater of two percent of average invested assets or 25% of net income for such year. The policy imposes a fiduciary duty on trustees to limit expenses in this manner. If such fees and expenses exceed the set limits, shareholders must be informed within 60 days of the end of the fiscal quarter concerned. Disclosures required quarterly are the ratio of the cost of raising capital to the capital raised, and the aggregate amount of advisory fees and the aggregate amount of other fees paid to the advisor and advisor affiliates.

There are various investment restrictions and conditions. Meaningful suitability criteria for REIT shareholders are prescribed, with the burden first placed upon sponsors to impose income and net worth standards that are reasonable in relation to the type of REIT and the risks involved. Minimum standards are prescribed, and the affirmative responsibility imposed upon sponsors and every person selling shares on behalf of the sponsor to make a reasonable effort to assure that every purchaser meets suitability criteria and understands the nature of the investment and its particular risks.

Finally, there are specific prescriptions in regard to disclosure and marketing. The policy statement focuses particularly upon the use of forecasts and projections in REIT offerings, placing controls on both the use and content of such presentations in offering materials.

[iv] Variable Annuities Companies and Trusts. The NASAA policy statement for Variable Annuities Companies and Trusts was repealed in October 2004.

[v] Debt Securities. Under this Statement of Policy, a public offering of debt securities may be disallowed if the issuer's "adjusted cash flow"ⁿ³⁴ for the last fiscal year or its average adjusted cash flow for the last three fiscal years prior to the offering was insufficient to cover its fixed charges, meet its debt obligations as they become due, and service the debt securities being offered. The administrator is allowed considerable flexibility in application of the policy, such that in his or her discretion, the basic policy need not be applied to offerings of convertible debt securities that are superior in right of payment of interest and liquidation proceeds to any convertible debt that is held by promoters.

Notwithstanding flexibility in regard to convertible debt offerings, public offerings of debt securities must be made pursuant to a trust indenture that provides for specified purchaser protections. Also, if the administrator determines that the issuer's cash flow is subject to cyclical fluctuation, sinking fund or redemption requirements may be imposed.

[vi] Asset-Backed Securities. Asset-backed securities are, by NASAA definition, those which provide a stated rate of return to holders, and which are primarily serviced as to both return of investment and return on investment by the cash flow from certain "eligible" assets. Eligible assets are, generally, financial or commercial assets that are (a) homogeneous in nature; (b) subject to reasonably objective valuation; (c) investment grade, or if not, then self-liquidating or easily liquidated; and (d) if not investment grade, capable of generating a predictable cash flow. The NASAA guidelines, adopted in 1995 for offerings of these securities, set requirements for sponsors of such offerings in regard to experience and financial condition, and other requirements aimed at establishing a reasonable likelihood that a stated rate of return will be realized. Provisions for credit enhancement, portfolio characteristics, and particular disclosures in the prospectus focus on the eligible assets backing such securities.

Further provisions of the guidelines impose requirements on issuers, servicers, and trustees, and also impose specific suitability requirements for security holders. The latter entails a mandated affirmative determination by the sponsor. The offering process itself is addressed further with disclosure requirements relating to fees, compensation, and expenses to conflicts of interest, and to the types and content of performance representations contained in the prospectus.

[vii] Commodity Pool Programs. The current NASAA guidelines for commodity pool programs were adopted in 1990. The intended focus of the guidelines is on commodity pool limited partnerships or analogous corporate offerings of securities rather than the technical aspects of futures trading. The guidelines make clear that they are not intended to supplant any existing or future rules of the Commodity Futures Trading Commission or the National Futures Association (NFA).

The guidelines are extensive and, in general, prescribe standards for sponsors in terms of experience, financial condition, program investment, reporting requirements, tax rulings and opinions, and liabilities. Suitability standards are prescribed for participants. The guidelines specify constraints on fees, compensation, and expenses. The rights and obligations of participants are prescribed in terms of voting rights, information access, liability, and rights to program transferability. There are significant suitability standards as well. Minimum program capital requirements, disclosure standards, and marketing standards are provided.

[viii] Cattle Feeding Programs. NASAA guidelines for cattle-feeding programs were adopted in 1980. The guidelines specify standards for sponsor experience, capitalization, compensation, reporting requirements, and a variety of other areas in the operational area. Standards regarding the plan of distribution, the prospectus, and disclosure are also provided.

[ix] Real Estate Programs. The current NASAA guidelines for real estate programs were adopted in 1991. They are expressly aimed at real estate limited partnerships, but may be applied by analogy to other forms of real estate programs.ⁿ³⁵ The guidelines include key definitions, and constitute the most complex of NASAA Statements of Policy. They specify requirements for sponsors regarding experience, net worth, requirements, and liability. Participant suitability requirements are also detailed. There is considerable attention paid to fees, compensation and expenses generally, and those associated with the investment in properties in particular. Sponsor investment standards are provided as well as standards in the conflict of interest and program investments areas. The guidelines include a Real Estate Guidelines Cross Reference Sheet to be completed and filed with registrations.

[x] Equipment Programs. The current version of these NASAA guidelines promulgated for equipment programs was adopted in 1986 and subsequently amended 1991. The standards apply to public programs designed to acquire and own and then either lease or operate any type of equipment. The guidelines are not intended for use in programs where equipment ownership or operation is incidental to the program business.

Requirements regarding experience, net worth, tax rulings and opinions, reporting obligations, and liability of the sponsor are provided as are the participant suitability standards. Standards for compensation and expenses, conflicts of interest and investment restrictions, the rights and obligations of participants, and disclosure requirements, are also provided.

[xi] Health Care Facility Offerings. The guidelines for non-profit health care facility offerings were adopted in 1985. Under the guidelines, an issuer must prove substantial compliance with certain principal standards, including:

- (1) the financial ability to cover the debt service requirements for all debt securities already outstanding, plus those proposed to be offered, based on operations in the current fiscal year and certain expenses during the three years prior to the offering;
- (2) the existence of a feasibility study undertaken in connection with a new health care facility;
- (3) issuance of the bonds under a trust indenture meeting certain minimum standards;
- (4) acquisition of a fixed-price contract and completion bond or another "acceptance form of assurance of performance"; and
- (5) provision of financial statements for the last three fiscal years, including an audited statement for the most recent fiscal year, to investors.

[xii] Mortgage Programs.

NASAA Mortgage Program Guidelines were adopted in 1996 and apply to registrations of direct participation mortgage programs in the form of limited partnerships, trusts, limited liability companies, and limited liability partnerships. The Mortgage Program guidelines are a counterpart to the Real Estate Programs policy statement. They impose specific requirements on sponsors regarding experience and financial condition, and in turn require program sponsors to establish minimum income and net worth standards for persons who purchase program interests. Fees, compensation, and expenses associated with a program must be reasonable, and the guidelines also deal specifically with investments in mortgages, conflicts of interest and investment restrictions, the rights and obligations of participants, and disclosure and marketing requirements.

[xiii] Viatical Investments.

NASAA takes the position that viatical investments, which are commonly known as viatical, senior, or life settlement contracts are securities, and are subject to registration under state Blue Sky laws. The NASAA Guidelines regarding viatical investments impose requirements on viatical issuers relating to experience, financial condition, and financial statements. The suitability of participants is also addressed. Additionally, there are escrow requirements, specific pre- and post-sale structured disclosure requirements, and requirements relating to record retention.

[e] NASAA Omnibus Guidelines. NASAA "omnibus" guidelines were adopted for application to the registration and qualification of offerings of programsⁿ³⁶ for which policy statements have not been adopted. The guidelines set requirements for sponsors of covered programs, establish suitability requirements for participants, and address other matters of common concern. These include fees, compensation and expenses, conflicts of interest, investment restrictions, rights and obligations of participants, disclosure, marketing, and other miscellaneous aspects of such offerings.ⁿ³⁷

The omnibus guidelines have been formally adopted by a handful of states.ⁿ³⁸ Their application is primarily to offerings of limited partnership interests in programs involving something other than real estate or oil and gas

properties. Many of the basic elements of the Omnibus Guidelines are similar to the elements of the NASAA real estate Statement of Policy, and in practice, the NASAA real estate guidelines were often applied to non-real estate programs. Thus, consistency is still afforded to issuers in those jurisdictions adopting the Omnibus Guidelines.

[f] Chart: NASAA Statements of Policy Adoptions. States formally adopting NASAA Statements of Policy are listed in the following chart. The list presented here includes only those states that have formally adopted particular NASAA Statements or Guidelines in a rule or published statement for application to registrations qualification.ⁿ³⁹ CCH paragraph references are to *CCH Blue Sky Law Reporter*, where both formal and informal adoptions, as for example by confirming letters, may be found.

Chart--NASAA Statements of Policy Adoptions

Policy Statement	State	CCH P	Adopted As
1. Affiliated Transactions and Loans	Alabama	7462	Rule 830-X-4-.21
	Alaska	8434E	Rule 3 AAC 08.190
	Arizona	9526	Rules, Sec. R144116
	Idaho	21,405	Rules, Sec. 005
	Iowa	25,457	Rule 191-50.57(502)
	Massachusetts	31,465	Rule 13.305(A)(1)
	Minnesota	33,499, 33,500	Rule 2875.3060, .3070
	Mississippi	34,429F	Rule 221
	Nebraska	37,424	Rules, Ch. 24
	Nevada	38,453	Rule 90.405(a)
	New Mexico	41,566J	Rule 12.11.9.10
	Ohio	45,709, 45,712	<i>Bulletin</i> 2003:12 & 7/86
	Pennsylvania	48,661	<i>Bulletin</i> 3/83
	Tennessee	54,411	Rule 0780-4-2.06
	Texas	55,590F	Rule 113.16
	Washington	61,582B	Rule 460-16A-205(1)(g)
2. Asset-Backed Securities	Arizona	9526	Rules, Sec. R144116
	Kansas	26,407A	Rule 81-7-2(a)(12)
	Missouri	35,453	Rule Sec. 3052.030
	Ohio	45,733	<i>Bulletin</i> 96:2
	Pennsylvania	48,684TT	Rel. 95-CF-4
	Texas	55,671	Rule 129.1
3. Cattle Feeding Programs	Washington	61,582B	Rule 460-16A-205(1)(q)
	Indiana	24,593A	Sec. 710 IAC 1128
	Kansas	26,407A	Rules, Sec. 8172
	Massachusetts	31,605	Rules Sec. 13.305

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		Minnesota	33,530	Rule 2875.6100
		Missouri	35,468	Sec. 30-52.180
		New Mexico	41,566H	Rule 12.11.9.8
		North Carolina	43,437	Rule 1313(c)
		Tennessee	54,411	Rule 0780-4-2-.06
		Utah	57,406A	Rule R164111(B)
		Virginia	60,435B	Rule 21 VAC 5-30-80(5)
		Washington	61,582B	Rule WAC 46016A-205
		W. Virginia	63,478	Rules Sec. 14.08
		Wyoming	66,435	Rules Sec. 2(f)
4.	Church	Arizona	9526	Rules, Sec. R144116
	Bonds	California	11,929M	Rule 260.140.72.5
		Florida	17,431	69W-400.001
		Indiana	24,593A	Sec. 710 IAC 1128
		Kansas	26,407A; 26,617	Rule 81-7-2(10)
		Michigan	32,560	Rel. 2/19/91, amended 3/24/94
		Missouri	35,507	Rules, Sec. 3054.070
		Nebraska	37,435	Rules, Ch. 35
		Nevada	38,453	Rules, Sec. 90.405
		North Carolina	43,419	Rule 1209
		Pennsylvania	48,686A	Rel. No. 02CF-1
		Tennessee	54,411	Rule 078042.06
		Texas	55,651	Rule 125.1
		Utah	57,406A	Rule R164111(B)
		Virginia	60,435B	Rule 21 VAC 53080
		Washington	61,582B	Rules WAC-16A-205
		W. Virginia	63,479	Sec. 14.09
5.	Church	Arizona	9526	Rules, Sec. R144116
	Extension	Kansas	26,617	Rule Sec. 8172
	Funds/	Missouri	35,507	Rules, Sec. 3054.070
	General	Nebraska	37,436	Rules Ch. 36
	Obligation	Nevada	38,453	Rules Sec. 90.405
	Financing	Pennsylvania	48,684T	Rel. No. 95CF-3
		South Dakota	52,810Z	Rules, Sec. 20:08:07:33
		Tennessee	54,411; 54,412	Rule 078042.06, .07
		Washington	61,582B	Rules WAC-16A-205

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6.	Commodity Pool Programs	Alabama	7462	Rule 830-X-4-.21
		Arizona	9526	Rules, Sec. R144116
		Indiana	24,593A	Sec. 710 IAC 1128
		Iowa	25,457	Rule, Sec. 9150.57
		Kansas	26,407A	Rule 81-7-2(a)(6)
		Massachusetts	31,465	Rule 13.305(a)
		Minnesota	33,534	Rule 2875.8100
		Mississippi	34,429F	Rule 221
		Missouri	35,453	Rule 30-52.180
		Nebraska	37,433	Rules, Ch. 20
		Nevada	38,453	Rules, Sec. 90.405
		New Mexico	41,566H	Rule 12.11.9.8
		North Carolina	43,437	Rule 1313
		Ohio	45,605	<i>Bulletin</i> 10/88
		Pennsylvania	48,673	<i>Bulletin</i> 6/86
		Tennessee	54,411	Rule 0780-4-2-.06
		Washington	61,582B	Rule 460-16A-205(1)(b)
		Wyoming	66,435	Rule Sec. 2(f)(vi)
7.	Corporate Securities Definitions	Idaho	21,405	Rule Sec. 005
		Iowa	25,457	Rule 191-50.57(502)
		Massachusetts	31,465	13.305(A)(3)
		Missouri	35,453	Rule Sec. 3052.030
		Nevada	38,453	Rule Sec. 90.405
		New Mexico	41,566G	Rule 12.11.9.7
		Pennsylvania	48,685H	Rel. No. 97CF-3
		Tennessee	54,411	Rule 0780-4-2-.06
		Texas	55,590D	Rule 113.14
		Washington	61,582B	Rule 460-16A-205(m)
8.	Equipment Programs	Alabama	7462	Rule 830-X-4-.21
		Arizona	9526	Rules, Sec. R144116 11/27/84
		Indiana	24,593A	Rule 710 IAC 1-12-8
		Iowa	25,457	Rule 191-50.57(502)
		Kansas	26,407A	Rule 81-7-2(a)(4)
		Massachusetts	31,465	Rule 13.305(A)(5)
		Michigan	32,589	<i>Update</i> Spr. 1983
		Mississippi	34,429F	Rule 221

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		Missouri	35,453	Rule 30-52.030
		Nebraska	37,420	Rule Ch. 20
		Nevada	38,453	Rule 90.405(a)
		New Mexico	41,566H	Rule 12.11.9.8
		North Carolina	43,437	Rule 1313
		Ohio	45,604	<i>Bulletin 7/86</i>
		Pennsylvania	48,667	Notice 7/29/83
		Tennessee	54,411	Rule 0780-4-3-.06
		Texas	55,590B	Rule 113.12(6)
		Utah	57,406A	Rule R164-11-1(B)
		Washington	61,582B	Rule 460-16A-205(1)(c)
		Wyoming	66,435	Rule Sec. 2(f)(vii) 11/27/84
9.	Health Care	Indiana	24,593A	Rule 710 IAC 1-12-8(5)
	Facility	Nebraska	37,422	Rule Ch. 22
	Offerings	Nevada	38,453	Rule 90.405(a)
		North Carolina	43,437	Rule 1313
		Pennsylvania	48,673A	<i>Bulletin 11/83</i>
		Tennessee	54,411	Rule 0780-4-2-.06
		Washington	61,582B	Rule 460-16A-205(1)(l)
10.	Impound-	Alabama	7451	Rule 830X-4.11
	ment of	Alaska	8432	Rule 3 AAC 08.190
	Proceeds	Arizona	9522, 9523	Rules, Sec. R14-4-112
		Arkansas	10,437	Rule 404.01
		California	12,111-118	Rule 260.141.20-.27
		Colorado	13,106	Rule 11-51-302(5)
		Delaware	15,121	Rule 7321
		Florida	17,479	Rule 69W-700.009
		Hawaii	20,456	Rule 16-38-11.5
		Idaho	21,405	Rules, Sec. 005
		Indiana	24,593B	710 IAC 1-12-9
		Iowa	25,457	Rule 191-50.57(502)
		Kansas	26,407	Rule 81-7-1(e)
		Maryland	30,426	Rule 06
		Massachusetts	31,465	Rule 13.305(A)(7)
		Michigan	32,438	Rule 451.705.3
		Minnesota	33,484-486	Rule 2875.2440
		Missouri	35,460	Rule 30-52.100

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		New Jersey	40,513	Rule 13:47A-10.3
		New Mexico	41,566I	Rule 12.11.9.9
		New York	42,571	Policy Statement 100
		North Carolina	43,438	Rule 1314
		Oregon	47,571	Rule 441-65-150
		Pennsylvania	48,117, 48,469, 49,685H	<i>Bulletin 3/83</i>
		South Carolina	51,514	Rule 13303
		Tennessee	54,411	Rule 0780-4-2-.06
		Texas	55,590E	Rule 113.15
		Utah	57,407	Rule R164-11-1(B)b
		Washington	61,582B	Rule 460-16A-205(1)(n)
		West Virginia	63,483	Rule 14.13
11.	Mortgage Programs	Arizona	9526	Rules, Sec. R144116
		Iowa	25,457	Rule Sec. 19150.57(502)
		Massachusetts	31,465	Rules Sec. 13.305
		Missouri	35,453	Rule Sec. 3052.030
		Nevada	38,453	Rule Sec. 90.405
		New Mexico	41,566H	Rule 12.11.9.8
		Washington	61,582B	Rules WAC-16A-205
12.	Oil and Gas Programs	Alabama	7462	Rule 830X-4.21
		Alaska	8424	3 AAC 08.110
		Arizona	9526	Rules, Sec. R144116
		Indiana	24,593A	Rules, Sec. 710 IAC 1128
		Iowa	25,457	Rules, Sec. 19150.57(502)
		Kansas	26,407A	Rules, Sec. 8172
		Massachusetts	31,465	Rules Sec. 13.305
		Michigan	32,589	<i>Update</i> Spring 1983
		Mississippi	34,429F	Rule 221
		Missouri	35,453	Rule Sec. 30-52.030
		Nebraska	37,433	Rules Ch. 33
		Nevada	38,453	Rules, 90.405
		New Mexico	41,566H	Rule 12.11.9.8
		North Carolina	43,437	Rule 1313(c)
		Pennsylvania	48,667	Notice 7-29-83
		Tennessee	54,411	Rule 0780-4-2-.06
		Texas	55,631	Rule 121.1

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	Utah	57,406A	Rule R164111(B)
	Virginia	60,435B	Rule 21 VAC 5-30-80
	Washington	61,582B	Rule 460-16A-205(1)(d)
	West Virginia	63,477	Sec. 14.07
	Wyoming	66,436	Rule Sec. 2(f)(i)
13. Options and Warrants	Alabama	7462	Rule 830-X-4-.14
			Rule 830-X-4-.15
	Alaska	8428	3 AAC 08.150
	Arizona	9516	Rules, Sec. R144106
			11/27/84
	Florida	17,477	69W-700.007
	Hawaii	20,455	Rules Sec. 163811.4
	Idaho	21,405	Rules, Sec. 005
	Indiana	24,588	Sec. 710 IAC 1-2-22
	Iowa	25,457	Rules, Sec. 19150.57(502)
	Massachusetts	31,465	Rules Sec. 13.305
	Mississippi	34,429F	Rule 221
	Missouri	35,453	Rules, Sec. 3052.030
	Nebraska	37,402	Chapter 10
	Nevada	38,453	Rules, Sec. 90.405
	New Mexico	41,566K	Rule 12.11.9.11.
	North Carolina	43,431	Rule 1307(c)
	Ohio	45,719A	<i>Bulletin</i> 3/93
	Oregon	47,582E	Rule 44185020
	South Carolina	51,516	Rule 13305
	Tennessee	54,411	Rule 0780-4-2-.06
	Texas	55,590G	Rule 113.17
	Utah	57,409	Rule R164121f
	Virginia	60,435B	Rule 21 VAC 53080
	Washington	61,582B	Rules WAC-16A-205
14. Preferred Stock and Debentures	Alabama	7450	Rule 830-X-4-.10
	Alaska	8435	Rule 3 AAC 08.220
	Arizona	9527	Rules, Sec. R144117
	Arkansas	10,437	Rule 404.01
	California	11,853	Rule 260.140.3
	Florida	17,480	3E-700.010
	Idaho	21,405	Rules, Sec. 005

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	Indiana	24,591	Rule 710 IAC 1-12-5
	Iowa	25,457	Rule 191-50.57(502)
	Kansas	26,407A	Rules, Sec. 8172
	Massachusetts	31,465	Rules Sec. 13.305)
	Missouri	35,453	Rule 30-52.120
	Nebraska	37,402; 37,429	Rule Ch. 9
	Nevada	38,453	Rule 90.405(a)
	New Mexico	41,566R	Rule 12.11.9.18; 12.11.9.19
	Ohio	45,708. 45,711	<i>Bulletin</i> 5/86 & 2003:12
	Tennessee	54,411	Rule 0780-4-2-.06(j)
	Texas	55,590H	Rule 113.18
	Washington	61,582B	Rule 460-16A-205(1)(o)
	Wyoming	66,435	Rule Ch. 7 Sec. 2(f)(v)
15.	Promoters'		
	Equity		
	Investment		
	Alaska	8430	3 AAC 08.170
	Arizona	9517	Rule R14-4-107
	Arkansas	10,437	Rule 404.01(G)
	Idaho	21,405	Rules, Sec. 005
	Florida	17,475	Rule 69W-700.005
	Massachusetts	31,465	Rules Sec. 13.305
	Missouri	35,453	Rule 30-52.080
	Nebraska	37,402	Rule Ch. 7
	Nevada	38,453	Rule 90.405(a)
	New Mexico	41,566L	Rule 12.11.9.12
	South Carolina	51,518	Rule 13307
	Tennessee	54,411	Rule 0780-4-2-.06
	Texas	55,590I	Rule 113.3(9)
	Washington	61,582B	Rule 460-16A-205(1)(p)
16.	Promotional		
	Shares		
	Alaska	8429	3 AAC 08.160
	Alabama	7462	Rule 830X-4.21
	Arizona	9515	Rule R14-4-105
	Arkansas	10,437	Rule 404.01(C)
	California	11,881; 11,882; 11,883	Rules 260.140.30, .32
	Florida	17,475	Rule 69W-700.005
	Hawaii	20,454	Rules Sec. 163811.3

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	Idaho	21,405	Rules, Sec. 005
	Indiana	24,589	Rule 710 IAC 1-12-3
	Iowa	25,457	Rule 191-50.57(502)
	Kansas	26,407	Rules Sec. 8171
	Massachusetts	31,465	Rules Sec. 13.305
	Missouri	35,453	Rule 3052.030
	Nebraska	37,422	Rules, Ch. 22
	Nevada	38,453	Rules, 90.405
	New Mexico	41,566M	Rule 12.11.9.13
	Ohio	45,719	<i>Bulletin 4/87, 3/93</i>
	Pennsylvania	48,468; 48,685H	Rel No. 97-CF-3
	Tennessee	54,411	Rule 0780-4-2-.06
	Texas	55,590J	Rule 113.20
	Washington	61,582B	Rule 460-16A-205
17. Real Estate	Alabama	7462	Rule 830X-4.21
Investment	Alaska	8433	3 AAC 08.200
Trusts	Arizona	9526	Rules, Sec. R144116
	Hawaii	20,458	Rules Sec. 163811.7
	Indiana	24,593A	Rules Sec. 710 IAC 128
	Iowa	25,457	Rules Sec 19150.57(502)
	Kansas	26,407A	Rules Sec. 8172
	Massachusetts	31,465	Rules Sec. 13.305
	Mississippi	34,429F	Rule 221
	Missouri	35,453	Rules, Sec. 30-52.030
	Nebraska	37,432	Rules Ch. 32
	Nevada	38,453	Rules, Sec. 90.405
	New Mexico	41,566H	Rule 12.11.9.8
	North Carolina	43,437	Rule 1313(c)
	Ohio	45,603	<i>Bulletin 7/86</i>
	Pennsylvania	48,679A	Notice 3/29/86
	Tennessee	54,411	Rule 0780-4-2-.06
	Texas	55,741	Rule 143.1
	Utah	57,406A	Rule R164111(B)
	Virginia	60,435B	Rule 21 VAC 53080
	Washington	61,582B	Rule 460-16A-205(1)(f)
	Wyoming	66,435	Rule Ch. 7 2(f)(ii)
18. Real Estate	Alabama	7462	Rule 830X-4.21

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Programs	Arizona	9526	Rules, Sec. R144116
	Indiana	24,593A	Rules Sec. 710 IAC 1128
	Iowa	25,457	Sec. 510-50.58 (502)
	Kansas	26,407A	Rules Sec. 8172
	Massachusetts	31,465	Rules Sec. 13.305
	Mississippi	34,429F	Rule 221
	Missouri	35,453	Rules, Sec. 30-52030
	Nevada	38,453	Rules, Sec. 90.405
	New Mexico	41,566H	Rule 12.11.9.8
	North Carolina	43,437	Rule 1312(c)
	Ohio	45,702	Policy Notice 6-1-84
	Pennsylvania	48,679A	Notice 5-1-82
	Tennessee	54,411	Rule 0780-4-2.06
	Texas	55,601	Rule 117.1
	Utah	57,406A	Rule R164111(B)
	Virginia	60,435B	Rule 21 VAC 5-30-80
	Washington	61,582B	Rule 460-16A-205
	Wyoming	66,435	Rule Ch. 7 2(f)(iv)
19. Underwriting and Selling Expenses	Alaska	8426	3 AAC 08.130
	Arkansas	10,437	Rule 404.01(E)
	Idaho	21,405	Rules, Sec. 005
	Iowa	25,457	Rule 191-50.57(502)
	Massachusetts	31,465	Rules Sec. 13.305
	Mississippi	34,429E	Rule 219
	Missouri	35,453	Rules, Sec. 3052.030
	Nebraska	37,421	Rules, Ch. 21
	Nevada	38,453	Rules, Sec. 90.405
	New Mexico	41,566O	Rule 12.11.9.15
	Oregon	47,582D	Rule 44185010
	South Carolina	51,515	Rule 13304
	Tennessee	54,411	Rule 0780-4-2-.06
	Texas	55,590L	Rule 113.22
	Virginia	60,435B	Rule 21 VAC 5-30-80(2)
	Washington	61,582B	Rule 460-16A-205(1)(t)
20. Unequal Voting Rights	Alabama	7462	Rule 830-X-4-.21
	Alaska	8434	3 AAC 08.210
	Arkansas	10,437	Rule 404.01(H)

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		California	11,851	Rule 260.140.1
		Florida	17,476	Rule 3E-700.006
		Idaho	21,405	Rules, Sec. 005
		Indiana	24,590	Rule 710 IAC 1-12-4
		Kansas	26,407	Rule 81-7-1(h)
		Minnesota	33,501	Rule 2875.3080
		Mississippi	34,429F	Rule 221
		Missouri	35,453	Rule 30-52.110
		Nebraska	37,426	Chapter 8
		Nevada	38,453	Rules, Sec. 90.405
		New Mexico	41,566P	Rule 12.11.9.16
		Ohio	45,707	<i>Bulletin</i> 5/86
		Pennsylvania	48,661	<i>Bulletin</i> 3/83
		Tennessee	54,411	Rule 0780-4-2-.06
		Texas	55,590N	Rule 113.23
		Washington	61,582B	Rule 460-16A-040, 045
21.	Unsound	Alaska	8425E	3 AAC 08.125
	Financial	Idaho	21,406	Rules, Sec. 005
	Condition	Iowa	25,457	Rule 191-50.57(502)
		Missouri	35,453	Rules Sec. 3052.030
		Nebraska	37,428	Rules, Ch. 28
		Nevada	38,453	Rules Sec. 90.405
		New Mexico	41,556Q	Rule 12.11.9.17
		Tennessee	54,411	Rule 0780-4-2-.06
		Texas	55,590M	Rule 113.23
		Virginia	60,435B	Rule 21 VAC 5-30-80
		Washington	61,582B; 61,585G	Rule 460-16A-205(1)(u)
22.	Use of	Alaska	8426E	3 AAC 08.135
	Proceeds	Idaho	21,405	Rules, Sec. 005
	(Specificity)	Iowa	25,457	Rule 191-50.57(502)
		Missouri	35,453	Rules Sec. 3052.030
		Nebraska	37,428	Rules Ch. 28
		Nevada	38,453	Rules, Sec. 90.405
		New Mexico	41,566N	Rule 12.11.9.14
		Tennessee	54,411	Rule 0780-4-2-.06
		Texas	55,590K	Rule 113.21
		Washington	61,582B;	Rule 460-16A-205(1)(s)

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			61,585G	
23.	Viatical	Idaho	21,405	Rules, Sec. 005
	Investments	Kansas	26,618	Admin. Order 7/23/02
		Missouri	35,453	Rules Sec. 3052.030
		South Dakota	52,810X	Rules, Sec. 20:08:07:31
		Virginia	60,435B	Rule 21 VAC 53080
24.	Omnibus	Arizona	9526	Rules, Sec. R144116
	Guidelines	Indiana	24,679	Policy Statement 2/5/93
		Iowa	25,457	Rules Sec. 19150.57(502)
		Kansas	26,407A	Rules Sec. 8172
		Massachusetts	31,465	Rules Sec. 13.305
		Mississippi	34,429F	Rule 221
		Missouri	35,453	Rules Sec. 3053.030
		Nevada	38,453	Rules Sec. 90.405
		New Mexico	41,566H	Rule 12.11.9.8
		Pennsylvania	48,683K	Rel. No. 92CF-2
		Washington	61,582	Rules WAC-16A-205

[g] Central Securities Administrators Council Statements of Policy The Central Securities Administrators Council (CSAC) has approved and published certain statements of policy that have, variously, been embraced by states comprising the council. CSAC policies address qualification of certain types of offerings, and have limited application. Certain of them addressing investment company offerings are no longer viable after NSMIA and the preemption of state regulatory authority over investment company securities generally.ⁿ⁴⁰ Other CSAC policies address offerings of finance company debt securities and commodity pool programs. Only two policies have general applications: "Terms of Escrow Requirements," for offerings involving cheap stockⁿ⁴¹ and "Loans to Company Officials."ⁿ⁴²

[h] Other Common Standards

[i] Offering Price and Dilution. Standards set in the area of offering price and dilution are intended to protect new investors from immediate excessive loss in value. The investor without access to information prior to the offering is the person of primary concern here, although in some cases, such regulations can assist new investors with access to information from excessive dilution by promoters or insiders who provide inadequate, misleading, or misrepresentative information. Merit standards are generally placed on the offering priceⁿ⁴³ of new unseasoned offerings in accordance with one or more of the techniques of price estimation described below.

Established Market Price. When an issuer is applying to register securities for public sale, the current market price of similar outstanding securities of the issuer may be considered appropriate. This situation may be the case only if the agency determines that there is an established market for similar class securities of the issuer. For an adequate public market to be deemed existent, it is usually necessary to show that there is a minimum number of shareholders of record. A common benchmark is 500 shareholders. The technique is, therefore, not typically available to small firms. While the number of shareholders of record is the most common standard, other tests of an adequate market may include the evaluation of the number of shares outstanding, the number of market-makers regularly making a market in the similar securities, the average or total number of transactions taking place over a specified period of time, or the existence of regular price quotation in an acceptable source, such as a securities manual.ⁿ⁴⁴

New Issue Underwriter Pricing. Where the underwriter has a firm commitment to purchase an issue with no prior history of earnings, or where there is no established market, the proposed underwriter offering price may be considered acceptable. An underwriter memorandum may be required to provide the basis for such price. The underwriter may additionally be required to provide verification of ability to complete the firm underwriting commitment. This verification is usually based on statements of financial position in terms of net capital. Additionally, the underwriter expertise at setting the offering price may be questioned and, therefore, may require some proof of reliability.

Comparable Firm Market Price. When there is a basis for argument that the filing non-public issuer is comparable to a firm currently trading publicly, the comparable firm's trading price may be allowed as the initial offering price. Generally, to be comparable, the issuer must be similar in terms of one or more of the following characteristics: asset size, industry, products, or other relevant factors. An underwriter memorandum may be required for such a price-setting request.ⁿ⁴⁵

Acceptable Level of Dilution. The initial offering price may be reviewed in relation to an acceptable level of dilution. Dilution is the difference per share outstanding after the offering between the offering price and the present net book value of the shares, increased by the net proceeds of the offering. Dilution levels are normally stated in terms of a percentage decrease from the offering price. The offering price may be deemed excessive if the percentage decrease in net book value of the shares versus the offering price is too high. Maximum allowable dilution varies among the states, and may vary in a state as between start-up and seasoned issuers.ⁿ⁴⁶

In addition to assisting in maximum offering price determinations, a dilution standard is often utilized in connection with cheap stock and promoter investment guidelines.

Insider Multiple. Whether formally or informally stated, merit standards are occasionally set in the area of price multiples of the insider price. The multiple may in fact be a value related to an acceptable dilution percentage or it may be set in a more arbitrary manner. For example, a multiple of two might be set for jurisdictions with a dilution percentage maximum of 25%. Where the insider price is \$2.00, the public offering price would be set no higher than two times \$2.00, or \$4.00. Where the dilution is restricted to 33 one-third percent, the multiple might be set at three. Thus providing an offering price of three times \$2.00, or \$6.00.

Price Earnings Multiple. For those firms not in the promotional or developmental stage, it may be possible to utilize the price earnings multiple method of offering price determination. This technique is applicable only to firms with some history of earnings prior to the offering date. The minimum earnings history is generally two years. The earnings value used may be based on the most recent earnings value or on an average of the period covered. The multiple standard set by the regulatory agency usually represents a maximum multiple of earnings for all firms and does not vary with industries or economic conditions. The administrator may approve, in some cases, an alternative multiple of earnings where there is adequate evidence that such a multiple is more relevant for the issuer.ⁿ⁴⁷

Stated Offering Price. In some cases, the merit standards may simply include a low stated maximum price per share as the alternative if no other method is applicable.

[ii] Cheap Stock. Merit jurisdictions generally restrict the amount of cheap stock that may be sold to insiders or promoters.ⁿ⁴⁸ Cheap stock may generally be described as stock issued to promoters or insiders prior to the public offering where the insider or promoter price paid is significantly below that proposed to be paid by the public investor. Alternatively, it may be described simply as stock where the insider or promoter price bears no relationship to that paid

by the public.

Usually cheap stock is made available to insiders as consideration for risk or performance in the development of the firm. Such stock may also be utilized as an employment enhancement to obtain and retain management or key employees. Additionally, cheap stock is often utilized as compensation for consultants, underwriters, and others. The purpose of merit standards regarding cheap stock is to eliminate the excessive issue of such stock. Some statutes specify maximum amounts, while others address only the reasonableness of cheap stock issues. The intent is to prohibit excessive dilution to new investors. In addition, such prohibitions may, in fact, restrain insiders from maintaining control of the firm through the use of stock while simultaneously not relinquishing equitable amounts of personal funds.

The use of cheap stock is generally disfavored,ⁿ⁴⁹ and conditions are commonly imposed. Apart from a general condition that the number of shares issued as cheap stock be justifiable in amount, and that the consideration have a reasonable relationship to the public offering price, particular standards prescribed usually pertain to some allowable level of dilution of ownership or value to new investors after completion of the offering. The standards may refer to some prescribed maximum proportion of total stock outstanding after issue or to allowable amounts of dilution after issue completion. Standards may differ within a jurisdiction depending on the industry of the filing issuer or the stage of development of that issuer.

In determining the maximum amount of cheap stock allowed, the standards usually prescribe some proportion-oriented rule such as:

Fair Value of Equity
Total Equity Invest-
ment

To determine the proportion standards, there is generally a stated multiple of the calculated proportion. For example, where the proportion is determined to be ten percent or less, the maximum percentage of cheap stock authorized may be defined as three times that proportion. Where the proportion is greater than ten percent the maximum percentage of cheap stock authorized may be stated as two times the proportion. A specific stated maximum boundary such as 80% or 90% may also be specified.

An alternative approach is to set a scale of boundaries relating the calculated proportion to the allowable percentage of cheap stock. The following is an example of such a standard scale.

Calculated Proportion	Maximum Percent of Cheap Stock
5%	15%
10%	30%
15%	40%
20%	50%
30%	70%
40%	90%
50%	90%

Cheap stock rules may be coordinated directly or indirectly with standards dealing with offering price, dilution, cheap stock, promoters investment, and voting rights.

[iii] Promoters' Equity Investment. The intent of the minimum promoters' equity investment requirement is to instill a sense of good faith in the promoter. The assumption is that the new investor will be provided more protection when the promoter has personal funds at risk. Such promoters and insiders are expected to be more conscientious and success-oriented when significant personal investment is involved. Such standards further discourage the unscrupulous promoter from raising funds for personal gain and with no intent to make the venture a successful and viable enterprise. Personal risk is the driving force of this form of merit standard. By providing a method of increasing insider and promoter concern for success of the underlying firm, these standards are, in fact, a means of minimizing the principal-agent problem that may exist between management, insiders, and public owners.

Promoter equity investment standards⁵⁰ are applied only when the underlying entity is in the promotional or developmental stage. By general definition, promotional or developmental firms are those with no significant earnings or operating record. Specific definitions vary from state to state. Such investment by promoters may, unless otherwise stated, be in the form of cash or tangible assets valued at reasonable amounts in accordance with some acceptable valuation technique. Reasonable value assessment is usually based on an independent appraisal of tangible assets. In certain cases, where the issuer has a history of operations and where there is an earned surplus, promoter investment credit may be granted the promoters for any earned surplus funding previously provided the issuer. In any case, the acceptable minimum amount of investment is often stated as a proportion of the total equity capital to be available at the completion of the offering in question.⁵¹ In other situations a scale such as ten percent or more for the first 1,000,000 of total equity capital and an additional five percent thereafter may be utilized. Other jurisdictions cite specific minimums at all levels of total equity investment. These are generally stated at the five percent to 15% level.

The promoters' equity investment standards must often be considered in conjunction with the standards dealing with offering price, dilution, cheap stock, and voting rights.

The promoters' equity investment standard can usually be met by the investment of assets such as real estate or motor vehicles. When such is the case, an independent appraisal, especially of the real estate, by a qualified appraiser can smooth the qualification procedure. Practitioners may also seek to negotiate for a lower promoters' investment standard than is normally required. In those situations, a cheap stock escrow greater than is normally required may be requested. Alternatively, the promoter may be required to invest assets that are extremely liquid, such as cash or marketable securities.

[iv] Escrow or Restriction of Promotional Shares. Merit standards requiring the escrow of promoter or insider stock or other restrictions relating to such stock are also intended to assure good faith of promoters and insiders. Since such stock is generally either escrowed or restricted as letter stock until some minimum level of earnings is attained, or until the passage of some specified period of time, there is an underlying assumption that escrow or restriction provides an increased incentive to perform effectively and toward the same goal that is in the best interest of the public investor.

When a disparity of substantial proportion exists between the promoter or inside price paid for securities and the price paid by the new public investor, an escrow or lettering of all or part of the promotional or cheap securities may be required. Certain jurisdictions may require promoter or insider stock to be escrowed or lettered regardless of whether there is a disparity in price.⁵²

Escrow restrictions generally restrict such stock to escrow for a minimum stated time or until earnings meet specified standards. The standards may specify that earnings after tax be equal to some stated percentage of the public offering price times the average number of shares outstanding each respective year of escrow. For example, where the percentage is stated as five percent and where the initial public price was \$6.00 per share, the required after-tax earnings level will be \$30,000 if the average number of shares outstanding over the escrow period is 100,000 shares.

Alternatively, the standard may be stated in terms of dividend payout in relation to the initial public offering price. The standard may, for example, require the escrow to continue until investors have received dividends of at least six percent

of the initial offering price for a specified period of time. Where the initial offering price is \$6.00 per share, and 100,000 shares are outstanding, dividends of \$36,000 must have been paid to allow the release of cheap stock from escrow.

In some cases, special escrow provisions are provided for particular types of offerings whether registered or exempt. One such example is the non-profit issue escrow requirement of Georgia.ⁿ⁵³

The conditions for the escrow of cheap stock are often left to the discretion of the securities administrator. Negotiation may be possible, however, and may set an acceptable precedent for other administrators. It may, for example, be possible to get release terms based on a measure of performance other than earnings, such as minimum rate of return on equity investment or sales growth.

Such letter restrictions and escrow requirements, additionally, serve as a dilution prevention measure. When cheap stock is provided to promoters and insiders and there is a significant difference in either offering price or secondary market price during the first four to six weeks or more in the market, there are gains from trading to be made by such insiders or promoters. Restricting the trading activity provides, therefore, dilution protection as well as insurance that the promoters or insiders continue to have monetary interest in the entity. Dilution and promoter investment standards are often tied to these standards.

[v] Impound of Proceeds. Where the offering being registered for public sale is based on an all-or-none, or a best efforts underwriting, all or part of the proceeds may be impounded until either the end of some stated period of time or the successful completion of the underwriting effort.ⁿ⁵⁴

For an all-or-none underwriting, all funds will usually be escrowed pending the complete sale of the issue. For a best-efforts underwriting, funds will generally be impounded until some minimum amount of funds are obtained. If, in either case, the marketing effort is unsuccessful, the impounded proceeds will be returned to the public investors in full plus any interest earned on the impound and less any expenses assessed for the administration of the impound.

The determination of the amount of impound varies across jurisdictions and, whether by rule or statutory section, generally provides the state administrator with the ability to impound the amount of proceeds deemed appropriate in each case.

[vi] Options and Warrants. Options and warrants may be issued for a variety of reasons. Frequently, such securities are utilized as sweeteners to enhance the marketability of an issue. They may also be provided to management and other key employees as payment for services or as incentives to induce productivity and/or continued loyalty to the issuing firm. Options and warrants may further be utilized as payment for services by consultants, attorneys, accountants, and underwriters. Such securities may also be viewed as an alternative to the issuance of cheap stock as a means of maintaining future promoter or insider firm control.

Option and warrant restrictions are primarily intended to protect the new investor from future excessive dilution in value, earnings per share, or control. The key here is that such restrictions constrain the amount of options and warrants or the amount of securities into which such options and warrants may be converted. The standards imposed, therefore, do not attempt to eliminate such securities or attachments from being issued but rather their issue in excessive amounts.

Option and warrant standardsⁿ⁵⁵ usually limit the volume of options and warrants that may be issued as attachments to issuer securities or that may be issued as separate securities. Merit standards may also restrict the amount of securities that options or warrants may be utilized to purchase. Merit standards restricting the issue of options and warrants generally restrict the amount of options and warrants simply to some reasonable amount, but may also impose a cap. Such standards provide flexibility to the regulator as well as to the issuer.

Specific restrictions may set time frames that must lapse prior to execution of the option or warrant. Such standards may

additionally specify a percentage of shares that may be made available upon exercise. A typical standard would prevent exercise for 11 to 12 months from the date of issuance and would restrict the amount of shares available through exercise to less than or equal to ten percent of the total shares offered to the public.ⁿ⁵⁶

Additional restrictions may provide for a step-up of exercise price over time,ⁿ⁵⁷ usually set by a scale. Another approach may allow, after a minimum waiting period, for unrestricted exercise at a price equal to the offering price plus some step-up amount. Generally, options and warrants to underwriters will be authorized only where there is a firm underwriting.ⁿ⁵⁸ In addition, the financial capability of the underwriter to fulfill the underwriting commitment is considered.

Specific option and warrant rules or guidelines may be set for areas such as qualified employee stock plans and employee stock purchase plans.ⁿ⁵⁹

[vii] Offering Expenses and Commissions. States commonly address the power of administrators to deal with the level of selling expenses, particularly underwriter commissions, discounts and other compensation, via general statutory authority to deny qualification for an offering that would be made with "unreasonable amounts of underwriters' and sellers' discounts, commissions or other compensation." This is the approach of the Uniform Act.ⁿ⁶⁰ Other additional or more specific expense restrictions are found in a number of states. Whether prescribed as a part of merit review, or generally, the attention to offering expenses is a constant in Blue Sky regulation.ⁿ⁶¹

Expenses include such items as cash, securities, options, warrants, commissions, discounts to underwriters, finders' fees, or generally anything of value provided to underwriters or similar parties as compensation. Certain states include vague terminology covering expenses not strictly accounted for in any way. A typical commission and expenses rule will require the total of all commissions and expenses to be less than or equal to some percentage of the gross proceeds from the offering. The expenses will usually include items such as: underwriter discounts and commissions; the value of options and warrants to underwriters; finders fees; the cost of printing and engraving; advertising expenses; registration expenses for blue skying and SEC federal registration; legal costs; accounting fees; and in general, any other expense associated with bringing the offering to the marketplace.ⁿ⁶²

Where the marketing expenses are segregated, the amount allowed in this area is also usually less than or equal to some stated percentage of the gross proceeds. These expenses are generally limited to: underwriter discounts and commissions; options and warrants to underwriters; and any other expenses associated with selling or marketing the issue. Thus, for example, where the total expenses may be limited to 20% of the gross proceeds, there may be an additional limitation that a maximum of 15% of the gross proceeds may be spent on marketing expenses.

Given the inherent level of risk associated with promotional or developmental-stage issues, these are the offerings most often affected by expense and commission limitations.ⁿ⁶³ States utilize one of two general varieties of commission and expense rules. The rule may be specific in terms of the maximum allowable percentage of the aggregate value or selling price that may be spent on such items.ⁿ⁶⁴

Alternatively, the rule may be somewhat subjective and require only that commissions and expenses be reasonable in amount.ⁿ⁶⁵ Such open-ended standards can be more strenuous for compliance purposes due to the use of unwritten rules and their subjective nature. The aggregate value or selling price often includes warrants and options to underwriters. In some states, the value is based only on actual purchases, not to include pledges to purchase. In other states, pledges are considered as part of the aggregate value.

A challenge in Blue Sky compliance is presented by the variety of expenses addressed among states.ⁿ⁶⁶ In addition, the restrictions can vary with the type of underwriting, size of the offering, and type of security being registered. In some cases, percentage limitations may be modified in relation to the size of the offering. Thus, in Kansas, for example, the fifteen percent (15%) of aggregate offering price overall expense limitation imposed may be waived for offerings of \$3

million or less.ⁿ⁶⁷

A number of jurisdictions set limitations on the combined amount of underwriter compensation and expenses to include legal fees, prospectus and offering circular printing costs, and accounting fees.ⁿ⁶⁸ Several states separate underwriter compensation and other expenses setting different restrictions in each area.ⁿ⁶⁹ A few states set restrictions only in the area of underwriter compensation.ⁿ⁷⁰ Underwriter compensation generally includes such items as finders' fees, commissions, and discounts. Stated percentages are generally, however, meant only as safe harbor rules. Registration may be granted where expenses exceed these standards when some basis-in-fact for a non-qualifying amount of expense can be presented and is deemed as necessary expense by the regulatory agency.

The determination of compliance may be especially difficult in states where the restriction is stated as reasonable. In those cases, where a limit of reasonable amount is stated, the implication is that some published or unpublished limits may exist as a benchmark. The registration will not necessarily be denied for non-compliance if a basis for costs over this standard can be shown and is proven to be both necessary and reasonable.

The restrictions affect promotional or developmental-stage issues more than established firms, because of the inherent high level of risk associated with such issues. As the risk of an issue increases, marketing success decreases. As a result, underwriters require additional compensation for services rendered to these issuers. This is especially true in the case of the firm commitment underwriting.

[viii] Rights and Protective Covenants. In general, rights protection comes in several forms: preemptive rights; voting rights; conflict of interest; loans to employees, directors, and officers; and capital structure.

[ix] Preemptive Rights. Several merit review states attempt to insure that there is no question as to the preemptive rights of stockholders.ⁿ⁷¹ Ordinarily, state corporation laws will provide such rights, and merit standards in these cases are merely an additional safeguard. The provisions may, however, be more explicit than the state corporation law and may guarantee a preemptive right to subscription of additional issues of any similar class of stock. The rights in these standards often also refer to stock splits and stock dividends.

[x] Voting Rights. Another common area of rights protection is that of voting rights. Several states either preclude non-voting stock outright, or impose requirements for qualification of an offering.ⁿ⁷² Generally, the merit standards set here attempt to provide equity between the classes of stock. Equity is evaluated on the basis of the voting rights provided each class. The proportion of shares outstanding in the stated classes is also considered in the equity of rights analysis.

An offering of similar class stock may be authorized without equitable voting rights. Such authorization can usually be obtained when the issuer can prove that alternative or offsetting rights with regard to preference are provided in areas such as dividend payment and liquidation. This is the approach taken in the NASAA Statement of Policy, and is the cornerstone of most state merit review policies on point. Thus in Texas, for example:

In offerings of non-voting shares or shares with disproportionate voting rights, which offerings normally are not fair, just and equitable, the commissioner may consider whether or not the disparity in voting rights is a temporary condition and whether or not the deprived shareholder receives an offsetting benefit (e.g., dividend preference or preference in liquidation) to compensate for such disparity.ⁿ⁷³

[xi] Conflicts of Interest. When there is a potential for conflict of interest between insiders, promoters, and public investors, merit standards may require that protective covenants or safeguards be instituted to protect the public investor.ⁿ⁷⁴

[xii] Loans to Key Employees and Officers. Loans to key employees are restricted for the same reasons a conflict of interest standard is promulgated generally. The ability of key employees and officers to obtain loans from the issuer

is not considered to be in the best interest of the public investor. Such loans may not be adequately collateralized and may have a rate of interest below that available in other investments. The issuer may often be prohibited or constrained by merit restrictions on these loans.ⁿ⁷⁵

[xiii] Debt Securities and Preferred Stock. Where debt securities are the subject of registration, merit states generally require verification of adequate earnings or cash flow from operations to cover the payment of required debt service, or make provision for other kinds of protections.ⁿ⁷⁶ Such requirements are generally based on tests of earnings exclusive of extraordinary items. Tests in this area are often based on verification of a record of historical earnings over a specified period of time. However, it may also be possible to meet fairness standards based upon substantiated future net earnings or cash flow capability. In Ohio, for example, an issuer may satisfy the administrator that it has "made material contracts, acquisitions or other significant changes in its business operations which will result in future net earnings or cash flow sufficient to cover the annual dividend, interest and principal amortization requirements on all such securities" while also meeting obligations on other outstanding senior securities.ⁿ⁷⁷

A number of jurisdictions require minimum protective covenants or issuer restrictions to be included in the indenture.ⁿ⁷⁸ Sinking fund requirements are common in this area. A sinking fund restriction might require, for example, that 75% of the principal repayment amount be placed into a sinking fund before the repayment date. Alternatively, the issue may be serial in nature. Where the sinking fund applies, it may not be necessary to institute such a fund until some period of time has elapsed. Generally, debt of short-term maturity such as five years or fewer will not have to meet sinking fund provisions. Additional indenture requirements provide that a maximum debt-to-equity capital structure be observed. Collateral requirements may also be imposed as a measure of protection. In a number of jurisdictions, a minimum amount of capitalization or equity capitalization is required before debt securities will be authorized for sale in the state.

For preferred stock issues, some merit jurisdictions require verification of adequate earnings, exclusive of extraordinary items, to pay preferred dividends. Such tests, as with debt issues, usually require verification of such earnings on an average or annual basis over a specified period of time prior to issue. In neither the debt nor the preferred stock case is there a requirement for principal repayment.

Certain restrictions regarding promotional-stage issuers may prohibit their issuance of debt or preferred stock.ⁿ⁷⁹ Special provisions may also be provided for issues of industrial revenue bonds, reorganization issues, or issues of non-profit or eleemosynary organizations.ⁿ⁸⁰

For either debt or interest coverage, the specified interest or dividend standards may be waived. This is generally possible only where some collateral is made available in trust or where, as noted above, a reasonable forecast of future earnings or cash flow indicates sufficient coverage. Substantiation is necessary in some manner.

[xiv] Capital Structure and Capitalization Generally. Inadequate capitalization has often been found to be the primary cause of business failure. Similarly, firms using an inordinate amount of fixed cost financing are candidates for failure due to inadequate coverage of such fixed costs. Thus, certain jurisdictions require minimal amounts of capitalization before allowing public offerings.ⁿ⁸¹ Such capitalization generally includes the amount of funding to be obtained from the offering.

The actual capital structure may be addressed in capitalization standards or as a separate standard. In some states, only common stock issues will be authorized for sale where the issuer is in the promotional or developmental phase or where there is no history of operating profit.ⁿ⁸²

[xv] Miscellaneous and Special Standards. A number of miscellaneous standards or specific sets of standards for types of issues may also exist in various jurisdictions. Some of the more common include:

[A] Plan of Business. The plan of business or operations may be evaluated in certain jurisdictions.ⁿ⁸³ The intent of

any plan of business evaluation is to ascertain if the operations of the issuer are based on sound business practices.

[B] Financial Condition. Specific standards may be set in the area of financial condition.ⁿ⁸⁴ Such standards are generally concerned with capitalization and protection in terms of issuer solvency.

[C] Honesty or Reputation. Some jurisdictions provide somewhat subjective provisions dealing with the honesty or business repute of the issuer.ⁿ⁸⁵

[D] Credit and Installment Sales. Standards restricting the sale of an issue on a credit or installment basis are provided in a number of jurisdictions.ⁿ⁸⁶

[E] Advertising and Sales Material. A number of jurisdictions apply standards to the advertising and sales literature pertaining to an offering. While such statutory provisions and rules may apply to both merit and non-merit filings, the restrictions may in fact be a form of merit regulation.ⁿ⁸⁷

[F] Differing Consideration. Contemporaneous sales of the same or similar securities to different purchasers at varying prices or for different consideration may be presumptively unfair. Sliding scale or quantity discount arrangements may be possible under some circumstances, but as a general rule the offering and sale of securities of the same class to different purchasers at different prices in the same offering or at approximately the same time will be deemed unfair to purchasers.ⁿ⁸⁸

[G] Special Standards Generally. Specific requirements regarding protective covenants, voting rights, capitalization, and other similar characteristics are provided for specialized programs and offerings by many jurisdictions. These special areas of standard setting are generally to be found in the following types of offerings:

- (1) Real Estate Investment Trusts,ⁿ⁸⁹
- (2) Real Estate Programs,ⁿ⁹⁰
- (3) Oil and Gas Programs,ⁿ⁹¹
- (4) Commodity Pool Programs,ⁿ⁹² and
- (5) Cattle Feeding Programs.ⁿ⁹³

FOOTNOTES:

(n1)Footnote 1. See § 5.02[3] .

(n2)Footnote 2. Section 306(a)(2)(E) of the original Uniform Act prescribes that the administrator may deny effectiveness of a registration statement on a finding that the offering would work or tend to work a fraud on purchasers. While the language of section 306(a)(2)(E) is not as broad as the "fair, just, and equitable" standard prescribed in some state laws, it is general enough when taken in conjunction with the broad definition of "fraud" in the Act to allow for some discretion in application of what amounts to a fairness standard. Indeed, section 401(d) of the Act makes clear that the definition of "fraud" for purposes of the Act is not limited to common law deceit.

Section 306 of the Uniform Act also prescribes several specific grounds upon which an offering may be rejected: (1) that underwriting and selling expenses are unreasonably high; (2) that promoters profits or participation is unreasonable; and (3) that there are unreasonable amounts or kinds of options involved.

(n3)Footnote 3. Although the first priority in merit review is submission of information to the administrator, regulatory requirements evolved so as to assure that disclosure to prospective investors via prospectuses or other

informational offering documents is also typically involved. The role of disclosure in merit regulation is discussed in § 6.04.

(n4)Footnote 4. Section 304(c) of the 2002 Uniform Securities Act is representative of the most common provisions in prescribing:

A registration statement under this section becomes effective 30 days, or any shorter period provided by rule adopted or order issued under this [Act], after the date the registration statement or the last amendment other than a price amendment is filed if:

- (1) a stop order is not in effect and a proceeding is not pending under Section 306;
- (2) the administrator has not issued an order under Section 306 delaying effectiveness; and
- (3) the applicant or registrant has not requested that effectiveness be delayed.

(n5)Footnote 5. The NASAA Statement of Policy Regarding Unsound Financial Condition, adopted in 1997, provides for denial of an application for registration, or the imposition of certain conditions on approval, when the financial statements of an issuer contain a "going concern" qualification or other specified indicia of unsound financial condition. *CCH NASAA Reports* P 3826.

(n6)Footnote 6. *See, e.g., "Real Estate Programs," CCH NASAA Reports* P 3601.

(n7)Footnote 7. For a complete presentation of NASAA Statement of Policy adoptions among the states *see CCH NASAA Reports* P 291, and the chart included in § 6.02[f]. The extent of, and variations in, adoption among the states is fully considered in § 6.02.

(n8)Footnote 8. *See generally*, 3D Harold S. Bloomenthal and Samuel Wolff, Securities and Federal Corporate Law §§ 14.11-14.19 (West Group 1997).

Particular NASAA guidelines in application have not escaped serious criticism, *see, e.g.,* Hurwitz, "Founders Shares: An Analysis of Merit Review Under the Oregon Securities Law," 32 *Willamette L. Rev.* 249 (1996) (addressing the "sometimes absurd nature" of certain NASAA policies).

(n9)Footnote 9. Although the focus here is on the extent of state authority for continuing merit review in regard to NSMIA "uncovered" securities, states also retain certain authority in connection with offerings of "covered" securities. With respect to these offerings (other than nationally traded securities), the states are empowered by NSMIA to require fee payments and/or notice filings. Residual authority over covered securities is discussed in Chapter 5.

(n10)Footnote 10. provides that 'The [Administrator] may, from time to time, make, amend, and rescind such rules, forms, and orders as are necessary to carry out the provisions of this act, including rules and forms governing registration statements, applications, and reports, and defining any terms, whether or not used in this act, insofar as the definitions are not inconsistent with the provisions of this act. For the purpose of rules and forms, the [Administrator] may classify securities, persons, and matters within his jurisdiction, and prescribe different requirements for different classes.'

(n11)Footnote 11. Although it is not a merit review provision as such, the 2002 Uniform Act also retains the administrator's authority to require escrow of securities or impoundment of proceeds of an offering in certain circumstances as a condition of registration. Section 305(f) of the 2002 Uniform Act provides:

A rule adopted or order issued under this [Act] may require, as a condition of registration, that a

security issued within the previous five years or to be issued to a promoter for a consideration substantially less than the public offering price or to a person for a consideration other than cash be deposited in escrow; and that the proceeds from the sale of the registered security in this State be impounded until the issuer receives a specified amount from the sale of the security either in this State or elsewhere. The conditions of any escrow or impoundment required under this subsection may be established by rule adopted or order issued under this [Act], but the administrator may not reject a depository institution solely because of its location in another state.

(n12)Footnote 12. 2002 Unif. Sec. Act § 306(a)(7)(A).

(n13)Footnote 13. 2002 Unif. Sec. Act § 306(a)(7)(B).

(n14)Footnote 14. 2002 Unif. Sec. Act § 306(a)(7)(C).

(n15)Footnote 15. *See* 2002 Unif. Sec. Act § 306(b).

(n16)Footnote 16. *See* 2002 Unif. Sec. Act § 608(c)(9) (Cooperation and coordination to include "formulating rules, statements of policy, guidelines, forms, and interpretive opinions and releases).

(n17)Footnote 17. "Procedure for the Adoption of Statements of Policy by the North American Securities Administrators Association, Inc.," *CCH NASAA Reports* P 352 (June 25, 1994).

(n18)Footnote 18. Coordinated Equity Review, also referred to as CR-EQUITY, is discussed in § 6.04.

(n19)Footnote 19. *CCH NASAA Reports* P 3203, at 1821 (Nov. 18, 1997). Definitions applicable to all of the new or revised NASAA Statements of Policy are contained in the separate (new) NASAA "Statement of Policy Regarding Corporate Securities Definition," *CCH NASAA Reports* P 3812, at 2087 (Apr. 27, 1997).

Throughout this chapter, citations of current NASAA Statements of Policy are to *CCH NASAA Reports*. For quick reference, NASAA Statements of Policy are also reproduced in Volume 3.

(n20)Footnote 20. *CCH NASAA Reports* P3103, at 1801 (Apr. 27, 1997).

(n21)Footnote 21. *CCH NASAA Reports* P 2806, at 1601 (Nov. 18, 1997).

(n22)Footnote 22. *CCH NASAA Reports* P 2161, at 1251 (Apr. 27, 1997).

(n23)Footnote 23. *CCH NASAA Reports* P 3826, at 2093 (Apr. 27, 1997).

(n24)Footnote 24. *CCH NASAA Reports* P 3671, at 2071 (Apr. 27, 1997).

(n25)Footnote 25. *CCH NASAA Reports* P 3006, at 1701 (Apr. 27, 1997).

(n26)Footnote 26. *CCH NASAA Reports* P 374, at 371 (Apr. 27, 1997).

(n27)Footnote 27. *CCH NASAA Reports* P 3835, at 2095 (Apr. 27, 1997).

(n28)Footnote 28. *CCH NASAA Reports* P 2401, at 1501 (Oct. 24, 1991).

(n29)Footnote 29. *CCH NASAA Reports* P 3812, at 2087 (Apr. 27, 1997).

(n30)Footnote 30. A complete collection of current NASAA Statements of Policy and Guidelines is contained in

Volume 3.

(n31)Footnote 31. "Program," for purposes of the guidelines, is defined as:

One or more limited or general partnerships or other investment vehicles formed, or to be formed, for the primary purpose of exploring for oil, gas, and other hydrocarbon substances or investing or holding any property interests which permit the exploration for or production of hydrocarbons or the receipt of such production or the proceeds thereof (a prospectus may offer a series of programs with individual programs being formed in sequence).

(n32)Footnote 32. In a related area, the NASAA Statement of Policy Regarding Church Extension Fund Securities was adopted in its current form in 2004. The standards prescribed in this Statement of Policy apply to the offer and sale of notes issued by a church extension fund, the proceeds of which are used primarily to finance or refinance the purchase, construction, or improvement of church property. The policy statement is not applicable to a single project financing by individual churches or congregations, but rather applies to a continuous offering to provide ongoing financing for affiliated churches. A single project financing by an individual church is covered by the NASAA Church Bond policy statement.

(n33)Footnote 33. See Matthew Bender's Securities Regulation Series, *Federal Securities Act of 1933*, Chapter 3 for a complete discussion of Securities Act § 3(a)(4), the exemption for any security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, or charitable purposes.

(n34)Footnote 34. As with most of the newer versions of NASAA Statements of Policy, this one, adopted in 1993, includes a number of definitions of key terms. "Adjusted cash flow," for purposes of a debt offering, means cash flow adjusted to reflect the effect such things as payments of interest or fees associated with other securities, outstanding proposed or required acquisitions, or capital expenditures that materially affect cash flow, accrued dividends, and other payments, or material changes to the issuer's future cash flow.

(n35)Footnote 35. A comment to the guidelines makes clear that the standards are "primarily designed for public real estate syndications and programs which make or invest in mortgage loans." As for the latter, all provisions of the guidelines are deemed applicable unless specifically excluded or modified.

(n36)Footnote 36. "Program" is defined for purposes of the guidelines as: "A limited or general partnership, joint venture, unincorporated association, or similar organization other than a corporation formed and operated for the primary purpose of investment in and the operation of or gain from and interest in the assets to be acquired by such entity." *CCH NASAA Reports* P 2321, at 1381, 1383 (Mar. 29, 1992).

(n37)Footnote 37. *Id.*

(n38)Footnote 38. Those states formally adopting the guidelines are: Indiana, Iowa, Kansas, Massachusetts, Mississippi, Ohio, Pennsylvania, and Washington.

(n39)Footnote 39. Although Wisconsin repealed NASAA Statements of Policy in 1997, and South Dakota did the same in 2001, in both states, the disclosure related provisions of many NASAA Statements of Policy or guidelines may be used for the purpose of reviewing the adequacy of disclosure in the prospectus filed with the registration application, but not for purposes of merit review, see *Wisconsin*: DFI-Sec. 3.03(4); *South Dakota*: Regs. Sec. 20:08:04:115.

In Oklahoma, the Administrator in his or her discretion, may apply any Statements of Policy or guidelines adopted by NASAA. None is specifically prescribed for application, however, see *Okla. Rule Sec. 660:11-9-34*.

(n40)Footnote 40. Securities issued by an investment company registered under the Investment Company Act of

1940 are "covered" securities under NSMIA, *see* Securities Act section 18(b)(2), 15 U.S.C. § 77r(b)(2).

(n41)Footnote 41. *CCH NASAA Reports* P 5412, at 1497-8 (Aug. 14, 1973).

This CSAC policy has been adopted by Indiana, Michigan and Minnesota.

(n42)Footnote 42. *Id.*, P 5421, at 1497-10.

This CSAC policy has been adopted by Illinois, Iowa, Michigan, Minnesota, Missouri and Ohio.

(n43)Footnote 43.

Alaska: Securities Rule 3 AAC 08.140.

Arkansas: Securities Rule 404.01(I).

California: Securities Rules 260.140.50, 260.140.51.

Florida: Securities Rule 3E-700.15.

Hawaii: Securities Rule § 16-38-11.8.

Indiana: Securities Rule § 710 IAC 1-12-6.

Kansas: Securities Rule § 81-7-1(i).

Kentucky: Securities Rule 808 KAR 10:080.

Missouri: Securities Rule § 30-52.050.

North Carolina: Securities Rule 1310.

North Dakota: *N.D. Cent. Code Ann. § 10-04-08.1(5)*.

Ohio: OSB 3.01 II ("Offering Price of Equity Securities"), *Ohio Sec. Bulletin* 9 (June 1973).

Tennessee: Securities Rule 0780-4-3-06(4)(d).

Texas: Securities Rule § 113.3(2), (3), (4).

Utah: Securities Rule § 164-10.2(G)(1).

(n44)Footnote 44. The burden of demonstrating a "market" falls upon the issuer. In Ohio, for example, the proposed offering price of either a going concern or a promotional company will not be considered excessive if it is the same as or within a few points of a "recent market price" of securities of the same class. However, "[t]he applicant has the burden of establishing or demonstrating to the satisfaction of the Division that securities of the same class are publicly traded in an active market of substantial depth." OSB 3.01 II, *Written Policy Guidelines*, (June 1973).

(n45)Footnote 45. *See, e.g., Indiana*: Securities Rule § 710 IAC 1-12-6(b) ("Comparative Justification").

(n46)Footnote 46.

Alabama: Securities Rule 830-X-4-.08.

Hawaii: Securities Rule § 16-38-11.3(b). This provision applies to promotional securities.

Kentucky: Securities Rule 808 KAR 10:080(2)(a).

Mississippi: Securities Rule 217.

Utah: Securities Rule R164-10-(G)(2).

(n47)Footnote 47. *See, e.g., Indiana:* Securities Rule § 710 IAC 1-12-26(a).

(n48)Footnote 48.

Alaska: Securities Rule § 3 AAC 08.160.

Arizona: Securities Rule § R14-4-105.

California: Securities Rules 260.140.30-.32.

Hawaii: Securities Rule § 16-38-11.3.

Indiana: Securities Rule § 710 IAC 1-12-3.

Iowa: Securities Rule § 191-50.37.

Kansas: Securities Rule § 81-7-1(c).

Kentucky: Securities Rule 808 KAR 10:080(1)(c).

Minnesota: Securities Rule Part 2875.3010.

Missouri: Securities Rule § 30-52.070.

Montana: Securities Rules §§ 6.10.104, 6.10.105.

Nebraska: Securities Rule Ch. 6.001.01.

North Dakota: *N.D. Cent. Code § 10-04-08.1(1).*

Ohio: OSB 3.01 IV ("Profits and Compensation of Promoters and Affiliates of the Issuer"), *Ohio Sec. Bulletin* 9 (June 1973).

Tennessee: Securities Rule § 0780-4-2-.06(4)(h).

West Virginia: Securities Rule §§ 14.05, 14.15.

(n49)Footnote 49. West Virginia, for example, declares by rule:

"[R]egistration of securities where cheap stock has been or will be issued may be looked upon with disfavor and as tending to work an imposition, as being an offering upon unfair terms, and as involving an unreasonable amount of underwriters' and sellers' discounts, commissions or other compensation unless [certain] minimum conditions are met" W. Va. Admin. Reg., Comm. Sec. § 14.05.

(n50)Footnote 50.

Alabama: Securities Rule 830-X-4.07.

Alaska: Securities Rule § 3 AAC 08.170.

Arizona: Securities Rule R14-4-107.

Florida: Securities Rule 3E-700.005.

Kansas: Securities Rule § 81-7-1(f).

Kentucky: Securities Rule 808 KAR 10:080(1)(c).

Minnesota: Securities Rule Part 2875.3000.

Mississippi: Securities Rule 221.

Missouri: Securities Rule § 30-52.080.

Nebraska: Ch. 7.

Nevada: Nev. Rev. Stat. §§ 90,510(f).

New Mexico: Securities Rule 86-5.05.

Ohio: OSB 3.01 III ("Capitalization of a Promotional Company: Promoters' and Managers' Contributions to Capital"), *Ohio Sec. Bulletin* 9 (June 1973).

Oklahoma: Securities Rule 660:10-9-36.

South Dakota: Securities Rule § 20.08:04:23-24.

Tennessee: Securities Rule 0780-4-3-.06(4)(i).

Texas: Securities Rule § 113.3(9).

Utah: Securities Rule R164-11-1(C) (development stage companies).

West Virginia: Securities Rules §§ 14.11, 14.15.

(n51)Footnote 51. See, e.g., Texas: Securities Rule § 113.3(9).

(n52)Footnote 52.

Alabama: Ala. Code Ann. § 8-6-8(b)(1), Securities Rule 830-X-4-.12.

Alaska: Alaska Stat. Ann. § 45.55.110(g), Securities Rule § 3 AAC 08.180.

Arizona: Securities Rule § R14-4-105(B).

California: Cal. Code Ann. §§ 25133, 25141, 25149, Securities Rules 260.140.8, 260.141.1-260.141.3, 260.141.10-260.141.15.

Florida: Fla. Stat. Ann. § 517.181.

Georgia: Securities Rules 590-4-3-.01, 590-4-3-.07.

Hawaii: Hawaii Rev. Stat. § 485.18.

Idaho: Idaho Code § 30-1428(1).

Indiana: Securities Rule § 710 IAC 1-2-23(c).

Minnesota: Minn. Stat. § 80A.12(5).

Mississippi: Securities Rule 221

Missouri: Securities Rules §§ 30-52.070-30-52.090.

Montana: Securities Rule § 6.10.104.

Nebraska: Neb. Rev. Stat. § 8-1108(2), Securities Rule Ch. 6.001.03.

New Mexico: Securities Rule § 86-5.04.

North Carolina: N.C. Gen. Stat. § 78A-28(g).

North Dakota: N.D. Cent. Code § 10-04-08.(1).

Ohio: Securities Rule 1301:6-3-09(C)(1) *see also* OSB 3.01 V ("Escrow Requirements and Procedures"), *Ohio Sec. Bulletin* 9 (June 1973).

Oklahoma: Securities Rule 660:10-9-32.

Oregon: Or. Rev. Stat. § 59.085(3).

Pennsylvania: Pa. Stat. Ann. § 207(g), Securities Rule § 207.071.

South Carolina: S.C. Code Ann. § 35-1-950.

South Dakota: S.D. Codified Laws § 47-31-14.2 Securities Rule §§ 20:08:04:09 16-22.

Tennessee: Tenn. Code Ann. § 48-2-107(f)(1), Securities Rule 0780-4-2-.06(4)(f)(3).

Texas: Tex. Rev. Civ. Stat. § 581-9(A), Securities Rule § 113.3(5).

Vermont: Vt. Stat. Ann. § 4223.

Virginia: Va. Code § 13.1-510(h).

West Virginia: W. Va. Code § 32-3-305(h), Securities Rule § 14.12

Wyoming: Wyo. Stat. § 17-4-111(g), Securities Rule Sec. 2(b)(iv).

(n53)Footnote 53. *See Ga. Securities Rule 590-4-3-.07.*

(n54)Footnote 54.

Alabama: Ala. Code § 8-6-8(b)(1), Securities Rule 830-X-4-.09.

Alaska: Alaska Stat. § 45.55.110(g), Securities Rule § 3 AAC 08.190.

Arizona: Securities Rules §§ R14-4-112, R14-4-113.

Arkansas: Securities Rule 404.01(D).

California: Securities Rules 260.141.20-260.141.27.

Colorado: Colo. Rev. Stat. § 11-51-304(7).

Florida: Securities Rule 3E-700.009.

Georgia: Securities Rule 590-4-3-.01.

Hawaii: Hawaii Rev. Stat. § 16-38-11.5.

Idaho: Securities Rule § 30-1428(2).

Iowa: Securities Rules §§ 191-50.31(502).

Kansas: Securities Rule § 81-7-1(c)(2).

Maryland: Securities Rule 06(A).

Michigan: Securities Rule R451.705.3.

Minnesota: Securities Rule 2875.2440.

Missouri: Securities Rule § 30-52.100.

Nebraska: Neb. Rev. Stat. § 8-1108(2)(a).

New Jersey: Securities Rule § 13:47A-9.11.

North Carolina: N.C. Gen. Stat. § 78A-28(g)(ii), Securities Rule 1314.

North Dakota: N.D. Cent. Code § 10-04-08.1(2).

Ohio: Securities Rule 1301:6-3-19.

Oklahoma: Securities Rule R-305(f).

Oregon: Or. Rev. Stat. § 59.085(3) Securities Rule 441-65-150.

Pennsylvania: Pa. Stat. Ann. § 207(g).

South Carolina: S.C. Code Ann. § 35-1-950, Securities Rules 113-8, 113-9.

South Dakota: S.D. Codified Laws § 47-31A-305(g)(2).

Tennessee: Tenn. Code Ann. § 48-2-107(f)(2), Securities Rule 0780-4-3-.06(4)(1).

Texas: Tex. Rev. Civ. Stat. § 581-9(A).

Washington: Wash. Rev. Code § 21.20.250.

West Virginia: W. Va. Code § 32-3-305(h), Securities Rule § 14.13.

Wyoming: Wyo. Stat. § 17-4-111(g)(ii), Securities Rule Sec. 2(b)(iv).

(n55)Footnote 55.

Alabama: Ala. Code § 8-6-9(a)(9), Securities Rules 830-X-4-.14, 830-X-4-15.

Alaska: Alaska Stat. § 45.55.120(a)(6), Securities Rule 3 AAC 08.150.

Arizona: Securities Rule R14-4-106.

California: Securities Rules 260.140.21, 260.140.40-260.140.45.

Delaware: Del. Code Ann. § 7308(a)(6).

Florida: Securities Rules 3E-700.07, 3E-700.08.

Hawaii: Hawaii Rev. Stat. § 485-13(a)(6), Securities Rule 16-38-11.4.

Idaho: Idaho Code § 30-1431(9).

Indiana: Securities Rule § 710 IAC 1-12-2.

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Iowa: Securities Rule §§ 510-50.38.

Kansas: Securities Rule § 81-7-1(d).

Michigan: Securities Rule R451.706.8.

Minnesota: Securities Rules Part 2875.3020, 2875.3030, 2875.3040.

Mississippi: Securities Rule 221.

Missouri: Securities Rule § 30-52-060.

Montana: Securities Rule § 6.10.111.

Nebraska: Securities Rules Chs. 5, 10.

New Mexico: Securities Rule § 86-5.03(A).

North Dakota: N.D. Cent. Code § 10-04-08.1(3).

Oklahoma: Okla. Stat. § 306(a)(2)(F).

Pennsylvania: Pa. Stat. Ann. § 208(a)(v).

South Carolina: S.C. Code Ann. § 35-1-1010(b)(vi), Securities Rule 113.11.

Tennessee: Securities Rules 0780-4-2-.06(3)(e)(2), 0780-2-3-.06(4)(c).

Texas: Securities Rules 113.3(10)(11).

Utah: Utah Code Ann. § 61-1-12(f).

Wyoming: Wyo. Stat. § 17-4-112(a)(vi).

(n56)Footnote 56. *See, e.g.:*

Indiana: Securities Rule § 710 IAC 1-2-12(c), (f) (time limits on exercise plus total number of options and warrants issued and outstanding or reserved for issuance at the date of the offering may not exceed ten percent of the number of shares to be outstanding upon completion of the offering).

(n57)Footnote 57. *See, e.g.,*

Indiana: Securities Rule § 710 IAC 1-2-12(c)(3)(A).

Texas: Securities Rule § 113.3(11)(C)(iii).

(n58)Footnote 58. *See, e.g.:*

Florida: Securities Rule 3E-700.007(1)(a).

(n59)Footnote 59. *See, e.g.:*

Indiana: Securities Rule § 710 IAC 1-2-22(a), (b).

(n60)Footnote 60. Unif. Sec. Act § 306(a)(F).

(n61)Footnote 61.

Alabama: Ala. Code § 8-6-9(a)(9), Securities Rule 830-X-4.09.

Alaska: Alaska Stat. § 45.55.120(a)(6), Securities Rule § 3 AAC 08.130.

Arizona: Securities Rules R14-4-108, R14-4-111.

Arkansas: Securities Rule 23-42-405(F).

California: Securities Rule 260.140.20(a).

Delaware: Del. Code Ann. § 7308(a)(6).

Hawaii: Hawaii Rev. Stat. §§ 485-10(c), 485-13(a)(6), Securities Rule § 16-38-11.2.

Idaho: Idaho Code § 30-1431(9).

Indiana: Securities Rule § 710 IAC 1-12-1.

Iowa: Securities Rules §§ 50.36(502).

Kansas: Securities Rule 81-7-1(B).

Massachusetts: Securities Rule § 13.305(A)(13).

Minnesota: Securities Rule Part 2875.3050.

Mississippi: Securities Rule 219.

Missouri: Securities Rule § 30-52.040.

Montana: Mont. Code Ann. § 30-10-207(i).

Nebraska: Securities Rules Ch. 5.

Nevada: Securities Rule 90-4051(b).

New Mexico: Securities Rule 86-5.01(A).

North Carolina: Securities Rule 1307.

North Dakota: N.D. Cent. Code § 10-04-08.1(6).

Ohio: Ohio Rev. Code § 1707.09(J) Securities Rule 1301:6-3-05 *see also* OSB 3.01 VI ("Selling Expenses and Underwriters' Compensation"), *Ohio Sec. Bulletin* 9 (June 1973).

Oklahoma: Securities Rule R-306(a)(2)(F).

Oregon: Securities Rule 441-65-030(h).

Pennsylvania: Pa. Stat. Ann. § 208(a)(v).

South Carolina: S.C. Code Ann. § 35-1-1010(b)(vi), Securities Rule 113-12.

South Dakota: Securities Rule 20:08:04:02.

Tennessee: Securities Rule 0780-4-2.06(4)(e).

Texas: Tex. Rev. Civ. Stat. § 581-9(B), Securities Rule 113.4(f).

Utah: Securities Rule 164-10-2(G)(4).

Vermont: Vt. Stat. Ann. § 4208(4).

West Virginia: W. Va. Code § 32-3-306(a)(2)(F), Securities Rule § 14.14(7).

Wyoming: Wyo. Stat. § 17-4-112(a)(vi).

(n62)Footnote 62. NASD member firms involved as underwriters are subject to the separate policy and procedures for review of corporate financings by the NASD. That review as well focuses on the extent of underwriter compensation, and operates independently of any state review.

(n63)Footnote 63. While not generally stated as the purpose of the restrictions, expenses and commission constraints serve as a means of keeping high risk issues from the market. The amount of underwriter compensation will vary directly with level of risk assessment in marketing the issue. The marketing risk can also be shown to be directly related to the potential success of the underlying enterprise. As a result, the imposition of expense and commission limitation serves as a means of identifying and eliminating high risk issues.

(n64)Footnote 64. *See, e.g., Alabama:* Securities Rule 830-X-4.09.

(n65)Footnote 65. *See, e.g., Pennsylvania:* Pa. Stat. Ann. § 208(a)(v).

(n66)Footnote 66. *See, e.g., Kansas:* Securities Rule 81-7-1(b).

(n67)Footnote 67. *Id.*

(n68)Footnote 68. *See, e.g., Alaska:* Securities Rule §3 AAC 08.130.

(n69)Footnote 69. *See, e.g., Utah*: Securities Rules R164-10-2(G)(4), R164-12-1f.

(n70)Footnote 70. *See, e.g., South Carolina*: Securities Rule 113-12.

(n71)Footnote 71.

California: Securities Rules 260.140.1-260.140.10.

Iowa: Securities Rule § 510-50.44.

Kansas: Securities Rule § 81-1-7(L).

Louisiana: Securities Rule C-08.

Minnesota: Securities Rules Parts 2875.3060, 2875.3070.

Missouri: Securities Rule § 30-52.130.

Montana: Securities Rule § 6.10.105.

North Dakota: N.D. Cent. Code § 10-04-08.1(7).

Tennessee: Securities Rule 0780-4-3-.06(3)(d)(1), (4)(b).

Texas: Securities Rule § 113.3(8), (13).

Washington: Securities Rules WAC 460-16A-110, WAC 460-16A-145.

(n72)Footnote 72.

Alaska: Securities Rule § 3 AAC 08.210.

California: Securities Rules 260.140.1, 260.140.2.

Florida: Securities Rule 3E-700.006.

Indiana: Securities Rule § 710 IAC 1-12-4.

Kansas: Securities Rule § 81-7-1(h).

Minnesota: Securities Rules Parts 2875.3080, 2875.3510.

Missouri: Securities Rule § 30-52.110.

Nebraska: Securities Rule Ch. 8.

Tennessee: Securities Rule 0780-4-3.06(4)(i).

Texas: Securities Rule P 113.3(6).

Washington: Securities Rule WAC 460-16A-040 (as to voting rights for preferred stock only).

(n73)Footnote 73. Tx. Admin. Code § 113.3(6).

(n74)Footnote 74. *See e.g., Texas:* Securities Rule § 113.3(8).

(n75)Footnote 75. *See, e.g., Minnesota:* Securities Rule Part 2875.3060.

(n76)Footnote 76.

Alabama: Securities Rule 830-X-4-.10.

Alaska: Securities Rule § 3 AAC 08.220.

California: Securities Rules 260.140.4-260.140.6.

Florida: Securities Rule 3E-700.010.

Hawaii: Securities Rule § 16-38-11.6.

Indiana: Securities Rule § 710 IAC 1-22-5.

Michigan: Securities Rule R451.706.2.

Minnesota: Securities Rules Parts 2875.3500-2875.3540.

Missouri: Securities Rule § 30-52.120.

Nebraska: Securities Rule Ch. 9.

Ohio: OSB 3.01 VII ("Senior Securities: Preferred Stock and Debt Securities"), *Ohio Sec. Bulletin* 9 (June 1973).

Pennsylvania: Pa. Stat. Ann. § 207(h).

Tennessee: Securities Rule 0780-4-2-.06(4)(j).

Texas: Securities Rule §113.3(7).

Washington: Securities Rules WAC 460-16A-045, WAC 460-16A-065.

West Virginia: Securities Rule § 14.09 (applies only to church securities debt).

(n77)Footnote 77. OSB 3.01 VII(1) ("General Standards Concerning Earnings or Cash Flow Capability for Dividend or Debt Service"), *Ohio Sec. Bulletin* 9 (June 1973).

(n78)Footnote 78. *See, e.g., Texas:* Securities Rule § 113.3(7).

(n79)Footnote 79. *See, e.g., Indiana*: Securities Rule § 710 IAC 1-2-25.

(n80)Footnote 80. *See, e.g., Alaska*: Securities Rule § 3 AAC 08.220.

(n81)Footnote 81. *See, e.g., Iowa*: Securities Rule § 510-50.44.

(N82)Footnote 82. *See, e.g., Alabama*: Securities Rule 830-X-4-.13.

(n83)Footnote 83. *See, e.g., California*: Cal. Code § 25140.

(n84)Footnote 84. *See, e.g., Minnesota*: Securities Rule Part 2875.3000.

(n85)Footnote 85. *See, e.g., California*: Cal. Code § 25140.

(n86)Footnote 86.

Alabama: Securities Rule 830-X-4-.17.

Arizona: Securities Rule R 14-4-110.

Georgia: Securities Rule 590-4-4-.02.

Kansas: Securities Rule § 81-7-1(j).

Missouri: Securities Rule § 30-52.140.

(n87)Footnote 87.

Arizona: Securities Rule R14-4-103.

Iowa: Securities Rule § 191-50.25.

Kansas: Securities Rule § 81-10-1.

Maryland: Securities Rule 08.

Massachusetts: Securities Rule § 14.403.

Missouri: Securities Rule § 30-53.010.

Montana: Securities Rule § 6.10.103.

North Carolina: Securities Rule 1308.

Oklahoma: Securities Rule 660:10-13-1 through 4.

Tennessee: Securities Rule 0780-4-2-.04.

(n88)Footnote 88. *See, e.g., Ohio*: OSB 3.01 X ("Consideration and Payment for Securities"), *Ohio Sec. Bulletin* 9 (June 1973).

(n89)Footnote 89.

Alaska: Securities Rule § 3 AAC 08.200.

California: Securities Rules 260.140.110.1.

Florida: Securities Rule 3E-700.014.

Hawaii: Securities Rule § 16-38-11.7.

Minnesota: Securities Rules Parts 2875.7100-2875.7290.

Missouri: Securities Rule § 30-52.150.

Nebraska: Securities Rule Chap. 19.

North Carolina: Securities Rule 1313.

Tennessee: Securities Rule 0780-4-2-.06.

West Virginia: Securities Rule § 14.06.

See also § 6.023[2][d][iii] for discussion of the NASAA Statement of Policy on Real Estate Investment Trusts.

(n90)Footnote 90.

Minnesota: Securities Rules Parts 2875.4500-2875.5280.

Missouri: Securities Rule § 30-52.190.

Nebraska: Securities Rule Ch. 20.

New Mexico: Securities Rule § 86-5.06.

New York: Securities Rules §§ 16.1-22.6, 80.1-80.16.

North Carolina: Securities Rule 1313.

Oregon: Securities Rule 441-65-050 (Condominium Securities).

West Virginia: Securities Rule § 14.06.

See also § 6.02[2][d][ix] for discussion of NASAA Statement of Policy on Real Estate Programs.

(n91)Footnote 91.

California: Securities Rules 260.140.120-260.140.139.

Florida: Securities Rules 3E-700.011, 3E-700.012.

Minnesota: Securities Rules Parts 2875.5600-2875.5780.

New Mexico: Securities Rule § 86-5.07.

North Carolina: Securities Rule 1313.

Ohio: OSB 5.01 (Regulatory Standards: Oil and Gas Offerings), *Ohio Sec. Bulletin* 5 (October 1973).

Tennessee: Securities Rule 0780-4-3-.06(4)(m)(3).

See also § 6.02[2][d][i] for discussion of the NASAA Statement of Policy on Oil and Gas Programs.

(n92)Footnote 92.

Minnesota: Securities Rule Parts 2875.8100-2875.8170.

See also § 6.02[2][d][vii] for discussion of NASAA Statement of Policy on Commodity Pool Programs.

(n93)Footnote 93.

Minnesota: Securities Rules Parts 2875.6100-2875.6260.

New Mexico: Securities Rule § 86-5.10.

Tennessee: Securities Rule 0780-4-3-.06(4)(m)(2).

West Virginia: Securities Rule § 14.08.

See also § 6.02[2][d][viii] for discussion of NASAA Statement of Policy on Cattle Feeding Programs.



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Blue Sky Regulation

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CHAPTER 6 Merit Regulation

1-6 Blue Sky Regulation § 6.03

§ 6.03 Merit Safe Harbors and Coordinated Equity Review

Merit Safe Harbors. For those offerings which remain subject to merit review, in some circumstances the process itself can be significantly streamlined. "Presumptive merit," "fast track," or "merit safe harbor" rules substitute particular criteria for merit standards so as to permit qualification of offerings having characteristics that lessen concerns for investor protection. These are not exemptions from registration and merit review. Rather, such rules provide that offerings which meet specified criteria will be deemed to meet the state's fairness standard, or be excused from compliance with one or more particular merit standards.

The ABA Reportⁿ¹ identified the major examples of such safe harbor provisions as operating in the circumstances of firm commitment underwritten offerings. In these situations, according to the ABA Report, there is at least the proposition that firmly committed underwriters can be relied upon "to ensure that the issuer is relatively stable, to negotiate offering terms reasonable fair to the public investor, to restrain self-dealing by the promoters, and to set a reasonable offering price."ⁿ²

Some underwriting safe harbors are quite narrow. California, for example, provides only that the offering price will not be considered unfair if securities are publicly offered for cash pursuant to a registration statement filed under the Securities Act of 1933 in a firm commitment underwriting by an underwriter or syndicate of underwriters all of whom are registered under the Securities Exchange Act of 1934.ⁿ³ West Virginia eliminates restrictions on "cheap and promotional shares" in firm commitment underwritings of at least \$4 million of securities at an offering price not less than \$5 per share, that involve the participation of at least 15 underwriting firms, each of which purchases at least \$100,000 of the securities being offered.ⁿ⁴ On the other hand, Michigan more broadly declares that a corporate equity offering firmly underwritten by a qualified underwriter, in which dilution and promoter's compensation are fully disclosed, and which meets all requirements of the Conduct Rules and policies of the National Association of Securities Dealers, Inc. (NASD) shall not be deemed "on unfair terms" or in violation of particular merit standards.ⁿ⁵

Michigan provides a further safe harbor when 25% of a corporate equity offering is purchased by accredited investors, and all other investors purchase on the same terms as the accredited investors.ⁿ⁶ Safe harbors such as this are grounded in the notion that a substantial group of purchasers will be positioned to ensure fairness in the terms of an offering, and that non-accredited investors will share the benefit. Investor *suitability* criteria are sometimes used to satisfy regulatory objectives.

Merit safe harbors available in other states generally fall into the categories evidenced by the above examples. Although the validity of the premise may be open to question where the availability of a safe harbor is controlled by minimal

suitability criteria, the essential consideration is that there are countervailing factors impacting the need for traditional Blue Sky merit regulation. However formulated, merit safe harbors must be approached state-by-state, an inherently inefficient process. It is for that reason that streamlined merit review through the Coordinated Equity Review program presents a utilitarian mechanism for at least some multi-state offerings that remain subject to merit regulation.

Coordinated Equity Review. The NASAA-sponsored Coordinated Equity Review (CER) program aims to make the process of multi-state qualification of offerings of NSMIA uncovered securities which are the subject of a registration statement filed with the Securities and Exchange Commission more efficient. The program was implemented in April 1997, in conjunction with revisions to NASAA Statements of Policy relating to public offerings of corporate equity securities. CER is available for corporate equity offerings that are registered with the SEC, and is intended particularly to benefit initial public offerings of smaller issuers.ⁿ⁷ Blue Sky qualification requirements for those offerings have not been changed, but the process in participating states has been altered considerably.ⁿ⁸

CER functions on the basis of two "lead" state reviews of the registration statement and prospectus filed by an issuer with the SEC under the Securities Act of 1933. An issuer desiring to take advantage of CER sends its registration materials to each state in which it intends to offer its stock, accompanied by a one page application form--Form CER-1 (also referred to as Form CR-EQUITY-1)--requesting CER. The same package is sent to the Pennsylvania Securities Commission, which functions as the CER program administrator. Within three days, the Pennsylvania administrator designates two lead states. Non-lead states to which the registration package has been sent may comment on the filing within ten days. All states participating in CER agree that offerings will be reviewed on the basis of NASAA Statements of Policy.

Comments of all participating states are collected, and the two lead states --one of which is responsible for disclosure issues, the other for merit review--collect comments into a single comment letter. The single comment letter is then sent to the issuer for resolution with the two lead states. Once the lead states clear the application, all participating states agree to clear it as well. Issuers requesting CER are advised that the process requires a minimum of 30 days. CER thus shifts the burden of collecting and collating state comments from the issuer to the regulator, and in the process saves time and reduces costs.

In conjunction with the implementation of CER, NASAA revised certain of its Statements of Policy having general application to equity offerings,ⁿ⁹ and promulgated three more, one of which establishes common definitions for use in all others. The revised Statements of Policy address: (1) loans and other material affiliated transactions; (2) preferred stock; (3) underwriting expenses, underwriter's warrants, selling expense, and selling securities holders; (4) options and warrants; (5) promoter's equity investment; (6) promotional shares; (7) the impoundment of proceeds; (8) specificity in use of proceeds; (9) unsound financial condition; (10) corporate securities definitions; and (11) unequal voting rights. The revisions were undertaken by NASAA in order to make guidelines less rigid, and to take into account the structure of equity offerings in today's marketplace.ⁿ¹⁰

CER generally is intended only for initial public offerings of common stock, preferred stock, warrants, rights and units comprised of equity securities that do not constitute NSMIA covered securities. The offering must also be registered (or be in the process of registering) with the SEC under the Securities Act of 1933. Particular forms are prescribed for submission by an issuer in each state in which it intends to offer the securities. State review under CER takes at least 30 days.

CER furthers uniformity and efficiency in the continuing exercise of state regulatory authority in regard to NSMIA non-covered securities. Acceptance of the revised NASAA Statements of Policy against which all CER offerings are to be reviewed is critical in the process, particularly since each participating state must still enter its own order clearing an offering, and each such state may become directly involved with an issuer in regard to issues that may not be resolved by the lead reviews. In any case, it is certain that CER and the revised NASAA Statements of Policy that accompanied its implementation, signal a genuine commitment to uniformity and the elimination of unnecessary barriers to capital

formation.

FOOTNOTES:

(n1)Footnote 1. *41 Bus. Lawyer at 802-804.*

(n2)Footnote 2. *Id., at 804.*

(n3)Footnote 3. *See Cal. Corp. Code § 25140(d).* The California safe harbor illustrates the comfort factor attendant to a firm commitment underwriting by financially responsible, *regulated*, intermediaries. However, the safe harbor also makes clear that nothing contained in it denies authority of the Commissioner to issue a stop order or refuse to issue a permit in circumstances where the underwriting nevertheless involves "unreasonable discounts, commissions or other compensation to underwriters, sellers, or others, unreasonable promoters' profits or participations or unreasonable amounts or kinds of options." *Id.*

(n4)Footnote 4. W. Va. Admin. Reg. 14.15.

(n5)Footnote 5. Mich. Admin. Code R. 451.706.26(2)(a).

(n6)Footnote 6. Mich. Admin. Code R. 451.706.26(2)(b).

(n7)Footnote 7. *See NASAA Uniformity Submission, supra.* NASAA identified the expected beneficiaries of the program as follows:

The CER program is targeted at equity offerings between \$5 million and \$20 million in size that typically are filed on SEC Forms SB-1, SB-2, and S-1, and F-1. These companies usually trade on the NASDAQ Small Cap, the OTC Bulletin Board and/or other smaller exchanges. CER is designed to shift some of the burden of gaining clearance to sell securities in individual states from the issuer to the states. *Id.*, at 13,119.

(n8)Footnote 8. Of the 43 states that require review of non-exempt equity offerings, 37 states have joined the CER program. The remaining six--Illinois, Ohio, Nebraska, Minnesota, Tennessee, and Wyoming--have elected not to participate.

(n9)Footnote 9. CER is available only for equity securities. However, by definition, an equity security includes one convertible into common stock. Thus, offerings of convertible debt are eligible. *See NASAA Statement of Policy Regarding Corporate Securities Definitions, CCH NASAA Reports P 3812 (Apr. 27, 1997).*

(n10)Footnote 10. NASAA Uniformity Submission, *supra*, at 13,120. These and other NASAA Statements of Policy are considered further in conjunction with an examination of merit standards generally in § 6.02[2].



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CHAPTER 6 Merit Regulation

1-6 Blue Sky Regulation § 6.04

§ 6.04 Disclosure in Merit Jurisdictions

As noted throughout, many merit review policies and state standards include particular disclosure requirements as conditions to approval. The NASAA Statement of Policy regarding specificity in use of proceeds, for example, mandates not only the content of, but also the manner of presenting information concerning estimated cash proceeds of an offering in the prospectus as a condition to qualification.ⁿ¹ Additionally, the NASAA Omnibus Guidelines address content and disclosure of certain kinds of information in prospectuses.ⁿ²

Beyond special disclosure requirements where particular policies or standards are applicable, all states mandate the use of a structured disclosure document regardless of the fact that an offering is subject to merit review. Contents of prospectuses, including requirements for financial statements to be a part of them, are often prescribed by the statute.ⁿ³ The Uniform Act, on the other hand, provides that the administrator may by rule or order require as a condition of registration that a prospectus containing specified information be sent or given to each offeree before or concurrently with certain stages of the selling process.ⁿ⁴ In application, the Uniform Act provision has been converted into a mandate for use of a disclosure document.

Whether prescribed by statute or rule, the general content of prospectuses for Blue Sky compliance is similar to that required for prospectuses in registration statements filed under the Securities Act of 1933. The adequacy of disclosure, that is, the required content as well as the substance and manner in which it is presented, is part of the merit review process. State administrators are generally empowered to require, in addition to any specified category of information, any other information deemed necessary or appropriate.ⁿ⁵ Disclosure is thus a further tool in the merit review process. With it, an administrator may compel and control the presentation of information to offerees to an extent that the terms of an offering may well be adjusted in response to a directive regarding their disclosure. There is great flexibility afforded to administrators in this process to use disclosure as a means of addressing troublesome issues and terms that are not directly controlled by an applicable policy or guideline.ⁿ⁶

The ultimate objective of "full disclosure" under state Blue Sky laws is no different than that underlying the federal Securities Act of 1933. Certainly in those states that are today "disclosure" jurisdictions the objective is paramount--allowing for an informed investment decision. The difference is that at the state level disclosure can be as much a part of merit regulation as the application of merit standards themselves. The power to assess the adequacy of disclosure, and to make valutive judgments on content, manner of presentation and the very need to disclose particular information at all as a condition to qualification, exemplifies the baseline distinction between merit and disclosure-based regulation. Both regulatory approaches mandate the preparation and dissemination of a structured disclosure document, and then provide meaningful remedies for fraud and information failures. Merit jurisdictions,

however, use the disclosure document as a means to achieving fairness *ex ante*. Disclosure is an extremely meaningful tool available to merit regulators, and its role in merit jurisdictions cannot be overestimated.

FOOTNOTES:

(n1)Footnote 1. *CCH NASAA Reports* P 3835, at 2095 (Apr. 27, 1997). The NASAA use of proceeds policy is discussed in § 6.02[2][c][ix].

(n2)Footnote 2. *CCH NASAA Reports* P 2328, at 1389-17 (Mar. 29, 1992).

(n3)Footnote 3. *See, e.g., Ariz. Rev. Stat. § 44-1892-1895.*

(n4)Footnote 4. Unif. Sec. Act § 304(d).

See also Mich. Comp. Laws § 451.702(17)(d).

(n5)Footnote 5. *See, e.g., Iowa Reg. § 191-50.27(3):*

Every prospectus required to be delivered ... shall be in a form acceptable to the administrator and shall contain the information specified in paragraphs (a) through (k) and paragraph (p) of subsection 2 of section 207 of the Act and any other information which the Administrator may deem necessary and appropriate.

NASAA "Uniform Disclosure Guidelines--Legends" prescribe uniform cover page legends for prospectuses or offering documents. The Guidelines set out specific language for regulatory disclaimers and legends, and regarding restrictions on transfer or resale that are involved in offerings made pursuant to exemption from state and federal registration requirements. As with all NASAA "guidelines," these may be waived or modified by an administrator where good cause is shown. However, the regulatory disclaimer and legend prescribed by the guideline may fairly be described as being universally required and utilized. For the Disclosure Guideline and the specific legends, *see CCH NASAA Reports* P 1352, at 851 (Apr. 29, 1989).

(n6)Footnote 6. In Minnesota, for example, qualification of an offering that is deemed by the administrator to be "speculative" may be conditioned to require:

[T]hat the prospectus or offering circular conspicuously state on its cover that the securities offered thereby are speculative or a brief description of material risks involved in the purchase of the securities with a cross-reference to further discussion (in greater detail) in the body of the prospectus and/or that each investor receive a statement concerning the speculative nature of the securities, sign a copy thereof, and file same with the commissioner. Minn. Rules 2875.3100(A).



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CHAPTER 6 Merit Regulation

1-6 Blue Sky Regulation § 6.05

§ 6.05 Compliance Challenges

As discussed throughout this Chapter, meaningful steps have been taken toward greater efficiency in the administration of Blue Sky laws generally, and merit regulation in particular. NSMIA has at the same time rationalized the dual state/federal system to account for national markets. But where it remains operative, merit-based Blue Sky regulation is still not homogeneous among the states, and challenges in compliance remain as issuers must contend with different sets of rules and resultant increased transaction costs. As seen earlier in the discussion of what securities remain subject to merit regulation, the issuers facing these challenges are most likely to be those least able to afford the costs.

Non-uniformity is the major source of confusion and complexity of compliance in offerings undertaken in two or more merit jurisdictions. Since each state has the ability to set its own standards, indeed its own "smell test," it is only when there is an agreement in philosophy and regulatory technique that some measure of uniformity exists. NASAA Statements of Policy have not been uniformly adopted, and even among states adopting particular Statements of Policy, the version officially adopted may not be the same. The more flexible, and efficient, approach more evident today is that exemplified by Massachusetts, which adopts specified NASAA Statements of Policy "in effect at the time of application" by an issuer for registration by qualification.ⁿ¹

Moreover, there is ample room in the application of the NASAA Statements of Policy for key assessments left to individual administrators. "Promoters' equity investment," for example is defined in the NASAA Corporate Securities Definition Statement of Policy as: "the total of cash and tangible assets that has been contributed by the promoters to the Issuer" ⁿ² However, the express proviso is that the value of tangible assets contributed must be accepted by the Administrator. Without regard to flexible definitions, each of the NASAA Policies of General Application is prefaced with the admonition that: "Nothing shall prevent the Securities Administrator ... from applying different standards than those contained in this Statement of Policy."ⁿ³

Unquestionably, compliance challenges associated with merit regulation have been significantly ameliorated by NSMIA preemption. As a practical matter, there simply will be far fewer multistate offerings of securities that remain subject to state registration and qualification procedures, and as discussed in § 6.03 above, Coordinated Equity Review is specifically available. It is also true that far more offerings that remain subject to merit review are of small amounts by small business issuers. State securities commissions are much more able to deal efficiently with merit reviews of a small number of relatively small offerings that are carried out on a localized basis. Moreover, many states have also enacted various forms of small issuer or limited offering exemptions that afford significant opportunities for capital formation without any consideration of costs associated with registration and qualification procedures, thus further limiting the extent to which merit regulation will actually present compliance challenges.ⁿ⁴ When registration is required,

procedures such as SCOR minimize the burden on qualifying small business issuers, and also streamline reviews in a single or multi-state compliance setting.

In the past there have been compliance challenges in the merit regulation process that ranged from dealing with unpublished guidelines or standards to the inadequacy of administrative staff to engage in the process, to a pervasive uncertainty in how to deal promptly and uniformly with new and evolving markets, investment products and financial technology. NSMIA largely eliminated the uncertainty for issuers that merit review injected into capital formation in integrated national and world markets. Securities administrators and NASAA have made major progress addressing other challenges that have historically made the merit review process burdensome and expensive. This is critical today, with the focus of the process on NSMIA non-covered securities that disproportionately impacts small business capital formation.

FOOTNOTES:

(n1)Footnote 1. *See* Cd. Mass. Regs. Sec. 13.305(A).

(n2)Footnote 2. *CCH NASAA Reports* P 3812, at 2090 (Apr. 27, 1997).

(n3)Footnote 3. On the other hand, merit review states generally make provision for waiver of any policies, or for approval of registrations which do not comply. *See, e.g.*, Code Mass. Regs. § 13.305(A) ("Nothing contained herein shall preclude establishing compliance ... in those instances in which the registration statement does not comply with the applicable statement of policy").

See also NASAA Statement of Policy Regarding Real Estate Investment Trusts, *CCH NASAA Reports* P 3401, at 1901 (Sept. 29, 1993) ("While applications not conforming to the standards contained herein shall be looked upon with disfavor, where good cause is shown, certain guidelines may be modified or waived by the Administrator").

(n4)Footnote 4. The array of issuer exemptions from registration and qualification requirements is presented in Chapter 8.



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CHAPTER 7 Exempt Securities

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[11] Securities of Cooperative Associations

§ 7.07 Administrative Authority over Security Exemptions



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CHAPTER 7 Exempt Securities

1-7 Blue Sky Regulation § 7.01

§ 7.01 Exempt Securities--Generally

All Blue Sky laws contain an array of exemptions from registration requirements for particular types of securities, as well as for transactions where the protections of registration are not necessary, or are achieved in some different manner. Where certain types of securities are involved, for example, investor protection objectives are satisfied by the very nature of the issuer, as with securities issued by the United States government or its agencies. For other types of securities the same objectives are met through some other regulatory scheme or system, as with bank deposit instruments or bank instruments issued in a federally supervised and regulated environment. Transaction exemptions have been similarly created in Blue Sky laws to permit offers and sales of securities in particular circumstances in which the need for registration and qualification is not present, or may be addressed by lesser, "limited" means.ⁿ¹

The operation, indeed the relevance, of certain security exemptions in Blue Sky laws have been impacted by NSMIA--the National Securities Market Improvements Act of 1996--which established classes of federal "covered securities" that are not subject to state registration and qualification requirements in any case. The role of NSMIA in regard to security exemptions, and its effect on exemptions remaining a part of state securities statutes is separately addressed later in this Chapter.ⁿ² As a general matter, however, other than those states which have adopted the 2002 Uniform Securities Act, which was drafted fully to reflect NSMIA and to modernize all aspects of a model Blue Sky law, states have not made wholesale changes except as absolutely needed, as, for example, to eliminate federal covered securities from registration and qualification requirements and impose permissible notice filing and fee requirements. Exemptions, both for securities and transactions, remain largely untouched. Perhaps the best example is the exemption for exchange listed securities, based in most cases on section 402(a)(8) of the original Uniform Securities Act, which remains intact today despite the fact that most listed securities are now NSMIA federal covered securities for which state registration requirements were preempted.ⁿ³ These federal covered securities are not subject to the securities registration requirements of Blue Sky laws without regard to any exemption. However, the relevance of a post-NSMIA exemption relating to exchange listed securities is illustrated by section 201(6) of the 2002 Uniform Act,ⁿ⁴ which addresses *derivative* securities based on exchange listed securities. The post-NSMIA version of this exemption is discussed later in this chapter.ⁿ⁵

Whether exempt securities or transactions are involved, the exemption applies only to registration requirements. Antifraud provisions of state securities laws remain fully in force and available to both administrators and investors under civil remedy provisions to address fraud and deception in the offer and sale of otherwise exempt securities. Likewise, exemptions from registration have no impact on broker-dealer, agent, investment adviser or investment

adviser representative licensing requirements.ⁿ⁶

There is an important distinction to be made between an exempt security and an exempt transaction. If a security is exempt, it is usually always exempt regardless of the number of times it is offered or sold by the issuer, provided the requirements for the exemption are met. On the other hand, a transaction exemption is available only as to a particular offer or sale. If, for example, there is an exemption for offers or sales to accredited investors,ⁿ⁷ it is necessary to examine each transaction in the security to ascertain whether the offeree or buyer does in fact qualify as accredited within the meaning of the exemption. Security exemptions in Blue Sky laws are for the most part issuer exemptions, and their availability depends upon the issuer meeting qualifying criteria. Thus, a security issued by and representing an interest in, or a debt, or that is insured or guaranteed by, an insurance company authorized to do business in a state is often exempt from registration.ⁿ⁸ Normally this means that the security retains its exempt status through the course of any subsequent transactions so long as the issuer remains qualified under the terms of the exemption. Trading, or secondary market, transactions in exempt securities may, however, impact exempt status. For example, subsequent transactions in a security of an issuer organized and operated exclusively for charitable purposes may adversely impact the availability of that common security exemption when the subsequent transactions involve ineligible purchasers or otherwise violate the qualifications placed on the security exemption. For the most part, however, an exempt security remains exempt, and subsequent transactions will not trigger registration requirements.

Because all Blue Sky laws include both securities and transaction exemptions, and because a considerable number of state laws are not based upon the Uniform Securities Act or its progeny, there are variations in exemptions themselves and how they are classified. What constitutes an exempt security under the original Uniform Securities Act may be treated as an exempt transaction in one or more states. For example, securities issued pursuant to ERISA regulated employee benefit plans are exempt securities under the Uniform Act,ⁿ⁹ but in Florida,ⁿ¹⁰ North Dakotaⁿ¹¹ and Texas,ⁿ¹² the exemption is transactional. In states adopting the 2002 Uniform Securities Act such interests are excluded from the definition of security entirely. Texasⁿ¹³ treats securities issued by cooperatives as exempt transactions, while the Uniform Act exempts the security itself.ⁿ¹⁴ Some states exempt securities that are not addressed the Uniform Securities Act. For example, North Carolinaⁿ¹⁵ exempts certain securities issued by professional associations. A comparable transactional exemption exists in other states.ⁿ¹⁶

In several states the administrator is empowered to create exemptions by rule or order, sometimes to accomplish particular state objectives such as economic development.ⁿ¹⁷ It is also common for state administrators to be empowered to revoke or suspend an exemption if such action is deemed to be in the public interest, and specified administrative procedures are followed.ⁿ¹⁸ In many states as well, the administrator may waive any conditions for an exemption. The 2002 Uniform Securities Act recognizes the broad authority of administrators to issue orders waiving, in whole or part, any conditions for an exemption.ⁿ¹⁹

Most security exemptions in Blue Sky laws are self-executing, meaning that no notice, fee, application, or approval process is required. Some states, however, require a pre-sale filing for certain exempt securities, as for example, those issued by not-for-profit organizations. The 2002 Uniform Securities Act provides specifically with respect to the offer and sale of notes, bonds, debentures, or other evidences of indebtedness by a non-profit issuer that rules may be adopted to limit the availability of the exemption, specifying its scope, and requiring the issuer to file a notice specifying material terms of the proposed offering and copies of any sales literature. The 2002 Uniform Act also authorizes a requirement that an issuer make a request for exemption authorization.ⁿ²⁰ The original Uniform Securities Act includes an advance notice filing requirement for investment contracts issued in connection with employee benefit plans, and this requirement is carried into several state Blue Sky laws.ⁿ²¹

In most cases, an advance notice requirement does not equate with advance *approval*. The notice requirement is intended to provide an opportunity for review by the administrator, and for further interaction or inquiry as may be deemed necessary or appropriate ahead of a proposed offering. As a practical matter, the ability of an administrator to suspend an exemption in the exercise of administrative enforcement powers underscores the importance of the review

process that is built into advance notice procedures. This procedure, as with administrative authority regarding exemptions generally, is discussed further in § 7.04.

As a prelude to consideration of the set of securities exemptions included in all Blue Sky laws, it is necessary first to examine statutory *exclusions* from the definition of "security" that are contained in Blue Sky laws. The effect of an exclusion from the definition of security is to remove the instrument or interest from all consideration under the Blue Sky law. Although there are few such exclusions, and none universally adopted,ⁿ²² the effect of an exclusion or exception is to eliminate coverage of the Blue Sky law entirely. Statutory exclusions are considered further below.

FOOTNOTES:

(n1)Footnote 1. Transaction exemptions in Blue Sky laws are addressed in Chapter 8, with expanded consideration of non-issuer transaction exemptions taken up in Chapter 9.

(n2)Footnote 2. *See* § 7.03, "NSMIA and Security Exemptions," *below*.

(n3)Footnote 3. As now defined in section 18(b)(1) of the Securities Act of 1933, 15 U.S.C. § 77r(b)(1) (2000), added by NSMIA, provides that "covered securities" include:

Securities listed or authorized to be listed on the New York Stock Exchange, the American Stock Exchange, the Global tier of the NASDAQ Stock Market, or any other national securities exchange approved by the SEC as having substantially similar listing standards.

(n4)Footnote 4. 2002 Unif. Sec. Act § 201(6).

(n5)Footnote 5. *See* § 7.04 ("2002 Uniform Securities Act Exemption Summary"), *infra*.

(n6)Footnote 6. Official Comments to the 2002 Uniform Act make clear:

"Section 201 includes exempt securities and Section 202 includes exempt transactions. Both exempt securities and exempt transactions are exempt from the securities registration, notice filing requirement of Section 302, and the filing of sales literature Section 504 of this Act. Neither Section 201 nor Section 202 provides an exemption from the Act's antifraud provisions in Article 5, nor the broker-dealer, agent, investment adviser or investment adviser representative requirements in Article 4." *Official Comments* 2002 Unif. Sec. Act Art. 2.

In most cases it is explicitly stated that the exemptions apply only for purposes of registration. *See Chester v. McDaniel*, 264 Or. 303, 504 P.2d 726 (1972). The states not utilizing qualified language contain other statutory provisions retaining fraud jurisdiction. *See Tex. Rev. Civ. Stat. Ann. art. 581-29* (penal provisions); 581-33 (civil liabilities).

(n7)Footnote 7. *See* Ch. 8 for a complete analysis of all transactional exemptions.

(n8)Footnote 8. *See, e.g.*, 2002 Unif. Sec. Act § 201(4).

(n9)Footnote 9. Unif. Sec. Act § 402(a)(11).

(n10)Footnote 10. *Fla. Stat. Ann. § 517.061(15)*.

(n11)Footnote 11. *N.D. Cent. Code § 10-04-06(11)*.

(n12)Footnote 12. *Tex. Rev. Civ. Stat. Ann. art. 581-5(I)(b)*.

(n13)Footnote 13. *Tex. Rev. Civ. Stat. Ann. art. 581-5(N)*.

(n14)Footnote 14. *Unif. Sec. Act § 402(a)(12); Rev. Unif. Sec. Act § 401(b)(13)*.

(n15)Footnote 15. *N.C. Gen. Stat. § 78A-16(13)*.

(n16)Footnote 16. *See, e.g., Cal. Code Regs tit. 10, § 260.105.6; Or. Rev. Stat. § 59.035(14)*.

(n17)Footnote 17. *See, e.g., Virginia: Code Va. § 13.1-514.1* (any security offered or sold as part of a community undertaking to attract new business or industry to the community, when certain conditions are met).

(n18)Footnote 18. Administrative authority over security exemptions is discussed in § 7.07, *infra*.

(n19)Footnote 19. *See* 2002 Unif Sec. Act § 203.

(n20)Footnote 20. *See* 2002 Unif. Sec. Act § 201(7). This and the 2002 Uniform Act security exemptions generally, are summarized in § 7.04, *infra*.

(n21)Footnote 21. *See, e.g., Massachusetts, 110A M.G.L. § 402(a)(11)*.

(n22)Footnote 22. The original Uniform Securities Act, which is the basis of a majority of state Blue Sky laws contains only one exclusion from the definition of "security." Section 401(l) of the Uniform Act provides that "security" does not include any insurance or endowment policy or annuity contract under which an insurance company promises to pay money either in a lump sum or periodically for life or for some other specified period. There is optional language provided to allow the exclusion to be based on payment of a fixed sum of money. Uniform Act states have widely adopted this exclusion in one form or another. However, as discussed below, there are variations, and additionally, exclusions for variable annuity insurance products are much more problematic.



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CHAPTER 7 Exempt Securities

1-7 Blue Sky Regulation § 7.02

§ 7.02 Statutory Exclusions

The significance of distinguishing between an exemption and an exclusion was recognized in the original Uniform Securities Act. The Official Comment to § 402(a) of the Uniform Act states: "The distinction between exemptions and exceptions from definitions is important in view of the fact that the exemptions enumerated in § 402 are not exemptions from the anti-fraud provisions" The drafters' commentary to the Act added:

In this statute the draftsmen have been careful to distinguish between *exemptions* and *exceptions from definitions*, both because there is usually a clear and inherent distinction and because the distinction assumes practical importance in view of the fact that the exemptions enumerated in § 402 are not exemptions from the anti-fraud provisions ⁿ¹ "Exceptions from definitions," *i.e.*, statutory exclusions do in fact eliminate any application of antifraud provisions. Consequently, legal proceedings involving excluded interests must be brought under some other applicable state law even if a particular transaction is tainted with fraud.ⁿ²

Exclusions from Blue Sky laws are thus mostly a function of the definition of "security" contained in each statute. A common statutory exclusion is for insurance products and annuities. Thus in California, for example, the definition of security does not include any annuity contract under which an insurance company licensed to do business in the state promises to pay a sum of money (whether or not based upon the investment performance of a segregated fund) either in a lump sum or periodically for life or some other specified period.ⁿ³ This is also the original Uniform Act model.ⁿ⁴ However, reflecting the fact that exclusions of *variable* insurance products from the definition of security are not provided in several states,ⁿ⁵ the 2002 Uniform Securities Act provides an option for states to include them in the exclusion that otherwise focuses only on an insurance company promise to pay a fixed sum of money. Section 102(28) of the 2002 Uniform Securities Act thus provides that the definition of "security" does not include:

[A]n insurance or endowment policy or annuity contract under which an insurance company promises to pay a fixed [or variable] sum of money either in a lump sum or periodically for life or other specified period.

As part of addressing insurance products generally, some states expressly exclude viatical settlement contracts from the definition of security. Viatical settlement contracts are based upon life insurance policies and represent agreements for the purchase, sale, assignment, transfer or other disposition of the death benefit or ownership of the policy for some consideration that is less than the expected death benefit of the policy. While states more commonly today include

viatical settlement contracts in the definition of security, others expressly exclude them, and thus leave regulation to the state insurance commissioner.ⁿ⁶

The 2002 Uniform Securities Act provides a further exclusion from the definition of security for "an interest in a contributory or noncontributory pension or welfare plan subject to the Employee Retirement Income Security Act of 1974."ⁿ⁷ This exclusion was not part of the original Uniform Act, and thus was not widely incorporated into Blue Sky laws as a specific statutory exclusion. It was, however, included in the Revised Uniform Securities Act. Whether such interests are securities at all is more commonly addressed as a matter of case law establishing the contours of an investment contract, as guided by the United States Supreme Court decision in *International Brotherhood of Teamsters v. Daniel*,ⁿ⁸ in which interests in noncontributory, compulsory pension plans were held not to be securities. In any event, states adopting the Revised Uniform Securities Act provision,ⁿ⁹ make the exclusion express in the statute. The specific exclusion is also now a part of Blue Sky laws based on the 2002 Uniform Act. More commonly, however, employee benefit plan interests have been addressed by a security or transaction exemption, rather than an exclusion. In that manner, antifraud authority under Blue Sky laws is preserved.

There are several other statutory exclusions from the definition of security found in particular state Blue Sky laws. Tennessee, for example, specifically excludes currency, checks, notes, or other evidences of indebtedness issued in a mercantile or consumer transaction, and interests in a deposit account with a bank or savings and loan association.ⁿ¹⁰ Pennsylvania and several other states provide a specific statutory exclusion from the definition of security for membership interests in limited liability companies that meet certain criteria regarding member participation in management of the company.ⁿ¹¹ A number of states expressly exclude certain mineral interests or real estate from their definitions. Other than in those states that address limited liability membership interests under statutory exemptions from the definition of security, there is no common thread for these various exclusions. Of course, in each instance an exclusion is necessarily based upon a determination that Blue Sky law protection is not necessary or appropriate, including antifraud protection.

FOOTNOTES:

(n1)Footnote 1. *Drafters' Commentary*, Unif. Sec. Act § 402.

(n2)Footnote 2. Thus, for example, actions concerning fraudulent sales of annuities in those states which exclude these interests from the statutory definition of security may not be brought under the Blue Sky law. *See, e.g., Mahaney v. John Hancock Mut. Life Ins. Co.*, 6 Mass. App. Ct. 919, 380 N.E.2d 140 (1978) .

(n3)Footnote 3. *Cal. Corp. Code* § 25019.

See also Mass. Gen. Laws Ann. Ch. 110A, § 401(k), which provides: " 'Security' does not include any ... annuity contract under which an insurance company promises to pay money either in a lump sum or periodically for life or some other specified period."

(n4)Footnote 4. *See* Unif. Sec. Act § 401(l).

(n5)Footnote 5. *See, e.g., Rhode Island, G.L.R.I. § 7-11-101(22)*. Rhode Island, a Uniform Act state, makes the exclusion applicable only to products involving an insurance company promise to pay a fixed sum of money. Other states limiting the exclusion to fixed payment insurance products include Kentucky, the District of Columbia, and Nevada. A number of other states, Ohio and Florida for example, provide no exclusion at all.

(n6)Footnote 6. *See, e.g., West Virginia: Code. W. Va. § 32-4-401(n)*. The treatment of viatical settlement contracts under Blue Sky laws is more fully considered in Ch. 2, *supra*.

(n7)Footnote 7. 2002 Unif. Sec. Act § 102(28)(C). This exclusion was originally made a part of the Revised Uniform Securities Act, *see* Rev. Unif. Sec. Act § 101(16)(ii).

(n8)Footnote 8. *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551, 99 S. Ct. 790, 58 L. Ed. 2d 808 (1979) .

(n9)Footnote 9. *See, e.g.*, Washington: Rev. Code Wa. § 21.20.005(12)(b).

(n10)Footnote 10. *Tenn. Code Ann. § 48-2-102(16)(A)-(D)*.

(n11)Footnote 11. Pa. Stat. § 102(t)(v). *See also Utah Code Ann. § 61-1-13(24)(b)*, which excludes an interest in a limited liability company formed as part of an estate plan where all the members are related by blood or marriage, there are five or few members, or when the person claiming the exclusion can demonstrate that all members are actively engaged in management of the limited liability company.



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CHAPTER 7 Exempt Securities

1-7 Blue Sky Regulation § 7.03

§ 7.03 NSMIA and State Securities Exemptions

The National Securities Markets Improvements Act (NSMIA),ⁿ¹ amended § 18 of the Securities Act of 1933ⁿ² to preempt significant aspects of state regulatory authority regarding "covered" securities. Where covered securities are involved, states may not directly or indirectly impose registration or qualification requirements, prohibit the offering or sale, impose conditions or additional disclosure requirements on the use of offering documents, proxy statements and other disclosure documents prepared by an issuer, or engage in merit regulation. Federal "covered" securities under NSMIA include:

- (a) Securities listed or authorized for listing on the New York Stock Exchange or the American Stock Exchange, or listed on the National Market System of the NASDAQ Stock Market, or listed or authorized for listing on a national securities exchange which the Securities and Exchange Commission ("Commission") determines to have substantially similar listing standards;
- (b) securities equal in seniority or senior to securities described above;
- (c) securities issued by an investment company registered under the Investment Company Act of 1940;
- (d) securities offered or sold to a "qualified purchaser" as defined by the SEC; and
- (e) several categories of exempt securities under § 3 of the Securities Act of 1933; and those offered and sold in various transactions securities exempt under § 4 of the Act, including transactions exempt under § 4(1)ⁿ³ (by persons other than an issuer, underwriter or dealer); § 4(3)ⁿ⁴ dealer transactions in securities of reporting issuers; and transactions exempt under § 4(4)ⁿ⁵ as brokers' transactions.ⁿ⁶

With only four exceptions, NSMIA classified exempt securities under section 3(a) of the Securities Act of 1933 as "covered" securities for purposes of federal preemption.ⁿ⁷ The four exceptions are for securities covered by federal exemptions in section 3(a)(4) (securities issued by charitable, educational, and other qualifying nonprofit issuers), section 3(a)(10) (securities issued in certain exchange transactions approved by a court or authorized agency) section 3(a)(11) (intrastate offerings); and municipal securities offered in their home state. The array of exempt securities contained in the Uniform Securities Act and many state Blue Sky laws includes several exempt securities in section 3(a) of the federal Act. When coupled with the NSMIA provision making exchange listed securities covered securities for

purposes of federal preemption, it is clear that NSMIA impacts several securities exemptions in state laws. It is no longer necessary, for example, for states to provide an exemption from registration for "commercial paper" arising out of current transactions and which evidences an obligation to pay cash within nine months of the date of issuance.ⁿ⁸ Section 3(a)(3) of the Securities Act of 1933 establishes the same exemption at the federal level and the qualifying securities are now NSMIA federal covered securities not subject to state regulation.

In the wake of NSMIA, the 2002 Uniform Securities Act streamlined the array of Blue Sky securities exemptions to eliminate overlap with federal exemptions which after NSMIA make the securities federal covered securities.ⁿ⁹ It also includes a general securities exemption for all federal covered securities.ⁿ¹⁰ Nevertheless, in states that have not adopted the 2002 Uniform Act, Blue Sky laws have for the most part not been amended to eliminate any preexisting securities exemptions, and in practice it is still important to examine and understand the scope of state exemptions and the limitations of federal "covered security" status that give those exemptions continued meaning. The situation is perhaps best illustrated by the major state enforcement initiatives directed at the widespread offers and sales of promissory notes and other debt securities which, by reason of terms, characteristics or controlling legal principles, do not qualify for the federal "commercial paper" exemption in section 3(a)(4) of the Securities Act of 1933, and thus are not federal covered securities. Such notes and debt securities remain subject to state registration and qualification requirements unless a state securities or transaction exemption is available. The scope of other state exemptions for particular securities can be meaningful as well when the state securities exemption is broader than a federal section 3 exemption.

Following the enactment of NSMIA, the North American Securities Administrators' Association (NASAA) developed model legislation recommended to the states to enable enactment of uniform provisions conforming state laws to NSMIA.ⁿ¹¹ To one degree or another, states adopted the NASAA recommended changes.ⁿ¹² These did not, however, address the elimination or retention of particular exemptions. Rather, "by incorporating a definition of federal covered security" into their statutes,ⁿ¹³ states simply provided that federal covered securities are excluded from the basic registration and related requirements prescribed in their Blue Sky laws.ⁿ¹⁴

As a practical matter, by various security and transaction exemptions in Blue Sky laws, most states had substantially presaged NSMIA. The conversion of what were formerly exempt securities into federal covered securities for purposes of preemption did not have significant impact except to the extent there were variations among states in qualification for particular exemptions, as, for example, with conditions for the exemption of exchange listed securities. After NSMIA, the 2002 Uniform Securities Act simply eliminated Blue Sky law securities exemptions that were no longer needed because the subject securities were after NSMIA federal covered securities. Nevertheless, states which have not adopted the 2002 Uniform Act retain the array of pre-NSMIA exemptions. In particular circumstances some of those exemptions remain meaningful to the extent that in spite of ostensible overlap with a federal Securities Act section 3 exemption, a federal covered security is in fact not present. In some circumstances, the breadth of a security exemption in a Blue Sky law may exempt securities that are not subject to NSMIA preemption. For example, after NSMIA states may continue to regulate municipal securities offered or sold within the state in which the issuer is located. The government securities exemption in the applicable Blue Sky law, however, may extend to those securities.

In all cases, states may continue to investigate and bring enforcement actions with respect to "fraud or deceit" or "unlawful conduct by a broker or dealer" in connection with these securities transactions. NSMIA also permits states to require a notice filing, including a consent to service of process, a filing fee, and a sales report with regard to these securities (except for "listed" securities), and states may suspend the offer or sale of securities within state borders for failure to file or to pay such fees.

FOOTNOTES:

(n1)Footnote 1. Pub. L. No. 104-290, 110 Stat. 3416 (1996).

(n2)Footnote 2. *15 U.S.C. § 77r (2000)*.

(n3)Footnote 3. 15 U.S.C. § 77d(1) (2000).

(n4)Footnote 4. 15 U.S.C. § 77d(3) (2000).

(n5)Footnote 5. 15 U.S.C. § 77d(4) (2000).

(n6)Footnote 6. 15 U.S.C. § 77c(a) (2000).

(n7)Footnote 7. Securities Act section 18(b)(4)(C), 15 U.S.C. § 77r(b)(4)(C) (2000), defines NSMIA covered securities as including those exempt under section 3 of the federal Securities Act:

[o]ther than the offer or sale of a security that is exempt from such registration pursuant to paragraph (4), (10) or (11) of such section, except that a municipal security that is exempt from such a registration pursuant to paragraph (2) of such section is not a covered security with respect to the offer or sale of such security in the State in which the issuer of such security is located.

(n8)Footnote 8. See, e.g., Unif. Sec. Act § 402(10).

(n9)Footnote 9. A summary of the post-NSMIA security exemptions contained in the 2002 Uniform Securities Act is presented in § 7.04, below .

(n10)Footnote 10. 2002 Unif. Sec. Act § 201(6).

The added security exemption for federal covered securities has also been adopted in some states that have not adopted the 2002 Uniform Act. Utah, for example, exempts; "a federal covered security specified in the Securities Act of 1933, Section 18(b)(1), 15 U.S.C. Section 77r(b)(1), or by rule adopted under that provision." *Utah Code. Ann. § 61-1-14(e)*.

(n11)Footnote 11. In its recommendations to states on conforming their registration and exemption schemes to NSMIA, NASAA encouraged states to modify, not repeal, existing exemptions affected by the federal legislation. See Rutledge, *National Securities Markets Improvements Act ... One Year Later: The States' Response*, 53 Bus. L. 563, 567 (Feb. 1998). In the event that the state exemption is broader than the federal exemption, those securities described by the state exemptions are presumably subject to state exemption practices.

(n12)Footnote 12. See Blue Sky L. Rep. P 6491 (CCH) at 2591; see also S. Miller & W. O'Brien, *The National Securities Markets Improvements Act of 1996*, Rev. Sec. and Comm. Reg. 21, 25 (Jan. 29, 1997); Campbell, R.B. *Blue Sky Laws and Congressional Pre-emption Failure*, 22 J. Corp. L. 175 (1997).

(n13)Footnote 13. In the wake of NSMIA states now include in their Blue Sky laws a specific definition of "federal covered security," as meaning: "A security that is, or upon completion of a transaction will be, a covered security under Section 18(b) of the Securities Act of 1933 (15 U.S.C. Section 77r(b)) or rules or regulations adopted pursuant to that provision." 2002 Unif. Sec. Act § 101(7).

(n14)Footnote 14. See, e.g., 2002 Unif. Sec. Act § 301, which provides in pertinent part: "It is unlawful for a person to offer or sell a security in this State [without registration] unless: (1) the security is a federal covered security"



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CHAPTER 7 Exempt Securities

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§ 7.04 2002 Uniform Securities Act Exemption Summary

As discussed above, NSMIA made several classes of exempt securities into federal "covered securities" for purposes of NSMIA preemption. Drafters of the 2002 Uniform Securities Act designed the new Uniform Act to take into account those categories of exempt securities and to streamline state Blue Sky laws by eliminating certain state exemptions that are no longer needed by reason of federal preemption. The 2002 Uniform Securities Act is the definitive post-NSMIA model for state Blue Sky laws, and prescribes securities exemptions that fully reflect realigned federal and state regulatory roles going forward. The 2002 Uniform Act has been adopted in Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Maine, Michigan, Minnesota, Mississippi, Missouri, New Mexico, Oklahoma, South Carolina, South Dakota, Vermont, Wisconsin, and the U.S. Virgin Islands. It is under active consideration in several other states. Because it sets the post-NSMIA standard for security exemptions in Blue Sky laws, understanding the modern array of exemptions is important not only in those jurisdictions in which they are now operative and under consideration, but also going forward to make sense of the application and operation of those retained schemes of exemptions in other states. The 2002 Uniform Act exemptions are summarized below. As with all Blue Sky securities exemptions, the post-NSMIA array now comprising section 201 of the 2002 Uniform Act provides no exemption from antifraud provisions, or the broker-dealer, agent, investment adviser or investment adviser representative requirements.

Domestic Government Securities. The 2002 Uniform Act¹ exempts any security, including a revenue obligation or a separate security as defined in Rule 131 under the Securities Act of 1933, issued, insured, or guaranteed by the United States or by a state; by a political subdivision of a state; by a public authority, agency or instrumentality of one or more states; or by a person controlled or supervised by and acting as an instrumentality of the United States under authority granted by Congress; or any certificate of deposit for any such security. The 2002 provision added "insured" to prior exemptions found in the original and revised Uniform Acts.

Foreign Government Securities. Securities issued, insured, or guaranteed by a foreign government with which the United States maintains diplomatic relations, or any of its political subdivisions, is exempt under the 2002 Uniform Act² if the security is recognized as a valid obligation of the issuer, insurer, or guarantor. Many state exemptions focus specifically on Canada, its provinces or political subdivisions. Separate treatment of Canadian securities is eliminated in the 2002 Uniform Act.

Depository Institution and International Banking Institution Securities. The 2002 Uniform Act³ exempts securities issued by and representing, or that will represent, an interest in or a direct obligation of, or be guaranteed by, specified

banking or depository institutions. The exemption includes securities of an "international banking institution" as that term is defined in the Act,ⁿ⁴ as well as U.S. banks that are members of the Federal Reserve System; FDIC or NCUSIF (credit unions) insured depository institutions; or other depository institutions that may be added by rule or order.

Insurance Company Securities. A security issued by and representing an interest in or a debit of, or which is insured or guaranteed by an insurance company authorized to do business in the state is exempt under the 2002 Uniform Act.ⁿ⁵ This exemption must be read together with the definition of "security" in section 102(28)(B) of the 2002 Uniform Act, which excludes endowment policies or annuity contracts under which an insurance company promises to pay a fixed sum from the definition, but leaves the language to include variable annuities and insurance products not promising a fixed payment as an option for adopting states. The difference is significant in terms of antifraud protection and enforcement authority of Blue Sky administrators under antifraud provisions.

Common Carrier and Public Utility Securities. The 2002 Uniform Actⁿ⁶ exempts securities issued or guaranteed by a railroad or other common carrier, a public utility, or a public utility holding company that meets certain criteria as to rate regulation and regulation regarding the issuance or guarantee of securities generally by the United States, a state, Canada or a Canadian province. A qualifying public utility holding company is one registered under the federal Public Utility Holding Company Act of 1935, or which has a subsidiary subject to that Act.

Federal Covered Securities. By this broad exemptionⁿ⁷ the 2002 Uniform Act exempts all federal covered securities from registration, and includes certain options and rights relating to those securities. With this exemption the 2002 Uniform Act in particular eliminated all previous Blue Sky forms of exemptions for exchange or Nasdaq listed securities that became covered securities under NSMIA. Even more broadly, the 2002 Uniform Act exemption includes specified options, warrants and rights regarding such securities that are not themselves federal covered securities under NSMIA, and it also addresses aspects of transactions in underlying securities when derivative securities are involved.

As discussed throughout the chapter, NSMIA preempted state securities laws with respect to all but three of the federal exemptions in section 3(a) of the Securities Act of 1933 by making securities covered by those federal exemptions into federal "covered securities." Thus, the 2002 Uniform Securities Act eliminated former Uniform Act exemptions for exchange listed securities, commercial paper, employee benefit plans, insurance company securities, common carrier and public utility securities, and revised prior exemptions for depository institution securities. Nevertheless, in states that have not adopted the 2002 Uniform Securities Act these individual securities exemptions remain, and may in particular circumstances be broader than the federal exemption. This advantage is not available under the 2002 Uniform Act, with its simple exemption for all "federal covered securities."

Nonprofit Organization Securities. Nonprofit organization securities represent one of the particular categories of securities for which an exemption is available under section 3 of the federal Securities Act of 1933, but which are specifically not deemed to be federal covered securities under NSMIA. Thus, the 2002 Uniform Actⁿ⁸ merely updates prior versions of the exemption in Blue Sky laws, and in particular underscores the authority of state administrators to make rules and orders in regard to debt securities of non-profits that have caused such great concern for investor protection in recent years.

Cooperatives. The 2002 Uniform Actⁿ⁹ continues the exemption commonly found in Blue Sky laws for securities representing a member's or owner's interest in, or retention certificate or similar security given in lieu of a cash patronage dividend issued by a cooperative that is organized and operated as a nonprofit membership cooperative under state law. The exemption is not available for such securities that are offered or sold to the public generally.

Equipment Trust Certificates. The final securities exemption in the 2002 Uniform Actⁿ¹⁰ continues exemptions developed to address equipment lease financing devices, and simply to recognize that if the securities of a person using a particular financing device would be exempt under some other provision of the Act, or would be federal covered securities,ⁿ¹¹ an equipment trust certificate or other security used to acquire the property should also be exempt.

This is the entire array of securities exemptions in the 2002 Uniform Securities Act. Noticeably absent are the exemptions for exchange listed securities, for commercial paper and for interests in certain employee benefit plans. The 2002 Uniform Act does not preclude the addition of any other securities exemption. To the contrary, section 203 of the Act expressly authorizes additional exemptions adopted by rule or order. This authority, the Official Comments make clear, is to allow new exemptions as circumstances warrant for new technologies such as the Internet.ⁿ¹² The drafters specifically recognized that there will be some exemptions that can most effectively be implemented by rule rather than statute.

FOOTNOTES:

(n1)Footnote 1. 2002 Unif. Sec. Act § 201(1).

(n2)Footnote 2. 2002 Unif. Sec. Act § 201(2).

(n3)Footnote 3. 2002 Unif. Sec. Act § 201(3).

(n4)Footnote 4. *See* 2002 Unif. Sec. Act § 102(14), which defines an international banking institution as one of which the United States is a member, and whose securities are exempt under the federal Securities Act of 1933.

(n5)Footnote 5. 2002 Unif. Sec. Act § 210(4).

(n6)Footnote 6. 2002 Unif. Sec. Act § 201(5).

(n7)Footnote 7. 2002 Unif. Sec. Act § 201(6).

(n8)Footnote 8. 2002 Unif. Sec. Act § 201(7).

(n9)Footnote 9. 2002 Unif. Sec. Act § 201(8).

(n10)Footnote 10. 2002 Unif. Sec. Act § 201(9).

(n11)Footnote 11. *See*, Securities Act of 1933 § 3(a)(6), 15 U.S.C. § 77c(6) (2000).

(n12)Footnote 12. *Official Comments*, 2002 Unif. Sec. Act § 203.



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CHAPTER 7 Exempt Securities

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§ 7.05 The State Guides

Volumes Three and Four of this Treatise are comprised of individual State Guides which, in addition to summarizing registration, licensing, and other essential aspects of individual Blue Sky laws, present the particular array of security and transaction exemptions in each state. Security exemptions, whether pre- or post-NSMIA and the 2002 Uniform Securities Act, fall under common headings or descriptors. Yet there are nuances among exemptions from state to state, and the State Guides address such nuances as may exist in a particular jurisdiction, as well as any unique exemptions. In Ch. 7.06 *below*, each of the common exemptions that continue as a part of Blue Sky laws in states which have not adopted the 2002 Uniform Securities Act, as well as those exemptions specifically left operationally intact at the state level by NSMIA, is examined. In all cases, however, the individual State Guides must be incorporated into full consideration of the continued meaning, relevance, and operation of a particular security exemption.



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CHAPTER 7 Exempt Securities

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§ 7.06 Common Blue Sky Securities Exemptions

Except in those states which have adopted the 2002 Uniform Securities Act, the full array of pre-NSMIA security exemptions remains a part of every Blue Sky law. As discussed previously, some exemptions are simply no longer relevant, except to the extent they are broader in exempting securities than what are currently defined in SEC rules as NSMIA covered securities. Others remain significant to the extent state registration and qualification requirements continue to apply to securities which are not NSMIA covered securities. The common security exemptions in Blue Sky laws are discussed below, with particular emphasis on the extent to which they remain relevant. In every consideration of security exemptions that remain in place, it is essential to keep in mind that regardless of the exemption, and regardless of whether securities included in an exemption are today NSMIA covered securities, the antifraud provisions of state securities laws and state licensing authority as to intermediaries are not impacted.ⁿ¹ The scope of state regulatory authority under antifraud provisions may in some circumstances be unclear or subject to challenge.ⁿ² However, the sole focus of security exemptions in Blue Sky laws is on registration provisions, not the application of antifraud provisions and state enforcement authority.

[1] Government Securities

[a] Domestic Government Securities

Securities issued or guaranteed by the United States, the states and their various agencies, political subdivisions and instrumentalities are generally exempt from Blue Sky registration requirements. The provision adopted by most states is taken from section 402(a)(1) of the original Uniform Securities Act which exempts:

[A]ny security (including a revenue obligation) issued or guaranteed by the United States, any state, any political subdivision of a state or any agency or corporate or other instrumentality of any one or more of the foregoing; or any certificate of deposit for any of the foregoing.ⁿ³

While "guaranteed" was included in the original Uniform Act exemption, the Revised Uniform Act added "insured" to the array of eligible U.S. Government securities. The terms were explained in the Revised Uniform Act as follows:

(1) *Guaranteed* means guaranteed as to payment of all or substantially all of principal and interest of dividends.

(2) *Insured* means insured as to payment of all or substantially all of principal and interest or dividend.ⁿ⁴

Both of these eligibility terms are included in the 2002 Uniform Securities Act as well. Comparable exemptions for mostⁿ⁵ domestic government securities have been enacted in all states.ⁿ⁶

As a matter of federal securities law, domestic government securities are exempt under section 3 of the Securities Act of 1933,ⁿ⁷ and as such, they are NSMIA covered securities pursuant to section 18(b)(4)(C) of the Act, which was added by NSMIA. The only NSMIA exception is for municipal securities with respect to the offer or sale of such security in the State in which the issuer of such security is located. That exception assures the continued vitality of government securities exemptions in state securities laws.

There are several types of municipal securities. Among the most common is the general obligation. These are debts of the municipality which are paid by virtue of the issuer's general taxing authority.ⁿ⁸ The revenue bond is another type of municipal security. These obligations typically represent money borrowed for use in a municipal project. Closely related to the revenue bond is the special obligation bond. Repayment of such bonds is made from a fund which collects money from the people who use a specially funded project. For example, a city might issue revenue bonds to build a sewer system and in order to repay the obligation it imposes a water use charge. The only lien bondholders have in such a situation is against the special fund set up for repayment. There is no claim against general tax revenues of the city.

Somewhat different is the industrial development bond, or private activity bond. Money raised from the sale of these bonds might typically be used to build some sort of industrial facility, such as an electric power plant. The facility is then leased to a private source to be run as an independent private business enterprise. The source of cash for repayment of the bonds is the money paid by the lessee for rental of the facility.ⁿ⁹ The problem with this sort of financing from the investor's point of view is that repayment is in no way guaranteed by the municipality. The total source of funds is the commercial private enterprise, and if this should fail, the investor is precluded from looking to the municipality for further payment.

All states that have adopted the municipal security exemption apply it to general obligations. Even in the area of revenue bonds and special obligation bonds, the exemption is generally available in states having the Uniform Act provision and in other statesⁿ¹⁰ which, as with the Uniform Act, exempt revenue obligations.

The exemptions in a few states are contingent upon the taxing power of the issuer or guarantor. A filing must be made in Ohioⁿ¹¹ to obtain an exemption for revenue bonds not payable out of a general tax.ⁿ¹² Similarly, a Florida Attorney General's opinion interpreted that State's exemption as applying only where obligations were backed by the full faith and credit of the governmental issuer or guarantor.ⁿ¹³

Private activity bonds present an entirely different problem, because of perceived abuses. Section 401(b)(1) of the Revised Uniform Securities Act offered states the option of adopting language to deny the exemption to the issue of industrial development bonds by persons whose securities are not otherwise exempt under other clauses of Section 401.ⁿ¹⁴ Several states have opted for this bar,ⁿ¹⁵ but have not necessarily adopted the language of the provision.ⁿ¹⁶ Texas securities regulations provide that industrial development bonds fall within the exemption if they are fully guaranteed as to repayment of principal and interest by the United States or any governmental agency or instrumentality.ⁿ¹⁷ Ohio, on the other hand, extends its exemption to securities payable out of revenues collected or administered by the governmental issuer when securities subject to such collection or administration are permitted by the laws of the issuer's state.ⁿ¹⁸ This would seem to allow the exemption for industrial development bonds when the requirements of the issuer's state are met.

In New York,ⁿ¹⁹ industrial development bonds are exempt if such bonds meet all the requirements of the Internal Revenue Code. This is because New York has adopted by reference the exemption for such bonds set forth in the Securities Act of 1933.ⁿ²⁰ A regulation under the Pennsylvania statute permits a like exemption when certification is obtained from the Internal Revenue Service and the Securities and Exchange Commission that the securities meet the requirements of those agencies.ⁿ²¹

Local governments also become involved with financing private enterprise when they organize local public corporations to issue debt securities to build industrial facilities which will be sold or leased to a private company. Once again, payment to security holders is from revenues collected from the private business.ⁿ²² Since the nature of these securities is similar to that of industrial development bonds issued directly by the municipality, it is likely that states will apply the same exemption criteria to both types of securities. Nevertheless, some states provide a specific statutory exemption for securities issued by a local development corporation.ⁿ²³

Small business investment corporations present further challenges. These are private corporations organized under state law which must first be approved by the federal Small Business Administration.ⁿ²⁴ As a rule, it would not appear that such corporations would be eligible for exemption for domestic governmental securities under most circumstances, since the securities are neither issued nor guaranteed by a governmental unit. However, the Small Business Administration has the power to guarantee certain securities of small business investment corporations.ⁿ²⁵ Some states provide an exemption for securities issued by small business investment corporations under specified conditions.ⁿ²⁶

[b] Foreign Government Securities

Blue Sky laws generally include an exemption for foreign government securities which meet certain criteria. The Uniform Securities Act exempts from registration:

[A]ny security issued or guaranteed by Canada, any Canadian province, any political subdivision of any such province, any agency or corporate or other instrumentality of one or more of the foregoing, or any other foreign government with which the United States maintains diplomatic relations, if the security is recognized as a valid obligation by the issuer or guarantor.ⁿ²⁷

Special attention given to Canadian securities in the original Uniform Act is largely redundant today. Securities of all foreign governments are exempt if they are issued or guaranteed by the national government,ⁿ²⁸ but only if diplomatic relations between the United States and the foreign country are maintained and the security is recognized by that country as a valid obligation.

The specific reference to Canadian securities continues in government securities exemptions of many states which have enacted the original Uniform Act provisionⁿ²⁹ as well as a few other states having their own provisions.ⁿ³⁰ In fact, some states exempt Canadian securities, but not those of any other foreign country. Other jurisdictions with a foreign governmental security exemption treat Canadian securities no differently than those of other nations.ⁿ³¹ These states typically extend the exemption to political subdivisions of all foreign governments otherwise eligible for the exemption.

The government securities exemption in section 3(a)(2) of the federal Securities Act does not extend to foreign government securities, and accordingly these securities are not NSMIA covered securities. State exemptions thus remain fully operative with regard to qualifying foreign government securities,ⁿ³² including in many cases political subdivisions of foreign governments.ⁿ³³

[2] Depository Institutions

Securities of "depository institutions"--banks, savings institutions, trust companies, credit unions, or similar

institutions³⁴--are for the most part exempt from the registration provisions of state securities laws. The original Uniform Securities Act addressed securities of banks, savings institutions and trust companies, and both Uniform and Non-Uniform Act states have since extended the exemptions to encompass credit unions and other institutions which receive federally insured deposits. NSMIA impacted the state exemption scheme for depository institutions to the extent of making securities exempt under section 3 of the federal Securities Act of 1933 into federal covered securities, thus preempting certain state regulatory authority, and rendering an overlapping exemption in Blue Sky laws unnecessary. Nevertheless, states not adopting the 2002 Uniform Securities Act, which was designed to harmonize state and federal exemptions after NSMIA, largely continue their pre-NSMIA security exemption schemes. As discussed further below, however, the retention of certain elements of state depository institution exemptions remains important because the scope of the federal exemption is not so wide as to encompass the full range of depository institution securities as covered by the state exemptions.

[a] Banks

The fact that depository institutions are usually subject to close regulation by the jurisdiction in which they are organized provided the basis for the original Uniform Securities Act's exemption for securities issued or guaranteed by banks.³⁵ Section 402(3) of the Uniform Act included an exemption for:

[A]ny security issued by and representing an interest in or a debt of, or guaranteed by, any bank organized under the laws of the United States, or any bank, savings institution, or trust company organized and supervised under the laws of any state.

States adopting the Uniform Act provision relied on their own as well as other states' banking regulations, since the Uniform Act's exemption applies to banks "organized and supervised under the laws of any state." This exemption, however, does not apply to securities of bank holding companies unless the holding company is itself a depository institution. State exemptions for bank securities are basically divided between the Uniform Act provision, allowing organization and supervision in other states, and those providing that the bank be domestic or under domestic control in the enacting state. Wyoming requires foreign banks to qualify before the exemption applies,³⁶ and Virginia, which permits exemption for foreign banks, is silent on domestic state supervision.³⁷

Prior to NSMIA, in one form or another, an exemption for bank securities was included in every state securities law. However, section 3(a)(2) of the federal Securities Act of 1933 provides an exemption for "any security issued or guaranteed by any bank."³⁸ *Bank* is defined for purposes of the federal section 3(a)(2) exemption as:

[A]ny national bank, or any banking institution organized under the laws of any State, Territory, or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official ³⁹

The federal exemption is also based on the fact that banks are subject to extensive government regulation, both state and federal. However, since there are many institutions that engage in financing activities that are not so heavily regulated, the limiting language in section 3(a)(2) as to business being substantially confined to banking has been fairly strictly construed.⁴⁰ Securities of finance companies, small loan companies, investment banks, and bank holding companies are outside the definition for the reason that such institutions are not in the strict sense primarily engaged in the banking business, and in most cases cannot use the word "bank" in their names. The federal exemption for securities guaranteed by a bank has been interpreted to include irrevocable letters of credit, without regard to whether a technical guaranty relationship exists.⁴¹ Travelers Checks, which are guaranteed as to payment by a bank, are exempt securities under section 3(a)(2).⁴²

For the operation of NSMIA, the federal exemption applies to *any* banking institution organized under the laws of *any* state, the only qualifier being that the business of the institution be substantially confined to banking. The federal section

3(a)(2) exemption thus makes "bank" securities federal covered securities over which state registration authority is preempted, and renders bank security exemptions in Blue Sky laws unnecessary. The 2002 Uniform Securities Act accordingly contains no "bank" securities exemption as such, but does include an exemption for securities of an "international banking institution,"ⁿ⁴³ although that term is narrowly defined.ⁿ⁴⁴ Nevertheless, "bank" security exemptions remain in Blue Sky laws in those states which have not adopted the 2002 Uniform Act. Their continuing relevance lies in the manner in which they are stated, and the depository institutions within their scope.

State exemptions for bank securities are more broadly worded than federal section 3(a)(2) in the inclusion of other financial institutions, such as savings and loan institutions and trust companies. Not every state includes securities of savings institutionsⁿ⁴⁵ and trust companiesⁿ⁴⁶ in the continuing "bank" exemption, although the definition of "bank" may in fact extend the scope of the exemption.ⁿ⁴⁷ In any event, although the simple "bank" securities exemption in Blue Sky laws is no longer meaningful by reason of NSMIA and the federal exemption, all of those continuing provisions based on the original Uniform Act, and those in most non-Uniform Act states, also address other categories of exempt securities under the broader notion of depository institutions, such as savings, institutions savings and loan associations and credit unions. In Arizona, for example, exempt securities include:

Securities issued by a national bank, a bank or a credit or loan association organized pursuant to an act of Congress and supervised by the United States or an agency of the United States, or issued by a state bank or savings institution the business of which is supervised and regulated by an agency of this state or the United States.ⁿ⁴⁸

Arizona further exempts:

Securities issued by a savings and loan association subject to supervision by an agency of this state.ⁿ⁴⁹

Section 3(a)(2) of the federal Securities Act only addresses "banking institutions" in the definition of "bank" for purposes of the exemption. There is nothing in section 3(a)(2) addressing the broader notion of depository institutions, although another federal section three exemption, section 3(a)(5), addresses "securities of savings and loan associations and similar institutions,"ⁿ⁵⁰ making these securities federal covered securities under NSMIA as well. Still, the availability of Blue Sky exemptions for qualifying savings and loan securities, credit union securities, trust companies, and depository institutions generally, remains a consideration. The scope of Blue Sky law exemptions for these securities is addressed below.

[b] Savings and Loan Associations

Section 3(a)(5) of the federal Securities Act of 1933ⁿ⁵¹ exempts securities issued by savings and loan and similar associations, and by farm cooperatives and related organizations. In pertinent part, the exemption is for:

Any security issued ... by a savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution, which is supervised and examined by State or Federal authority having supervision over any such institution ⁿ⁵²

The key requirement as it applies to savings and loan and other associations is that they be institutions that are supervised and examined by federal or state authorities appropriate for the type of organization. NSMIA makes securities covered by section 3(a)(5) of the federal Securities Act covered securities, and any remaining vitality of state securities law exemptions for like securities must be assessed in terms of any broader scope of coverage at the state level.

In Blue Sky laws, a simple exemption combining traditional depository institutions for purposes of a single exemption is common. Thus in New Jersey, for example, the exemption is for:

Any security issued by and representing an interest in or a debt of, or guaranteed by, any bank, savings institution, or trust company organized and supervised under the laws of any state or under the laws of the United States.ⁿ⁵³

As further illustrated in New Jersey, in states adopting the original Uniform Act modelⁿ⁵⁴ an additional specific exemption is provided for "any security issued by and representing an interest in or a debt of, or guaranteed by, any savings institution," for which the definition keys on accounts being insured by a federal corporation or agency.ⁿ⁵⁵

Federal savings and loan associations are associations organized under the Home Owners' Loan Act of 1933.ⁿ⁵⁶ Although the purposes of the federal actⁿ⁵⁷ and the various state acts permitting organization of savings and loan associations are the same, there are numerous differences in the statutes regarding the organization and operation of these entities.ⁿ⁵⁸ Basically, savings and loan associations are corporations formed for the purpose of making loans, usually for the acquisition of homes.ⁿ⁵⁹ The statutes under which organization occurs usually provide for strict regulation and control with respect to operating procedure. Generally, the terms "savings and loan association" and "building and loan association," especially when used by the states, are synonymous.

In most states the exemption for savings and loan association securities extends to those institutions organized in any states, which is the Uniform Act model.ⁿ⁶⁰ Other states offer the exemption if the qualification to do business in the state precedes the offer and sale of the securities.ⁿ⁶¹ Some states merely require the institution to be regulated in its domicile state,ⁿ⁶² while others demand that foreign associations be subject to specific regulatory requirements.ⁿ⁶³ Other states granting the exemption provide that if the association is not organized under federal law,ⁿ⁶⁴ it must be a domestic corporation.ⁿ⁶⁵

There being no qualifiers on the federal exemption for securities issued by *any* savings and loan association or similar institution other than the supervision and examination requirement, the overlap between the federal exemption and state exemptions is clear. State exemptions provide no broader exemption for these institutions. To the contrary, state exemptions are in fact more limited in the face of the federal "similar institution" element, which will be seen below as bearing on a federal section 3(a) exemption for credit union securities. Taking section 3(a) of the federal Securities Act into consideration after NSMIA, the remaining state savings and loan association exemptions no longer serve any useful role.

[c] Credit Unions

Credit unions are corporate organizations formed for the purpose of lending money to members.ⁿ⁶⁶ These associations are usually formed under laws strictly defining their powers and duties in addition to providing for special state supervision and control.ⁿ⁶⁷ A majority of states exempt the securities of credit unions from registration under the Blue Sky laws. The Uniform Securities Act provision exempts: "any security issued or guaranteed by any federal credit union or any credit union, industrial loan association, or similar association organized and supervised under the laws of this state ...".ⁿ⁶⁸

Section 3(a)(5) of the federal Securities Act of 1933 exempts securities of savings and loan associations and other "similar" institutions that are supervised and examined by federal or state authorities. Credit unions are supervised and examined by federal or state authorities. Federal Credit Unions are chartered under the terms of the Federal Credit Union Act and supervised by the National Credit Union Administration (NCUA). State chartered credit unions are supervised by a designated state agency, and are required to maintain federal deposit insurance administered by the National Credit Union Administration. Thus, the securities of both federal and state chartered credit unions fall under the federal Securities Act section 3(a)(5) exemption, and are NSMIA covered securities.ⁿ⁶⁹ State law security exemptions for credit unions are co-extensive with the federal exemption and, accordingly, have no further role in state securities regulation except to the extent that in unusual circumstances the federal exemption would not apply.

[3] Insurance Company Securities

State Blue Sky laws generally provide exemptions for securities of insurance companies in one of two ways. The statute may exempt:

- (1) all insurance securities unless otherwise specified,ⁿ⁷⁰ or
- (2) only those "securities" which are ordinarily considered to be issued as part of the insurance business, insurance policies themselves, endowments and annuities.ⁿ⁷¹

Most states provide statutory exclusions for insurance and endowment policies.ⁿ⁷² As a result, these interests are generally not subject to blue sky law registration regardless of whether there is an exemption provision.

Section 3(a)(8) of the Securities Act of 1933ⁿ⁷³ provides an exemption from federal registration requirements for:

Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia.

Thus, Insurance securities are federal covered securities and are preempted from state regulation (except for antifraud enforcement) under NSMIA. However, as with other categories of securities that are now federal covered securities by reason of section 3(a) exemptions under the federal Securities Act of 1933, most states have retained their insurance company securities exemption after NSMIA. In the event that the state exemption is broader than the federal exemption, those securities described by the state exemptions are presumably subject to state exemption practices.ⁿ⁷⁴

The extent, if any, of continued vitality of an exemption for insurance company securities in Blue Sky laws is best addressed with respect to variable annuities.ⁿ⁷⁵ Insurance policies are excluded from coverage of Blue Sky laws. The original Uniform Securities Act specifically excluded from the definition of "security" any insurance or endowment policy or annuity contract under which the insurance company promises to pay a fixed sum of money either in a lump sum or periodically for life or some other specified period.ⁿ⁷⁶ It was silent, however, on the treatment of variable annuities, except to include within the exemption from registration for securities issued by insurance companies the specific option to carve variable annuities out of the exemption.ⁿ⁷⁷

Most states provide an exclusion from the definition of "security" for variable annuity contracts issued by insurance companies.ⁿ⁷⁸ Several of those states supply an exemption for all insurance company securities if other statutory conditions are met.ⁿ⁷⁹

Some states have retained the alternate provision recommended by the Uniform Securities Act. This provision was designed to include variable annuity contracts in the definition of "security," and then to specifically make the exemption inapplicable to such annuity contracts.ⁿ⁸⁰

In some states the statute is silent on the security status of variable annuities.ⁿ⁸¹ Of these states, a few exempt all securities issued by insurance companies meeting other statutory requirements,ⁿ⁸² and others specifically exempt variable annuities of insurance companies subject to the state's supervision. Only a few states require registration of variable annuities under all circumstances.ⁿ⁸³

Because section 3(a)(s) of the federal Securities Act does not include variable annuities in the exemption for insurance policies, there is no NSMIA covered security and no preemption of state authority in regard to them. It is necessary, therefore, to examine the particular insurance exemption in each state securities law, as well as any statutory exclusion

from the definition of "security," to determine the continuing significance of an exemption for securities issued by insurance companies.

The first part of Section 402(a)(4) of the Uniform Securities Act exempts from registration: "Any security issued by and representing an interest in or a debt of, or guaranteed by, any insurance company organized under the laws of any state and authorized to do business in this state ...".ⁿ⁸⁴ The exemption granted by this particular phrase (absent the above discussed variable annuities exclusion) is not very troublesome and has, in fact, been substantially adopted in some states as the entire exemption for insurance company securities.

The extent of governmental control over the insurer also plays a role when determining whether or not its securities are entitled to exemption. Most states follow the recommendation of the Uniform Act and grant an exemption to securities of insurance companies authorized to do business in the state.ⁿ⁸⁵ Other Blue Sky laws require the company to be under the control of a specific state agency.ⁿ⁸⁶ Floridaⁿ⁸⁷ and Ohioⁿ⁸⁸ do not require the insurer to be supervised within their respective states, but do require the company to be regulated by some other government body. Illinoisⁿ⁸⁹ allows the exemption for any insurance company organized under the laws of any state with no further restrictions.

Texas has a different type of exemption. Although there is no exemption in the statute for securities issued by an insurance company, an exemption does exist for a non-issuer sale by an insurance company of securities which constitutes a legal investment for such a company. A further requirement of this provision is that the company be under the supervision or control of the Texas Board of Insurance Commissioners.ⁿ⁹⁰

[4] Common Carriers, Public Utilities, and Holding Companies

[a] Generally

The Uniform Securities Act exempts from registration securities issued or guaranteed by railroads, other common carriers, public utilities or holding companies if the issuer or guarantor is subject to regulation by federal or state agencies other than those administering the Blue Sky laws.ⁿ⁹¹ The exemption is granted to companies subject to one of four types of regulation:

- (1) companies subject to the jurisdiction of the Interstate Commerce Commission (ICC);ⁿ⁹²
- (2) companies that are registered holding companies regulated under the Public Utility Holding Company Act or subsidiaries of such companies; and
- (3) companies regulated in respect of their rates and charges by a governmental authority of the United States or any state; and
- (4) companies regulated in respect of the issuance or guarantee of the security by a governmental authority of the United States, any state, or Canada.

The exemption is based upon the presumption that the stringent standards of the governmental agency involved will protect the investing public, making registration unnecessary under the state securities acts.ⁿ⁹³ Most states follow the Uniform Act example, and broadly exempt railroads, other common carriers, public utilities or holding companies which are regulated as to their securities by any agency of the federal government.ⁿ⁹⁴

There is no comparable exemption in section 3(a) of the federal Securities Act. Section 3(a)(6) of the federal act exempts securities of "railroad equipment trusts," which are defined to include common carrier equipment trusts. The federal exemption covers:

1-7 Blue Sky Regulation § 7.06

Any interest in a railroad equipment trust. For purposes of this paragraph any "interest in a railroad equipment trust" means any interest in an equipment, trust, lease, conditional sales contract, or other similar arrangement entered into, issued, assumed, guaranteed by or for the benefit of, a common carrier to finance the acquisition of rolling stock, including motive power.ⁿ⁹⁵

The federal section 3(a)(6) exemption is largely meaningless today. Legislation has made the securities of common carrier subject to the full requirements of the federal securities laws. All that remains of the section 3(a)(6) exemption today is any interest in a "railroad equipment trust," which is far narrower than the broadly worded state Blue Sky exemptions. No NSMIA covered security is involved except to the narrow extent of a railroad or common carrier equipment trust, and the state law exemptions thus have continuing vitality and importance.

Under state securities laws, an exemption is granted if the company is a registered holding company under the Public Utility Holding Company Act of 1935 or is a subsidiary of such a company within the meaning of that Act.ⁿ⁹⁶ The purpose of the Public Utility Holding Company Actⁿ⁹⁷ is to protect investors in public utility holding companies.ⁿ⁹⁸ These holding companies are parent to the operating public utility.ⁿ⁹⁹ Under this federal law, the regulating agency is the Securities and Exchange Commission. The Public Utility Holding Company Act allows the states to impose their own regulation over the securities of public utility holding companies.ⁿ¹⁰⁰ Consequently, these securities are subject to registration under the blue sky laws unless the state has a statutory provision granting an exemption. The attitude of most states is to grant the exemption either by following the Uniform Securities Act example of specifically exempting companies coming under the Public Utility Holding Company Act,ⁿ¹⁰¹ or by generally granting the exemption to public utilities and their holding companies subject to federal regulation.ⁿ¹⁰²

An exemption from registration is provided if the company is regulated in respect of its rates and charges by a governmental authority of the United States or any state.ⁿ¹⁰³ Although a number of states have substantially adopted this provision as it is set out in the Uniform Act,ⁿ¹⁰⁴ a few states have broadened it slightly to allow the exemption if rates and charges are regulated by a municipality of a state.ⁿ¹⁰⁵ According to the Uniform Act commentary, the provision as originally drafted is broad enough to include municipalities,ⁿ¹⁰⁶ but apparently these few states preferred to close any possible gap. The issue remains open as to whether the comment to the Act will be accepted by the courts of those states which do not specifically include municipalities within the statute.

The 2002 Uniform Securities Act exemption is an amalgam of all approaches, and allows the exemption for:

[a] security issued or guaranteed by a railroad, or other common carrier, public utility, or public utility holding company that is:

- (A) regulated in respect to its rates and charges by the United States or a State;
- (B) regulated in respect to the issuance or guarantee of the security by the United States, a State, Canada, or a Canadian province or territory; or
- (C) a public utility holding company registered under the Public Utility Holding Company Act of 1935 or a subsidiary of such registered holding company within the meaning of that act.ⁿ¹⁰⁷

Of the non-Uniform Act states which permit a comparable exemption, some states add that the exemption is applicable when the companies' rates and charges are regulated by an agency of the Dominion of Canada or of a Canadian province. The Uniform Securities Act purposely avoids this exemption, and, instead, provides the fourth regulatory condition for exemption if the company is regulated in respect of the issuance or guarantee of the security by a governmental authority of the United States, any state, Canada or any Canadian province or territory.ⁿ¹⁰⁸

The division between the Uniform Act provisions permitting exemption when rates and charges are regulated and permitting it when securities are regulated is to avoid the application of the "rates and charges regulation exemption" when the source of such regulation is in Canada.ⁿ¹⁰⁹ Nevertheless, some states grant the exemption when rates and charges are regulated by Canadian authorities.

With regard to the exemption for securities of companies subject to security regulation in other states, most states have adopted either the Uniform Act provisionⁿ¹¹⁰ or similar provision embracing the same concepts.ⁿ¹¹¹ However, there are a few jurisdictions which do not fit into broad categories. Oregonⁿ¹¹² will give exemptions only to companies subject to regulation within the state. Virginiaⁿ¹¹³ requires the company to be supervised as to rates *and* issuance of securities under United States law, the law of a state, Canada or Canadian province. Some states will not accept any Canadian regulation for purposes of the exemption.ⁿ¹¹⁴

Persons seeking this exemption should bear in mind that a few states require the filing of specified documents before the securities can be offered or sold as exempt.ⁿ¹¹⁵

[b] Equipment Trust Certificates

When an operating railroad or utility needs equipment, it often turns to an equipment company for its supplies. These companies, while retaining title, turn the equipment over to the railroad or utility for a stipulated profit, rental or hire. The railroad or utility issues trust certificates to protect payments for the equipment from becoming subject to liens of other trust deeds or mortgages executed by the railroad or utility.

Although it would seem that equipment trust certificates issued by railroads or utilities would be exempt if the issuer's other securities are exempt, some states have enacted specific statutory provisions covering the exemption, generally under the condition that other securities issued by the railroad or utility are exempt.ⁿ¹¹⁶ The original Uniform Securities Act contained no provision regarding equipment trusts. However, section 401(b)(6) of the Revised Uniform Act specifically exempts "equipment trust certificates in respect to equipment leased or conditionally sold to a person, if securities issued by the person would be exempt under this section."ⁿ¹¹⁷ The Revised Uniform Act provision was carried into section 201(9) of the 2002 Uniform Securities Act, which exempts:

An equipment trust certificate with respect to equipment leased or conditionally sold to a person, if any security issued by the person would be exempt under this section or would be a federal covered security under Section 18(b)(1) of the Securities Act of 1933 (15 U.S.C. § 77r(b)(1)).ⁿ¹¹⁸

Other states reach substantially the same result by providing that the exemption applies if standards of given governmental jurisdictions are met.ⁿ¹¹⁹

[5] Listed Securities

[a] Listed Securities as NSMIA Federal Covered Securities

Prior to enactment of NSMIA, all state Blue Sky laws included an exemption from registration requirements for securities listed or approved for listing upon issuance on designated national securities exchanges or the National Market System (NMS) tier of the Nasdaq Stock Market, or securities of the same issuer equal in seniority or senior to those securities. State exemptions were based on the quality characteristics of securities meeting exchange and Nasdaq listing standards, and recognition that the protections of Blue Sky registration are not needed. Moreover, these listed securities trade in truly national markets, and provisions by the states for a securities exemption at least implicitly recognized the appropriately limited role of state regulatory authority regarding national securities markets. This, of course, was the essential premise of NSMIA, which excised exchange and Nasdaq NMS listed securities from state registration and qualification requirements altogether by including them as federal "covered securities" for purposes of

NSMIA preemption. Thus today, section 18(b)(1) of the Securities Act of 1933ⁿ¹²⁰ establishes exclusive federal authority for registration of nationally traded securities, making them covered securities when the security is:

(A) listed, or authorized for listing, on the New York Stock Exchange or the American Stock Exchange, or listed or authorized for listing, on the National Market System of the Nasdaq Stock Market (or any successor to such entities);

(B) listed or authorized for listing, on a national securities exchange (or tier or segment thereof) that has listing standards that the Commission determines by rule (on its own initiative or on the basis of a petition) are substantially similar to the listing standards applicable to securities described in subparagraph (A); or

(C) is a security of the same issuer that is equal in seniority or that is a senior security to a security described in subparagraph (A) or (B).

Under the authority to determine substantially similar listing standards, the SEC, by Rule 146 under the Securities Act of 1933,ⁿ¹²¹ originally designated securities listed on or in the following markets as federal covered securities:

- The New York Stock Exchange (the "NYSE");
- The American Stock Exchange (the "AMEX");
- The Nasdaq Global Market of the Nasdaq Stock Market (the "NGM");
- Tier I of the Pacific Exchange;ⁿ¹²² and
- The Chicago Board Options Exchange.

Subsequently, the SEC amended Rule 146, finding that the following national securities exchanges, or segments or tiers thereof, have listing standards that are substantially similar to those of the New York Stock Exchange ("NYSE"), the American Stock Exchange ("Amex"), or the National Market System of the Nasdaq Stock Market ("Nasdaq/NGM"), and that securities listed, or authorized for listing, on these exchanges are also deemed to be covered securities:

- Tier I of NYSE Arca, Inc.;
- Tier I of the Philadelphia Stock Exchange, Inc.;ⁿ¹²³
- The Chicago Board Options Exchange, Incorporated;
- Options listed on the International Securities Exchange, LLC; and
- The Nasdaq Capital Market.

State Blue Sky exemptions for listed securities are commonly broader, including in most cases the Midwest Stock Exchange,ⁿ¹²⁴ and in many instances granting the administrator authority to approve any additional securities exchanges that are registered with the SEC under the federal Securities Exchange Act of 1934, or which the administrator may otherwise designate.ⁿ¹²⁵ The combination of NSMIA and the authority of state administrators to exempt other listed securities is now the basis for the simplified approach of the 2002 Uniform Securities Act which, be the exemption provided in section 201(6), covers:

[A] federal covered security specified in Section 18(b)(1) of the Securities Act of 1933 ... or by rule

adopted under that provision or a security listed or approved for listing on another securities market specified by rule under this [Act] n126

Blue Sky law exemptions for listed securities are also broader than the NSMIA "covered security" definition in regard to options, rights or warrants to purchase or subscribe to listed securities.ⁿ¹²⁷ Because state exemptions encompass but also go beyond what is provided in NSMIA, states not adopting the 2002 Uniform Act have retained their listed securities exemptions. In the wake of NSMIA the North American Securities Administrators Association (NASAA) entered into Memoranda of Understanding with registered exchanges providing that states would exempt all listed securities.ⁿ¹²⁸ Thus, each state's listed securities exemption remains meaningful for such securities that are not federal covered securities. Particular characteristics and elements of those exemptions that remain in states not adopting the 2002 Uniform Act are discussed below.

[b] Listed Securities--Generally

The states granting a registration exemption for securities listed on stock exchanges use several types of statutory provisions to identify exchanges acceptable for the exemption.

- (1) Exchanges listed in the statute.
- (2) Exchanges (a) listed in the statute and (b) designated by the state administrator in his or her discretion.
- (3) Exchanges (a) listed in the statute and (b) additional exchanges registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934 which are designated by the state administrator.
- (4) Exchanges designated by the state administrator in his or her discretion.

The provisions vary. New York, for example, exempts securities listed on all exchanges registered under the Securities Exchange Act of 1934.ⁿ¹²⁹ Virginia grants an exemption to any security quoted on an automated quotation system operated by a national securities association registered with the SEC and approved by the State Corporation Commission.ⁿ¹³⁰ Florida offers a transactional exemption for securities sold by a registered dealer when the price is reasonably related to the current market price of the securities and they appear in any list of securities dealt in on any stock exchange registered under the 1934 Act.ⁿ¹³¹ In California, the exemption is available for:

Any security listed or approved for listing upon notice of issuance on a national securities exchange or designated or approved for designation upon notice of issuance as a national market system security on an interdealer quotation system by the National Association of Securities Dealers, Inc., if the exchange or interdealer quotation system has been certified by rule or order of the commissioner and any warrant or right to purchase or subscribe to the security. ...ⁿ¹³²

However, California specifies in detail the criteria upon which the certification of an exchange may be made.ⁿ¹³³

The question sometimes arises as to when the exemption is effective. There is no doubt that securities, once fully listed on appropriate exchanges, are entitled to exemption; the individual state enactments are clear on this point. Most states, however, are more flexible and permit the exemption when the security is approved for listing upon notice of issuance.ⁿ¹³⁴ This language is the prescribed example of the Uniform Securities Act. Only a few states apply other standards for listings.ⁿ¹³⁵

An important feature of the listed securities exemption is that other securities of the same issuer are often exempt once a

class of securities is listed on an acceptable exchange. In virtually every state, securities senior to those listed are granted an exemption.ⁿ¹³⁶ Almost as often, securities of equalⁿ¹³⁷ or substantially equalⁿ¹³⁸ rank are also exempt.ⁿ¹³⁹ Further, it is generally provided that the exemption applies to "any security called for by subscription rights or warrants so listed or approved."ⁿ¹⁴⁰ A few states provide that if any of the corporation's stock is exempt due to listing, then the exemption also applies to evidences of indebtedness of that corporation.ⁿ¹⁴¹ A common extension of the exemption is to allow warrants or rights to purchase or subscribe to any security exempt from registration through stock exchange listing to also be exempt.ⁿ¹⁴²

As already noted, many states authorize their securities administrators to approve stock exchanges for exemption purposes. On occasion, specific statutory standards for approving an exchange are set.ⁿ¹⁴³ Some states provide that an exchange seeking an exemption for its listed securities must make a formal application to the state administrator.ⁿ¹⁴⁴ Many states authorize the administrator to revoke the approval,ⁿ¹⁴⁵ although formal procedures may be required before the revocation is effective.ⁿ¹⁴⁶ The authority to revoke exchange qualification sometimes applies even to the exchanges designated by statute.ⁿ¹⁴⁷

Administrative authority also may be exercised with respect to particular securities listed on prescribed or approved exchanges. This authority is demonstrated by giving the administrator discretionary power to revoke or deny the exemption accorded to particular securities.ⁿ¹⁴⁸ In some states, filings are required before the exemption is effective with respect to particular securities.ⁿ¹⁴⁹

[c] OTC Margin Stocks

Although not *exchange* listed securities falling within the specific listing exemptions in Blue Sky laws, some states provide another category of exemption for securities traded in the over-the-counter that qualify as OTC Margin Stocks by the Federal Reserve Board. Thus in Illinois, for example, an exemption is provided for:

Any security appearing on the list of OTC Margin Stocks published by the Board of Governors of the Federal Reserve System or any security incorporated by reference into the List of OTC Margin Stocks by the Board of Governors of the Federal Reserve System; any other securities of the same issuer which are of senior or substantially equal rank; any securities called for by subscription rights or warrants so listed or approved; or any warrants or rights to purchase or subscribe to any of the foregoing.ⁿ¹⁵⁰

The power to regulate margin or credit terms under which equity securities may be sold is vested in the Board of Governors of the Federal Reserve System. The Board's authority extends to securities listed on national securities exchanges and to those not so listed. Actively traded stocks not listed on an exchange are generally said to be part of the "over-the-counter market (OTC)."ⁿ¹⁵¹

The Board's statutory authority is exercised through Regulation T.ⁿ¹⁵² Among its other provisions, Regulation T requires the Board to release, from time to time, a list of over-the-counter (OTC) margin stocks meeting specified standards.ⁿ¹⁵³ Basically, OTC margin stock is not listed on a national securities exchange, but has what the Board determines to be sufficient trading interest to subject the stock to the Board's margin requirements.ⁿ¹⁵⁴

Although the standards spelled out in Regulation T are beyond the scope of this chapter, awareness of the existence of the list of OTC margin stock is important. Various states, such as Connecticut, Illinois,ⁿ¹⁵⁵ New Hampshire,ⁿ¹⁵⁶ and Pennsylvaniaⁿ¹⁵⁷ have provisions authorizing an exemption from state registration for securities satisfying certain requirements of Regulation T.

[d] Foreign Exchange Listed Securities

Some states provide an exemption for securities listed on foreign exchanges. California, for instance, provides a transactional exemptionⁿ¹⁵⁸ from qualification when the transaction in a foreign exchange listed is not directly or indirectly for the benefit of the issuer of the security.ⁿ¹⁵⁹ The exemption has been granted under a rule of the Commissioner of Corporations when one of specified conditions have been met, such as the requirement that the issuer is currently subject to reporting requirements under section 15(d) of the 1934 Act or the security appears in the most recent Federal Reserve Board List of Foreign Margin Stocks.ⁿ¹⁶⁰

[6] The "Blue Chip" Exemption

In 1977, the North American Securities Administrators Association (NASAA) recommended the creation of a "Blue Chip" exemption from registration to replace the common exemption for securities listed on stock exchanges. NASAA reasoned that the listing of a security on one or more national exchanges was an imprecise test of whether the securities were of such quality that registration was unnecessary for the protection of investors.ⁿ¹⁶¹ Rather, an exemption should be based on those characteristics of the issuer and its securities that are valid indicators of such quality.

The characteristics of the "Blue Chip" security and its issuer, as identified by NASAA, may be summarized as follows:

- (1) A class of the issuer's securities must be and is registered under Section 12 of the Securities Exchange Act of 1934 for three years preceding the offering date. This requirement is designed to demonstrate an historical availability of information concerning the issuer's securities as well as the issuer's acceptance of the responsibility for making continuous public disclosure.ⁿ¹⁶² Apparently, voluntary registration, which is permitted by § 12 of the Exchange Act, would not satisfy the "must be" requirement.
- (2) There has been no material default by the issuer or a significant subsidiary for seven years in the payment of principal, interest, dividend, sinking fund installment, or rentals with terms of three years or more. This characteristic is intended to provide convincing evidence of an issuer's financial stability. The term "material" refers to a default on indebtedness for borrowed money that exceeded 5% of the total assets of the issuer and its consolidated subsidiaries, a default on a lease under which rental obligations over the unexpired term exceed such percentage, or an arrearage in required dividend payments not cured within 30 days on a class of preferred stock. "Default" as applied to indebtedness for borrowed money refers to "a default, the effect of which is to cause the indebtedness to become due prior to its stated maturity date." Presumably, this would not include a technical default in which the due date clause has not been accelerated. As applied to rentals under leases, "default" refers to a condition which causes termination or re-entry prior to its stated expiration date.ⁿ¹⁶³
- (3) The issuer has had consolidated net income of at least \$1 million during four of the last five fiscal years; if the securities are interest bearing, net income, before deduction of income taxes and depreciation, must have been at least one and one-half times the issuer's annual interest expense. The additional earnings test for debt securities is computed before the effect of income taxes and depreciation because interest is paid out of cash flow and before income taxes.ⁿ¹⁶⁴
- (4) The securities, if other than preferred stock, have voting rights. All non-preferred stock being offered must have voting rights at least equal in kind and in proportion to the number of securities of each class outstanding. An exception is provided when an applicable statute requires otherwise.ⁿ¹⁶⁵
- (5) For six months prior to the offering, the securities must have been owned by at least 1200 persons and there must have been 750,000 shares outstanding with an aggregate market value of \$3,750,000. Issuers of exempt securities are required to demonstrate a breadth and depth of market involvement sufficient to indicate widespread public awareness of an interest in the issuer. The numerical tests are primarily those required by the Federal Reserve Board for marginable securities.ⁿ¹⁶⁶

The "Blue Chip" exemption was substantially adopted by a third of the states.ⁿ¹⁶⁷ In 1979 NASAA amended the exemption in two respects. First, it added an exemption for the securities of international banks of which the United States is a member.ⁿ¹⁶⁸ A few states added this section to the exemption.ⁿ¹⁶⁹ Second, it provided a special interest coverage test for debt securities of finance companies,ⁿ¹⁷⁰ which was also added by several states.ⁿ¹⁷¹ Under this section, if a finance company has liquid assets of at least 105 percent of its liabilities at the end of its last five fiscal years, the net income requirement is reduced from one and one-half times to one and one-quarter times the issuer's annual interest expense.

Prior to the amendments, securities issued by banks and financial institutions would not have been able to qualify for the exemption, because of the interest coverage test in paragraph (D), which requires net income before income taxes and depreciation of at least 1.5 times the annual interest expense. Many large, highly rated finance companies regularly maintain ratios of less than 1.5 as a result of the high level of borrowings inherent in the business.ⁿ¹⁷²

Finally, NASAA added an optional section,ⁿ¹⁷³ adopted by a few states,ⁿ¹⁷⁴ that reduces the time period during which a default must not have occurred to five years and the annual net earnings requirement to \$250,000 for issuers of securities listed on the New York Stock Exchange or the American Stock Exchange. The reduced requirements for NYSE issuers are allowed because NYSE listing requirements provide for certain "normative" standards, such as required voting rights and credit committees composed of outside directors, that justify the lower requirements.ⁿ¹⁷⁵

Some states eschewed the complexity of the NASAA form of Blue Chip exemption. In Florida, for example, an exemption is provided for:

A security, other than common stock, providing for a fixed return, which security has been outstanding in the hands of the public for a period of not less than 5 years, and upon which security no default in payment of principal or failure to pay the fixed return has occurred for an immediately preceding period of 5 years.ⁿ¹⁷⁶

And similarly, Ohio exempts:

(1) Any securities outstanding for a period of not less than five years, on which there has occurred no default in payment of principal, interest, or dividend or distribution for the five years immediately preceding the sale, are exempt.

(2) For the purpose of division (J) of this section, the dividend, distribution, or interest rate on securities in which no such rate is specified shall be at the rate of at least four per cent annually on the aggregate of the price at which such securities are to be sold.ⁿ¹⁷⁷

More than half the states that adopted the "blue chip" exemption also retained the exemption for exchange-listed securities, which the former was intended to replace.ⁿ¹⁷⁸ These retained exemptions are, of course, today in large part rendered meaningless by NSMIA, which makes most listed into federal covered securities.

The Revised Uniform Securities Act contained a "blue chip" exemption for mutual funds and unit trusts (investment companies) conditioned on the experience of the investment advisor or sponsor. The exemption is provided when: (1) the fund's investment advisor has been registered with the SEC and has advised SEC-registered funds for at least three years; or (2) the trust's sponsor has sponsored SEC-registered trusts with assets in excess of \$100 million for at least three years.ⁿ¹⁷⁹ About a quarter of the states amended their Blue Sky laws to provide this exemption.ⁿ¹⁸⁰ But here again, NSMIA operates to make securities registered under the federal Investment Company Act of 1940 into federal covered securities,ⁿ¹⁸¹ such that the state exemption extending to mutual funds is now superfluous.

There is no "Blue Chip" exemption in section 3 of the federal Securities Act, and thus no federal covered securities are involved when considering the state exemptions on a stand-alone basis. The 2002 Uniform Securities Act contains no "Blue Chip" securities exemption. It does, however, include several non-issuer exemptions that are based on "Blue Chip" criteria.ⁿ¹⁸²

[7] World Class Securities

Much as with the quality characteristics of securities qualifying for "Blue Chip" exemptions from registration under Blue Sky laws, an exemption for "world class" securities has been adopted by rule in several states. Many large, multinational corporations domiciled outside of the United States cannot take advantage of exemptions from registration under Blue Sky laws because their securities are not listed on a United States stock exchange, or they are not reporting companies to the SEC. In order to provide large multi-national corporations that do not have securities listed on a United States securities exchange with an exemption from the registration provisions of Blue Sky laws, to provide parity with securities of large United States corporations whose securities qualify for exemption under listed securities or Blue Chip exemptions, the North American Securities Administrators Association (NASAA) in September 1996 promulgated a "World Class Foreign Issuer Exemption."

Whether referenced as a "world class foreign issuer exemption," or simply as a world class securities exemption, this exemption provides an exemption from registration requirements for securities of a qualifying foreign issuer, as follows:

- (A) Equity securities except options, warrants, preferred stock, subscription rights, securities convertible into equity securities or any right to subscribe to or purchase such options, warrants, convertible securities, or preferred stock;
- (B) Units consisting of equity securities permitted by (A) and warrants to purchase the same equity security being offered in the unit;
- (C) Non-convertible debt securities that are rated in one of the four highest rating categories of Standard & Poor's, Moody's, Dominion Bond Rating Services of Canadian Bond Rating Services or such other rating organization which the Administrator by rule or order may designate. For purposes of this subparagraph, non-convertible debt securities means securities that cannot be converted for at least one year from the date of issuance and then only into equity shares of the issuer or its parent; or
- (D) American Depositary receipt representing securities described in (A), (B), or (C).ⁿ¹⁸³

The foreign issuer of such world class securities must meet certain qualifications, as follows:

- (A) The issuer must not be organized under the laws of the United States, or of any state, territory or possession of the United States, or of the District of Columbia or Puerto Rico;
- (B) The issuer, at the time an offer or sale is made, has been a going concern engaged in continuous business operations for the immediate past five years, and during that period has not been the subject of a proceeding relating to insolvency, bankruptcy, involuntary administration, receivership or similar proceeding;
- (C) The issuer, at the time an offer or sale is made, has public float of at least US \$1 billion or more;
- (D) The market value of the issuer's equity shares, at the time an offer or sale is made, is US \$3 billion or more; and

(E) The issuer, at the time an offer or sale is made, has a class of equity securities listed for trading on or through the facilities of a foreign securities exchange or recognized foreign securities market designated by SEC rule.ⁿ¹⁸⁴

Where adopted, the world class securities exemption is self-executing. There are no filing requirements. As a practical matter, this exemption has not been widely adopted, and for that reason it has limited utility for a qualifying issuer.

[8] Securities of Nonprofit Organizations

Most states exempt the securities of nonprofit organizations from registration if two statutory conditions are met:

- (1) The organization and operation must be on a not for private profit basis, and
- (2) The organization and operation must be for the specific purposes set forth in the statute.ⁿ¹⁸⁵

Securities of nonprofit organizations, although also exempted by § 3(a) of the Securities Act of 1933, are *not* federal covered securities, and are not pre-empted from state regulation under NSMIA.ⁿ¹⁸⁶

The exemption is typically represented by the original Uniform Securities Act which provides the exemption for:

any security issued by any person organized and operated not for private profit but exclusively for religious, educational, benevolent, charitable, fraternal, social, athletic, or reformatory purposes, or as a chamber of commerce or trade or professional association ... ⁿ¹⁸⁷

This provision has been enacted in a number of states, and is carried into the 2002 Uniform Securities Act in much the same form.ⁿ¹⁸⁸ Statutory provisions which differ substantially from the Uniform Act usually impose additional or alternate conditions for exemption availability.ⁿ¹⁸⁹ States may require that the nonprofit institution be a corporationⁿ¹⁹⁰ or that it be organized under the laws of the state in which the exemption is sought. The purposes of organization and operation may differ in some respects from those under the Uniform Act.ⁿ¹⁹¹ It should be noted that a few states deny the exemption to evidences of indebtednessⁿ¹⁹² and to securities made liens upon revenue producing property subject to taxation.ⁿ¹⁹³

Even though securities of eligible nonprofit corporations need not be registered, a number of states require that organizations seeking exemption make a filing disclosing the terms and risks of the offering.ⁿ¹⁹⁴ In North Dakota, for example, the exemption involves a filing and approval process in which the required submission to the administrator includes:

- The Nonprofit Organization Claim of Exemption--Form NP;
- Proof of current tax status under the Internal Revenue Code;
- An Offering disclosure document; and
- Consent to Service of Process--Form U-2.ⁿ¹⁹⁵

In most states where a filing is required, and in some in which it is not, the nonprofit exemption is a permissive exemption, meaning that the securities administrator, in his or her discretion, may deny the exemption to any particular security.ⁿ¹⁹⁶ The construct of the exemption in the 2002 Uniform Securities Act encompasses all elements of the common approach in exempting:

[A] security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, social, athletic, or reformatory purposes, or as a chamber of commerce, and not for pecuniary profit, no part of the net earnings of which inures to the benefit of a private stockholder or other person, or a security of a company that is excluded from the definition of an investment company ... except that with respect to the offer or sale of a note, bond, debenture, or other evidence of indebtedness issued by such person, a rule may be adopted under this [Act] limiting the availability of this exemption by classifying securities, persons, and transactions, imposing different requirements for different classes, specifying with respect to paragraph (B) the scope of the exemption and the grounds for denial or suspension, and requiring an issuer:

(A) to file a notice specifying the material terms of the proposed offer or sale and copies of any proposed sales and advertising literature to be used and provide that the exemption becomes effective if the administrator does not disallow the exemption within the period established by the rule;

(B) to file a request for exemption authorization for which a rule under this [Act] may specify the scope of the exemption, the requirement of an offering statement, the filing of sales and advertising literature, the filing of consent to service of process complying with Section 611, and grounds for denial or suspension of the exemption; or

(C) to register under Section 304.

As the drafters of the 2002 Uniform Act observed, the nonprofit exemption is of particular concern to state securities administrators.ⁿ¹⁹⁷ The concern is fueled in large part by the proliferation of religious scams and the prevalence of affinity fraud. Reflecting different times, the original Uniform Securities Act made no provision for administrative review, and left the non-profit exemption as self-executing. That remains the case in a significant number of states. It is certain, however, that the exemption is intended to apply only to securities of those organizations which are exclusively organized for one of the purposes identified in the statute, and which for the most part will qualify under *section 501(c) of the Internal Revenue Code*.ⁿ¹⁹⁸

[9] Commercial Paper

Prior to NSMIA, Blue Sky laws in all states contained an exemption from registration requirements for securities loosely referred to as commercial paper. NSMIA preempted state regulatory authority in the area, however, to the extent that "commercial paper" is exempt under section 3(a)(3) of the Securities Act of 1933, thus making such securities federal "covered securities."ⁿ¹⁹⁹ States that have not adopted the 2002 Uniform Securities Act now provide a blanket exemption from registration and qualification requirements for federal covered securities. Nevertheless, those states also retain their specific commercial paper securities exemptions. Nearly all such exemptions were based on § 402(a)(10) of the Uniform Securities Act. Thus in Maryland, for example, the exemption is available for:

Any commercial paper which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions and which evidences an obligation to pay cash within nine of the date of issuance, exclusive of days of grace, or any renewal of such paper which is likewise limited, or any guarantee of such paper or of any such renewal.ⁿ²⁰⁰

The Uniform Act exemption was patterned on the comparable provision contained in § 3(a)(3) of the federal Securities Act of 1933.ⁿ²⁰¹ The provisions of both acts contemplate an exemption for "short-term paper of the type available for discount at a Federal Reserve Bank and of a type which is rarely bought by private investors."ⁿ²⁰² In simplest terms, the federal exemption covers only "prime quality negotiable commercial paper."ⁿ²⁰³ Although the intended scope of the exemption was to be so limited, in practice there was a considerable potential for abuse given the fact that on its face the exemption applied to any commercial paper meeting the nine month maturity criterion. Moreover, on the face of the exemption there was no limitation on the scope of an offering of such securities, thus leaving open the prospect of an

effective public offering of nine month promissory notes or other debt securities without any protection of blue sky registration or qualification. Many states, therefore made the intended scope of the exemption clear either by qualifying the exemption itself or by adopting a rule, order or policy statement making clear that the exemption is intended to apply only to prime quality negotiable paper not of a type ordinarily purchased by the general public, and that it is not available for offerings to the general public.ⁿ²⁰⁴

Some states opted for a different approach designed to identify more specifically the intended scope of the exemption. In 1985 the Revised Uniform Securities Act restated the exemption as applying to:

[A] promissory note, draft, bill of exchange, or banker's acceptance that evidences an obligation to pay cash within nine months after the date of issuance, exclusive of days of grace, is issued in denominations at least \$50,000, and receives a rating in one of the three highest rating categories from a nationally recognized statistical rating organization; or a renewal of such an obligation that is likewise limited, or a guarantee of such an obligation or of a renewal ...ⁿ²⁰⁵ Variations on this approach include a minimum aggregate amount sold to any one purchaser, and requiring that the commercial paper be sold through a registered broker-dealer or otherwise to a financial institution whose securities are exempt.

For all cases it is safe to generalize, however, that for the Blue Sky commercial paper exemption to apply:

- (1) The commercial paper must be of the type eligible for discount at a Federal Reserve Bank;ⁿ²⁰⁶ and
- (2) The offer and sale of the securities to the general public is either restricted or prohibited.

That being the case, it is at once apparent that state Blue Sky law exemptions for commercial paper based on the original Uniform Act provision, and in any iteration since, are coextensive with the federal exemption and thus no longer meaningful to the extent that NSMIA federal covered securities are involved by application of the federal exemption. Other than states that have adopted the 2002 Uniform Securities Act, which contains no commercial paper exemption, the exemption remains in Blue Sky laws. It is meaningful to the extent that a particular state exemption is broader than the federal counterpart, such that the subject security is not a federal covered security. It is for that reason that after enactment of NSMIA states were encouraged by the North American Securities Administrators Association (NASAA) to modify, but not to repeal, their existing exemptions.ⁿ²⁰⁷ No significant modifications have been made, however.

As a practical matter, in the intended sphere of application--prime quality commercial paper eligible for discounting by Federal Reserve Banks and not of the type ordinarily purchased by the general public--there is no doubt after NSMIA that a state exemption (and any qualifications that may be attached to it) is no longer meaningful. Antifraud protections of Blue Sky laws remain fully in place in any case, but the availability of an exemption from state registration or qualification requirements is no longer in question when these federal covered securities are present.

It is also true that state commercial paper exemptions are, in practical terms, no broader than the federal section 3(a)(3) exemption. However worded, their actual applications have been limited to the same securities intended to be covered by the federal exemption. The important question going forward, then, will not be whether a state exemption will be available for a security that is deemed not to be a federal covered security, but rather whether *any* exemption is available in the first place. NSMIA did not alter eligibility analysis at either the state or federal level. By leaving their commercial paper exemptions and interpretive rules or positions in place states maintain the essential premises for determining whether an exemption will be available. In the exercise of their jurisdiction regarding "commercial paper" and the many variations of debt instruments for which the label is sought to be attached, state administrators must make the same determination as always whether a particular security is in fact within the scope of the exemption. The determination now is whether the security is a federal covered security; but in making it the analysis will be the same as before.

The 2002 Uniform Securities Act eliminated any commercial paper exemption, thus fully reflecting NSMIA preemption. One of the states adopting it, however, elected to retain the commercial paper exemption, and also to retain its rule limiting application of the exemption to prime quality negotiable commercial paper.ⁿ²⁰⁸ In the last decade state securities administrators have faced widespread fraud and abuse in the offer and sale of nine month promissory notes and other high risk debt securities to public investors in attempted reliance on commercial paper exemptions. Although it should be clear that these securities bear no relation to the instruments intended to be covered by state exemptions, and now to be federal covered securities by reason of applying the federal section 3(a)(3) exemption, maintaining the pre-NSMIA regulatory construct at the state level serves to anchor continuing enforcement initiatives.

[10] Employee Benefit Plan Interests

Section 402(a)(11) of the Uniform Securities Act created an exemption from registration provisions under Blue Sky laws for:

[A]ny investment contract issued in connection with an employees' stock purchase, savings, pension, profit-sharing, or similar benefit plan if the Administrator is notified in writing thirty days before the inception of the plan or, with respect to plans which are in effect on the effective date of this act, within sixty days thereafter (or within thirty days before they are reopened if they are closed on the effective date of this act).ⁿ²⁰⁹

At the federal level, section 3(a)(2) of the Securities Act of 1933ⁿ²¹⁰ provides an exemption from federal registration requirements for qualifying employee benefit plan securities. It further directs the SEC to exempt, by rules, regulations or on order consistent with the protection of investors, any interest or participation issued in connection with a stock bonus, pension, profit-sharing, or annuity plan which covers employees some or all of whom are employees within the meaning of *section 401(c)(1) of the Internal Revenue Code*. Pursuant to this authority the SEC adopted Rule 701 under the Act.ⁿ²¹¹ The rule creates a transactional safe harbor for securities issued in compensatory circumstances, and is available to any issuer that is not subject to the reporting requirements of sections 13 or 15(d) of the Securities Exchange Act of 1934, and is not an investment company registered or required to be registered under the Investment Company Act of 1940. The Rule 701 safe harbor exempts offers and sales of securities under a written compensatory benefit plan established by the issuer for the participation of employees, directors, partners, officers and others when several requirements and limitations are met. There are limitations on the amount of securities that may be sold, as well as requirements for disclosure.

In addition to, or in some cases instead of, providing an exemption for employee benefit plans, a number of states adopted a transaction exemption specifically incorporating SEC Rule 701.ⁿ²¹² After NSMIA, however, securities exempt under § 3(a)(2) of the Securities Act of 1933 are federal covered securities,ⁿ²¹³ and thus preempted from state registration or qualification requirements (although as with all federal covered securities state Blue Sky antifraud provisions continue to apply). The 2002 Uniform Securities Act accordingly eliminated an exemption for benefit plan securities. The 2002 Uniform Act does, however, include a *transaction* exemption for:

[E]mployees' stock purchase, savings, option, profit-sharing, pension, or similar employees' benefit plan, including any securities, plan interests, and guarantees issued under a compensatory benefit plan or compensation contract, contained in a record, established by the issuer, its parents, its majority-owned subsidiaries of the issuer's parent for the participation of their employees including offers or sales of such securities to:

(A) directors, general partners, trustees, if the issuer is a business trust; officers, consultants; and advisors;

(B) family members who acquire such securities from those persons through gifts or domestic relations orders;

(C) former employees, directors, general partners, trustees, officers, consultants, and advisors if those individuals were employed by or providing services to the issuer when the securities were offered; and

(D) insurance agents who are exclusive insurance agents of the issuer, or the issuer's subsidiaries or parents, or who derive more than 50% of their annual income from those organizations.ⁿ²¹⁴

In one form or another, however, the exemption is still in place in the remaining states. To the extent that any state exemption is broader than the federal exemption under section 3(a)(2) of the federal act, that state exemption remains meaningful. As a practical matter, however, the scope of state exemptions for employee benefit plan securities has been uniformly coextensive with the federal exemption, and it is unlikely that a particular state exemption would be seen as offering any greater coverage.

The wording of a particular state exemption relating to employee benefit plans may have significance in determining whether the exemption encompasses securities that are not federal covered securities. For example, in one state adopting the Uniform Act provision, Delaware,ⁿ²¹⁵ the exemption was seen as exempting investment contracts, but not necessarily certificates of interest in or participation in a profit sharing agreement. To overcome this apparent conflict, the state's Securities Commissioner issued an interpretative rulingⁿ²¹⁶ declaring that a certificate of interest in or participation in a profit sharing agreement is included within the scope of an investment contract.ⁿ²¹⁷ The conclusion reached was that an employee benefit plan in the nature of a certificate of interest in or participation in a profit sharing plan was within that exemption provision.ⁿ²¹⁸ The federal section 3(a)(2) exemption is for "any security" meeting the benefit plan criteria, and the federal definition of security encompasses investment contracts as well as certificates of interest or participation in any profit-sharing agreement. Thus, the interpretation in Delaware or any other state adopting the Uniform Act language that the Blue Sky exemption extends beyond just "investment contracts" does not make the exemption more expansive than that provided by federal law.

Although employee benefit plan interests are federal covered securities, NSMIA preserved state authority to impose notice filing requirements for federal covered securities generally. States that previously required a filing in connection with their benefit plan securities exemption may continue to do so after NSMIA, but only to the extent of a notice filing. No precondition on the availability of the exemption may be imposed.

[11] Securities of Cooperative Associations

The original Uniform Securities Act did not contain a specific provision exempting the securities of cooperative associations. At the time the Act was written, however, at least eighteen states had some provision for exempting securities issued by cooperatives.ⁿ²¹⁹ Those provisions, as well as the statutes generally governing the organization and operation of cooperatives, were so varied that the drafters of the Uniform Act deemed it impracticable to recommend a single provision exempting cooperative securities.ⁿ²²⁰ It was the drafters' position that if such an exemption was desired, it should be included.ⁿ²²¹ However, in adopting the Revised Uniform Securities Act, the National Conference of Commissioners on Uniform State Laws included an exemption for such securities. Section 401(b)(13) of the Revised Uniform Act exempts "a membership or equity interest in, or a retention certificate or like security given in lieu of a cash patronage dividend issued by, a cooperative organized and operated as a nonprofit membership cooperative under the cooperative laws of any state if not traded to the public."ⁿ²²²

The fact that a uniform provision was not originally included is reflected in the divergent cooperative exemptions which have been adopted. No two provisions are alike; even similarities in drafting are rare.ⁿ²²³ If any pattern is to be found it is because a number of states apply the exemption to agricultural or similar cooperativesⁿ²²⁴ and/or require the association to be organized in the state in which the exemption is sought.ⁿ²²⁵ Filings are required for exemption

availability in some states; in others, the exemption is permissive. The 2002 Uniform Securities Act adopts the most common provision regarding cooperatives, and exempts:

[A] member's or owners interest in, or a retention certificate or like security given in lieu of a cash patronage dividend issued by, a cooperative organized and operated as a nonprofit membership cooperative under the cooperative laws of a State, but not a member's or owner's interest, retention certificate, or like security sold to persons other than bona fide members of the cooperative.n226

FOOTNOTES:

(n1)Footnote 1. Securities Act section 18(c)(1), 15 U.S.C. § 77r(c)(1) (2000), provides:

Fraud Authority--Consistent with this section, the securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker-dealer, in connection with securities or securities transactions.

(n2)Footnote 2. See *People v. Edward D. Jones & Co.*, 154 Cal. App. 4th 627, 65 Cal. Rptr. 3d 130 (2007) ; *Capital Research & Management Co. v. Brown*, 147 Cal. App. 4th 58, 53 Cal. Rptr. 3d 770 (2007) .

(n3)Footnote 3. See, e.g., California: Cal. Corp. Code § 25100(a):

Any security (including a revenue obligation) issued or guaranteed by the United States, any state, any city, county, city and county, public district, public authority, public corporation, public entity or political subdivision of a state or any agency or corporate or other instrumentality of any one or more of the foregoing; or any certificate of deposit for any of the foregoing.

See also Illinois: Ill. Cons. Stat. § 5/3; Massachusetts: Mass. Gen. L. Ann., Ch. 110A, § 402(a)(1). Section 201(1) of the 2002 Uniform Securities Act encompasses the same securities and somewhat broader categories with its exemption for:

[A] security, including a revenue obligation or a separate security as defined in Rule 131 (17 C.F.R. 230.131) adopted under the Securities Act of 1933, issued, insured, or guaranteed by the United States; by a State, by a political subdivision of a State; by a public authority, agency, or instrumentality of one or more States; by a political subdivision of one or more states; or by a person controlled or supervised by and acting as an instrumentality of the United States under authority granted by the Congress; or a certificate of deposit for any of the foregoing.

(n4)Footnote 4. Rev. Unif. Sec. Act §§ 401(a)(1)-(2).

The Official Code Comment explained:

The purpose of subsection (a) is to identify the extent of the guaranty or insurance coverage needed in order to be eligible for exempt security status under certain subparagraphs of Section 401(b). ... A partially guaranteed or insured security, e.g., of 75% of the principal, is not eligible for any of the specified exemptions

(n5)Footnote 5. Although non-Uniform Act exemptions will generally reach most of the same type of securities, a question exists with respect to revenue obligations and similar securities. Not all states specifically exempt such

securities. Some states will not allow the government security exemption if the issuer or guarantor is in default or has been in default as to principal or interest with respect to an obligation issued by the issuer or its successor unless fully disclosed as required by regulation (other than general obligation bonds). *See Fla. Stat. Ann. § 517.051(1)*.

(n6)Footnote 6. *See, e.g., La. Rev. Stat. Ann. § 51:708*, which provides an exemption for:

Any security, including a revenue obligation, issued or guaranteed by the United States or any state, any political subdivision of a state, or any agency, authority, public corporation, or other instrumentality of one or more of the foregoing including any underlying or separate security which secures any of the foregoing securities.

However, Louisiana's government exemption does not extend to securities issued pursuant to the Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689 (1984).

Tex. Rev. Civ. Stat. Ann., art. 581-5(M), provides that securities issued or guaranteed by the governmental unit are only exempt when sold by registered dealers or the issuer itself.

(n7)Footnote 7. Section 3(a)(2) of the federal Securities Act, *15 U.S.C. § 77c(a)(2) (2000)*, exempts:

Any security issued or guaranteed by the United States or any territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or territory, or by any public instrumentality of one or more States or territories, or by any person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit for any of the foregoing

(n8)Footnote 8. Investment Bankers Association of America, *Fundamentals of Municipal Bonds* (1965).

(n9)Footnote 9. Note, *Municipal Bonds and the Federal Securities Laws: The Results of Forty Years of Indirect Regulation*, 28 *Vand. L. Rev.* 561 (1975). *See also* Seamons, Q.F. and D. Sheaffer, Jr., *Emerging Disclosure Issues for Municipal Securities*, 24 *Sec. Reg. L.J.* 392 (1997); J. Funk & P. Poe, *Applicability of State Securities Laws to Securities Issued by Governmental Entities*, 43 *Bus. Law* 433, 436 (1987).

(n10)Footnote 10. *See, e.g., Cal. Corp. Code § 25100(a)*.

See also North Dakota's provision which allows the exemption for governmental securities "payable from assessments for improvements or revenues of publicly owned utilities" *N.D. Cent. Code § 10-04-05(1)*.

(n11)Footnote 11. *Ohio Rev. Code Ann. § 1707.02(B)*.

(n12)Footnote 12. *Id.* The exemption applies only:

[I]f the issuer or guarantor has the power of taxation or assessment for the purpose of paying the obligation represented by the security, or is in specific terms empowered by the laws of the state of issuance to issue securities payable as to principal or interest, or as to both, out of revenues collected or administered by such issuer

(n13)Footnote 13. *Op. Att'y Gen.* 062-90 (1962).

(n14)Footnote 14. Rev. Unif. Sec. Act § 401(b)(1), as amended, provides:

[T]his exemption does not include a security payable solely from revenues to be received from a non-governmental industrial or commercial enterprise unless the payments are insured or guaranteed by a person whose securities are exempt from registration under paragraph (2), (3), (4), (5), (7), (9), or (13) or the revenues from which the payments are to be made are a direct obligation of such a person

(n15)Footnote 15. *See, e.g., Mont. Code Ann. § 30-10-104(1).*

(n16)Footnote 16. N.H. Rev. Stat. Ann. § 421B:17I(a) ("but this exemption shall not include any industrial development bond or any industrial revenue bond").

(n17)Footnote 17. *Tex. Admin. Code tit. 7 §§ 135.3, 135.4.*

(n18)Footnote 18. The provision exempting the securities requires a filing if obligations are not payable out of general tax proceeds. *See Ohio Rev. Code Ann. § 1707.02(B)*. In addition, *Ohio Rev. Code Ann. § 1707.02(K)* provides an exemption for industrial development bonds issued pursuant to Ohio law.

(n19)Footnote 19. *N.Y. Gen. Bus. L. § 359-ff(5).*

(n20)Footnote 20. *15 U.S.C. § 77c(a)(2)*. This provision is reproduced at Ch.8, *infra*.

(n21)Footnote 21. *64 Pa. Code § 202.010.*

(n22)Footnote 22. The local development corporation might be formed by a municipality seeking to draw new business or industry to its jurisdiction. The money raised by the public company is actually for private use. The advantage to the industry is that the bonds will be tax free since they are issued by an arm of the municipality. This makes them easier to sell and provides a lower rate of interest to be paid by the private business.

(n23)Footnote 23. *See, e.g., N.C. Gen. Stat. § 78A-17(13)*, which exempts:

Any offer or sale by a domestic corporation of its own securities if (i) the corporation was organized for the purpose of promoting community, agricultural or industrial development of the area in which the principal office is located, (ii) the offer or sale has been approved by resolution of the county commissioners of the county in which its principal office is located, and, if located in a municipality or within two miles of the boundaries thereof, by resolution of the governing body of such municipality, and (iii) no commission or other remuneration is paid or given directly or indirectly for soliciting any prospective buyer in this State

In Ohio, an exemption is provided for bonds issued by a Port Authority organized under Ohio law. *Ohio Rev. Code Ann. § 1707.02(K)*. In the above states, except Ohio, the exemption is for the transaction and applies only to the sale of the security by the issuer. The Ohio exemption is for the security itself and applies to all sales of such security.

(n24)Footnote 24. *15 U.S.C. § 681 (2000).*

(n25)Footnote 25. *15 U.S.C. § 683 (2000)*. *See also* § 3(c) of the Securities Act of 1933, *15 U.S.C. § 77c (2000)* (giving SEC discretion to exempt small business investment company securities).

(n26)Footnote 26. *See, e.g., N.D. Cent. Code § 10-04-06(10).*

(n27)Footnote 27. Unif. Sec. Act § 402(a)(2).

(n28)Footnote 28. Unif. Sec. Act § 402(a)(2). As noted below, foreign governmental securities are not federal covered securities under NSMIA. However, there may be certain transactional exemptions for these securities. *See* Chs. 8 and 9 *infra*.

(n29)Footnote 29. *See, e.g., N.J. Stat. Ann. § 49:3-50(a)(2); Va. Code Ann. § 13.1-514(a)(2).*

(n30)Footnote 30. *See, e.g., Cal. Corp. Code § 25100(b):*

Any security issued or guaranteed by the Dominion of Canada, any Canadian province, any political subdivision or municipality of any such province, or by any other foreign government with which the United States currently maintains diplomatic relations, if the security is recognized as a valid obligation by the issuer or guarantor; or any certificate of deposit for any of the foregoing.

See also Mass. Gen. L. Ann., Ch. 110A, § 402(a)(2), exempting:

[A]ny security other than a revenue obligation issued or guaranteed by Canada, any Canadian province, any political subdivision of any such province, any agency or corporate or other instrumentality of one or more of the foregoing, or any other foreign government with which the United States currently maintains diplomatic relations if the security is recognized as a valid obligation by the issuer or guarantor

In Ohio, Canada is given special treatment only with respect to corporations and governmental agencies created under the laws of the Dominion. *Ohio Rev. Code Ann. § 1707.02(C).*

(n31)Footnote 31. *See, e.g., Fla. Stat. Ann. § 517.051(2):*

Any security issued or guaranteed by any foreign government with which the United States is maintaining diplomatic relations at the time of the sale or offer of sale of the security, or by any state, province or political subdivision thereof having the power of taxation or assessment, which security is recognized at the time it is offered for sale in this state as a valid obligation by such foreign government or by such state, province or political subdivision thereof issuing the security.

See also Ohio Rev. Code Ann. § 1707.02(B)(1):

The following securities are exempt, if the issuer or guarantor has the power of taxation or assessment for the purpose of paying the obligation represented by the security, or is in specific terms empowered by the laws of the state of issuance to issue securities payable as to principal or interest, or as to both, out of revenues collected or administered by such issuer:

* * *

Any security issued or guaranteed by, and recognized, at the time of sale, as its valid obligation by, any foreign government with which the United States is, at the time of sale, maintaining diplomatic relations;

Any security issued or guaranteed, and recognized as its valid obligation, by any political subdivision or any governmental or other public body, corporation, or agency in or of the United States, any state, territory, or possession of the United States, or any foreign government with which the United States is, at the time of sale, maintaining diplomatic relations.

(n32)Footnote 32. That is not always the case. In Arizona, for example, the state exemption for foreign government securities does not apply unless the securities are registered under the federal Securities Act. *See, e.g., Ariz. Rev. Stat. Ann. § 44-1843(9)*:

Securities issued or guaranteed by any foreign government with which the United States is at the time of the sale maintaining diplomatic relations, or securities issued or guaranteed by a political subdivision of such foreign government having the power of taxation, if none of the securities of the foreign government or political subdivision are in default either as to principal or interest, and which securities when offered for sale in this state are acknowledged as valid obligations by the foreign government or political subdivision and registered under the Securities Act of 1933.

(n33)Footnote 33. Section 201(2) of the 2002 Uniform Securities Act is representative of the full breadth of state security exemptions for foreign government securities in providing an exemption for:

[A] security issued, insured, or guaranteed by a foreign government with which the United States maintains diplomatic relations, or any of its political subdivisions, if the security is recognized as a valid obligation of the issuer, insurer, or guarantor.

(n34)Footnote 34. The most useful definition of "depository institution" today is that provided in states which have adopted the 2002 Uniform Securities Act, in which section 102(5) provides in pertinent part that "depository institution" means:

(A) a bank; or

(B) a savings institution, trust company, credit union, or similar institution that is organized or chartered under the laws of a State or of the United States, authorized to receive deposits, and supervised and examined by an official or agency of a State or the United States if its deposits or share accounts are insured to the maximum amount authorized by statute by the Federal Deposit Insurance Corporation, the National Credit Union Share Insurance Fund, or a successor authorized by federal law

2002 Unif. Sec. Act § 102(5).

(n35)Footnote 35. Draftsmen's commentary to Unif. Sec. Act § 402(a)(3); L. Loss & E. Cowett, *Blue Sky Law* 355 (1958).

In general, it is control over the institution issuing the securities that is the basis of the exemption, not control over the securities themselves. *See State ex rel. Holloway v. First American B. & T. Co., 186 N.W.2d 573 (N.D. Supp. 1971)* .

(n36)Footnote 36. *Wyo. Stat. Ann. § 17-4-114-(a)(iii)*: "[A]ny security issued by a state or national bank authorized to do business in the state. ..."

(n37)Footnote 37. *Va. Code Ann. § 13-1-514(a)(3)*:

Any security issued by and representing an interest in or a debt of, or guaranteed by, the International Bank for Reconstruction and Development, or any national bank, or any bank or trust company organized under the laws of any state

(n38)Footnote 38. 15 U.S.C. § 77c(2) (2000).

(n39)Footnote 39. For purposes of section 3(a)(2), a security issued or guaranteed by a bank does not include any interest or participation in any collective trust fund maintained by a bank. 15 U.S.C. § 77c(2) (2000).

A branch or agency of a foreign bank located in the United States is deemed to be a national bank or a banking institution organized under the laws of any state, territory, or the District of Columbia for purposes of the section 3(a)(2) exemption provided that there is substantially equivalent regulation. Sec. Act Rel. No. 33-6661, 1986 SEC LEXIS 729 (Sept. 23, 1986) .

(n40)Footnote 40. See, e.g., *Capital Funds, Inc. v. SEC*, 348 F.2d 582 (8th Cir. 1965) . The fact that a lending institution performed some banking functions and was subject to supervision by the state banking commissioner did not entitle it to the section 3(a)(2) exemption. The institution was incorporated under a state statute that created a clear distinction between industrial loan companies and banks, and prohibited the former from using the word "bank" in their names.

(n41)Footnote 41. Frontier Gas Storage Co., 1981 SEC No-Act LEXIS 2797 (Jan. 5, 1981).

(n42)Footnote 42. See American Bankers Club, Inc., 1980 SEC No-Act LEXIS 3427 (June 26, 1980).

(n43)Footnote 43. See 2002 Unif. Sec. Act § 201(3)(A).

(n44)Footnote 44. As defined in section 101(14) of the 2002 Uniform Act, *international banking institution* means "an international financial institution of which the United States is a member and whose securities are exempt from registration under the Securities Act of 1933."

(n45)Footnote 45. For example, securities issued or guaranteed by savings institutions are not specifically included in the statutory exemption language in Ohio, *Ohio Rev. Code Ann. § 1707.02(c)* or Washington, *Wash. Rev. Code § 21.20.310(3)*.

(n46)Footnote 46. For instance, securities issued or guaranteed by trust companies are not specifically included in the statutory exemption language in Ohio, *Ohio Rev. Code Ann. § 1707.02(c)*; see also Pennsylvania, Pa. Cons. Stat. Ann. § 202(b); and Texas, *Tex. Rev. Civ. Stat. Ann. art. 581-5(L)* (transactional exemption).

(n47)Footnote 47. Ohio, for example, has a definition of "bank" which specifically includes trust companies and savings associations. *Ohio Rev. Code Ann. § 1707.01(O)* provides:

"Bank" means any bank, trust company, savings and loan association, or savings bank, that is incorporated or organized under the laws of the United States, any state of the United States, Canada or any province of Canada, and that is subject to regulation or supervision by that country, state, or province.

(n48)Footnote 48. *Ariz. Rev. Stat. § 44-1843(2)*.

(n49)Footnote 49. *Ariz. Rev. Stat. § 44-1843(3)*.

Pennsylvania provides an exemption for "Any security issued or guaranteed by any bank or savings association ... ," and broadly defines "bank":

"Bank" means any bank, banking and trust company, savings bank, trust company or private bank ... or any savings and loan association ... or any successor statutes thereto, or any banking institution, trust

company or savings and loan institution organized under the laws of the United States, or of any state, territory or the District of Columbia, or a receiver, conservator or other liquidating agent of any of the foregoing.

70 Pa. Cons. Stat. Ann. § 1-102(d).

(n50)Footnote 50. 15 U.S.C. § 77c(a)(5) (2000).

(n51)Footnote 51. 15 U.S.C. § 77c(a)(5) (2000).

(n52)Footnote 52. 15 U.S.C. § 77c(a)(5) (2000).

(n53)Footnote 53. 49 N.J. Stat. § 3-50(3)(a)(3).

(n54)Footnote 54. Section 402(a)(4) of the Uniform Act provides the exemption for:

[A]ny security issued by and representing an interest in or a debt of, or guaranteed by, any federal savings and loan association, or any building and loan or similar association organized under the laws of any state and authorized to do business in this state.

(n55)Footnote 55. 49 N.J. Stat. § 3-50(3)(a)(4). *Savings institution* for purposes of the New Jersey exemption means any savings and loan association or building and loan association operating pursuant to the "Savings and Loan Act (1963)," and any federal savings and loan association and any association or credit union organized under the laws of the United States or of any state whose accounts are insured by a federal corporation or agency.

(n56)Footnote 56. 12 U.S.C. §§ 1461 *et seq.*

(n57)Footnote 57. *See* 12 U.S.C. § 1464(a) (2000):

In order to provide thrift institutions for the deposit of funds and for the extension of credit for homes and other goods and services, the Director is authorized ... to provide for the organization, incorporation, examination, operation, and regulation of associations to be known as Federal savings associations

In response to the collapse of the thrift industry during the 1980s, Congress enacted The Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 ("FIRREA"). Among other actions, FIRREA abolished the Federal Savings and Loan Insurance Corporation ("FSLIC"). Accordingly, any reference to the FSLIC in Rev. Unif. Sec. Act § 401(b)(3) or in analogous state provisions setting forth exemptions for Federal savings associations will refer to "a successor to an applicable agency authorized by federal law." *See* Rev. Unif. Sec. Act § 401(b)(3). *See also* Felsenfeld, *The Savings and Loan Crisis*, 59 *Fordham L. Rev.* 87 (1991).

(n58)Footnote 58. *See, e.g.,* Cal. Fin. L. §§ 5000 *et seq.*; Fla. Stat. Ann. §§ 665.012 *et seq.*; N.Y. Bank. L. §§ 375 *et seq.*

(n59)Footnote 59. *See Louisville Gas & E. Co. v. Coleman*, 277 U.S. 32, 48 S. Ct. 423, 72 L. Ed. 770 (1928) (interpreting Kentucky law); *SEC v. American International S. & L. Ass'n*, 199 F. Supp. 341 (D. Md. 1961) (interpreting Maryland Law).

(n60)Footnote 60. *See, e.g.,* R.I. Gen. Laws § 7-11-401(3); Vt. Stat. Ann. tit. 9 § 4203a(3).

Other states have retained the language of Unif. Sec. Act § 402(a)(4), exempting securities of any federal savings and loan or building and loan associations authorized to do business in that state. *See, e.g., Mass. Gen. L. Ann., ch. 110A, § 402(a)(4).*

(n61)Footnote 61. Blue Sky laws do not necessarily prescribe that savings and loan associations must be subject to control of specific state agencies. However, such agency control may be prescribed by other statutes before authority to do business will be granted. For states that specify state agency control in the context of the securities acts. The states listed below are representative of those which have adopted a provision similar to Unif. Sec. Act. § 402(a)(4), but which differ from the Uniform Act with respect to a provision other than the one allowing exemption for securities of a foreign state building and loan association when the association is authorized to do business in the state.

Ark. Code Ann. § 23-42-503(a)(4):

Any security issued by and representing an interest in or a debt of any state or federal savings and loan association or any federally insured savings bank, or any building and loan or similar association organized under the laws of any state and authorized to do business in this state

Note that the words "or guaranteed by" used in the Uniform Act provision are omitted from the Arkansas provision.

Del. Code Ann. tit. 6 § 7309(a)(4):

Any security issued by and representing an interest in or a debt of, or guaranteed by, any federal savings and loan association, or any building and loan association organized and supervised under the laws of any state and authorized to do business in this state

The words "or similar association," which were used in the Uniform Act, are omitted from the Delaware provision.

(n62)Footnote 62. Both Ohio and Pennsylvania include savings and loan associations within the statutory definition of "bank", and exempt the securities when the bank is organized in other states.

Pennsylvania also has a regulation on the meaning of "savings and loan institution." *See 64 Pa. Code § 102.041(b):*

For the purpose of § 102(d), the term "savings and loan institution" means an institution organized under the applicable State or Federal law: The business of which is substantially confined to the savings association business Examined and supervised as a savings association by the appropriate State or Federal authorities having supervision over an institution. For the purpose of this subsection, the "savings association business" is deemed to be the receipt of deposits from and the making of loans to members of the association. The term "savings and loan institution" does not include a savings and loan holding company or a savings and loan in organization.

(n63)Footnote 63. *See, e.g., Cal. Corp. Code § 25100(d), (g):*

Any security issued or guaranteed by a federal savings and loan association or federal land bank or joint land bank or national farm loan association or by any savings association ... which is subject to the supervision and regulation of the Commissioner of Financial Institutions of this state.

Any mutual capital certificates or savings accounts, as defined in the Savings Association Law, issued by a savings association as defined by subdivision (a) of Section 5102 of the Financial Code, and holding a license or certificate of authority then in force from the Commissioner of Financial Institutions

of this state.

New York exempts securities which are exempt under the Securities Act of 1933 (except for the intrastate offering exemption). *N.Y. Gen. Bus. L. § 359-ff(5)*. Section 3(a)(5) [15 U.S.C. § 77c(a)(5)] of the 1933 act provides that the exemption applies to:

Any security issued (A) by a savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution, which is supervised and examined by State or Federal authority having supervision over any such institution; or (B) by (i) a farmer's cooperative organization exempt from tax under *section 521 of the Internal Revenue Code of 1954*, (ii) a corporation described in section 501(c)(16) of such Code and exempt from tax under section 501(a) of such Code, or (iii) a corporation described in section 501(c)(2) of such Code which is exempt from tax under section 501(a) of such Code and is organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization or corporation described in clause (i) or (ii)

See also N.D. Cent. Code § 10-04-05(3): "Securities issued by a building and loan association subject to supervision by an agency of the state of North Dakota"

(n64)Footnote 64. Most states include the exemption for securities of federal savings and loan institutions within the same statutory subsection as the exemption for securities of similar state institutions.

A few states provide for the exemption of the two types of organizations in separate subsections of the exemption section. *See, e.g., Ariz. Rev. Stat. Ann. § 44-1843A(2)*: "Securities issued by a national bank or a bank or credit or loan association organized pursuant to an act of Congress and supervised by the United States or an agency thereof" *See also Or. Rev. Stat. § 59.025(3)*: "A security which represents an interest in or a direct obligation of or is guaranteed by a national bank, federal savings and loan association, federal credit union or federal land bank or joint stock land bank or national farm loan association."

(n65)Footnote 65. *See, e.g., Fla. Stat. Ann. § 517.051(5)*: "A security issued or guaranteed by any of the following which are subject to the examination, supervision, or control of this state or of the Federal Deposit Insurance Corporation ... A building or savings and loan association."

See also Virginia: Va. Code Ann. § 13.1-514(4) provides: "Any security issued by and representing an interest in or a debt of, or guaranteed by, any federal savings and loan association, or by any savings and loan association which is organized under the laws of this Commonwealth"

(n66)Footnote 66. *See, e.g., Cal. Fin. Code § 14002*:

A credit union is a cooperative, organized for the purpose of promoting thrift and savings among its members and creating a source of credit for them at rates of interest set by the board of directors, and providing an opportunity for them to use and control their own money on a democratic basis in order to improve their economic and social conditions.

(n67)Footnote 67. *See Cal. Fin. Code § 14002; Fla. Stat. Ann. § 657.003*.

(n68)Footnote 68. Unif. Sec. Act § 402(a)(6).

(n69)Footnote 69. *See also Idaho Central Credit Union, 1977 SEC No-Act. LEXIS 286 (Feb. 14, 1977)* (a credit

union could rely on the section 3(a)(5) federal exemption where the supervision by a state finance department was similar to the supervision of savings and loan associations, and the general purpose and operation of the credit union was to maintain share accounts for members and to make loans to members on approved credit).

(n70)Footnote 70. *See, e.g., Alaska Stat. § 45.55.900(a)(7)*, which exempts:

[A] security issued by and representing an interest in or a debt of, or guaranteed by, an insurance company organized under the laws of a state and authorized to do business in this state; but this exemption does not apply to an annuity contract, investment contract, or similar security under which the promised payments are not fixed in dollars but are substantially dependent upon the investment results of a segregated fund or account invested in securities; except that policies or annuity contracts of insurance companies admitted to do business in the state are not subject to this chapter...

See also Cal. Corp. Code § 25100(e) ("Any security ... the issuance of which is subject to authorization by the Insurance Commissioner ... of this state."); *Hawaii Rev. Stat. § 485-4(5)* ("Any security issued by and representing an interest in or a debt of, or guaranteed by, any insurance company organized under the laws of any state or territory and authorized to do business in the State")

(n71)Footnote 71. *See, e.g., N.Y. Gen. Bus. L. § 359-ff(5)(f)*:

This section shall not be applicable to offerings or sales of securities ... which constitutes an insurance or endowment policy or annuity contract or interest or participation therein, whether payable in fixed or variable dollar amounts or both, issued by an institution subject to the supervision of the superintendent of insurance of this state.

(n72)Footnote 72. *See Ch. 2, supra*. Rev. Unif. Sec. Act § 101(16) provides that the definition of security does not include "an insurance or endowment policy or annuity contract under which an insurance company promises to pay a fixed sum of money either in a lump sum or periodically for life or some other specified period."

For purposes of this discussion it must be assumed that insurance interests are issued by insurance companies. The Uniform Securities Act, and many state statutes, clearly indicates that exclusions and exemptions for the specified insurance interests apply only to *bona fide* insurance companies. If the wording of these statutes is taken literally, neither exclusions nor exemptions would apply to issuances by persons or entities other than insurance companies. For example, with this qualification in mind, insurance and endowment policies and fixed annuity contracts are excluded from the definition of "security" in the following representative statutes and/or codes:

Cal. Corp. Code § 25019:

"Security" does not include: ... (3) any ... annuity contract under which an insurance company admitted in this state promises to pay a sum of money (whether or not based upon the investment performance of a segregated fund) either in a lump sum or periodically for life or some other specified period

Mass. Gen. Laws. Ann. Ch. 110A, § 401(k): "Security does not include any ... annuity contract under which an insurance company promises to pay money either in a lump sum or periodically for life or some other specified period."

R.I. Gen. Laws 7-11-101(20)(i): "[Security] does not include: (i) an insurance or endowment policy or annuity contract under which an insurance company promises to pay a fixed sum of money either in a lump sum or periodically

for life or some other specified period."

Tex. Rev. Civ. Stat. Ann. art. 581-4A:

Provided, however, that this definition shall not apply to any insurance policy, endowment policy, annuity contract, optional annuity contract ... issued by an insurance company subject to the supervision or control of the State Board of Insurance when the form of such policy or contract has been duly filed with the Board

(n73)Footnote 73. 15 U.S.C. § 77c(8).

(n74)Footnote 74. *See also Berent v. Kemper Corp.*, 780 F. Supp. 431 (E.D. Mich. 1991) .

(n75)Footnote 75. Variable annuities differ from fixed annuities in that, rather than promising repayment in dollars upon maturity of the contract, as in a fixed annuity, they provide a liquidation in units of value which fluctuate proportionately to the value of the securities in which the combined unit of such contracts are invested. In *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 79 S. Ct. 618, 3 L. Ed. 2d 640 (1959) , the United States Supreme Court held that variable annuities are securities under the Federal Securities Act of 1933. The Court applied investment contract analysis in reaching its conclusion, without regard to the "insurance" aspect of the product.

(n76)Footnote 76. *See* Unif. Sec. Act § 401(l).

(n77)Footnote 77. Section 402(5) of the Uniform Act created an exemption for any security issued by and representing an interest in or a debt of, or guaranteed by, an insurance company organized under the laws of any state, but included the optional provision:

[B]ut this exemption does not apply to an annuity contract, investment contract, or similar security under which the promised payments are not fixed in dollars but are substantially dependent upon the investment results of a segregated fund or account invested in securities.

(n78)Footnote 78. *See, e.g., Cal. Corp. Code* § 25019; *Ga. Code Ann.* § 10-5-2(26); *N.J. Stat. Ann.* § 49:3-49(m); *70 Pa. Cons. Stat. Ann.* § 1-102(t); *Va. Code Ann.* § 13.1-501A.

(n79)Footnote 79. *See, e.g., Cal. Corp. Code* § 25100(e).

(n80)Footnote 80. The original intent of the Uniform Act's drafters was to include variable annuities as securities, but they did provide an alternate provision for states wishing to exclude these interests. § 402(a)(5) exempts:

Any security issued by and representing an interest in or a debt of, or guaranteed by, any insurance company organized under the laws of any state and authorized to do business in this state, but this exemption does not apply to any annuity contract, investment contract, or similar security under which the promised payments are not fixed in dollars but are substantially dependent upon the investment result of a segregated fund or account invested in securities

See Alaska Stat. § 45.55.900(a)(7).

(n81)Footnote 81. *See, e.g., Fla. Stat. Ann.* § 517.021(9); *N.Y. Gen. Bus. L.* § 359ff(5)(f); *Ohio Rev. Code* § 1707.01(B).

(n82)Footnote 82. *See, e.g., Fla. Stat. Ann.* § 517.051(10); *Ohio Rev. Code* § 1707.02(H).

(n83)Footnote 83. *See, e.g., Ariz. Rev. Stat. Ann. §§ 44-1801(23) and 44-1843A(4)* (No exclusionary provision; exemption covers annuity contracts, but not variable annuities specifically); *Fla. Stat. Ann. §§ 517.021(19); 517.051(10)* (No exclusion; exemption covers annuity contracts, but not variable annuities specifically); *Neb. Rev. Stat. §§ 8-1101(15); 8-1110* (Exclusion provision mentions annuities, but not variable annuities. Even here registration is doubtful since the wording seems to be based on the former Uniform Act provision, but with considerable rephrasing. There is no exemption provision.); *Tex. Rev. Civ. Stat. Ann. arts. 581-4A; 581-56(2)* (Exclusion mentions annuities generally, but not specifically variable annuities.)

(n84)Footnote 84. Unif. Sec. Act § 402(a)(4). Rev. Unif. Sec. Act § 401(b)(4), as redesignated and amended in 1985 by the National Conference of Commissioners on Uniform State Laws exempts: "Any security issued by and representing an interest in or a direct obligation of, or guaranteed by, any insurance company organized under the laws of any state and authorized to do business in this state" The amendments deleted the optional provision making the exemption inapplicable to variable annuities.

The Official Code Comment provides:

A variable annuity contract ... is a security under [Section 101(b)(16)] ... but would be exempt under this subsection, as are any other securities issued by insurance companies. The result is that the latter securities are not required to be registered under this Act but are subject to the antifraud provisions of Section 501.

(n85)Footnote 85. These Blue Sky laws do not prescribe that the insurer be under control of any specific state agency. However, control by a specific agency may be mandated by other statutes before authority to do business will be granted. *See Alaska Stat. § 45.44.900(a)(7); Mass. Gen. L. Ann., ch. 110A, § 402(a)(5).*

In North Dakota, the exemption is granted to securities of insurers under the control of any North Dakota state agency. *See N.D. Cent. Code § 10-04-05(3).*

(n86)Footnote 86. *See Cal. Corp. Code § 25100(e); Idaho Code § 30-1434(1)(e); N.Y. Gen. Bus. § 359-ff(5)(f).*

(n87)Footnote 87. State supervision of the issuer must exist. *See Fla. Stat. Ann. § 517.051(10):*

Any insurance or endowment policy or annuity contract or optional annuity contract or self insurance agreement issued by a corporation, insurance company, reciprocal insurer, or risk retention group subject to the supervision of the insurance commissioner or bank commissioner, or any agency or officer performing like functions, of any state or territory of the United States or the District of Columbia.

(n88)Footnote 88. The insurance company and the issuance or guaranty of its securities must be regulated by "a state." *Ohio Rev. Code Ann. § 1707.02(H).*

(n89)Footnote 89. *Ill. Comp. Stat. Ann. ch. 815 § 5/3M.*

(n90)Footnote 90. *Tex. Rev. Civ. Stat. Ann., art. 581-5(c)(2):* Sale by or on behalf of any insurance company subject to the supervision or control of the Board of Insurance of any security owned by such company as a legal and bona fide investment, provided that in no event shall any such sale or offering be exempt from the provisions of this Act when made or intended, either directly or indirectly, for the benefit of any other company as that term is defined in this Act.

(n91)Footnote 91. Unif. Sec. Act § 402(a)(7).

(n92)Footnote 92. The ICC was abolished and its functions transferred to the Surface Transportation Board ("STB") effective January 1, 1996 by 49 U.S.C. § 702 and the ICC Termination Act of 1995, 109 Stat. 803. Any references to the ICC in federal law or regulation are deemed to refer to the STB. Former § 1130(b)(1), relating to the authority of certain carriers to issued securities, was abrogated by Pub. L. No. 104-88.

(n93)Footnote 93. Draftsmen's commentary to Unif. Sec. Act § 402(a)(7), L. Loss & E. Cowett, Blue Sky Law 358 (1958). *See also* Official Code Comment to § 401(b)(5), as amended.

(n94)Footnote 94. Note that the statutory provisions of some states refer to exemption when certain state governmental agencies are in a regulatory position. Due to the fact that these provisions do not lend themselves to the type of divisional discussion allowed by states following the Uniform Act, examples of the pertinent regulatory portions of the entire section are set forth below.

Ariz. Rev. Stat. Ann. § 44-1843A(5):

Securities issued or guaranteed either as to principal, interest or dividend by a railroad or public utility if the issuance of its securities is regulated by an agency of the United States, a state, territory or insular possession thereof, or an agency of the District of Columbia, or an agency of the Dominion of Canada or any province thereof

Fla. Stat. Ann. § 517.051(4):

A security issued or guaranteed either as to principal, interest or dividend by a corporation owning or operating a railroad or any other public service utility; provided, that such corporation is subject to regulation or supervision whether as to its rates and charges or as to the issue of its own securities by a public commission, board or officer of the government of the United States, of any state, territory, or insular possession of the United States, or of any municipality located therein, or of the District of Columbia, or of the Dominion of Canada or of any province thereof

N.Y. Gen. Bus. L. §§ 359-f(1)(d), 359-ff(5)(e). Section 359-ff(5)(e) grants an exemption to securities described in § 359-f(1)(d), which describes the following securities:

Any securities issued or guaranteed by a public service or utility corporation, including a railroad corporation, provided such corporation is subject to regulation or supervision either as to its rates and charges or as to the issue of its own securities by a public commission, board or officer of the government of the United States, or of any territory, or insular possession thereof, or of any state or municipality or other political subdivision thereof, or of the Dominion of Canada, or any province thereof

Tex. Rev. Civ. Stat. Ann. art. 581-6(D):

Any security issued or guaranteed either as to principal, interest, or dividend, by a corporation owning or operating a railroad or any other public service utility; provided, that such corporation is subject to regulation or supervision either as to its rates and charges or as to the issue of its own securities by the Railroad Commission of Texas, or by a public commission, agency, board or officers of the Government of the United States, or of any territory or insular possession thereof, or of any state or municipal corporation, or of the District of Columbia, or of the Dominion of Canada, or any province thereof

(n95)Footnote 95. *15 U.S.C. § 77c(a)(6) (2000).*

(n96)Footnote 96. *Unif. Sec. Act § 402(a)(7); Rev. Unif. Sec. Act § 401(b)(5)(ii).*

(n97)Footnote 97. *15 U.S.C. §§ 79 et seq.*

(n98)Footnote 98. *See 15 U.S.C. § 79a*, which provides, in pertinent part:

(b) Protection of investors and interests of consumers. Upon the basis of facts disclosed by the reports of the Federal Trade Commission ... it is declared that the national public interest, the interest of investors in the securities of holding companies and their subsidiary companies and affiliates, and the interest of consumers of electric energy and natural and manufactured gas, are or may be adversely affected--

(1) when such investors cannot obtain the information necessary to appraise the financial position or earning power of the issuers, because of the absence of uniform standard accounts; when such securities are issued without the approval or consent of the States having jurisdiction over subsidiary public-utility companies; when such securities are issued upon the basis of fictitious or unsound asset values having no fair relation to the sums invested in or the earning capacity of the properties and upon the basis of paper profits from intercompany transactions, or in anticipation of excessive revenues from subsidiary public-utility companies; when such securities are issued by a subsidiary public-utility company under circumstances when subject such company to the burden of supporting an overcapitalized structure and tend to prevent voluntary rate reductions;

(2) when subsidiary public-utility companies are subjected to excessive charges for services, construction work equipment, and materials, or enter into transactions in which evils result from an absence of arm's-length bargaining or from restraint of free and independent competition; when service, management, construction, and other contracts involve the allocation of charges among subsidiary public-utility companies in different States so as to present problems of regulation which cannot be dealt with effectively by the States;

(3) when control of subsidiary public-utility companies affects the accounting practices and rate, dividend, and other policies of such companies so as to complicate and obstruct State regulation of such companies, or when control of such companies is exerted through disproportionately small investment;

(4) when the growth and extension of holding companies bears no relation to economy of management and operation or the integration and coordination of related operating properties; or

(5) when in any other respect there is lack of economy of management and operation of public utility-companies or lack of efficiency and adequacy of service rendered by such companies, or lack of effective public regulation, or lack of economies in the raising of capital.

(c) Declaration of policy of chapter. When abuses of the character above enumerated become persistent and wide spread the holding company becomes an agency which, unless regulated, is injurious to investors, consumers, and the general public; and it is declared to be the policy of this chapter ... to meet the problems and eliminate the evils as enumerated in this section, connected with public-utility

holding companies which are engaged in interstate commerce or in activities which directly affect or burden interstate commerce; and for the purpose of effectuating such policy to compel the simplification of public-utility holding-company systems and the elimination therefrom of properties detrimental to the proper functioning of such systems

(n99)Footnote 99. *15 U.S.C. § 79b(a)(7)*.

(n100)Footnote 100. *See 15 U.S.C. § 79u*:

Nothing in this chapter shall affect (1) the jurisdiction of the Commission under the Securities Act of 1933, as amended... or the Securities Exchange Act of 1934 ... over any person, security, or contract, or (2) the rights, obligations, duties, or liabilities of any person under such Acts; nor shall anything in this chapter affect the jurisdiction of any other commission, board, agency, or officer of the United States or of any State or political subdivision of any State, over any person, security, or contract, insofar as such jurisdiction does not conflict with any provision of this chapter or any rule, regulation, or order thereunder.

(n101)Footnote 101. The states below are representative of those that exempt public utilities and their holding companies when the parent is regulated under the Public Utilities Holding Company Act of 1935. Unless otherwise stated, the state statutory provision, with regard to this federal Act, is substantially the same as the Uniform Securities Act provision:

See:

Cal. Corp. Code § 25100(i). California also exempts securities issued under the authorization of the State Public Utilities Commission. *See Cal. Corp. Code § 25100(e)*.

See also Ill. Comp. Stat. Ann. ch. 815 § 5/3E.

N.J. Stat. Ann. § 49:3-50(a)(7).

(n102)Footnote 102. *See Ariz. Rev. Stat. Ann. § 44-1843A(5); Fla. Stat. Ann. § 517.051(4)*.

(n103)Footnote 103. Unif. Sec. Act § 402(a)(7); Rev. Unif. Sec. Act § 401(b)(5)(iii), as amended. *See n.1 supra*.

(n104)Footnote 104. *See Alaska Stat. § 45-55-900(a)(9)(C)*, which exempts those securities issued or guaranteed by a railroad, other common carrier, public utility or holding company which is "regulated in respect of its rates and charges by a governmental authority of the U.S. or a state"

See also Mass. Gen. L. Ann., Ch. 110A, § 402(a)(7)(C); N.J. Stat. Ann. § 49:3-50(a)(7)(C).

(n105)Footnote 105. *See e.g., Ky. Rev. Stat. Ann. § 292.400(7)(C); Wash. Rev. Code § 21.20.310(7)(C)*.

(n106)Footnote 106. Official comment to Unif. Sec. Act § 402(a)(7), Loss & Cowett, Blue Sky Law 357, 358 (1958).

(n107)Footnote 107. 2002 Unif. Sec. Act § 201(5).

(n108)Footnote 108. Unif. Sec. Act § 402(a)(7); Rev. Unif. Sec. Act § 401(b)(5)(iv), as amended.

(n109)Footnote 109. Draftsmen's commentary to Unif. Sec. Act § 402(a)(7), Loss & Cowett, Blue Sky Law at 358 (1958):

[T]he only reason for two separate clauses is that it seems appropriate to exempt a public utility which is subject to federal or state regulation in respect to its rates or the issuance of the security, but to insist in the case of a utility which is subject only to Canadian regulation that actual issuance of the security be regulated.

(n110)Footnote 110. *See, e.g., Ala. Code § 8-6-10(6)(d); Cal. Corp. Code § 25100(i).* California further requires that the security be subject to registration with or authorization of issuance by the authority.

See also 6 Del. Code Ann. § 7309(a)(7); Iowa Code § 502.202(7)(c); N.J. Stat. Ann. § 49:3-50(a)(7).

(n111)Footnote 111. *See Utah Code Ann. § 61-1-14(1)(f).*

(n112)Footnote 112. *Or. Rev. Stat. § 59.025(8):* "A security, the issuance of which is under supervision, regulation or control by the Public Utility Commissioner of this state, if the Public Utility Commissioner is exercising control over, or is regulating or supervising, the issuer thereof."

(n113)Footnote 113. *See Va. Code Ann. § 13.1-514(A)(7):* "Any security issued or guaranteed by any railroad, other common carrier or public service company supervised as to its rates and the issuance of its securities by a governmental authority of the United States, any state, Canada or any Canadian province."

(n114)Footnote 114. *See, e.g., 70 Pa. Cons. Stat. Ann. § 1-202(b):*

Any security issued or guaranteed by any bank or savings association and any security the offer, sale, issuance or guarantee of which (i) is subject to regulation by the Interstate Commerce Commission, or (ii) is registered under the Public Utility Holding Company Act of 1935 or ... the "Public Utility Law," or (iii) the issuer of which is regulated as to the issuance or guarantee of such security by a governmental authority of the United States.

(n115)Footnote 115. *See also N.D. Cent. Code § 10-04-05(4), (11):*

(4) Securities issued or guaranteed as to principal, interest, or dividends, by a corporation or limited liability company owning or operating a railroad or other public service utility, if the corporation or limited liability company is subject to regulation or supervision either as to its rates and charges or as to the issue of its securities by a public service commission, or by a board, body, or official having like powers, of the United States or of any state, territory, or insular possession thereof, or of any municipality located therein, or of the District of Columbia, or of the Dominion of Canada, or any province thereof, provided, however, that a corporation or a limited liability company issuing securities, exempted under this subsection, and which has not filed an application for approval of such securities with the public service commission of the state of North Dakota, shall file with the commissioner a copy of the registration statement with all amendments thereto filed with the securities and exchange commission of the United States, if such a registration statement is made or filed, or a copy of the informative statement made to or filed with any commission, board, or body of the United States or of any state, territory, or insular possession thereof, or of any municipality located therein, or of the District of Columbia, or of the Dominion of Canada, or any province thereof, by which said corporation or limited liability company is subject to regulation or supervision either as to its rates and charges or as to the issue of its securities, and shall pay a filing fee of twenty-five dollars...

(n116)Footnote 116. *See, e.g., Ariz. Rev. Stat. Ann. § 44-1843(5)*: "[E]quipment trust certificates in respect to equipment conditionally sold or leased to a railroad or public utility, if other securities issued by such railroad or public utility would be exempt under this paragraph."

See also Cal. Corp. Code § 25102(g):

Any offer or sale of conditional sale agreements, equipment trust certificates, or certificates of interest or participation therein or partial assignments thereof, covering the purchase of railroad rolling stock or equipment or the purchase of motor vehicles, aircraft, or parts thereof, in a transaction not involving any public offering.

This is a transactional exemption--note the absence of a proviso that other securities be exempt.

(n117)Footnote 117. Rev. Unif. Sec. Act § 401(b)(6), added in 1985 by the National Conference of Commissioners on Uniform State Laws. The Official Code Comment states:

[P]aragraph (b)(6) reflects the extensive development of equipment lease financing through leveraged leases, conditional sales, and other devices. The underlying premise is that if the securities of the person using such a financing device would be exempt under some other paragraph of Section 401, the equipment trust certificate or other security issued to acquire the property in question also is exempt.

See Ill. Comp. Stat. Ann. ch. 815 § 5/3(F), Me. Stat. Ann. tit. 32 § 10502(G).

(n118)Footnote 118. 2002 Unif. Sec. Act § 201(9).

(n119)Footnote 119. *See, e.g., Fla. Stat. Ann. § 517.051(4)*.

[E]quipment securities based on chattel mortgages, leases, or agreements for conditional sale of cars, motive power or other rolling stock mortgaged, leased or sold to or furnished for the use of or upon such railroad or other public service utility corporation or where the ownership or title of such equipment is pledged or retained in accordance with the provisions of the laws of the United States or of any state, or of the Dominion of Canada, to secure the payment of such equipment securities. ...

See also N.Y. Gen. Bus. L. §§ 359-f(1)(d), 359-ff(5)(e), which grants exemption to securities described in § 359-f(1)(d). The latter section describes:

[E]quipment and trust certificates or equipment notes or bonds based on chattel mortgages, leases, or agreements for conditional sale of cars, motive power, or other rolling stock mortgaged, leased or sold to or furnished for the use of or upon such a railroad or public-service utility corporation, or equipment trust certificates, or equipment notes or bonds where the ownership or title of such equipment is pledged or retained in accordance with the provisions of the laws of the United States, or of any state, territory or insular possession thereof, or of the District of Columbia, or of the Dominion of Canada, or of any province thereof, to secure the payment of such equipment trust certificates, bonds, or notes.

(n120)Footnote 120. 15 U.S.C. § 77r(b)(1).

(n121)Footnote 121. 17 C.F.R. § 230.146(b).

(n122)Footnote 122. In 2006 the Pacific Stock Exchange was acquired by the New York Stock Exchange, and is no longer operated separately under the name Pacific Exchange. Former Pacific Stock Exchange trading is today conducted as the NYSE Arca, electronic trading platform for "Arca Equities" and "Arca Options."

(n123)Footnote 123. The Philadelphia Stock Exchange is now known as NASDAQ OMX PHLX, reflecting its acquisition by NASDAQ OMX Group in 2008.

(n124)Footnote 124. The Midwest Stock Exchange is today known as the Chicago Stock Exchange, its original name to which it reverted in 1993, reflecting its roots and identity within the Chicago financial community.

(n125)Footnote 125. *See, e.g.,* Conn. Gen. Stat., § 36-b-21(8)(c): "[A]ny security listed or approved for listing upon notice of issuance on the New York Stock Exchange, the American Stock Exchange, the Chicago Board Options Exchange and such other securities exchanges as may be designated by the commissioner from time to time"

See also Ill. Cons. Stat. Ann. ch. 815, § 5/3(G):

Any security which at the time of sale is listed or approved for listing upon notice of issuance on the New York Stock Exchange, Inc., the American Stock Exchange, Inc., the Pacific Stock Exchange, Inc., the Chicago Stock Exchange, Inc., the Chicago Board of Trade, the Philadelphia Stock Exchange, Inc., the Chicago Board Options Exchange, Incorporated, the National Market System of the Nasdaq Stock Market or any other exchange, automated quotation system, or board of trade which the secretary of state, by rule or regulation deems to have substantially equivalent standards for listing or designation as required by any such exchange, automated quotation system or board of trade

See also Wash. Rev. Code § 21.20.310(8). Washington Admin. Code § 460-42A-081(1) exempts securities listed on the New York, American, Chicago Board Options Exchanges, Tier I of the Pacific and Philadelphia Stock Exchanges, as well as the NASDAQ/NMS interdealer quotation system. For nonissuer transactions, § 460-42A-081(2) exempts the NASDAQ/NMS, New York, American, Midwest, Spokane, Chicago Board Options, Pacific and Philadelphia Exchanges or any other exchanges registered with the SEC and approved by the director.

In Massachusetts, *Mass. Gen. L. Ann., Ch. 110A, § 402(a)(8)* certifies the American Stock Exchange, Boston Stock Exchange, Midwest Stock Exchange, New York Stock Exchange, Pacific Stock Exchange. The Secretary of the Commonwealth has the authority to designate additional exchanges for exemption purposes, and has added securities listed or approved for listing on the Philadelphia Stock Exchange, and designated or approved for designation on the Nasdaq/NMS. *Mass. Reg. Code tit. 950 § 14.402(A)(8); (B)(13)(h)*. The Nasdaq exemption is transactional.

In Texas, *Tex. Rev. Civ. Stat., art. 581-6(F)* identifies the American Stock Exchange, Boston Stock Exchange, Midwest Stock Exchange, New York Stock Exchange, and NASDAQ/NMS. The Commissioner may add exchanges subject to statutory criteria, and has added the Pacific Stock Exchange and the Chicago Board Options Exchange. *Tex. Admin. Code tit. 7, § 111.2(b)*. However, the Commissioner will only certify exchanges that are registered with the SEC. *Id.* § 111.2(d).

See also N.C. Gen. Stat. § 78A-16(8) which certifies the New York Stock Exchange, American Stock Exchange, and Midwest Stock Exchange. Rule 1201 adds the Pacific and Philadelphia Stock Exchanges, Chicago Board Options Exchange and NASDAQ/NMS with certain exceptions, to the list. *Va. Code Ann. § 13.1-514(a)(8), (12)* identifies the New York Stock Exchange, and American Stock Exchange. The State Corporation Commission has added the NASDAQ/NMS, and the Pacific and Philadelphia Stock Exchanges, Chicago Board Options Exchange subject to certain requirements. Rules 21 VAC §§ 5-40-20, 5-40-40, 5-40-60, 5-40-80, 5-40-90.

See also Cal. Corp. Code §§ 25100(o) (subject to certain listing standards as prescribed in the statute), 25101(a) (nonissuer transactions). Rule 260.101.2 certifies the following exchanges pursuant to the statute: New York Stock Exchange, American Stock Exchange, Pacific Stock Exchange, Philadelphia Stock Exchange, NASDAQ/NMS. Rule 260.105.35 certifies the Chicago Board Options Exchange. *Cal. Corp. Code* § 25101(b) prescribes the conditions for exemption from registration of non-issuer transactions involving certain securities listed on a national securities exchange that is not certified by the commissioner.

(n126)Footnote 126. 2002 Unif. Sec. Act § 201(6).

An administrator's determination to designate a particular exchange in accordance with whatever authority is provided in the Blue Sky law may also be expressly made subject to revocation if the administrator finds that the listing standards have been so changed or insufficiently applied that the protection of investors contemplated by listing standards is no longer afforded. *See, e.g.* Code Md. Regs. Rule .06.

(n127)Footnote 127. *See, e.g.*, Unif. Sec. Act § 402(a)(8).

(n128)Footnote 128. *See* CCH NASAA Reports P 13,047 (Aug. 22, 1997).

(n129)Footnote 129. *See N.Y. Gen. Bus. L.* § 359-ff(5)(c).

Section 6 of the Exchange Act requires national securities exchanges to register with the Securities and Exchange Commission. Section 12 of the Exchange Act requires that securities traded on a national securities exchange go through a formal registration procedure with the exchange in question.

(n130)Footnote 130. Virginia: *Va. Code Ann.* § 13.1-514(a)(12).

(n131)Footnote 131. *Fla. Stat. Ann.* § 517.061(17)(a)(4).

(n132)Footnote 132. *Cal. Corp. Code* § 25100(o).

(n133)Footnote 133. *Cal. Corp. Code* § 25100(o). Section 25100(o) further provides:

That certification of any exchange or system shall be made by the commissioner upon the written request of the exchange or upon the written request of the exchange or system if the commissioner finds that the exchange or system: (i) in acting on applications for listing of common stock substantially applies the minimum standards set forth in either alternative (A) or (B) of paragraph (1) ...

(1) Listing standards:

(A) Shareholders equity of at least four million dollars (\$4,000,000) ...

(ii) Pretax income of at least seven hundred fifty thousand dollars (\$750,000) in the issuer's last fiscal year or in two of its last three fiscal years.

(iii) Minimum public distribution of 500,000 shares (exclusive of the holdings of officers, directors, controlling shareholders, and other concentrated or family holdings), together with a minimum of 800 public holders, or minimum public distribution of 1,000,000 shares together with a minimum of 400 public holders. The exchange or system may also consider the listing or designation of a company's securities if the company has a minimum of 500,000 shares publicly held, a minimum of 400 shareholders and daily trading volume in the issue has been approximately 2,000 shares or more for the six months preceding the date of application. In evaluating the suitability of an issue for listing or

designation under this trading provision, the exchange or system shall review the nature and frequency of that activity and other factors as it may determine to be relevant in ascertaining whether the issue is suitable for trading. A security which trades infrequently shall not be considered for listing or designation under this paragraph even though average daily volume amounts to 2,000 shares per day or more. Companies whose securities are concentrated in a limited geographical area, or whose securities are largely held in block by institutional investors, normally may not be considered eligible for listing or designation unless the public distribution appreciably exceeds 500,000 shares.

(iv) Minimum price of three dollars (\$3) per share for a reasonable period of time prior to the filing of a listing or designation application; provided, however in certain instances an exchange or system may favorably consider listing an issue selling for less than three dollars (\$3) per share after considering all pertinent facts, including market conditions in general, whether historically the issue has sold above three dollars (\$3) per share, the applicant's capitalization, and the number of outstanding and publicly held shares of the issue.

(v) An aggregate market value for publicly held shares of at least three million dollars (3,000,000).

(B)(i) Shareholders equity of at least four million dollars (\$4,000,000).

(ii) Minimum public distribution set forth in clause (iii) of subparagraph (A) of paragraph (1).

(iii) Operating history of at least three years;

(iv) An aggregate market value for publicly held shares of at least fifteen million dollars (\$15,000,000) ...

(n134)Footnote 134. *See, e.g., Alaska Stat. § 45.55.900(a)(10); 6 Del. Code Ann. § 7309(a)(8); Ohio Rev. Code Ann. § 1707.02(E); 70 Pa. Cons. Stat. Ann. § 1-202(f).*

In Virginia, the exemption is for securities "listed or approved for listing upon notice of issuance ... " upon exchanges specifically mentioned in the statute. However, when additional exchanges are approved by the Corporation Commissioner the statute gives exemption to "any security listed on an exchange registered with the United States Securities and Exchange Commission and approved by regulations of the State Corporation Commission." Va. Code Ann. § 13.1-514(a)(8), (12).

(n135)Footnote 135. *See, e.g., Tex. Rev. Civ. Stat. Ann. art. 581-6(F).* Texas requires securities to be "fully listed" on prescribed or approved exchanges before the exemption is effective.

See also Utah Code Ann. § 61-1-14(1)(g). The Utah exemption applies to "any security listed" on a prescribed or approved exchange.

(n136)Footnote 136. For example, an exemption for senior securities is granted in Alaska, Connecticut, Delaware, Florida, Illinois, Massachusetts, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Texas and Utah.

Note that the New York provision exempts *any* class of securities of the same issuer. *N.Y. Gen. Bus. L. § 359-ff(5)(c).* Virginia exempts senior securities of those listed on exchanges specifically named in the statute. However, the statute is silent on the subject when the exchange is approved by the Corporation Commission *Va. Code Ann. § 13.1-514(8), (12).*

But see Cal. Corp. Code § 25100(o), which offers no exemption for senior securities.

(n137)Footnote 137. For example, exemption for securities "equal in rank" to those listed is provided for in

Arizona, *Ariz. Rev. Stat. Ann. § 44-1843 (A)(7)* and Louisiana, *La. Rev. Stat. Ann. § 51:708(8)*. Texas provides an exemption for securities "on a parity with" those so listed. *Tex. Rev. Civ. Stat. Ann. art. 581-6(F)*.

(n138)Footnote 138. For example, exemption for securities "substantially equal in rank" to those listed is provided for in Alaska, Connecticut, Delaware, Illinois, Massachusetts, New Jersey, and Pennsylvania.

(n139)Footnote 139. However, of the states providing a stock exchange exemption, some have no provision exempting securities of equal or substantially equal rank to those listed. *See, e.g., Cal. Corp. Code § 25100(o)*; Fla. Stat. Ann. § 516.061(17)(a)(4); *Ohio Rev. Code Ann. § 1707.02(E)*.

(n140)Footnote 140. This phrase, or a comparable exemption provision, is found, for example, in the statutes of Alaska, Connecticut, Delaware, Florida, Massachusetts, New Hampshire, New Jersey, North Carolina, Pennsylvania, Texas, Utah, and Virginia.

In Virginia, the exemption applies to securities listed on exchanges specifically named in the statute. However, the statute is silent on the subject when the exchange is one approved in the discretion of the Corporation Commission. *See Va. Code Ann. § 13.1-514(8), (12)*. Massachusetts, by regulation, exempts the offer and sale of put or call contracts when the put or call contract is endorsed and its performance guaranteed by a broker-dealer registered with the SEC or issued by the Options Clearing Corporation ("OCC") pursuant to a registration statement filed by the OCC with the SEC and the underlying security is registered under Section 12(g) of the Securities Exchange Act of 1934 or is exempt under the statute or the put or call contract is listed or quoted on NASDAQ. Mass. Regs. Code tit. 950, § 14.402(B)(13)(b).

(n141)Footnote 141. *See, e.g., Tex. Rev. Civ. Stat. Ann. art. 581-6(F)*:

[a]lso all securities senior to, or if of the same issues, upon a parity with, any securities so listed or designated or represented by subscription rights which have been so listed or designated, or evidence of indebtedness guaranteed by any company, any stock of which is so listed or designated

(n142)Footnote 142. *See, e.g., Cal. Corp. Code § 25100(0)*; *Mass. Gen. L. Ann. ch. 110A, § 402(a)(8)*; *N.J. Stat. Ann. § 49:3-50(a)(8)*; *70 Pa. Cons. Stat. Ann. § 1-202(f)*.

See also Rev. Unif. Sec. Act § 401(b)(9), which exempts:

[A]n option issued by a clearing agency registered under the Securities Exchange Act of 1934, other than an off-exchange futures contract or substantially similar arrangement, if the security, currency, commodity, or other interest underlying the option: is registered under Section 302, 303, or 304; is exempt under this section; or is not otherwise required to be registered under this [Act]

The Official Comment provides:

Paragraph (b)(9) ... reflects the development of the options trading markets. As with other subsections, the premise is that the option security will be exempt from registration if the underlying security to which the option relates is either registered under this Act, exempt from registration under this section 401, or not required to be registered under this Act. A common example of the latter category would be nonissuer transactions in the underlying security, currency, commodity, or other interest exempt under Section 402(2), (3), or (4).

For states with similar provisions, *see, e.g., Fla. Stat. Ann. § 517.061(16)*(transactional exemption by registered dealer); *Nev. Rev. Stat. § 90.520(2)(i)*; *N.M. Stat. Ann. § 58-13B-26(G)*.

(n143)Footnote 143. Such standards in California have already been addressed, Statutory standards for exchange approval have also been enacted in Texas. *See Tex. Rev. Civ. Stat. Ann. art. 581-6(F)*.

(n144)Footnote 144. *See, e.g. Cal. Corp. Code § 25100(o); Ohio Rev. Code Ann. § 1707.02(E)*, reproduced at n.14 *supra*.

(n145)Footnote 145. *See, e.g., Ariz. Rev. Stat. Ann. § 44-1843(A)(7)*: "The commission may at anytime by order withdraw a designation of an exchange or association made under this paragraph."

See also Cal. Corp. Code § 25100(o); Ohio Rev. Code Ann. § 1707.02(E).

(n146)Footnote 146. Usually the minimum requirement is that revocation be imposed by written order. *See Vt. Stat. Ann. tit. 9 § 4203a(6)*: "Notice of such revocation shall be given in writing by mail to the exchange concerned."

In some states, formal procedures for notice and hearing are required. *See, e.g., Tex. Rev. Civ. Stat. Ann. art. 581(6)(F)*.

(n147)Footnote 147. *See, e.g., Ohio Rev. Code Ann. § 1707.02(E)*.

(n148)Footnote 148. *See N.H. Rev. Stat. Ann. § 421-B:17(f); N.D. Cent. Code § 10-04-05(15); Utah Code Ann. § 61-1-14(g)*.

(n149)Footnote 149. *See, e.g., Neb. Rev. Stat. § 8-1110(5)(b)*.

After NSMIA, states may not require a filing to obtain an exemption for listed securities that are federal covered securities.

(n150)Footnote 150. *Ill. Comp. Stat. Ch. 815 § 5/3(Q)*.

(n151)Footnote 151. *15 U.S.C. § 78g (2000)*.

(n152)Footnote 152. *12 C.F.R. § 220*.

(n153)Footnote 153. *12 C.F.R. § 220.2(u); 17 C.F.R. § 220.17*.

(n154)Footnote 154. *12 C.F.R. § 220.2(u)*:

"OTC margin stock" means any equity security not traded on a national securities exchange that the Board has determined has the degree of national investor interest, the depth and breadth of market, the availability of information respecting the security and its issuer, and the character and permanence of the issuer to warrant being treated like an equity security traded on a national securities exchange.

(n155)Footnote 155. *Conn. Gen. Stat. § 36b-21(a)(8)*; *Ill. Cons. Stat. Ann., Ch. 815, § 5/3(Q)*. Connecticut exempts all securities on the list of over-the-counter securities approved for margin by the Board of Governors of the Federal Reserve System. Illinois exempts any security appearing on the Board's List of OTC Margin Stocks.

(n156)Footnote 156. *N.H. Rev. Stat. Ann. § 421-B:17(I)(f)*. New Hampshire exempts securities designated by the Board of Governors of the Federal Reserve System as "O.T.C. Margin Stocks."

(n157)Footnote 157. *70 Pa. Cons. Stat. Ann. § 1-202(f)*. Pennsylvania exempts any security that satisfies the margin requirements of Regulation T.

In Virginia, the foreign issuer exemption is available solely on the basis of an equity security's being on the Federal Reserve Board's List of Foreign Margin Stocks or a debt security's meeting the Reg. T margin requirements.

(n158)Footnote 158. *Cal. Corp. Code §§ 25105, 25130.* § 25105 gives the Commissioner of Corporations authority to exempt from qualification transactions other than those included in the statute. § 25130 requires qualification of securities offered or sold in non-issuer transactions. Regulation 260.105.11, adopted by the Commissioner pursuant to Section 25105, exempts from qualification under Section 25130 securities listed on foreign exchanges otherwise meeting the conditions of the regulation. *Cal. Code Regs. tit. 10 § 260.105.11. See also Cal. Corp. Code § 25101.1.*

(n159)Footnote 159. *Id. See also Cal. Corp. Code § 25011.*

(n160)Footnote 160. Regulation 260.105.11 of the Commissioner of Corporations. The regulation in its entirety provides:

(a) There is hereby exempted from the provisions of Section 25130 of the Code as not being comprehended within the purposes of the Corporate Securities Law of 1968 and the qualification of which is not necessary or appropriate in the public interest or for the protection of investors, any offer or sale of a security issued by any corporation organized under the laws of a foreign country or of a certificate of deposit, receipt or other evidence relating to such a security, provided one of the following conditions is met: The issuer is currently required to file with the Securities and Exchange Commissioner information and reports pursuant to Section 15(d) of the Securities Exchange Act of 1934 ... and is not delinquent in such filing.

The security appears in the most recent Federal Reserve Board List of Foreign Margin Stocks.

The issuer is not subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934 and all of the following conditions are met:

The issuer, including any predecessors, has been in continuous operations for at least 5 years and is a going concern actually engaged in business and neither in the organization stage nor in bankruptcy or receivership.

The number of shares outstanding is at least 2.5 million worldwide and the number of shareholders is at least 5,000 worldwide.

The market value of the outstanding shares, other than debt securities and preferred stock, is at least US \$100 million worldwide.

The issuer, as of the date of its most recent financial statements, which may not be more than 18 months old and which have been audited in accordance with the generally accepted accounting principles of its country of domicile, has net tangible assets of at least US \$100 million worldwide.

The issuer has net income after all charges, including taxes and extraordinary losses, and excluding extraordinary gains, of either (i) at least U.S. \$50 million in total for its last 3 fiscal years or (ii) at least U.S. \$20 million in each of its last 2 fiscal years.

If the security is a debt security or preferred stock, the issuer has not during the past five years, or during the period of its existence if shorter, defaulted in the payment of any dividend, principal, interest, or sinking fund installment thereon.

Regarding exemptions in other states for securities listed on foreign exchanges, *see Ariz. Rev. Stat. §§ 44-1844; 44-1845; Ariz. Comp. Admin. R. & Regs. tit. 14 § R14-4-138* (non-issuer transactions).

Arizona provides an exemption if certain criteria are met, including:

The securities must have been outstanding in the hands of the public for at least 90 days prior to the transaction date;

Either Moody's International Manual or Standard and Poor's Corporation Records must contain information regarding the issuers of foreign securities unless certain conditions are met; or the issuer has a class of securities subject to 1934 Act reporting requirements or is exempt from registration under the Act;

The issuers, including all predecessors, must have been operating continuously for a minimum of the preceding five years;

The issuers must meet certain financial tests, including both being listed or traded on stock exchanges organized under the laws of their respective countries of domicile, and attaining a particular amount of net tangible assets; and

There are at least two market makers who are registered broker dealers under the Securities Exchange Act of 1934, or one market maker with a specified minimum net capital.

See also Va. Code Ann. § 13.1-514(a)(13); Rule 21 VAC 5-40-50, Rules of State Corp. Comm.

(n161)Footnote 161. NASAA Uniform Securities Act Revision Committee, "Resolution on Exemption from Registration for Blue Chip Securities."

(n162)Footnote 162. Comment to paragraph (B). *See* "NASAA Draft Proposal on Blue Sky Registration Exemptions for Exchange Listed Securities," Sec. Reg. & L. Rep. (BNA), No. 396 at H-1 (March 30, 1977).

(n163)Footnote 163. *Id.*, paragraph (C). The term "significant subsidiary" is intended to have the same meaning as under Securities Act Rule 405.17 *C.F.R.* § 230.405. *Id.*

(n164)Footnote 164. *Id.*, paragraph (D).

(n165)Footnote 165. *Id.*, paragraph (E).

(n166)Footnote 166. *Id.*, paragraph (F).

(n167)Footnote 167. *See, e.g.*, Washington: WAC 460-42A-080.

There are variations. Texas, for example, makes the blue chip exemption into a transaction exemption, stating:

The sale of any security by the issuer itself or by a registered dealer is exempt from the registration requirements of the Securities Act if all of the following conditions are met:

(1) If the issuer is not organized under the laws of the United States or a state, it has appointed a duly authorized agent in the United States for service of process, and has set forth the name and address of such agent in its prospectus, offering memorandum or similar disclosure document.

(2) The security is senior to or on a parity with a class of the issuer's securities registered under section 12 of the Securities Exchange Act of 1934, and the class of securities has been so registered for

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the three years immediately preceding the offering date.

(3) Neither the issuer nor a subsidiary, which accounts for more than 15% of assets or revenues on a consolidated basis, has had a default that exceeded 5.0% of total assets on a consolidated basis during the last seven years (or the issuer's existence if less than seven years) in the payment of:

(A) principal, interest, dividend, or sinking fund installment on preferred stock or indebtedness for borrowed money; or

(B) rentals under leases with terms of three years or more.

(4) The issuer has had consolidated net income after taxes (but before extraordinary items and the cumulative effect of accounting changes) of at least \$1 million in each of four of its last five fiscal years including its last fiscal year. In addition, if the offering is of interest-bearing securities, the issuer must have had net income for its last fiscal year (but before deduction for income taxes and depreciation) of at least 1-1/2 times the issuer's annual interest expense, giving effect to the proposed offering and the intended use of the proceeds. "Last fiscal year" means the most recent year for which audited financial statements are available, provided that such statements cover a fiscal period ended not more than 12 months from the commencement of the offering.

(5) If the offering is of stock or shares, other than preferred stock or shares, such securities have voting rights and such rights include:

(A) the right to have at least as many votes per share; and

(B) the right to vote on at least as many general corporate decisions, as each of the issuer's outstanding classes of stock or shares, except as otherwise required by law.

(6) If the offering is of stock or shares, other than preferred stock or shares, such securities are owned beneficially or of record, on any date within six months prior to the commencement of the offering, by at least 1,200 persons, and on such date there are at least 750,000 such shares outstanding with an aggregate market value, based on the average bid price for that day, of at least \$3,750,000. In connection with the determination of the number of persons who are beneficial owners of the stock or shares of an issuer, the issuer or broker dealer may rely in good faith for the purposes of this section upon written information furnished by the record owners.

(7) Any security issued or guaranteed as to both principal and interest by an international bank of which the United States is a member is exempted without regard to the conditions in this section.

(8) If the offering is of interest-bearing securities of a finance company with liquid assets of at least 105% of its liabilities (other than deferred income taxes, deferred investment tax credits, capital stock, and retained earnings) at the end of each of its last five fiscal years, the applicable net income requirements of paragraph (4) of this section, but before deduction for interest expense, shall be 1-1/4 times the issuer's annual interest expense. "Finance company" means a company engaged primarily in the business of wholesale, retail, installment, mortgage, commercial, industrial, and consumer financing, banking, or factoring. "Liquid assets" means cash, receivables payable on demand or not more than 12 years following the close of the company's last fiscal year, and readily marketable securities; in each case, less applicable reserves and unearned income.

(9) The issuer is not in bankruptcy.

Tex. Admin. Code Rule § 139.3.

(n168)Footnote 168. NASAA Exemption, paragraph (G). The World Bank, the Inter-American Development Bank, and the Asian Development Bank are the only international banks of which the United States is a member. The debt securities of International Banks are "blue chip," but without paragraph (G) would not qualify for the exemption because they are registered under Section 12 of the Securities Exchange Act, as exempt securities under Section 3(a)(12) of that Act. *Id.*

(n169)Footnote 169. *See, e.g., Texas Admin. Code tit. 7 § 139.3.*

(n170)Footnote 170. NASAA Exemption, paragraph (H).

(n171)Footnote 171. *See, e.g., N.D. Cent. Code § 10-04-05(6); Texas Admin. Code tit. 7 § 139.3.*

(n172)Footnote 172. Comment to NASAA Exemption, paragraph (H).

(n173)Footnote 173. NASAA Exemption, paragraph (I).

(n174)Footnote 174. *See, e.g., Arkansas Securities Rule 503.01(A)(9); N.D. Cent. Code § 10-04-05(6).*

(n175)Footnote 175. Comment to NASAA Exemption, paragraph (I).

(n176)Footnote 176. *23 Fla. Stat. § 517.051(6).*

(n177)Footnote 177. *Ohio Rev. Code § 1707.02(J).*

(n178)Footnote 178. *See, Illinois, New Hampshire, North Dakota.*

(n179)Footnote 179. Rev. Unif. Sec. Act 401(b)(14) provides:

[A] security issued by an issuer registered as an open-end management investment company or unit investment trust under Section 8 of the Investment Act of 1940 if:

(i) the issuer is advised by an investment adviser that is a depository institution exempt from registration under the Investment Adviser Act of 1940 or that is currently registered as an investment advisor, and has been registered or is affiliated with an adviser that has been registered, as an investment adviser under the Investment Advisors Act of 1940 for at least three years next preceding an offer or sale of a security claimed to be exempt under this paragraph and the issuer has acted or is affiliated with an investment adviser that has acted, as investment adviser to one or more registered investment companies or unit investment trusts for at least three years next preceding an offer or sale of a security claimed to be exempt under this paragraph; or

(ii) the issuer has a sponsor that has at all times throughout the three years before an offer or sale of a security claimed to be exempt under this paragraph sponsored one or more registered investment companies or unit investment trusts the aggregate total assets of which have exceeded [100,000,00]. For the purpose of this paragraph, an investment adviser is affiliated with another investment adviser if it controls, is controlled by or is under common control with the other investment advisor.

1-7 Blue Sky Regulation § 7.06

The rationale behind the exemption adjudges adequate the protection offered by the fact that investment companies are subject to not only the disclosure requirements of the 1933 Act but also to substantive regulation under the Investment Company Act of 1940. Official Code Comment to § 401(b)(14).

(n180)Footnote 180. *See, e.g., Colo. Rev. Stat. § 11-51-307(k); R.I. Gen. Laws § 7-11-401(14); Utah Code Ann. § 61-1-14(1)(k).*

See also Cal. Code Regs. tit. 10 § 260.105.39, in which California exempts resales of units in unit investment trusts when previously qualified under the statute and when meeting certain other conditions of compliance with the 1933 Act and the Investment Act of 1940.

(n181)Footnote 181. *See 15 U.S.C. § 77r(b)(3) (2000).*

(n182)Footnote 182. *See 2002 Unif. Sec. Act. §§ 202(2), (3), and (4).*

(n183)Footnote 183. *CCH NASAA Reports* P 3803, at 1389 (Sept. 10, 1996).

(n184)Footnote 184. *CCH NASAA Reports* P 3803, at 1389 (Sept. 10, 1996).

(n185)Footnote 185. Ohio, for example, provides the exemption to all nonprofit organizations, and then gives examples of the type of nonprofit organization contemplated by the exemption. *See Ohio Rev. Code Ann. § 1707.02(I):*

Any security, except notes, bonds, debentures, or other evidences of indebtedness or of promises or agreements to pay money, which is issued by a person, corporation, or association organized not for profit, including persons, corporations, and associations organized exclusively for conducting county fairs, for co-operative marketing, or for religious, educational, social, recreational, athletic, benevolent, fraternal, charitable, or reformatory purposes, is exempt, if no part of the net earnings of such issuer inures to the benefit of any shareholder or member of such issuer or to any individual, and if the total commission, remuneration, expense, or discount in connection with the sale of such securities does not exceed two per cent of the total sale price thereof plus five hundred dollars.

In Texas, the exemption applies to securities of associations organized for specified purposes. However, the exemption is broadened to include any nonprofit corporation which is organized in Texas without capital stock. *See Tex. Rev. Civ. Stat. Ann. art. 581-5(K), 586(E), (J).* Art. 581-5(K) provides:

Any security or membership issued by a corporation or association, organized exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any stockholder, shareholder, or individual members, and where no commission or remuneration is paid or given or is to be paid or given in connection with the disposition thereof.

Additionally, Art. 581-6(E) provides an exemption for: "Any security issued and sold by a domestic corporation without capital stock and not organized and not engaged in business for profit." And Art. 581-6(J) provides exemption for "Notes, bonds or other evidence of indebtedness of religious, charitable or benevolent corporations"

Note that the exemption under Article 581-5(K) constitutes an exempt transaction under the Texas statute.

In *Scholarship Counselors, Inc. v. Waddle*, 507 S.W.2d 138 (Ky. Ct. App. 1974), the Kentucky Court of Appeals held that in order for an organization to be within the meaning of the exemption, earnings must be for the benefit of the public generally and not for private investors or sponsors. A scholarship trust fund had been established for the benefit

of the children of members. Members paid an entrance fee and individually opened a savings account which irrevocably paid interest to the trust fund. Money in the fund was used to pay college expenses of designated beneficiaries (named by the member) once the sophomore year in college was reached. The court found the memberships to be securities and not exempt as those issued by a nonprofit organization. Although the earnings of the fund were for educational expenses, they benefited private investors and sponsors and not the general public. The fact that the sponsor's children were the beneficiaries, and not any qualified student candidate, eliminated the plan as one organized and operated on a nonprofit basis.

(n186)Footnote 186. The federal exemption for non-profit organization securities is section 3(a)(4) under the federal Securities Act, 15 U.S.C. § 77c(a)(4) (2000). Section 18 of the federal act, expressly excises section 3(a)(4) from NSMIA coverage, see 15 U.S.C. § 77r(b) (4)(C). Leaving these securities fully subject to state regulation recognizes the demonstrated potential for abuse in the area which has historically been addressed by state securities regulators, as well as the fact that numerous state exemptions for non-profits require filings and the opportunity for administrative review.

(n187)Footnote 187. Unif. Sec. Act § 402(a)(9).

(n188)Footnote 188. See 2002 Unif. Sec. Act § 201(7).

(n189)Footnote 189. See, e.g., Cal. Corp. Code § 25100(j):

Any security (except evidences of indebtedness, whether interest bearing or not) of an issuer (1) organized exclusively for educational, benevolent, fraternal, religious, charitable, social, or reformatory purposes and not for pecuniary profit, if no part of the net earnings of the issuer inures to the benefit of any private shareholder or individual, or (2) organized as a chamber of commerce or trade or professional association. The fact that amounts received from memberships or dues or both will or may be used to construct or otherwise acquire facilities for use by members of the nonprofit organization does not disqualify the organization for this exemption. This exemption does not apply to the securities of any nonprofit organization if any promoter thereof expects or intends to make a profit directly or indirectly from any business or activity associated with the organization or operation of such nonprofit organization or from remuneration received from such nonprofit organization.

The Commissioner of Corporations in California has issued Rule 260.105.20 extending the exemption to nonprofit organizations meeting the criteria of the above quoted statute, except that if the conditions of the rule are met, certain persons involved with the organization are permitted to incur private profit.

In addition, subsection (k) of Section 25100 grants exemption to life income contracts issued by nonprofit organizations designated by the Commissioner:

Any agreement, commonly known as a "life income contract," of an issuer (1) organized exclusively for educational, benevolent, fraternal, religious, charitable, social, or reformatory purposes and not for pecuniary profit and (2) which the commissioner designates by rule or order, with a donor in consideration of a donation of property to such issuer and providing for the payment to the donor or persons designated by him or her of income or specified periodic payments from the donated property or other property for the life of the donor or those other persons.

By Rule 260.100.2, the Commissioner has defined "life income contract" as follows:

The term "life income contract" as used in subdivision (k) of Section 25100 of the Code means an agreement between the issuer and a donor in consideration of a donation of property (which must be irrevocable) to such issuer (and only to such issuer) and providing for the payment to the donor or

persons designated by him, for the life of the donor or such other persons, of a variable return measured or determined by the original value of the donated property and the return on designated assets (which may be other than the donated property).

The life income contract exemption has been granted on a class basis only to "any non-profit college or university which has total endowment funds (including annuity and life income funds) according to its most recent audited financial statement of not less than \$2,000,000." Rule 260.100.

See also In the Matter of Shekinah Cloister Christian Church, Inc., [1978-1981 Transfer Binder], Blue Sky L. Rep. (CCH) P 71,405 (Order of Fla. Comptroller, 1978). The exemption for a security issued by a religious or other nonprofit organization may be lost if the offerees are not given a written report amounting to full and fair disclosure of all material information. In this case, a permanent cease and desist order was entered because of the church's failure to disclose such material information as: unsatisfied judgments against an offeror, lack of proper zoning for the anticipated project, and insufficient revenue to cover the issue of the securities involved.

(n190)Footnote 190. *See, e.g., Ariz. Rev. Stat. Ann. § 44-1843-(A)(6); Fla. Stat. Ann. § 517.051(9).*

(n191)Footnote 191. New Jersey, for example, omits the social or athletic purposes prescribed in the Uniform Act. *See N.J. Stat. Ann. § 49:3-50(a)(9).*

(n192)Footnote 192. *See Cal. Corp. Code § 25100(j), (k); 70 Pa. Cons. Stat. Ann. § 1-202(e), 1-203(p).* Note that in Pennsylvania evidences of indebtedness may come under the transaction exemption.

(n193)Footnote 193. *See, e.g., Ariz. Rev. Stat. Ann. § 44-1843(A)(6).*

(n194)Footnote 194. *See, e.g., Alaska Adm. Code, 3 AAC § 08.910(1):*

(1) Not-for-private-profit issuers shall file a notice with the administrator at least 15 days before making any offers or sales of securities; the notice must contain a ruling or determination by the U.S. Internal Revenue service recognizing the issuer's exempt status under *Section 501(c)(3) or 501(e) of the Internal Revenue Code of 1954* ... or other documentation the administrator may require including, but not limited to, proposed offering circular, certified financial statement, bylaws and articles of incorporation, plan of financing, plan of operation, use of proceeds, background of officers and directors (or principals if unincorporated).

See also In the Matter of Caucus Distributors, Inc. [1986-1987 Transfer Binder], Blue Sky L. Rep. (CCH) P 72,506 at 72,383 (Alaska Div. of Bank. and Sec. No. 86-17 1986) in which the Division held that filing of notice and supporting documents was necessary to claim the nonprofit exemption under the Alaska Securities Act; absent such a filing, the hearing officer declined to consider the issue.

California Securities Rule 260.100 requires eligible nonprofit organizations desiring to issue exempt life income contracts to file a form containing the information required in the cited rule. The form is designated a "260.100.1" *See n.4 supra.*

(n195)Footnote 195. N.D. Cent. Code § 10-4-5(5).

(n196)Footnote 196. *See, e.g., Conn. Gen. Stat. § 36b-21(f); N.J. Stat. Ann. § 49:3-50(c); N.C. Gen. Stat. § 78A-18(a).*

(n197)Footnote 197. *See* Official Comment 7, 2002 Unif. Sec. Act.

(n198)Footnote 198. If there is a question whether the organization falls under this exemption, it may be helpful to refer to IRS Publication #78. IRS Publication #78 is a listing of national organizations that are considered to be exempt from paying taxes, or charitable. However, this publication is not all inclusive.

(n199)Footnote 199. Section 3(a)(3) of the federal Act, 15 U.S.C. § 77c(a)(3) (2000), exempts:

Any note, Draft, bill of exchange, or bankers' acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

(n200)Footnote 200. Ann. Code Md. § 11-601(10).

Section 402(a)(10) of the Uniform Act provides the exemption for:

[A]ny commercial paper which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which evidences an obligation to pay cash within nine months of the date of issuance, exclusive of days of grace, or any renewal of such paper which is likewise limited, or any guarantee of such paper or of any such renewal

See also Ariz. Rev. Stat. § 44-1843(8):

Commercial paper which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, which evidences an obligation to pay cash within nine months of the date of issuance or sale, exclusive of days of grace, or any renewal of such paper which is likewise limited, or any guarantee of such paper or of any such renewal.

There are variations. In California, for example, *Cal. Corp. Code § 25100(l)* provides:

Any note, draft, bill of exchange, or banker's acceptance which is freely transferable and of prime quality, arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which evidences an obligation to pay cash within nine months of the date of issuance, exclusive of days of grace, or any renewal of such paper or of such renewal, provided that such paper is not offered to the public in amounts of less than twenty-five thousand dollars (\$25,000) in the aggregate to any one purchaser

And in Illinois: Ill. Cons. Stat. Ann. ch. 815, § 5/3(L):

Any negotiable promissory note or draft, bill of exchange or bankers' acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which evidences an obligation to pay cash within 9 months of the date of issuance exclusive of days of grace, or any renewal of such note, draft, bill or acceptance which is likewise limited or any guarantee of such note, draft, bill or acceptance or of any such renewal. Any instrument exempted under this subsection from the requirement of section ... 5 shall bear across the face thereof the following type: "THIS INSTRUMENT IS NEITHER GUARANTEED, NOR IS THE ISSUANCE THEREOF REGULATED BY ANY AGENCY OR DEPARTMENT OF THE STATE OF ILLINOIS OR THE UNITED STATES." However, the foregoing legend shall not be required with respect to any such instrument:

- (i) sold to a person described in subsection C or H of Section 4 of this Act.
- (ii) sold to a "Qualified Institutional Buyer" as that term is defined in Rule 144a adopted under the Securities Act of 1933;
- (iii) where the minimum initial subscription for the purchase of such instrument is \$100,000 or more; or
- (iv) issued by an issuer that has any class of securities registered under Section 12 of the Securities Exchange Act of 1934 or has any outstanding class of indebtedness rated in one of the 3 highest categories by a rating agency designated by the Department

(n201)Footnote 201. See Drafter's commentary to Unif. Sec. Act § 402(a)(10).

(n202)Footnote 202. The quoted phrase was originally used in the House of Representatives Report on the then proposed federal act H.R. Rep. No. 85, 73d Cong., 1st Sess. 15 (1933).

(n203)Footnote 203. *Sanders v. John Nuveen & Co.*, 463 F.2d 1075, 1079 (7th Cir. 1972) , *cert. denied*, 409 U.S. 1009, 93 S. Ct. 443, 34 L. Ed. 2d 302 (1972) .

(n204)Footnote 204. See, e.g., Illinois: 14 Ill. Admin. Code § 130.233 ("The phrase 'promissory note or draft, bill of exchange or bankers' acceptance' as used in Section 3(L) of the Act shall mean a negotiable security which is eligible for discounting pursuant to 12 U.S.C., Sections 24(7) and 85, by banks which are members of the Federal Reserve System")

See also 950 Mass. Regs. Code § 14.402(A)(10):

To coordinate the interpretation and administration of the act with the related federal regulations, "commercial paper" as used in ... § 402(a)(10) includes prime quality negotiable commercial paper of a type not ordinarily purchased by the general public, that is, paper used to facilitate well recognized types of current operational business requirements and of a type eligible for discounting by Federal Reserve Banks as set forth in SEC Release No. 33-4412.

Some states simply exempt commercial paper not offered for sale to the public. See, e.g., Ohio: *Ohio Rev. Code Ann. § 1707.02(g)*; Oregon: *Or. Rev. Stat. § 59.025(7)*.

Or. Rev. Stat. § 59.025(7) provides an exemption for: "Commercial paper issued, given or acquired in a bona fide way in the ordinary course of legitimate business, trade or commerce, where such commercial paper is not made the subject of a public offering."

See also *State of Oregon v. Crooks*, 84 Or. App. 440, 734 P.2d 374 (Ct. App. 1987) (promissory note given by individual engaged in business of buying and selling real estate securities interests not exempt as commercial paper under statute which includes only "unsecured short term negotiable debt instruments issued by commercial entities").

In *Caucus Distributors, Inc. v. Maryland*, [1988-1990 Transfer Binder], Blue Sky L. Rep. (CCH) P 73006 at 73,975 (Cir. Ct. June 16, 1989), *aff'd*, 320 Md. 313, 577 A.2d 783 (1990) promissory notes issued by a political organization to private individual were not entitled to an exemption for prime quality commercial paper.

(n205)Footnote 205. Rev. Unif. Sec. Act § 401(b)(11). The Official Code Comment provides:

The provision in the 1956 Act ... followed the counterpart provision in the Securities Act of 1933. The latter has been the subject of considerable, and often changing, interpretation. The approach in the present subsection is to identify certain objective criteria which must be satisfied in order for the exemption to be applicable.

(n206)Footnote 206. *See* 12 U.S.C.A. § 343; 12 CFR §§ 201.4, 201.5.

See also Sec. Act. Rel. No. 4412, 1 Fed. Sec. L. Rep. (CCH) P 2045 (1961). *See also* *UBS Asset Management (New York) Inc. v. Wood Gundy Corp.*, 914 F. Supp. 66 (S.D.N.Y. 1996) .

In *People v. Dempster*, 396 Mich. 700, 242 N.W.2d 381(1976) , the Michigan Supreme Court rejected the argument that an instrument which fit the definition of commercial paper under the Uniform Commercial Code would be accepted as commercial paper under the blue sky laws. The court held that the U.C.C. concept was meant to "simplify, clarify and modernize the law governing commercial transactions," while the blue sky law was intended to prevent the sale of securities until the blue sky administrator could investigate the merits of the offering. 242 N.W.2d at 385 . The commercial paper exemption was found to be based on the comparable exemption under the 1933 Federal Securities Act requiring that the commercial paper be of a type not ordinarily purchased by the general public and eligible for discounting by Federal Reserve banks. 242 N.W.2d at 386 . However, the court reversed the defendant's criminal conviction for selling non-exempt, unregistered, securities on the ground that the instruments involved met an acceptable definition of "commercial paper," and it would be a denial of due process to apply a narrower definition under the blue sky law retroactively. 242 N.W.2d at 388 , 389.

(n207)Footnote 207. *See* Rutledge, G.P., *National Securities Markets Improvements Act ... One Year Later: The States' Response*, 53 Bus. L. 563, 567 (Feb. 1998).

(n208)Footnote 208. *See* Kan. Stat. Ann. § 17-1261(i); Kan. Admin. Regs., Off. of Sec. Comm'r § 81-5-11.

(n209)Footnote 209. Unif. Sec. Act § 402(a)(11).

The drafters of this original Uniform Act exemption explained that it was designed to solve the problem arising from the position taken in some states and by the SEC that benefit plans of various kinds involve an offer of a security in the nature of an investment contract if participation is voluntary and an employee must contribute under the plan in order to participate. *See* Off. Code Comment, Subsec. (a)(11).

(n210)Footnote 210. 15 U.S.C. § 77c(a)(2).

(n211)Footnote 211. 17 C.F.R. § 230.701.

(n212)Footnote 212. *See, e.g.,* Tennessee: *Tenn. Code Ann. § 48-2-103(a)(9)* ("The offering meets the requirements of Rule 701 of the Securities Act of 1933").

(n213)Footnote 213. *See* Securities Act section 18(b)(4)(C), 15 U.S.C. § 77r(b)(4)(C).

(n214)Footnote 214. 2002 Unif. Sec. Act § 202(21).

(n215)Footnote 215. 6 Del. Code Ann. § 7309(a)(11).

(n216)Footnote 216. Interpretive Ruling 9(11), Delaware Securities Commissioner.

(n217)Footnote 217. *Id.* 6 Del. Code Ann. § 7302(1)(m), defining the term "security," includes within the meaning of that term a "certificate of interest in or participation in any profit-sharing agreement" and an "investment contract." It is the opinion of the Commissioner that the term "investment contract" is inclusive, that is, a term of wide scope which could include other classifications and in this specific instance includes a "certificate of interest in or participation in any profit-sharing agreement."

(n218)Footnote 218. Interpretive Ruling 9(11) of the Delaware Securities Commissioner. 6 Del. Code Ann. § 7309(a)(11) exempts from the requirements of Sections 7304 and 7312, under certain circumstances, investment contracts issued in connection with an employee's stock purchase, savings, pension, profit sharing, or similar benefit plan. While Section 7309(a)(11) exempts these investment contracts it does not mention "certificates of interest in or participation in any profit-sharing agreement" thus raising the question of whether such are also within the exemption of Section 7309(a)(11). In light of the conclusion that such instruments are investment contracts it is clear that they are subject to the exemption of Section 7309(a)(11). It should be noted that 7309(a)(11) does not exempt all certificates of interest in or participations in any profit-sharing agreement, but only those involving employees. Therefore, a certificate of interest in or participation in any employee's profit-sharing plan would be subject to the exemption granted in Section 7309(a)(11).

(n219)Footnote 219. Draftsmen's commentary to Unif. Sec. Act § 401(a)(12), Loss and Cowett, Blue Sky Law 362 (1958).

(n220)Footnote 220. *Id.*

(n221)Footnote 221. *Id.*

(n222)Footnote 222. Revised Uniform Securities Act § 401(b)(13). The Official Comment provides no illumination regarding how, if at all, the drafters standardized the disparate state provisions, but merely states:

A number of states presently exempt securities issued by cooperatives. This paragraph proposes an exemption for such securities as long as they are not traded to the public generally.

Some states have adopted the Revised Uniform Securities Act language. *See, e.g., R.I. Gen. L. § 7-11-401(13).*

Cooperative securities are not federal covered securities and are not pre-empted from state regulation under NSMIA.

(n223)Footnote 223. *See, e.g., Cal. Corp. Code § 25100(m)*, which exempts: "Any security issued by any corporation organized and existing under the provisions of ... the Food and Agricultural Code." Section 54061 of the Food and Agricultural Code describes the purposes for which cooperatives may be established. An exemption from requirements of the Securities Law is also provided in Food and Agricultural Code Section 54201:

An association is not subject in any manner to the terms of the Corporate Securities Law, Division 1 (commencing with Section 25000), Title 4 of the Corporations Code, and any association may issue its membership certificates or stock or other securities as provided in this chapter without the necessity of any qualification under that law.

Cal. Corp. Code § 25100(q) exempts unincorporated inter-indemnity or reciprocal or inter-insurance contracts between members of cooperative corporations composed solely of licensed physicians and surgeons when the contracts indemnify solely against medical malpractice.

See also Fla. Stat. Ann. § 517.051(7): "Securities of nonprofit agricultural cooperatives organized under the laws of this state when said securities are sold or offered for sale to persons principally engaged in agricultural production or

selling agricultural products."

Ill. Cons. Stat. Ann. Ch. 815, § 5/3(R) provides an exemption for:

Any security issued by a bona fide agricultural cooperative operating in this State that is organized under the laws of this State or as a foreign cooperative association organized under the law of another state that has been duly qualified to transact business in this State.

See also Ill. Cons. Stat. Ann. Ch. 815, § 5/4(K), which covers securities for patronage, marketing agreements by cooperative associations organized exclusively for agricultural, producer, marketing, purchasing or consumer purposes, and the sale of subscriptions for stock of cooperative associations, provided no commission or remuneration is paid and no person beneficially owns more than 5% of the aggregate amount of outstanding capital stock of the cooperative association.

See also Ohio Rev. Code § 1707.02(I).

(n224)Footnote 224. *See, e.g., Cal. Corp. Code 25100(m); Mass. Gen. L. Ann. ch. 110A, § 402(a)(12); N.Y. Gen. Bus. L. § 359-ff(5)(b); Tex. Rev. Civ. Stat. art. 581-5(N).*

(n225)Footnote 225. *See, e.g., Fla. Stat. Ann. § 517.051(7); Ill. Cons. Stat. Ann. Ch. 815 § 5/3(R); Iowa Code § 505.202(12).*

(n226)Footnote 226. 2002 Unif. Sec. Act § 201(9).



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Blue Sky Regulation

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CHAPTER 7 Exempt Securities

1-7 Blue Sky Regulation § 7.07

§ 7.07 Administrative Authority over Security Exemptions

Although in most instances security exemptions in Blue Sky laws are self-executing, and thus do not require any filing or request procedure, state administrators may be authorized to police the use of exemptions through the power to deny, suspend, revoke, condition, or limit the use of at least certain exemptions. Section 204 of the 2002 Uniform Securities Act exemplifies such potentially far-reaching authority:

(a) [Enforcement related powers] Except with respect to a federal covered security or a transaction involving a federal covered security, an order under this [Act] may deny, suspend application of, condition, limit, or revoke an exemption created under Section 201(3)(C) [securities of "any other" depository institution], (7) [non-profit organizations] or (8) [interests in a non-profit membership cooperative] or 202 or an exemption, or waiver created under section 203 with respect to a specific security, transaction, or offer. An order under this section may be issued only pursuant to the procedures in Section 306(d) or 604 and only prospectively.ⁿ¹

This authority must be exercised in compliance with applicable due process and statutory requirements. The administrator's decision is accorded substantial deference by courts.ⁿ²

The basis upon which an administrator may exercise such power may or may not be set out in the statute. In Oregon, for example, the director may by order withdraw, condition or deny the use of any exemption by a person if the director has reason to believe that the person has engaged in or is about to engage in an act or practice constituting a violation of the Oregon Securities Law or that the use of any exemption by that person would work a fraud or imposition on purchasers.ⁿ³ Orders may in some states issue summarily, but in all cases there must be appropriate findings and follow-on administrative proceedings.ⁿ⁴

Although not a part of the original Uniform Securities Act, which made no provision for administrative enforcement authority relating to exemptions at all, the Revised Uniform Act added specific authority to revoke an exemption,ⁿ⁵ which was carried into and significantly expanded in the 2002 Uniform Act. Uniform and Non-Uniform Act states have established authority to deny or revoke, as illustrated in Pennsylvania:

The commission may by order deny or revoke any exemption specified in section 202 or 203 with respect to a specific security or transaction. The order shall be issued summarily without notice or hearing. Upon issuance of a summary order, the commission shall promptly provide the order to the

person against whom it is issued. The order shall contain findings of fact and conclusions of law and include a notice affording the person an opportunity for a hearing under section 607(a). No order under this section shall operate retroactively. No person shall be considered to have violated section 201 by reason of any offer or sale effected after the entry of an order under this section if he sustains the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the order.ⁿ⁶

Section 204 of the 2002 Uniform Act further points out the common authority of administrators under Blue Sky laws to waive, in whole or part, any conditions for an exemption set out in the statute.ⁿ⁷ This authority extends to the creation of an exemption by rule or order in particular circumstances as well as to waiving requirements for an existing exemption. Thus, for example, in California:

There shall be exempted from the provisions of Section 25110, 25120 or 25130 any other transaction which the commissioner by rule exempts as not being comprehended within the purposes of this law and the qualification of which he finds is not necessary or appropriate in the public interest or for the protection of investors.ⁿ⁸

Although securities exemptions in all states are for the most part self-executing, the most notable exception is the filing requirement often attached to the exemption for securities of a particular type issued by qualifying non-profit organizations. These requirements, applicable to debt securities issued by such organizations typically consist of a either a notice filing requirement, a request for an exemption authorization, or a particular form of registration. They are discussed in more detail in § 7.06[6] above, and are today included in section 201(7) of the 2002 Uniform Securities Act. The drafters of the 2002 Uniform Act noted that the non-profit exemption is of particular concern to state securities regulators, particularly referencing religious scams.ⁿ⁹ Other security exemptions may not be self-executing when they are of a type designed or authorized by particular statutes or for particular state purposes.ⁿ¹⁰

Whether self-executing or not, in any proceedings concerning a claimed security exemption, the burden of proving the availability of the exemption is on the person claiming it.ⁿ¹¹

As this provision indicates, only certain security exemptions are considered permissive, and thus subject to the administrator's authority to revoke, condition, or suspend. For purposes of the 2002 Uniform Act these specific securities are:

- (1) securities by certain depository institutions;
- (2) securities of nonprofit issuers; and
- (3) certain securities of cooperatives.

In some states all exempt securities are deemed permissive.ⁿ¹² In any case, adherence to administrative procedures is required. The Uniform Securities Act contains procedural safeguards that entitle interested parties to notice of denial or revocation of an exemption and the right to a hearing.ⁿ¹³ Most states have also adopted requirements for notice and hearing, though procedural aspects may differ from those of the Act.ⁿ¹⁴ Where prescribed procedures are followed, the courts give an administrator's decisions to deny or revoke exemptions substantial deference.ⁿ¹⁵ The discretion is granted with respect to a specific case and does not extend to any statutory exemption generally.ⁿ¹⁶ The scope of an administrator's authority to deny, revoke or suspend an exemption is presented on a state-by-state basis in the State Guides that comprise Volumes Three and Four of this Treatise.

FOOTNOTES:

(n1)Footnote 1. 2002 Unif. Sec. Act § 204(a). Section 204 further provides:

(b) [**Knowledge of order required.**] A person does not violate Section 301, 303 through 306. 504 or 510 by an offer to sell, offer to purchase, sale, or purchase effected after the entry of an order issued under this section if the person did not know, and in the exercise of reasonable care could not have known, of the order.

(n2)Footnote 2. *See, e.g., Johnson-Bowles Co. v. Division of Sec. of Dep't of Commerce*, 829 P.2d 101 (Utah Ct. App. 1991) .

(n3)Footnote 3. [Oregon CITE section 59.045]

(n4)Footnote 4. *See, e.g., Washington, R.C.W. § 21.20325:*

The director or administrator may by order deny, revoke, or condition any exemption specified in subsections (10), (11), (12), or (13) of *RCW 21.20.310* or in *RCW 21.20.320*, as now or hereafter amended, with respect to a specific security or transaction. No such order may be entered without appropriate prior notice to all interested parties, opportunity for hearing, and written findings of fact and conclusions of law, except that the director or administrator may by order summarily deny, revoke, or condition any of the specified exemptions pending final determination of any proceeding under this section. Upon the entry of a summary order, the director or administrator shall promptly notify all interested parties that it has been entered and of the reasons therefor and that within fifteen days of the receipt of a written request the matter will be set down for hearing. If no hearing is requested and none is ordered by the director or administrator, the order will remain in effect until it is modified or vacated by the director or administrator. If a hearing is requested or ordered, the director or administrator, after notice of and opportunity for hearing to all interested persons, may modify or vacate the order or extend it until final determination. No order under this section may operate retroactively. No person may be considered to have violated *RCW 21.20.140* as now or hereafter amended by reason of any offer or sale effected after the entry of an order under this section if he or she sustains the burden of proof that he or she did not know, and in the exercise of reasonable care could not have known, of the order.

(n5)Footnote 5. Rev. Unif. Sec. Act § 404.

(n6)Footnote 6. 70 P.S. § 1-204.

(n7)Footnote 7. 2002 Unif. Sec. Act § 203.

(n8)Footnote 8. *Cal. Corp. Code § 25105; see also Virginia: Code Va. § 13.1-514.1.*

(n9)Footnote 9. *See Off. Comment 7, 2002 Unif. Sec. Act.*

(n10)Footnote 10. *See, e.g., Arizona: Ariz. Rev. Stat. § 44-1843.01* (certain government securities).

(n11)Footnote 11. *See, e.g., Montana: M.C.A § 30-10-106.*

See also 2002 Unif. Sec. Act § 503(a) ("In a civil action or administrative proceeding under this [Act], a person claiming an exemption, exception, preemption, or exclusion has the burden to prove the availability of the claim").

(n12)Footnote 12. *See, e.g., Minn. Stat. Ann. § 80A.15(3); 70 Pa. Cons. Stat. Ann. § 1-204(b).*

(n13)Footnote 13. Unif. Sec. Act § 402(c); Rev. Unif. Sec. Act. § 404, Official Code Comment.

(n14)Footnote 14. *See, e.g., N.H. Rev. Stat. Ann. § 421-B:17(III), (IV).*

(n15)Footnote 15. *See, e.g., Johnson-Bowles Co. v. Division of Sec. of Dep't of Commerce*, 829 P.2d 101 (Utah App. 1991) .

(n16)Footnote 16. Official comment to Unif. Sec. Act § 402(c), redesignated as § 404 in the Revised Uniform Securities Act in 1985 by NCCUSL. L. Loss & E. Cowett, Blue Sky Law 380 (1958).



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CHAPTER 8 Exempt Issuer Transactions

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CHAPTER 8 Exempt Issuer Transactions

1-8 Blue Sky Regulation § 8.01

§ 8.01 Exempt Issuer Transactions Generally

As presented in Chapter 7, particular types or categories of securities are exempt from registration or qualification requirements under state blue sky laws when their characteristics are such that there is no need for the protection afforded by these procedures. Whether because of other applicable regulation or quality assurances that are a function of listing requirements; other "blue chip" qualifications or their non-traditional elements; or the purpose for which they are used; the risk characteristics of exempt securities do not indicate the need for special investor protection afforded by registration or qualification under blue sky laws. The same holds true in certain transactional settings, and the collection of exempt transactions that is included in all blue sky laws also reflects the fundamental point that there are situations in which the protection of registration or qualification is simply not needed or is substantially diminished to the extent that the regulatory objective can be achieved by lesser or limited means, or through alternative mechanisms. This conclusion has historically driven not only the collection of statutory transaction exemptions in blue sky laws for both issuer and non-issuer transactions, but also the evolution of other significant transactional exemptions and limited offering mechanisms adopted in states by way of regulations or administrative orders. These include special provisions for small offerings by issuers intended to eliminate barriers to capital formation and promote local economic development.

This chapter explores the range of transaction exemptions for issuers of securities. Non-issuer transaction exemptions--those not involving distributions for the purpose of capital formation--are considered in depth in Chapter 9. As a prelude to considering both, however, it is essential to recognize that transactional exemptions apply only with regard to registration or qualification provisions of blue sky laws. Antifraud provisions and the administrative enforcement and civil remedies associated with them remain fully operational for exempt transactions. Equally important with regard to exempt transactions is the fact that in several instances a transactional "exemption" is in reality only a form of limited offering for which there are filing and other compliance elements. As noted above, the premise for any exemption is that there is no need for the full protections that registration or qualification procedures provide. The compensating circumstances of a transaction, however, may still involve certain mechanics of compliance that operate to assure that investor protection goals are not compromised even in those settings where full compliance with registration provisions is not required. Although significant uniformity in this process has historically been achieved through initiatives that have produced the Uniform Limited Offering Exemption (ULOE), for example, variations remain among the states in regard to some common transaction exemptions and, indeed, in the availability of some exemptions. Such variations are particularly significant for small business capital formation across state lines.

Although transaction exemptions operate to excuse compliance with registration or qualification requirements of state blue sky laws, another important consideration is that not all of them are self-executing. Some exemptions in several states have their own specific qualification requirements involving filings or a "Claim of Exemption,"ⁿ¹ for example,

and fee requirements. In some cases there are affirmative administrative approval requirements. The exemption of offers and sales by non-profit or charitable issuers, for example, is frequently made subject to filing and approval requirements, as are transactions with an issuer's existing security holders under certain circumstances. These requirements are all discussed further below. In all states the burden of proving an exemption is upon the person claiming it, and administrators are commonly empowered to deny or revoke any transaction exemptions through administrative procedures that include temporary summary orders of revocationⁿ² when such action is deemed necessary or appropriate for the protection of investors.ⁿ³ The loss of a transaction exemption triggers significant enforcement authority and private civil remedies that in most instances involve rescission rights.ⁿ⁴

The Uniform Securities Act, in all of its iterations,ⁿ⁵ includes an array of issuer exemptions common to all state blue sky laws, whether or not a particular state law is based on the Uniform Act. They are likewise consistent with several of the transactional exemptions included in the federal Securities Act of 1933, and in most instances federal and state coordination of issuer transactions in reliance upon an exemption is not difficult. Also, state regulation of transactions by an issuer that are of a national character is now preempted by NSMIA, such that large scale "private" offerings conducted by an issuer in compliance with Rule 506 of Regulation D under the Securities Act of 1933 are not subject to registration or qualification provision of state blue sky laws. The beginning premise, however, is that in all circumstances an exemption must be available for *every* transaction by an issuer that is conducted without compliance with the registration or qualification provisions of applicable state blue sky laws. Thus, the analysis below focuses on those specific statutory exemptions that are most commonly available in states whose laws are based upon the Uniform Act, or which otherwise have adopted common transaction exemptions in their statutes. Later in the chapter, limited offerings and other common administratively adopted forms of issuer exemptions are discussed in detail, with particular emphasis on their role today after the NSMIA redefinition of state and federal responsibility in the issuer distribution setting.

There is an important preliminary consideration for issuers, however. That is the extent to which an issuer may, without regard to the availability of any exemption, proceed to "test the waters" for proposed capital formation by soliciting indications of interest in advance of undertaking blue sky registration or qualification of certain types of offerings. "Test the waters" provisions in several states have been adopted and operate as exemptions to permit early assessment of the cost effectiveness of going forward in proposed capital formation activities. As a prelude to consideration of the array of statutory exemptions under blue sky laws these provisions are discussed immediately below.

FOOTNOTES:

(n1)Footnote 1.

Nevada: See, e.g., Nev. Admin. Code § 90.495 (Claim of Exemption).

(n2)Footnote 2.

Indiana: See, e.g., Ind. Code § 23-2-1-2(d).

(n3)Footnote 3.

New Jersey: See, e.g., N.J. Stat. § 49:3-50(c).

(n4)Footnote 4. Although the authority to administratively suspend or revoke transaction exemptions exists in all

states, many also provide relief from the harsh result of such an action to an issuer that engages in the offer or sale of a security in reliance on the exemption, and does not know and in the exercise of reasonable care could not have known of the administrative order suspending or revoking it, *see, e.g. Missouri: Mo. Rev. Stat. § 409.2-204(b)*; *see also* 2002 Unif. Sec. Act § 204(b).

(n5)Footnote 5. *See* Unif. Sec. Act § 402(b); Rev. Unif. Sec. Act § 402; 2002 Unif. Sec. Act § 202.



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CHAPTER 8 Exempt Issuer Transactions

1-8 Blue Sky Regulation § 8.02

§ 8.02 Solicitation of Interest ("Test the Waters")

A pilot project of NASAA--the North American Securities Administrators Association--led in 1993 to a proposed rule addressing solicitations of interest prior to the filing of a registration statement under state blue sky laws. The NASAA *Proposed Statement of Policy on Solicitation of Interest (Test the Waters)* n1 has not been adopted by the NASAA membership pending a study of its effect in states that choose to adopt its use on an experimental basis. By rule, several states have adopted the procedure,n2 and in the State Guides included in Volumes Three and Four of this treatise, specific "test the waters" provisions adopted in various states are highlighted. All are patterned directly on the NASAA proposed statement, and all utilize a standard form (SOI), also developed by NASAA, to establish filing and minimum disclosure requirements for undertaking the process.

Under "testing the waters" procedures an issuer may make an offer, but not a sale, of a security for the sole purpose of soliciting an indication of interest in receiving a prospectus or similar disclosure document for the security. Conditions on testing the waters in all states that permit it are as follows:

- (1) The issuer is or will be a business entity organized under the laws of a U.S. state or possession, or a province or territory of Canada, and be engaged in or propose to engage in a business other than petroleum exploration and production, mining, or other extractive industries, and may not be a blind pool or other offering for which the specific business or properties cannot presently be described;
- (2) Indications of interest may be solicited only within a set period of time after receiving approval from the administrator;
- (3) No commission or fee may be paid to any person other than a registered dealer or agent for soliciting a potential investor;
- (4) The issuer intends to register the securities in the state, or seek approval for an exemption from registration or qualification;
- (5) The issuer files Form SOI, along with copies of any advertising or marketing materials at least ten business days before beginning any solicitation;
- (6) No money is accepted and no contract documents are signed until at least ten business days after the issuer completes registration or otherwise obtains approval to offer and sell the securities in the state, and

no sale is made until three days after delivery of a prospectus or similar disclosure document;

(7) The issuer has no reason to believe that it is subject to any "bad boy" disqualification;ⁿ³ and

(8) Required legends are included on or with any published notice or materials used in the solicitation.ⁿ⁴

As addressed individually in the State Guides, the fact that a particular state has not adopted a specific testing the waters provision does not mean there is no accommodation made for the process. Other exemptions may be available to permit some limited pre-sale communications, as for example in the limited offer of preorganization subscriptions, for which a specific statutory transaction exemption is normally provided. Several states also provide *de minimis* or local issuer's exemptions among limited offering alternatives that are described in § 8.06 below. Designed to support small business capital formation, these provisions nevertheless typically involve significant restrictions. In states that provide specific testing the waters procedures, however, the process offers much greater flexibility and is particularly useful for small businesses and as an encouragement to small business capital formation. But for compliance with the above-described requirements, there are no limitations on solicitations of interest in terms of numbers, types of investors solicited or any other qualifying criteria.

In states with solicitation of interest procedures the process operates wholly apart from any coordinate "offer" exemption that may be available in regard to securities for which a registration statement has been filed under the federal Securities Act of 1933 but is not yet effective, or securities that are exempt from federal registration but for which a state registration has been filed and is not effective. These coordinate "offer" exemptions are discussed in section 8.03[12] below. In practice they permit mostly unrestricted offers of securities, but they are premised on the filing of a federal or state registration statement. The solicitation of interest procedure is intended to operate in advance of any such filing, in order to allow for a decision that such a filing will in fact be undertaken, or to determine whether another exemption may be available based upon indications of interest.

FOOTNOTES:

(n1)Footnote 1. The NASAA Proposed Statement of Policy is reproduced in *CCH NASAA Reports* P 4001, at 2541.

(n2)Footnote 2. *See, e.g.,*

Indiana: Ind. Admin. Code §1-13-7.

North Dakota: N.D. Cent. Code § 10-04-06(15).

Virginia: 21 Va. Admin. Code § 5-40-70.

Wisconsin: WAC-DFI-Sec. 2-027.

(n3)Footnote 3. "Bad boy" disqualifications are those established for eligibility to use the Uniform Limited Offering Exemption (ULOEE) and other common limited offering exemptions permitted by states. They primarily involve having no prior history of criminal acts, no state enforcement proceedings based on fraud, no stop orders or other orders prohibiting the registration of securities or reliance on an exemption, and no civil injunctive orders relating to conduct or practices in connection with the purchase or sale of securities.

(n4)Footnote 4. "Legend" requirements imposed by states generally, and the standard form of legend required in testing the waters documents in particular, are discussed in § 8.10[2], *infra*.



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CHAPTER 8 Exempt Issuer Transactions

1-8 Blue Sky Regulation § 8.03

§ 8.03 Statutory Issuer Exemptions

[1] "Offer" and "Sale" Definition Exclusionsⁿ¹ Applications of transactional exemptions for issuers under blue sky laws are premised upon the occurrence of a triggering event--an "offer" or "sale" of a security. In numerous states, however, the application of an exemption is never reached in certain circumstances in which by exclusions from key definitions there is no triggering event. For example, by definition the terms "sale," "offer," "sell" or "offer to sell" often expressly exclude:

- (a) Any stock dividend, whether the corporation distributing the dividend is the issuer of the stock or not, if nothing of value is given by stockholders for the dividend other than the surrender of a right to a cash or property dividend when each stockholder may elect to take the dividend in cash or property or in stock; or
- (b) Any stock split, reverse stock split or change in par value which involves the substitution of a security of an issuer for another security of the same issuer.ⁿ²

These transactions do not involve the essential "value" element of the definitions of offer or sale in blue sky laws, which in all cases turn on an attempt to dispose of a security "for value."ⁿ³ These transactions, by their very nature, do not evoke any need for blue sky law protection because they are essentially non-economic events and involve no investment decision. There are other transactions that are in some states also excluded from the key definitions that have different economic characteristics, but are nevertheless deemed to be outside the scope of needed protections. Thus in Delaware, for example, the terms "offer," "sale," "sell," or "offer to sell" also expressly exclude:

- (a) Any bona fide pledge or loan;
- (b) Any act incident to a vote by stockholders pursuant to the certificate of incorporation, or other provisions of law, on a merger, consolidation, reclassification of securities, dissolution or sale of corporate assets in consideration of the issuance of securities of the same or another corporation; or
- (c) Any act incident to a judicially approved reorganization in which a security is issued in exchange for one or more outstanding securities, claims, or property interests, or partly in such exchange and partly for cash.ⁿ⁴

These exclusions more commonly appear as specific transaction exemptions in blue sky laws rather than as exclusions from the key definitions of triggering events. Including them as exemptions rather than exclusions assures continued application of antifraud provisions and remedies while still excusing compliance with registration or qualification requirements. This is the approach taken in the 2002 Uniform Actⁿ⁵ and a majority of states.ⁿ⁶ Other than availability of antifraud protections, however, functionally there is no difference in blue sky treatment between definition exclusions and transaction exemptions as they relate to these particular types of transactions. Because they are more commonly treated as exemptions, however, further discussion of pledges or loans, acts incident shareholder approved corporate transactions, and acts incident to judicially approved reorganizations are separately discussed later. As for stock dividends and stock splits, certain considerations that are applicable whether they are treated as exclusions or exemptions are considered below.

[a] Stock Dividends Although stock dividends are not normally subject to blue sky registration, two questions often arise with respect to a stock dividend exclusion or exemption. The first is, does the exemption apply when the shareholder has a choice between a cash dividend and the stock dividend? Most states follow the Uniform Act provision,ⁿ⁷ and answer in the affirmative. The stock dividend is either excluded or exempt when nothing of value is given by stockholders for the dividend other than the surrender of a right to a cash or property dividend when each stockholder may elect to take the dividend in cash or property or stock. That is not the case in California, however, where a stock dividend paid on common stock must, among other qualifications, consist only of such common stock.ⁿ⁸ The distribution of the stock that is the subject of the dividend must be registered in California, unless otherwise exempt, if stockholders are given a choice between cash or shares.ⁿ⁹

The second question deals with the identity of the issuer of the securities that are the subject of the dividend. In other words, is registration required when the dividend securities are not issued by the declarer of the dividend? In the majority of states the exclusion or exemption is available regardless of the issuer's identity. This is also the Uniform Act approach. Here again, however, California, joined by several other states, requires that the distributor and the issuer be the same.ⁿ¹⁰

[b] Stock Splits When a corporation distributes additional stock to its shareholders pursuant to a stock split, the proportion of equity an individual holder has in the corporation is not changed, and there is no economic consequence for the transaction. Thus, it is logical to exclude stock splits from the scope of registration or qualification provisions in blue sky laws, and most states expressly do so.ⁿ¹¹ In states where relief is not specifically granted, it is difficult to say whether stock splits must be registered. However, an argument favoring their exemption can easily be made. As discussed above, the Uniform Securities Actⁿ¹² and the statutes of a number of states exclude stock dividends from the definition of "sale." The declaration of stock dividends affects the capital of a corporation and can conceivably detrimentally affect the status of holders of other classes of stock or other types of corporate securities.ⁿ¹³ On the other hand, a stock split has no effect on capital. Under such circumstances, it would not be unreasonable to say that there is less danger to security holders generally from a stock split than from a stock dividend, and to relieve dividends from registration requirements and not splits would seem illogical. Further, many states follow the Uniform Securities Actⁿ¹⁴ and provide an exemption for "any transaction pursuant to an offer to existing security holders of the issuer." A stock split should fall within such a provision. It would seem that a more realistic debate would center around whether stock splits are excluded from blue sky coverage because they do not constitute sales or whether they are merely exempt from registration because they are transactions with existing security holders.

Reverse stock splits present a different issue. In these situations, the corporation is decreasing the number of outstanding shares by offering, for example, one share for every ten and then buying up any fractional shares. This type of scheme could endanger stockholders of a publicly held corporation that plans to go private. This can have the effect of freezing out many shareholders and leaving them with only a fraction of their original investment.ⁿ¹⁵ Only a few states have a specific exemption for reverse stock splits, and in view of the problem facing shareholders in a reverse stock split it would be hazardous to conclude that a general exemption for a stock split would apply to reverse splits.

The statutes that exempt stock splits, or reverse stock splits, generally provide for the exemption without further ramification, but the California provision has a number of clauses designed to protect stockholders.ⁿ¹⁶ First, if there is more than one class of outstanding voting shares, neither type of split is permitted without registration.ⁿ¹⁷ Second, in the case of an ordinary stock split, registration is required if the securities are listed or admitted for trading on a national securities exchange or are the subject of two-way quotations regularly published in the National Daily Quotation Serviceⁿ¹⁸ and the market price of the stock as of the date of the split is less than two dollars per share.ⁿ¹⁹ Finally, in the case of a reverse stock split, the exemption is not available if the stock is not listed or admitted on a national securities exchange or published in the National Daily Quotation Service, if the corporation has the option of purchasing fractional shares that would result in substantial alteration of the proportionate interests of the shareholders.ⁿ²⁰

[c] Acts Incident to Class Votes by Stockholders As seen in the Delaware example quoted earlier, states may also exclude acts incident to shareholder approval of a merger or other corporate reorganization transaction of sale of corporate assets in consideration for issuance of securities from the definition of offer or sale, and thus place them entirely outside the scope of blue sky law coverage. This approach was taken in the original Uniform Securities Act,ⁿ²¹ and reflects the notion that charter documents and corporation laws control in this setting, and provide protections and remedies. As also noted above, however, the more common blue sky treatment of such transactions today is to make them the subject of a specific exemption, but which is also tied to security holder approval in accordance with controlling charter documents and laws. Exemptions for reorganizations and business transactions are discussed in *section 8.03[8]* below.

[d] Judicially Approved Reorganizations Business reorganizations are carried out on occasion by judicial proceedings. The common method of voluntary judicial reorganization is under Chapter 11 of the Bankruptcy Codeⁿ²² where an insolvent business can continue operating by having the court approve an arrangement satisfactory to creditors. One of the methods that may be ordered or approved by the courts is to have the failing entity issue new securities in exchange for outstanding securities or in redemption of debt. Securities issued and exchanged pursuant to a court-ordered reorganization are excluded from the scope of the Uniform Securities Actⁿ²³ and Revised Uniform Act, Several states have adopted the approach,ⁿ²⁴ and exclude from the definition of offer or sale:

[Any] act incident to a judicially approved reorganization in which a security is issued in exchange for one or more outstanding securities, claims or property interests, or partly in exchange and partly for cash.ⁿ²⁵

Other states have opted instead to include this provision as an exemption rather than an exclusion from the offer and sale definition.ⁿ²⁶ This is the approach of the 2002 Uniform Securities Actⁿ²⁷ as well.

Various types of consideration may be given for the securities under these provisions. First, there may be an exchange for any outstanding securities. Second, there may an exchange with creditors for their claims against the organization or for any property interests outstanding. Although outright cash sales of the new securities are not permitted, the business undergoing judicial reorganization may accept a partial cash consideration, presumably when the value of the securities used for the exchange exceeds the value of the outstanding securities, claims or property interests held by an individual owner.ⁿ²⁸ A few states have general exemptions for judicial reorganizations without stipulations on acceptable consideration.ⁿ²⁹ The Illinois exemption differs from the Uniform Securities Act provision in wording alone and seems to adopt the same tests as the Uniform Act, including those bearing on consideration.ⁿ³⁰ Ohio's exemption stresses that the exchange must be strictly for outstanding securities, claims or property interests, and thus prohibits all cash sales, even those partly for outstanding interests and partly for cash.ⁿ³¹

The exemption for transactions with existing security holders, in general, is a transaction exemption and not an exemption for the securities. In other words, the exemption would not apply to any non-issuer trading in the securities. Any secondary trading in such securities would have to be registered or the subject of another exemption. As to judicially approved reorganizations, the rule is the same, but California and Massachusetts have acted to exempt all

trading in securities issued pursuant to a reorganization under the Bankruptcy Act when approved by a court of competent jurisdiction.ⁿ³²

[2] Fairness-Approved Exchanges for Outstanding Securities, Claims or Property Interests Section 202(9) of the 2002 Uniform Securities Act is a new provision added to provide a state counterpart to the exemption in section 3(a)(10) of the federal Securities Act of 1933.ⁿ³³ The exemption permits an issuer to distribute securities in exchange for outstanding securities or claims when the transaction is subject to a fairness determination and would be most commonly applicable to corporate reorganization or recapitalization transactions. The provision for fairness approved exchange transactions has always been a part of the federal securities laws. However, because few state counterparts existed its utility was limited. Ohio is one of the few states that included a counterpart provision in its blue sky law.ⁿ³⁴ The utility of such an exemption is apparent, however,ⁿ³⁵ and the drafters of the 2002 Uniform Act specifically added section 202(9), which provides an issuer exemption for:

[A] transaction in a security, whether or not the security or transaction is otherwise exempt, in exchange for one or more bona fide outstanding securities, claims, or property interests, or partly in such exchange and partly for cash, if the terms and conditions of the issuance and exchange or the delivery and exchange and the fairness of the terms and conditions have been approved by the administrator after a hearing.ⁿ³⁶

With the introduction or enactment of the 2002 Uniform Securities Act, and with it this particular transaction exemption, in an increasing number of states,ⁿ³⁷ recognition of the utility of fairness-approved reorganization transactions pursuant to the exemption will expand. Its inclusion in the 2002 Uniform Act when there is no such provision in either the 1956 or 1985 versions of the Act clearly reflects the drafters' recognition that this formerly obscure and largely unavailable exemption has an important role to play in modern blue sky regulation.

[3] Transactions with Underwriters Under the federal Securities Act of 1933, negotiations and agreements between an issuer and an underwriter, or between underwriters, to publicly sell the issuer's securities are not considered sales for purposes of the statute.ⁿ³⁸ Because the federal provision is exclusionary, the effect is to remove such transactions from all protection offered by the Act, including the antifraud provisions.ⁿ³⁹ The Uniform Securities Act, while allowing a registration exemption for these transactions, still protects the participating parties by retaining application of the antifraud portion of the statute.ⁿ⁴⁰ The recommended Uniform Securities Act exemption (as opposed to exclusion) is for "any transaction between the issuer or other person on whose behalf the offering is made and an underwriter, or among underwriters...."ⁿ⁴¹

While most states have adopted the language of this provision,ⁿ⁴² it is probable that those jurisdictions without a comparable statutory exemption would imply a similar rule as a matter of necessity.ⁿ⁴³

California has a provision similar to the one in the Uniform Securities Act, but stipulates that the exemption is valid only if the securities are registered at the time of any distribution made in the state.ⁿ⁴⁴ Kansas has a blanket exemption for any offer or sale to an underwriter.ⁿ⁴⁵ Note also that in New York,ⁿ⁴⁶ except for the federal intrastate offering exemption,ⁿ⁴⁷ state registration is not required for any security which need not be registered under the Securities Act of 1933. The federal exclusion would, therefore, apply at least for registration purposes in these two states.

[4] Transactions in Secured Evidences of Indebtedness The investor who purchases shares of stock is risking money on the future value of equity of a company. The risk to the purchaser of priority debt securities of the same company may be somewhat less, but if the company fails, the investor will find herself in line with other creditors attempting to recover a fraction of the investment, assuming there is anything to recover at all. In both these cases, blue sky registration offers some protection to the investor willing to take the time to ascertain the company's financial position. If, however, a debt security is collateralized by a tangible asset, the risk of loss to the investor is significantly decreased.

Consider the example in which *ABC* Corporation holds a bond and mortgage on a warehouse owned by the *XYZ* Corporation. *ABC*, needing cash, decides to sell the bond and mortgage to investor *I*. The debt on the bond is now payable by *XYZ* to *I*. If *XYZ* defaults on its principal or interest payments, *I* can foreclose on the mortgage and recoup its losses at a foreclosure sale. In such a situation, the investor can as easily protect himself by examining the value and other aspects of the mortgaged property as he can by examining registration documents. Further, his position is safer than that of unsecured creditors since he can look to specific property to satisfy the debt. It is therefore logical to provide a registration exemption for transactions in secured evidences of indebtedness, such as the one in the Uniform Securities Act.ⁿ⁴⁸ However, this exemption is limited by the requirement that the entire mortgage, together with all the evidences of indebtedness which it secures, be sold as a unit.ⁿ⁴⁹ The unit limitation is an apparent attempt to keep the investor from being put in the position of competing with other creditors with similar claims against the same collateral.

There are several important considerations regarding the Uniform Securities Act exemption in the states that have adopted it.ⁿ⁵⁰ First, the provision is worded to permit public offerings of bonds and mortgages in unit transactions.ⁿ⁵¹ Nevertheless, one state adopting the Uniform Act language has, by regulation, prohibited media advertising or mass mailings soliciting offers or sales of mortgage units.ⁿ⁵² However, mailings advertising the offering may be made to registered broker-dealers and institutional investors.ⁿ⁵³ Second, the exemption is generally applicable to issuer transactions.ⁿ⁵⁴ However two states make it only a non-issuer transaction exemption.ⁿ⁵⁵

In some Uniform Act states, other restrictions have been placed on the use of the exemption. For example, one statute provides that the exemption is inapplicable if lands used to secure the indebtedness are subdivisions required to be registered under the Federal Interstate Land Sales Act.ⁿ⁵⁶ Another state bars the exemption to securities in the nature of investment contracts or profit sharing agreements.ⁿ⁵⁷

As indicated, the reasoning behind the exemption is that the purchaser is protected because identifiable tangible property secures the investment. This principle has been stressed in several states. As a result, regulations have been promulgated prohibiting, as part of a unit offering, any other property interest which would itself constitute a security.ⁿ⁵⁸ At least two non-Uniform Securities Act states have emphasized the exclusive nature of the purchaser's remedy in their statutes.ⁿ⁵⁹

A number of states not adopting the Uniform Securities Act provision have similar exemptions for unit sales of secured evidences of indebtedness.ⁿ⁶⁰ Often in these states, the statutes refer to sales to "a single purchaser at a single sale" in lieu of a "unit" sale. Interpretations comparing these terms have not yet been made, but there would seem to be little difference between them. One state requires that the property securing the indebtedness be located in the state.ⁿ⁶¹

The "unit" or "single sale to a single purchaser" requirement is not exclusive. Some states permit the sale of secured evidences of indebtedness to more than one purchaser. Some states specify the permissible number of purchasers and amount of indebtednessⁿ⁶² and may require that the pledged property be located in the state.ⁿ⁶³

Up to this point, only evidences of indebtedness secured by real property mortgages have been discussed, but the exemption provisions in most states also apply to sales of evidences of indebtedness secured by liens against tangible personal property.ⁿ⁶⁴ Illinois has a separate provision exempting evidences of indebtedness issued pursuant to conditional sales contracts.ⁿ⁶⁵ One unique provision exempts sales of evidences of indebtedness secured by the pledge of other securities.ⁿ⁶⁶ Also unique is another state's exemption for all evidences of indebtedness, secured or unsecured, when the transaction does not involve a public offering.ⁿ⁶⁷

[5] Bankruptcy, Receiver or Conservator Transactions The Uniform Act in all of its iterations, and the blue sky law in every state, exempts transactions by an executor, administrator of an estate, sheriff, marshal, receiver, trustee in bankruptcy, guardian or conservator.ⁿ⁶⁸ Although the statutory exemption encompasses transactions by certain non-issuers acting in some official capacity, the provision for transactions by bankruptcy trustees, receivers or conservators permits the offer and sale of securities directly on behalf of an issuer. In most cases the sale of securities of

an issuer by or at the direction of a bankruptcy trustee, receiver or conservator will be subject to approval of a court or administrative body responsible for establishing the supervised status of the issuer. Thus, as with securities issued in the context of reorganization proceedings, based on fairness determinations or judicial approval in accordance with section 3(a)(10) of the federal Securities Act of 1933, the offer and sale of securities by an issuer under the control of a bankruptcy trustee, receiver or conservator in connection with a court or agency supervised proceeding does not have the earmarks of a traditional distribution of securities for which the protection of registration or qualification under blue sky laws is necessary.

The exemption for transactions by bankruptcy trustees, receivers or conservators is nearly universally adopted in the form prescribed by the Uniform Act. There are, however, a few variations. New Hampshire, for example, makes an exemption available only for a sale, exchange or issuance of securities made pursuant to an order of a court of competent jurisdiction.ⁿ⁶⁹ Maine adds the requirement, perhaps otherwise implied, that transactions made in reliance on the exemption must be made by the trustee, receiver or conservator "acting in their official capacities."ⁿ⁷⁰ Ohio makes the exemption available where the sales are subject to approval by, or are made pursuant to authority granted by a court, or are "otherwise lawfully made" by the fiduciary.ⁿ⁷¹ These variations only serve to underscore the baseline premise of the exemption that the circumstances in which securities distributed by the issuer are supervised and have characteristics different from a normal distribution.

[6] Offers and Sales to Institutional or Financial Investors With few variations, blue sky laws provide an exemption for offers and sales of securities to banks, savings institutions, trust companies, insurance companies, registered investment companies, pension or profit-sharing trusts, and, in general, to other financial or institutional buyers, or to broker-dealers.ⁿ⁷² Historically, the exemption has been loosely referred to as one for "sophisticated" investors. It does not, however, encompass "accredited investor" transactions, which are treated separately in all states, and in this treatise,ⁿ⁷³ although accredited investor definitions generally include the same entities that qualify as financial and institutional investors under this exemption with the addition of qualifying individuals.

For purposes of this exemption a "person" meeting the criteria of a particular state's definition can be a "financial or institutional investor." Indeed in Maine, for example, the definition expressly provides that a person may be a financial or institutional investor, whether acting for itself or others in a fiduciary capacity.ⁿ⁷⁴ In this context, however, "person" does not include a natural person or "individual," and indeed this is made clear in the 2002 Uniform Securities Act provision set out below.

Some states broadly define "institutional investor" to include any corporation.ⁿ⁷⁵ Because of the potential for abuse of the exemption that is inherent in such a broad definition, the scope of "institutional buyer" or "institutional investor" is often limited by rule or definition so as to make clear the exemption will not be available to cover sales of securities to an entity formed for the specific purpose of buying them, or for the purposes of avoiding compliance with the registration and qualification provisions of the blue sky law. The 2002 Uniform Securities Act defines "institutional investor" by various categories based on the federal definition contained in Rule 501(a) of Regulation D under the Securities Act of 1933,ⁿ⁷⁶ and thus makes clear the intended scope of the exemption as being limited to:

1. A depository institution or international banking institution;
2. An insurance company;
3. A separate account of an insurance company;
4. An investment company as defined in the Investment Company Act of 1940;
5. A broker-dealer registered under the Securities Exchange Act of 1934;

1-8 Blue Sky Regulation § 8.03

6. An employee pension, profit-sharing, or benefit plan if the plan has total assets in excess of \$10,000,000 or its investment decisions are made by a named fiduciary, as defined in ERISA, that is a broker-dealer registered under the Securities Exchange Act of 1934, an investment adviser registered or exempt from registration under the Investment Advisers Act of 1940, an investment adviser registered under state law, a depository institution, or an insurance company;
7. A plan established and maintained by a state, political subdivision of a state, or any agency or instrumentality of a state or political subdivision of a state for the benefit of its employees, and which meets the same criteria specified in (f) above;
8. A trust, if it has total assets in excess of \$10,000,000, its trustee is a depository institution, and its participants are exclusively plans of the type identified in (f) and (g) above, regardless of the size of their assets, except a trust that includes as participants self-directed individual retirement accounts or similar self-directed plans;
9. A U.S. Internal Revenue Code section 501(c)(3) organization, corporation, Massachusetts trust or similar business trust, limited liability company, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of \$10,000,000;
- 10 A Small Business Investment Company licensed by the Small Business Administration in accordance with federal law and which has total assets in excess of \$10,000,000;
11. A private business development company as defined under the Investment Advisers Act of 1940, and having total assets in excess of \$10,000,000;
12. A federal covered investment adviser acting for its own account;
13. A "qualified institutional buyer" as defined in Rule 144 under the Securities Act of 1933;
14. A "major U.S. Investor" as defined in Rule 15a-6(b)(4)(i) under the Securities Exchange Act of 1934; and
15. Any person, other than an individual, of institutional character with total assets in excess of \$10,000,000 not organized for the specific purpose of evading the law.ⁿ⁷⁷

Financial and institutional purchasers of securities are deemed to be so knowledgeable with respect to their investments that they do not need the protection of blue sky registration provisions.ⁿ⁷⁸ The exemption applies to any offer or sale to a qualifying entity whether the purchaser is acting for itself or in some fiduciary capacity.ⁿ⁷⁹

Many states have enacted this specific provision,ⁿ⁸⁰ but even states that have adopted a comparable independent provision often designate the same investors as those named in the Uniform Securities Act.ⁿ⁸¹ It is at this point, however, that categorical breakdowns of financial and institutional investors begin to differ in Uniform Securities Act and non-Uniform Securities Act states. For example, while sales to broker-dealers are always exempt in many Non-Uniform Securities Act statesⁿ⁸² (as they are under the Uniform Securities Act),ⁿ⁸³ one provides that the exemption is applicable only if the broker-dealer is actively engaged in business.ⁿ⁸⁴ A more important difference among the statutes deals with the definition of sophisticated investors. As has already been pointed out, both Uniform Securities Act and Non-Uniform Securities Act states designate specific purchasers who are deemed sophisticated investors, and, of course, additional designations are often made.ⁿ⁸⁵ But there is a definite limit placed on categories by requiring the investor to be a financial institution or institutional investor. This limitation exists in Uniform Securities Act statesⁿ⁸⁶ and in a number of non-Uniform Securities Act states.ⁿ⁸⁷ It has been stated that such a provision is broad

enough to include as an institutional buyer a college purchasing for an endowment fund or a labor union investing surplus fundsⁿ⁸⁸ but would exclude a corporation having no further attribute indicating sophistication.ⁿ⁸⁹ The reason for the exclusion is that incorporation alone does not necessarily imply knowledge of the investment world.ⁿ⁹⁰ Nevertheless, some statutes do include corporations as sophisticated investorsⁿ⁹¹ and allow a registration exemption whenever a security is sold to a corporation.

Provisions also exist which allow the exemption for sales to any association,ⁿ⁹² corporation,ⁿ⁹³ organization,ⁿ⁹⁴ or even personⁿ⁹⁵ with substantial business activity in purchasing securities. The effect of such a provision may be to deprive purchasers of needed protection. In one case,ⁿ⁹⁶ a family association was formed to which individual members contributed money for the purpose of purchasing securities. Although none of the persons involved had any experience in dealing in securities, the group was found to be an association with substantial business dealings in securities within the meaning of the statute.ⁿ⁹⁷

Sometimes, unexpected results are the outcome of having to look to other laws to ascertain who are qualifying investors. For example, sales to insurance companies are usually exempt,ⁿ⁹⁸ but in a case where securities were sold to a fraternal benefit society, it was held that the sale was to a sophisticated investor since fraternal benefit societies were subject to the provisions of the state's insurance law.ⁿ⁹⁹ It should also be noted that the exemption applies only where the qualifying investor is the purchaser. Thus, in a case where securities were exchanged, the portion of the transaction where securities were transferred by the qualifying investor to one not qualified was not exempt from registration.ⁿ¹⁰⁰

In some states, the exemption applies not only to offers and sales of securities, but to any transfer or delivery.ⁿ¹⁰¹ The difference was deemed important in a criminal prosecution where the defendant had delivered securities to a bank. The court overruled the state's contention that the exemption applied only to securities which are sold, and held that if the legislature did not intend mere delivery to be within the exemption, the word should have been deleted from the statute.ⁿ¹⁰² One state will not allow the exemption to apply to oil, gas and mining securities unless the purchaser is knowledgeable in dealing in these specific securities.ⁿ¹⁰³ Under the laws of the states adopting the Uniform Securities Act provision,ⁿ¹⁰⁴ the purchaser may buy the securities either for itself or as trustee. This is also true under the laws of some other states,ⁿ¹⁰⁵ but if the purchaser is buying in a fiduciary capacity, he may be required to act as trustee under specific applicable law.ⁿ¹⁰⁶ Allowing purchases as trustee, however, is not the same as permitting resales to customers. This practice is specifically prohibited in two states.ⁿ¹⁰⁷

For purposes of the New York exemption, it is necessary to look at the "private offering" exemption under the Federal Securities Act of 1933.ⁿ¹⁰⁸ New Yorkⁿ¹⁰⁹ has a blanket exemption for any security exempt from the Act unless the exemption involved is for intrastate offerings.ⁿ¹¹⁰ Under the federal private offering exemption, one of the factors to be considered in determining whether an offering is public or private is the financial sophistication of the purchaser. Thus, it has been said: "An offering to 100 commercial banks is probably not public but an offering to 10 individuals including one old lady unversed in financial matters probably is."ⁿ¹¹¹ In view of the New York statute, it is probable that a similar outlook would be taken.ⁿ¹¹² Filings for the financial and institutional investor exemption are also required in certain states.ⁿ¹¹³

Issuer-Affiliated Investors. As a variant on the financial and institutional investor exemption, a few states extend qualification for an exemption based on association with the issuer. These are separate exemptions, but are based on the notion that the association with the issuer in some meaningful capacity negates the need for protection that registration or qualification would provide. Importantly, the exemption also encompasses individuals who meet the association requirements. Indiana, for example, exempts the offer, sale or issuance of corporate securities to persons employed by the issuer as a director, executive officer, administrator, manager or full time professional for at least one year.ⁿ¹¹⁴ The exemption also extends to offers, sales and issuances to such employees of any affiliate of the issuer.ⁿ¹¹⁵ Pennsylvania exempts offers and sales made by issuers to principals which, as defined, comprises officers, directors, beneficial owners of more than 10 percent of outstanding stock, persons engaged in a principal business function for the issuer and relatives of such persons.ⁿ¹¹⁶ Illinois exempts the offer or sale of securities to any director, executive officer, or

general partner of the issuer, or any director, executive officer, or general partner of a general partner of the issuer.ⁿ¹¹⁷ Indiana exempts the same persons, in addition to certain accountants, lawyers, and affiliates of the issuer and certain persons who own at least ten percent of the issuer's outstanding stock.ⁿ¹¹⁸

Pennsylvanianⁿ¹¹⁹ and Wisconsinⁿ¹²⁰ exempt securities issued by a licensed broker-dealer to its officers, partners or employees. Under regulations in both states, filings are usually required.ⁿ¹²¹ However, Pennsylvania will not require the filing if the securities are issued to a general partner or to the broker-dealer's president, secretary, treasurer or any vice-president in charge of a principal business function of the broker-dealer.ⁿ¹²² In Wisconsin, the filing is not required if the security evidences a temporary subordinated borrowing by a broker-dealer that is a member of a national securities exchange, which is made in accordance with the rules of that exchange.ⁿ¹²³

[7] Transactions With Existing Security Holders The Uniform Securities Act has an exemption for transactions with existing security holders, and most state blue sky laws track that exemption. Note, however, that the exemption is in addition to the previously discussed exclusions of certain transactions from the definitions of "offer" and "sale."ⁿ¹²⁴ The specific exemption is for any transaction pursuant to an offer to existing security holders of the issuer, including persons who at the time of the transaction are holders of convertible securities, non-transferable warrants, or transferable warrants exercisable within not more than ninety days of their issuance, provided: (1) no commission or other remuneration (other than a standby commission) is paid or given directly or indirectly for soliciting any security holder; or, if there is to be solicitation; (2) the issuer first files a notice specifying the terms of the offer and the Administrator does not by order disallow the exemption within a specified time period.ⁿ¹²⁵ The latter provision, although common in blue sky laws, is no longer viable after NSMIA in connection with exchange offers. Section 3(a)(9) of the federal Securities Act of 1933ⁿ¹²⁶ exempts exchange offers with existing security holders. Under NSMIAⁿ¹²⁷ the securities involved in transactions exempt from federal registration under section 3(a)(9) are federal "covered securities."ⁿ¹²⁸ Thus, state administrators may not impose approval requirements or otherwise subject transactions to any requirement relating to registration or qualification, the result being that the state exemption for those specific transactions is conditioned only on there being no commission or remuneration paid for solicitation. However, as discussed below in regard to filing requirements generally,ⁿ¹²⁹ states are not preempted from continuing to enforce filing and associate approval requirements when no federal section 3(a)(9) transaction is involved.

The federal exemption for transactions with existing security holders is focused specifically on exchanges by an issuer with its security holders. State exemptions, on the other hand, follow the Uniform Act approach and generally encompass any transaction involving the distribution of the securities of the issuer exclusively among its own security holders.ⁿ¹³⁰ The scope of the blue sky exemption for distributions to existing security holders produces some complexity in application, and there are divergent approaches among the states. First, the subject has been touched upon before in terms of statutory inclusions and exclusions that pertain to the definition of the terms "offer" or "sale" in blue sky laws.ⁿ¹³¹ If a particular distribution has been excluded from the definition, registration, of course, is not required. Other states may in fact relieve the same type of distribution from registration requirements by means of an exemption rather than an exclusion. While the effects of an exclusion are broader than those of an exemption, the results of both types of statutes are the same as far as registration is concerned. In the same respect, some transactions with existing security holders are deliberately retained within the definition of "sale," thus implying that registration is required.ⁿ¹³² Nevertheless, the statutes often exempt from registration transactions that are specifically designated as "sales."

More substantive complexity occurs in particular situations, such as the distribution of preemptive rights, exchanges of equity securities for debt instruments, and particular aspects of transactions involving conversions, warrants and other rights. Reorganization or reclassification transactions involving exchanges with existing holders also present certain issues. All of these are discussed more particularly below, along with procedural elements.

[a] Preemptive Rights Preemptive rights give existing corporate stockholders the right to purchase newly issued stock before the shares can be offered to non-stockholders.ⁿ¹³³ The Uniform Securities Act exemption applies to "any transaction pursuant to an offer to existing security holders of the issuer,"ⁿ¹³⁴ and is intended to encompass the

distribution of preemptive rights.ⁿ¹³⁵ Presumably, this is also the case with exemptions based on the Uniform Act. It is important to note that the exercise of preemptive rights involves the sale of securities for a cash consideration. This is quite different from an exchange of securities with existing security holders such as would occur in a conversion. It is also different from a distribution of securities such as would occur pursuant to a stock split.ⁿ¹³⁶ The draftsmen of the Uniform Securities Act indicated that an exemption for preemptive rights might be constitutionally mandated under the commerce clause.ⁿ¹³⁷ It is therefore important to consider that the exemption for transactions with existing security holders in some states applies only to exchanges of securities or new distributions of securities without monetary consideration.ⁿ¹³⁸

If the drafters of the Uniform Act were correct, then exemptions for sales in preemptive rights are implied in every state on constitutional grounds. But exemption provisions not directly or indirectly referring to cash sales with existing security holders would probably not exempt such transactions in other circumstances.ⁿ¹³⁹ Iowa, for example,ⁿ¹⁴⁰ has several exemptions involving transactions with existing security holders. One deals with exchanges of securities in reorganizations, mergers and similar transactions.ⁿ¹⁴¹ A second exempts judicially approved reorganizations where securities are exchanged for outstanding securities, claims or property interests.ⁿ¹⁴² A third exempts distributions of stock dividends.ⁿ¹⁴³ Except for transactions pursuant to judicial reorganizations in which partial cash consideration is permitted,ⁿ¹⁴⁴ the only transactions with existing security holders which may be for cash are those which involve preemptive rights and those which involve warrants and similar rights when exercised.ⁿ¹⁴⁵ Under such a statute an exemption would not be available where a corporation issued new shares and offered them strictly to previously existing shareholders in the absence of preemptive rights.

The particular focus on distributions involving preemptive rights--issuer sales to its security holders for cash--points up a more general consideration. There is a danger to the investing public in exempting cash sales to existing security holders. Consider, for example, the following situation: In 1992, X buys non-exempt stock in the ABC corporation not knowing that the stock is not registered. In 1995, the corporation issues additional shares which are offered to and purchased by X. In 1996, X brings suit against ABC corporation to recover the investment on the grounds that the sales were made in violation of the blue sky law. ABC defends the first sale on the ground that there is a two year statute of limitation on such actions under the securities act and X's suit is not timely. This is held a valid defense. X counters that the second sale is not so barred and seeks recovery as to that sale. However, in a case analogous to this situationⁿ¹⁴⁶ it was held that recovery could not be had since X had become an existing security holder by virtue of the first sale and the statute exempted sales by a corporation to its security holders. The judgment in this case seems harsh, however, especially in view of an almost simultaneous decision of another state holding that the exemption for sales to existing security holders did not apply where the original securities were sold in violation of a previously claimed exemption.ⁿ¹⁴⁷

[b] Conversions, Warrants and Other Rights A convertible security usually consists of preferred stock or a debt security which may be exchanged for the common stock of the issuer. At the time of the conversion, the securities are exchanged without additional consideration.ⁿ¹⁴⁸ A warrant is a transferable right, often attached to preferred stock or a debt security, which gives the owner the right to purchase other securities, usually stock, of the issuer. At the time the warrant is exercised, the owner keeps the preferred stock or debt security and pays an additional consideration for the securities purchased under the warrant.ⁿ¹⁴⁹ The term "warrant" is sometimes used interchangeably with "option." Apparently, the technical difference between the two is that options are purchased or received independently of any other security, they are usually non-transferable and generally run to corporate underwriters, promoters, executives and employees.ⁿ¹⁵⁰ They are also usually not evidenced by a document constituting a security, as a warrant is.

It has already been seen how exchanges of convertible securities and the exercise of rights to purchase other securities are generally considered sales under the various securities acts.ⁿ¹⁵¹ Nevertheless, such conversions or purchases pursuant to rights are usually exempt as transactions with existing security holders. Conversions, particularly, which involve no more than an exchange without other consideration, are exempt from registration in most states.ⁿ¹⁵² Warrants and other purchase rights, however, are exempt only when specified in the statute or when the statute

generally exempts sales to, as opposed to exchanges with, existing security holders.

The Uniform Securities Act exemption treats holders of non-transferable warrants as existing security holders.ⁿ¹⁵³ If, however, the warrants are transferable, they must be exercisable not more than ninety days after their date of issuance or the holders will not be considered existing security holders within the meaning of the exemption.ⁿ¹⁵⁴ This ninety-day rule for transferable warrants is a common feature of the exemption provision in many states.ⁿ¹⁵⁵ x-ref Illinois, in fact, will deny the exemption if it involves transferable purchase rights regardless of the period in which they may be exercised.ⁿ¹⁵⁶

[c] Debt Securities and Creditor Claims When securities are issued pursuant to a judicially approved reorganization they may, in most states, be exchanged not only for outstanding debt securities, but for claims and property interests in the hands of creditors.ⁿ¹⁵⁷ A few states permit similar exchanges in statutory reorganizations conducted without court approval, even to the extent of allowing partial cash consideration.ⁿ¹⁵⁸ However, outside of reorganization situations, the question arises as to whether or not the exemption for transactions with existing security holders applies to holders of outstanding debt securities or even to exchanges with holders of claims against or property interests in the issuer.

It has already been established that exchanges of convertible securities, which are often debt securities, are exempt in most states.ⁿ¹⁵⁹ Generally, in situations where securities are exchanged with existing security holders, rather than sold for cash, the statutes exempting such exchanges ordinarily extend the exemption to issuers making the exchange with holders of debt securities.ⁿ¹⁶⁰ Under a broad exemption, such as the one in the Uniform Securities Act,ⁿ¹⁶¹ there appears to be nothing to prevent the cash sale of newly issued securities to holders of debt securities, even where the new issue is of a different type of security. This is seemingly the case under most of the state exemptions.ⁿ¹⁶² However, some statutes specify the types of securities that may be outstanding for purposes of the exemption and these provisions tend to eliminate debt securities.ⁿ¹⁶³ In all these states the statutes do not treat ordinary creditors as security holders unless the exchange is pursuant to a reorganization.

[d] Reorganization and Reclassification Exchanges Where two corporations are involved in a merger or consolidation at least one of those corporations is going to disappear, and the holders of securities in the corporation which will no longer exist, unless they are bought out, will have to receive the securities of the surviving corporation in exchange for their old securities. Similarly, if corporation ABC agrees to buy all the assets of corporation XYZ in exchange for ABC's securities, the exchange is not with security holders of the ABC corporation. The California exemption for mergers, consolidations and sales of corporate assets applies to "Any exchange incident to [such transactions]," and would therefore apply to exchanges with security holders of the other corporation when other statutory conditions are met.ⁿ¹⁶⁴ This principle is applicable in many states with exemptions more liberal than California's.

In statesⁿ¹⁶⁵ that have substantially adopted the Uniform Securities Act exemption for transactions with existing securities holders,ⁿ¹⁶⁶ exchanges with the issuer's own holders would seem to be exempt in a reorganization whether one or more entities were involved. Outside of the Uniform Securities Act provision, and sometimes in addition to it,ⁿ¹⁶⁷ exemptions exist which would apply to exchanges with existing security holders in various types of reorganizations.ⁿ¹⁶⁸

Exchanges with security holders of a non-surviving corporation through a reorganization qualify for a registration exemption rather than an exclusion in other states.ⁿ¹⁶⁹ While such exchanges would probably be exempt as transactions with existing security holders in most states, California, on the other hand, has no such blanket exemption. There are a few provisions which supply an exemption for corporate reorganizations, but only under the most stringent of conditions. First, if the restructuring involves only changes within a single corporation, negotiations or agreements prior to solicitation of shareholder approval are exempt.ⁿ¹⁷⁰ Insofar as the change itself is concerned, alternate exemptions are provided. The first allows the exemption for changes in rights, preferences, privileges or restrictions on

the condition that the number of security holders of any class which will be directly or indirectly, substantially and adversely affected by the change who reside in California represent less than twenty-five percent of the total number of holders of such class or classes of outstanding securities.ⁿ¹⁷¹ The second exemption is for such changes in outstanding equity securities generally, but not if any class of shareholders is adversely affected by the change.ⁿ¹⁷² If the reorganization involves a second corporation, such as in a merger, then the exemptions which apply are only for negotiations and agreements prior to shareholder approvalⁿ¹⁷³ and for exchanges of securities where the number of security holders in California of any class adversely affected by the change is less than twenty-five percent of the total number of holders.ⁿ¹⁷⁴

[e] Commissions or Other Remuneration Commissions are generally prohibited for soliciting purchases or exchanges for a new issue of securities from among existing security holders.ⁿ¹⁷⁵ However, this prohibition is not intended to preclude compensated officers, directors and employees from selling or offering the securities. It merely prevents them from receiving additional compensation for doing so.ⁿ¹⁷⁶ The prohibition against payment of commissions also has an exception under the Uniform Securities Actⁿ¹⁷⁷ and in most states.ⁿ¹⁷⁸ When securities are sold pursuant to a rights offering in which an underwriter is working on a standby basis,ⁿ¹⁷⁹ a commission is permitted.ⁿ¹⁸⁰

[f] Filings As noted earlier, under the original Uniform Securities Act and as the exemption is currently in place in many states, a filing is required for the exemption for transactions with existing security holders if a commission, other than a standby commission, is to be paid for soliciting purchasers from among the existing security holders. However, the procedure, which also involves the opportunity for the administrator to review terms and disallow the exemption is no longer permitted after NSMIA with respect to exchange offers that are federally exempt under section 3(a)(9) of the Securities Act of 1933. For offers and sales of new or additional securities by an issuer to its existing security holders other than by way of an exchange offering, however, there is no NSMIA preemption of state authority under existing blue sky exemption requirements. States may continue to enforce advance filing and disallowance provisions for distributions to existing security holders not involving an exchange offer, and in which a commission or other remuneration is to be paid.

Other states with general exemptions for transactions with existing security holders, but which differ from the Uniform Securities Act, require filings in any case in which the exemption is claimed.ⁿ¹⁸¹ Some states require filings when securities are to be exchanged pursuant to a reorganization. Other states require the filing whenever a non-judicial reorganization will result in an exchange of securities.ⁿ¹⁸² In one state, a filing is required only in a non-corporate reorganization involving consideration of securities of another entity.ⁿ¹⁸³ Filings in a few states are required in any statutory or judicial reorganization, including stock splits,ⁿ¹⁸⁴ but in one of these states, only when commissions are paid for soliciting the transactions.ⁿ¹⁸⁵ A few states require a filing when an exemption is sought for distributing a stock dividend,ⁿ¹⁸⁶ but one state limits the requirement by requiring the filing only when the securities distributed as the dividend are of another issuer.ⁿ¹⁸⁷

[8] Reorganizations and Business Combinations In the course of a business reorganization transaction securities in the hands of existing holders are often affected. Par value of shares may be raised or lowered, voting rights may be changed, preemptive rights may be granted or extinguished or there may be any number of changes which might affect the previous investment of the holder. A reorganization of a corporation might affect the structure of only that corporation, such as through recapitalization,ⁿ¹⁸⁸ or it might affect the structure of two or more corporations, such as through merger, consolidation or sale of corporate assets. A change in the rights, preferences, privileges or restrictions of outstanding securities may be considered a sale of securities.ⁿ¹⁸⁹ Moreover, many mergers and similar transactions have since 1972 been defined as sales for purposes of the federal securities laws.ⁿ¹⁹⁰ Nearly all states provide an exemption for such transactions from blue sky registration and qualification requirements in these settings, and section 202(18) of the 2002 Uniform Securities Act today reflects the substance of all such exemptions. Section 202(18) exempts:

[a] transaction involving the distribution of the securities of an issuer to the security holders of another person in connection with a merger, consolidation, exchange of securities, sale of assets, or other reorganization to which the issuer, or its parent or subsidiary and the other person, or its parent or subsidiary, are parties.ⁿ¹⁹¹

Although the 2002 Uniform Securities Act exemption and its 1985 Revised Uniform Act predecessorⁿ¹⁹² do not explicitly require that the subject transaction be the result of security holder approval, state corporation laws control in the process and generally require shareholder approval. Likewise, articles of incorporation or corporate charters, or partnership or LLC operating agreements may contain specific provisions mandating security holder approval. Most states incorporating the exemption into blue sky laws added the express security holder approval requirement. Thus in Georgia, for example, the blue sky transaction exemption is available for:

Any transaction involving the issuance or transfer of securities of the issuer by the issuer or a subsidiary of the issuer to a corporation or its shareholders, to a business or real estate investment trust, or to the holders of beneficial interest thereof, or to a partnership or limited partnership or the partners thereof in connection with merger, share exchange, consolidation, reclassification of securities or sale or transfer of corporate, trust, or partnership assets in consideration of the issuance or transfer of such securities, where the transaction must be approved by the holders of at least a majority of the voting shares, beneficial interests, or partnership interests of such corporation, trust, or partnership pursuant to its articles or certificate of incorporation, corporate charter or trust instrument, partnership agreement, or the applicable corporation, trust or partnership statute.ⁿ¹⁹³

Some states simply exclude "act[s] incident to a class vote by stockholders" pursuant to articles of incorporation or an applicable statute from the definition of "offer" or "sale" and thus exclude those transactions from blue sky law coverage altogether.ⁿ¹⁹⁴ One of the reasons for the exclusion is that in most states the corporation law or other general statutes provide an adequate remedy for defrauded or injured security holders victimized in such transactions.ⁿ¹⁹⁵

[9] Preorganization Subscriptions In most blue sky statutes, preorganization subscriptions are specifically included within the definition of security.ⁿ¹⁹⁶ However, states have long recognized the need for some level of flexibility in the earliest stage of capital formation, and thus include an exemption for limited preorganization subscription activity. These exemptions, based on the original Uniform Act provisionⁿ¹⁹⁷ permit offers or sales of a "preorganization certificate or subscription" to a small number of persons provided that no commission or other remuneration is paid for solicitation, and that no payment is made by any subscriber. It is important to bear in mind that because of the nature of preincorporation subscriptions, this exemption, at best, only postpones registration unless the securities subscribed to can be sold pursuant to a separate exemption.ⁿ¹⁹⁸ For example, if promoters of an incipient corporation are offering preincorporation subscriptions to the stock that will be issued upon incorporation, this exemption will not apply to the stock. If another exemption applicable to the stock is not available, registration is required.ⁿ¹⁹⁹

The Uniform Securities Act exemption permits up to ten subscribers, although the number varies considerably among the states.ⁿ²⁰⁰ Regardless of the number of permitted subscribers, the availability of the exemption for preincorporation subscriptions is conditioned on there being no payment made by any of the subscribers.ⁿ²⁰¹ In one state, provision is made for holding subscription payments in escrow.ⁿ²⁰² In another, subscriptions are voidable at the will of the purchaser until organization is complete and the securities subscribed to have been registered.ⁿ²⁰³ As a general rule, there is a prohibition against the payment of commissions for soliciting buyers for preorganization subscriptions,ⁿ²⁰⁴ although there is no intention to prevent compensated directors, officers and employees from selling the subscriptions on the condition that additional compensation is not paid for any of the solicitations or sales.ⁿ²⁰⁵

The Uniform Actⁿ²⁰⁶ and the blue sky laws of most statesⁿ²⁰⁷ apply the exemption to "any offer or sale of preorganization certificate or subscription. ..." At face value, this would appear to apply to a preorganization subscription for any type of security issued by any type of organization. However, in one state having this provision,ⁿ²⁰⁸ a court interpretation limited the applicability of the exemption.ⁿ²⁰⁹ In that case it was held that the

exemption was only for "[s]ubscriptions for shares of the capital stock of a corporation prior to the incorporation thereof."²¹⁰ As a result, the subscriptions, which included subscriptions for debentures as well as capital stock, were held not to be eligible for the exemption.²¹¹ In an apparent reaction to this decision, the state legislature amended the statute to make the exemption applicable to "any offer or sale of a preorganization certificate or subscription *for any security to be issued by any person*."²¹² It would seem unlikely that such a judicial result would be reached in other states having language similar to that in the Uniform Securities Act. Where it is the intention of the exemption to limit the subscription to a particular security of a particular issuer, such stipulations are usually set forth in the statute.²¹³ Other states have individual requirements such as requiring the purchase to be for investment purposes.²¹⁴

Several states do not specifically exempt preorganization subscriptions from registration and qualification requirements.²¹⁵ Nevertheless, such subscriptions may in fact escape registration under certain conditions. One state court has ruled that preincorporation subscriptions need not be registered, at least under circumstances where all the subscribers act as promoters of the corporation and are fully informed of the nature and risks of the venture.²¹⁶ Other states have an exemption for issuance of stock to incorporators,²¹⁷ and it has been suggested that this exemption might also apply to a preincorporation subscription among such incorporators.²¹⁸ It is also likely that other limited offering exemptions would apply to preincorporation subscriptions.²¹⁹

[10] Employee Stock Purchase Programs and Other Benefit Plan Transactions Section 202(21) of the 2002 Uniform Securities Act is an amalgam of prior Uniform Act provisions and the common provisions made in blue sky laws throughout the country regarding the sale of employee benefit plan securities to plan participants. Although as a matter of law not all benefit plan interests are securities, many blue sky laws specifically address transactions involving the issuance of a security in connection with a stock bonus or other plan requiring no payment or consideration other than services.²²⁰ The 2002 Uniform Act broadly summarizes the area by providing an exemption for:

[e]mployees' stock purchase, savings, option, profit-sharing, pension, or similar employees' benefit plan, including any securities, plan interests, and guarantees issued under a compensatory benefit plan or compensation contract, contained in a record, established by the issuer, its parents, its majority-owned subsidiaries, or the majority-owned subsidiaries of the issuer's parent for the participation of their employees including offers or sales of such securities to:

- (A) directors; general partners; trustees, if the issuer is a business trust; officers; consultants; and advisors;
- (B) family members who acquire such securities from those persons through gifts or domestic relations orders;
- (C) former employees, directors, general partners, trustees, officers, consultants, and advisors if those individuals were employed by or providing services to the issuer when the securities were offered; and
- (D) insurance agents who are exclusive insurance agents of the issuer, or the issuer's subsidiaries or parents, or who derive more than 50% of their annual income from those organizations.²²¹

The 2002 Uniform Act exemption is modeled in part on Rule 701 under the federal Securities Act of 1933,²²² which establishes an exemption from federal registration requirements for offers and sales of securities pursuant to certain compensatory benefit plans and contracts relating to compensation. A number of states simply incorporate Rule 701 into a blue sky exemption for any transaction that is or would be exempt under the federal rule.²²³ Others treat employee benefit plans as exempt securities, rather than exempt transactions, which is the approach of both the original and revised Uniform Acts.

[11] Transactions by Non-Profit or Charitable Issuers Most states accommodate the issuance of securities by charitable or non-profit issuers²²⁴ with a specific exemption for *securities* of a qualifying issuer rather than a transaction exemption. This is the approach taken in the Uniform Act.²²⁵ It is also the approach under the federal securities laws, and for that reason full consideration of the exemption is undertaken in Chapter 7--Exempt Securities.

Some states, however, address sales of securities by these issuers as a transactional exemption under their blue sky laws.ⁿ²²⁶ The distinction is one of syntax, and could impact the scope of the exemption in particular settings. Whereas the more common security exemption encompasses a security "issued by" a qualifying charitable or non-profit issuer, transaction exemptions deal with the "sale of a security issued by" a qualifying issuer. However, whether treated as exempt securities or exempt transactions several states condition the availability of the exemption on advance filing, and in some cases advance approval (or failure to disallow) procedures. In some states the use of particular disclosure forms or offering materials is mandated as well.

Although not treated under the heading of non-profit or charitable issuers, a variety of blue sky transaction exemptions exist for agricultural and other cooperatives, and various types of development entities, all of which have special purposes that are significant in a particular state. In most cases particular qualifying criteria for the organization or cooperative are specified. The issuers must typically exist by reason of state law, as, for example, an agricultural cooperative organized under state law,ⁿ²²⁷ or a development corporation formed under state law for a specifically recognized economic development objective in the state. Here again, however, the availability of a transactional exemption may be subject to a claim of exemption or other specific filing and approval requirement.ⁿ²²⁸ Transaction exemptions are also increasingly being added by states to support and encourage small business and jobs creation.ⁿ²²⁹

[12] Coordinate Federal and State "Offer" Exemptions One of the early inconsistencies between federal and state securities regulation was the difference in approaches to offers during the "waiting period" under the federal Securities Act of 1933. The "waiting period" under the federal act refers to that period between the filing of a registration statement and its effective date.ⁿ²³⁰ Section 5 of the federal act, and rules adopted by the SEC under it, permit oral offers and certain types of written communications during the waiting period. State blue sky laws, on the other hand, uniformly prohibited any offer, without regard to what was permissible as a matter of federal law. As a result, so-called "red herring" prospectuses, identified by their prominent red print disclaimer of any "offer," came into use specifically for the purpose of avoiding offer prohibitions of blue sky laws that would otherwise apply. Ultimately, with the Revised Uniform Securities Act and the adoption of exemptions designed to harmonize federal and state "waiting period" procedures, the artificial "red herring" approach to dealing with blue sky laws gave way to specific exemptions in state securities laws for offers, but not sales, of securities for which a registration statement has been filed under the Securities Act of 1933, but is not yet effective. This exemption has been carried into the 2002 Uniform Act,ⁿ²³¹ evidencing the extent to which the exemption is now a part of blue sky laws.ⁿ²³² The only qualifications on the availability of the exemption for offers under these provisions are that a federal registration statement, offering statement or similar record as required by the Securities Act of 1933 has been filed; and that no stop order has been issued against the offeror by the state administrator or the federal Securities and Exchange Commission; and no audit, inspection, or proceeding that is public and that may culminate in a stop order is known by the offeror to be pending.ⁿ²³³

In effect, the exemption limits the types of offers that may be made to those permitted under the federal Securities Act. Blue sky laws do not contain any other provision allowing any other types of offers to be made prior to an effective registration. If an offer is made in violation of the types permitted by the SEC, action will be taken by federal authorities to halt the violation. Such action would affect the state offerings under the provision which bars the exemption if a federal stop or refusal order is in effect or actions toward such an order are pending. Presumably this is the case in the states that have substantially adopted the Uniform Securities Act provision,ⁿ²³⁴ and in a few other states with exemptions that seem to reach the same result through alternate language.ⁿ²³⁵

The Oregonⁿ²³⁶ and South Carolinaⁿ²³⁷ exemptions require a registration to be pending under both state and federal acts, but provide that only a state stop or refusal order, or proceedings toward such an order, may be used to halt offerings during the waiting period. Apparently, the fact that such an order or proceedings have been instigated by the SEC under the federal statute is not in and of itself sufficient to stop exempt offers in the absence of further proceedings by the respective state administrators. The exemption in Delawareⁿ²³⁸ is unusual. Under its provision, federal registration is not required. This means that the exemption for offers applies to all pending registrations under the

respective state acts including intrastate offerings. Since a pending registration with the SEC is not required, there is no reliance on the manner in which offers may be made under federal law. In lieu of such reliance, the manner in which offers may be made is prescribed.

As discussed earlier,ⁿ²³⁹ the majority of states do not make any provision for solicitations of interest prior to the filing of a registration statement or proceeding with an offering in reliance upon an exemption. Nevertheless, several states do include an exemption for offers (but not sales) when a registration statement is filed but is not yet effective under just the blue sky law.ⁿ²⁴⁰ The 2002 Uniform Securities Act recognizes the extent to which states have made this accommodation, but expressly conditions availability of the exemption on use of a solicitation of interest in compliance with such rules as may be adopted by the administrator.ⁿ²⁴¹ Other than in those states that have so far adopted the 2002 Uniform Act, there is no qualification on the availability of the "offer" exemption when a registration statement has been filed under the blue sky law.ⁿ²⁴² Thus, in the absence of particular rules the nature and scope of permitted offers once a registration statement is filed is not limited. A considerable number of states do, however, impose restrictions on the type of written offers that may be made during the "waiting period," and also almost universally impose advance submission requirements for offering or sales literature generally. The State Guides describe particular requirements applicable in each state.

[13] Coordinate "Private" Offering Exemptions Prior to the adoption of Regulation D under the federal Securities Act of 1933 and widespread implementation of the Uniform Limited Offering Exemption (ULOE) by states to coordinate with it, several states adopted an exemption for transactions not involving any "public offering" within the meaning of section 4(2) of the Securities act of 1933.ⁿ²⁴³ Conditions may be imposed. In Ohio, for example, there are limitations on the amount of aggregate commissions, discounts or other remuneration for sales in the state pursuant to the exemption, as well as notice and filing fee requirements.ⁿ²⁴⁴ Although the vast majority of "private" securities offerings today are conducted in accordance with Regulation D under the Securities Act of 1933, and the safe harbor it affords, particularly when carried out in coordination with the ULOE at the state level for offerings that are not NSMIA preempted. Nevertheless, the federal section 4(2) private offering exemption remains available without regard to Regulation D, and in those states having a specific coordinate private offering exemption it remains a meaningful alternative in capital formation.

State offering exemptions that incorporate or specifically compliment section 4(2) of the federal act independently of Regulation D are in practical terms limited offering exemptions. Thus, more detailed consideration of these coordinate private offering exemptions is undertaken in *section 8.05[3] below* as part the overall scheme of limited offering exemptions in blue sky laws.ⁿ²⁴⁵

[14] Other Coordinate State and Federal Exemptions A handful of states provide a statutory registration exemption for securities registered under the federal Securities Act of 1933.ⁿ²⁴⁶ Under the federal law, registration with the SEC is required of all securities offered or sold in interstate commerceⁿ²⁴⁷ unless such offer or sale is of an exempt securityⁿ²⁴⁸ or constitutes an exempt transactionⁿ²⁴⁹ in accordance with the statute or regulations issued pursuant to it. An exemption from federal registration may also be the trigger for a state registration exemption. New York,ⁿ²⁵⁰ for instance, relieves from state registration securities that are exempt under federal law, except for securities sold strictly in intrastate commerce.ⁿ²⁵¹ Under New York law,ⁿ²⁵² dealers are required to file a "Further State Notice" with respect to any securities they sell. This is little more than a slip of paper calling for the name of the security, the name of the issuer, the issuer's address and the place of the issuer's organization. Such a filing is usually considered more a part of dealer registration than securities registration.ⁿ²⁵³

The rest of the states are more selective in their incorporation of federal exemptions into statutory blue sky exemptions. Georgia exempts securities that are exempt under Securities Act regulations.ⁿ²⁵⁴ All of the federal exemptions, except the intrastate offering exemption and those pursuant to certain regulations, are applicable in Pennsylvania but only in certain non-issuer transactions.ⁿ²⁵⁵ However, a separate provision makes eligible for exemption all transactions in securities exempt pursuant to such previously omitted regulations, but this provision does not extend to any other

federal exemptions.ⁿ²⁵⁶ A third provision exempts certain exchanges of securities when such exchanges are exempt under the Securities Act.ⁿ²⁵⁷ Some states require a filing for the availability of the exemption.ⁿ²⁵⁸

FOOTNOTES:

(n1)Footnote 1. The general subject of "offers" and "sales" of securities under blue sky laws, and more detailed consideration of statutory exclusions from the key definitions, are presented in Chapter 3, *supra*, and § 3.03 in particular.

(n2)Footnote 2. *See, e.g., Ark. Code § 23-42-102(13)(B).*

(n3)Footnote 3. The key definitions in the 2002 Uniform Act reflect what is found in every state definition:

"Sale" includes every contract of sale, contract to sell, or disposition of, a security for value, and "offer to sell" includes every attempt to offer to dispose of, or solicitation of an offer to purchase, a security or interest in a security for value. 2002 Unif. Sec. Act § 102(26).

(n4)Footnote 4. Del. Code Ann. § 7302(11)d.

(n5)Footnote 5. *See* 2002 Unif. Sec. Act §§ 202 (18), (22).

(n6)Footnote 6. *See, e.g.:*

California: Cal. Corp. Code § 25017(f)(2).

Florida: Fla. Stat. Ann. § 517.061(4), (6).

Idaho: Idaho Code § 30-1435(1)(M).

Indiana: Ind. Code § 23-2-1-1(i)(8)(ii).

Massachusetts: Mass. Gen. Laws Ann., Ch. 110A, § 401(i)(6)(B).

Michigan: Mich. Comp. L. § 451.801(j)(6)(B).

Minnesota: Minn. Stat. Ann. §§ 80A.17(6)(ii).

Missouri: Mo. Ann. Stat. § 409.401(jm)(6).

Pennsylvania: 70 Pa. Stat. Ann. § 1-102(v)(vii)(B), 1-203(q).

Texas: Tex. Rev. Civ. Stat., Art 581-5(D).

(n7)Footnote 7. *See* Unif. Sec. Act § 401(j)(6)(B); Rev. Unif. Sec. Act § 101(13)(vi).

(n8)Footnote 8. *Cal. Corp. Code § 25017(f).*

(n9)Footnote 9. *See also* Cal. Code Regs. § 260.017(b).

(n10)Footnote 10. Cal. Code Regs. § 260.017(a) ("The term 'stock dividend'... means the issuance of additional shares (including treasury shares) of the issuer to its existing shareholders...."); *see also* Pennsylvania: 70 Pa. Stat. § 1-102(r)(vii), (viii); Colorado: Colo. Rev. Stat. § 11-51-201(13)(h) (Terms do not include any dividend payable by an

issuer only in its own securities); *Ohio: Ohio. Rev. Code § 1707.03(K)(1)* (The distribution by a corporation of its securities to its security holders as a share dividend is exempt).

Further nuances in the treatment of stock dividends among the sates are addressed in § 3.03[2], *supra*

(n11)Footnote 11. *See, e.g.,*

Alaska: Alaska Stat. § 45.55.900(b)(13).

California: Cal. Corp. Code § 25103(f); Cal. Code Regs. tit. 10, § 260.103.2.

Idaho: Idaho Code § 30-1435(1)(n).

Minnesota: Minn. Stat. Ann. § 80A.15(2)(n).

Montana: Mont. Rev. Code Ann. § 30-10-105(14).

Nebraska: Neb. Rev. Code § 8-1111(14).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17(II)(n).

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(q).

Texas: Securities Rule 065.05.00.004.

Virginia: Va. Code Ann. § 13.1-514(B)(15).

Washington: Wash. Rev. Code § 21.20.320(14).

Wisconsin: Wis. Stat. Ann. § 551.23(14).

(n12)Footnote 12. Unif. Sec. Act § 401(j)(6)(B).

(n13)Footnote 13. The California Corporation Commissioner has, for example, opined that a stock dividend will be deemed to be a sale of securities if there is more than one class of voting stock because it changes the rights, preferences, privileges or restrictions of or on other outstanding securities. *See Cal. Code Regs. § 260.017.*

(n14)Footnote 14. The states listed below all have exemption provisions substantially based on Uniform Securities Act § 402(b)(11). Some of the provisions vary as to wording but the meaning is probably the same.

Alaska: Alaska Stat. § 45.55.900(b)(7).

Arkansas: Ark. Stat. Ann. § 23-42-504(a)(10).

Colorado: Colo. Rev. Stat. § 11-51-308(1)(l).

Connecticut: Conn. Gen. Stat. Ch. 662 § 36b-21(b)(11).

Delaware: 6 Del. Code Ann. § 7309(b)(11).

Hawaii: Haw. Rev. Stat. Ann. § 485-6(11).

Idaho: Idaho Code § 30-1435(1)(k).

Indiana: Ind. Code § 23-2-1-2(b)(11).

Kansas: Kan. Gen. Stat. Ann. § 17-1262(h).

Kentucky: Ky. Rev. Stat. Ann. § 292.4101(k).

Maryland: Md. Code Ann. § 11-602(11).

Massachusetts: Mass. Gen. Laws Ann., Ch. 110A, § 402(b)(11).

Michigan: Mich. Comp. L. § 451.802(b)(11).

Mississippi: Miss. Code Ann. 75-71-203(12).

Missouri: Mo. Ann. Stat. § 409.402(b)(11).

Montana: Mont. Rev. Code Ann. § 30-10-105(10).

Nebraska: Neb. Rev. Code § 8-1111(11).

New Hampshire: N.H. Rev. Code Ann. § 421-B:17(II)(p).

New Jersey: N.J. Stat. Ann. § 49:3-50(b)(11).

New Mexico: N.M. Stat. Ann. § 58-13B-27(N).

North Carolina: N.C. Gen. Stat. § 78A-17(11).

Oklahoma: 71 Okla. Stat. § 401(b)(12).

South Carolina: S.C. Rev. Stat. § 35-1-320(11).

Utah: Utah Code Ann. § 61-1-14(2)(j).

Virginia: Va. Code Ann. § 13.1-514(B)(8).

Washington: Wash. Rev. Code § 21.20.320(11).

West Virginia: W. Va. Code Ann. § 32-4-402(b)(11).

Wyoming: Wyo. Stat. Ann. § 17-4-114(b)(xi).

(n15)Footnote 15. According to a staff opinion of the Wisconsin Commissioner of Securities, a 1-for-3000 reverse stock split designed to squeeze out minority shareholders did not qualify as a "reclassification of securities" eligible for exemption from registration. However, the staff said the transaction might qualify for the exemption for offers to

existing security holders. Monthly Bulletin, June, 1979, Wisconsin Office of Commissioner of Securities, 3 CCH Blue Sky L. Rep. P 64,882 (1979).

An analogous problem can occur in an ordinary stock split situation. Consider the example in which X buys shares in a close corporation, the stock of which is then split ten for one. Several other share holders thereafter start selling shares in exempt transactions (i.e. an isolated transaction). It is also conceivable that some of these buyers will resell some of their shares. Before long what once was a private corporation is now, at a minimum, semi-public and X's voice in corporate management is severely watered down. The difference between this and a reverse stock split, however, is considerable. The blue sky laws are generally for the protection of the purchaser of securities. As discussed above, the terms "offer" and "sale" do not ordinarily include offers to buy. Further, unsolicited offers to purchase securities are often exempt. See ch. 9 *infra*. It is therefore easier for a corporation to "buy up" its securities either outright or through a reverse stock split than it is for a number of shareholders to dispose of their shares through exempt transactions. In the situation of X, it is presumed that even if the selling shareholders are required to register the securities, the administrator would examine the circumstances to see if the purpose of the split was to the detriment of X.

(n16)Footnote 16. See *Cal. Corp. Code § 25103(f)*.

(n17)Footnote 17. *Id.*

(n18)Footnote 18. *Cal. Code Regs. § 260.103.4*.

(n19)Footnote 19. See also *Cal. Corp. Code § 25103(f)*.

(n20)Footnote 20. *Id.*

(n21)Footnote 21. *Unif. Sec. Act § 401(j)(6)(b)*.

(n22)Footnote 22. *11 U.S.C. § 1101 et seq.*

Blue sky law provisions governing the registration of securities and the registration or licensing of an issuer of, underwriter of, or broker-dealer in, securities do not apply to transactions in bankruptcy-related securities covered by Title 11 of the Bankruptcy Code. See *11 U.S.C. § 1145*.

(n23)Footnote 23. *Unif. Sec. Act § 401(j)(6)(D); Rev. Unif. Sec. Act § 101(13)(vi)*.

(n24)Footnote 24. See, e.g.:

California: Cal. Corp. Code § 25017(f)(3).

Hawaii: Haw. Rev. Stat. Ann. § 485-1(11)(F)(iv).

Indiana: Ind. Code § 23-2-1-1(i)(8)(iii).

Maryland: Md. Code, Ann. § 11-102(a)(3).

Massachusetts: Mass. Gen. Stat. Ann., Ch. 110A, 401(i)(6)(D).

Michigan: Mich. Comp. L. § 451.801(j)(6)(B).

Missouri: Mo. Ann. Stat. § 409.401(m)(6)(D).

New Jersey: N.J. Stat. Ann. § 49:3-49(j)(6)(iv).

Oregon: Or. Rev. Stat. § 59.015(17)(b)(C).

South Carolina: S.C. Rev. Stat. § 35-1-20(13)(f)(iv).

Tennessee: Tenn. Code Ann. § 48-2-10211(F)(viii).

Utah: Utah Code Ann. § 61-1-13(22)(d)(vi).

West Virginia: W. Va. Code Ann. § 32-4-401(l)(6)(D).

Wyoming: Wyo. Stat. Ann. § 17-4-113(a)(ix)(F)(IV).

See also Pennsylvania: Interp. Op. January 19, 1988, Blue Sky L. Rep. (CCH) P 48,679I, taking a no-action position on the sale of the issuer's stock out of a Chapter 11 reorganization. The requesting letter relies on 70 Pa. Stat. Ann. § 1-203(k), exempting "[a]ny judicial sale or any transaction by ... [a] trustee in bankruptcy."

(n25)Footnote 25.

Nevada: Nev. Rev. Stat. §90.280(6)(c).

(n26)Footnote 26. *See, e.g.,*

Florida: Fla. Stat. Ann. § 517.061(1).

Iowa: Iowa Code § 502.203(16).

North Dakota: N.D. Cent. Code § 10-04-06(6).

Wisconsin: Wis. Stat. Ann. § 551.23(13).

(n27)Footnote 27. 2002 Unif. Sec. Act § 202(22)(B).

(n28)Footnote 28. "Value" elements of a transaction that bear upon whether an offer or sale of securities within the coverage of blue sky laws is actually involved are discussed in more detail in Chapter 3, *supra*.

(n29)Footnote 29. *See, e.g.:*

Alaska: Alaska Stat. § 45.55.900(13).

Idaho: Idaho Code § 30-1435(1)(n).

Kentucky: Ky. Rev. Stat. Ann. § 292.410(1)(n).

Nebraska: Neb. Rev. Code § 8:1111(14).

Virginia: Va. Code Ann. § 13.1-514(B)(15).

Washington: Wash. Rev. Stat. § 21-20.320(14).

See also:

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17(II)(e).

Illinois: Ill. Comp. Stats., ch. 815, § 5/4(J).

Ohio: Ohio Rev. Code Ann. § 1707.03(L).

California: Cal. Corp. Code § 25102(k).

Massachusetts: Mass. Regs. Code tit. 950, § 14.402(B)(13)(e). The Massachusetts exemption applies only to securities issued under a Chapter 11 proceedings.

(n30)Footnote 30. Ill. Comp. Stats., ch. 815, § 5/4(J).

(n31)Footnote 31. Ohio Rev. Code Ann. § 1707.03(L).

(n32)Footnote 32.

California: Cal. Corp. Code § 25102(k).

Massachusetts: Mass. Regs. Code tit. 950, § 14.402(B)(13)(e). The Massachusetts exemption applies only to securities issued under a Chapter 11 proceedings.

(n33)Footnote 33. 15 U.S.C. § 77c(10). Section 3(a)(10) of the federal Act exempts:

[A]ny security which is issued in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash, where the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court, or by any official or agency of the United States, or by any State or Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval.

Section 202(9) of the 2002 Uniform Securities Act, supplies the "governmental authority" for a fairness determination by a state securities administrator, upon which the federal exemption operates.

(n34)Footnote 34. See Ohio Rev. Code § 1707.04.

(n35)Footnote 35. See Rapp, "The Interface Between Securities Act 3(a)(10) and Ohio Revised Code § 1707.04: Utilitarian Considerations for Ohio Mergers and Corporate Reorganization Transactions," 27 *Cleveland St.L.Rev.* 1 (1978) (Discussing the "rediscovery" of the federal section 3(a)(10) exemption in states having the requisite authority to make fairness determinations in covered transactions).

(n36)Footnote 36. 2002 Unif. Sec. Act § 202(9).

(n37)Footnote 37.

Missouri: See, e.g. Mo. Rev. Stat. §409.2-202(9).

(n38)Footnote 38. *15 U.S.C. § 77b(a)(3).*

(n39)Footnote 39. Draftmen's commentary to Unif. Sec. Act. § 402(b)(4), Loss & Cowett, Blue Sky Law 365, 366 (1958).

(n40)Footnote 40. *Id.*

(n41)Footnote 41. Unif. Sec. Act. § 402(b)(4).

(n42)Footnote 42. *See, e.g.:*

Alabama: Ala. Code § 8-6-11(a)(4).

Alaska: Alaska Stat. § 45.55.900(b)(1).

Arkansas: Ark. Stat. Ann. § 23-42-504(a)(3).

Colorado: Colo. Rev. Stat. § 11-51-308(1)(d).

Connecticut: Conn. Gen. Stat., Ch. 662, § 36-b-21(b)(4).

Delaware: 6 Del. Code Ann. § 7309(b)(4).

Hawaii: Haw. Rev. Stat. Ann. § 485-6(4).

Idaho: Idaho Code § 30-1435(1)(e).

Indiana: Ind. Code § 23-2-1-2(b)(4).

Iowa: Iowa Code § 502.203(4).

Kentucky: Ky. Rev. Stat. Ann. § 292.410(1)(d).

Maine: 32 Me. Rev. Stat. Ann. § 105022E.

Maryland: Md. Code Ann. § 11-602(4).

Massachusetts: Mass. Gen. Laws Ann., Ch. 110A, § 402(b)(4).

Michigan: Mich. Comp. L. § 451.802(b)(4).

Minnesota: Minn. Stat. Ann. § 80.15(2)(m).

Mississippi: Miss. Code Ann. § 75-71-203(4).

Missouri: Mo. Ann. Stat. § 409.402(b)(4).

Montana: Mont. Rev. Code Ann. § 30-10-105(4).

Nebraska: Neb. Rev. Code § 8-1111(4).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17(II)(m).

New Jersey: N.J. Stat. Ann. § 49:3-50(b)(4).

New Mexico: N.M. Stat. Ann. § 58-13B-27(E).

North Carolina: N.C. Gen. Stat. § 78A-17(4).

Oklahoma: 71 Okla. Stat. § 401(b)(5).

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(g).

South Carolina: S.C. Rev. Stat. § 35-1-320(4).

Texas: 7 Tex. Admin. Code § 139.8.

Utah: Utah Code Ann. § 61-1-14(b)(d).

Washington: Wash. Rev. Code § 21.20.320(4).

West Virginia: W. Va. Code Ann. § 32-4-402(b)(4).

Wisconsin: Wis. Stat. Ann. § 551.23(4).

Wyoming: Wyo. Stat. Ann. § 17-4-114(b)(iv).

(n43)Footnote 43. Loss & Cowett, Blue Sky Law 365, 366 (1958).

In a comment written prior to popular adoption of the Uniform Securities Act, the draftsmen stated:

The exemption is not spelled out as such in the present statutes, but it is usually read in as a matter of necessity. Since the terms of the offering must be disclosed in registering, it must be contemplated that the issuer or other person who proposes to make an offering may negotiate with prospective underwriters, and that the prospective underwriters may negotiate among themselves, before registration.

(n44)Footnote 44.

California: Cal. Corp. Code § 25102(d).

(n45)Footnote 45.

Kansas: Kan. Gen. Stat. Ann. § 17-1262(f).

(n46)Footnote 46.

New York: N.Y. Gen. Bus. L. § 359-ff(5)(b).

(n47)Footnote 47. *15 U.S.C. § 77c(a)(11).*

(n48)Footnote 48. Unif. Sec. Act § 402(b)(5). The exemption is for:

any transaction in a bond or other evidence of indebtedness secured by a real or chattel mortgage or deed of trust, or by an agreement for the sale of real estate or chattels, if the entire mortgage, deed of trust, or agreement, together with all the bonds or other evidences of indebtedness secured thereby, is offered and sold as a unit. ...

See also 15 U.S.C. § 77d(5) for a comparable but more restrictive exemption under the Securities Act of 1933.

The Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689 (1984), preempted state securities laws dealing with registration of mortgage-backed securities. Section 106 of the Act provided that offerings of mortgage-backed securities that are exempt under federal securities laws are also exempt from the registration requirements of state blue sky laws. Also, state-chartered and state-regulated financial institutions, insurance companies, pension funds, trustees, or other regulated entities were permitted to purchase, hold, or invest in investment-grade mortgage-backed securities to the same extent that they were authorized to purchase, hold, or invest in obligations issued or guaranteed by the United States or any of its agencies or instrumentalities. The law gave states the option to override the preemption if they enacted appropriate legislation before October 3, 1991.

(n49)Footnote 49. *Id.*

(n50)Footnote 50.

Alabama: Ala. Code. § 8-6-11(a)(5).

Alaska: Alaska Stat. § 45.55.900(b)(2).

Arkansas: Ark. Stat. Ann. § 23-42-504(a)(4)

Arizona: Ariz. Rev. Stat. § 44-1844A.20.

Colorado: Colo. Rev. Stat. § 11-51-308(1)(e).

Connecticut: Conn. Gen. Stat. Ch. 662 § 36-b-21(b)(5).

Delaware: 6 Del. Code Ann. § 7309(b)(5).

Hawaii: Haw. Rev. Stat. Ann. § 485-6(5).

Idaho: Idaho Code § 30-1435(1)(o).

Indiana: Ind. Code § 23-2-1-2(b)(5).

Kansas: Kan. Gen. Stat. Ann. § 17-1262(d).

Kentucky: Ky. Rev. Stat. Ann. § 292.410(1)(e).

Maryland: Md. Code Ann. § 11-602(5).

Massachusetts: Mass. Gen. Laws Ann. Ch. 110A § 402(b)(5).

Michigan: Mich. Comp. L. § 451.802(b)(5).

Mississippi: Miss. Code Ann. § 75-71-203(5).

Missouri: Mo. Ann. Stat. § 409.402(b)(5).

Nebraska: Neb. Rev. Code § 8-1111(5).

New Jersey: N.J. Stat. Ann. § 49-3-50(b)(5).

New Mexico: N.M. Stat. Ann. § 58-13B-27(E).

North Carolina: N.C. Gen. Stat. § 78A-17(5).

Oklahoma: 71 Okla. Stat. § 401(b)(6).

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(j).

Cf. Securities Rule 202.092 (exempt guarantees of debt securities).

South Carolina: S.C. Rev. Stat. § 35-1-320(5).

Utah: Utah Code Ann. § 61-1-14(2)(e).

Washington: Wash. Rev. Code § 21.20.320(5).

West Virginia: W. Va. Code Ann. § 32-4-403(b)(5).

Wisconsin: Wis. Stat. Ann. § 551.23(4).

Wyoming: Wyo. Stat. Ann. § 17-4-114(b)(v).

(n51)Footnote 51. Official comment to Unif. Sec. Act § 402(b)(5), Loss & Cowett, Blue Sky Law 366 (1958) ("This exemption is severely restricted by the requirement that everything be both offered and sold as a unit. But it permits a *public* offering as a unit.").

(n52)Footnote 52.

Pennsylvania: 64 Pa. Code § 203.101.

(n53)Footnote 53. *Id.* See § 8.04 *supra* for a discussion of exempt transactions with institutional investors.

(n54)Footnote 54.

Georgia: Ga. Code Ann. § 10-5-8(10) ("Notes issued in connection with the acquisition of real or personal property or renewals thereof, if such notes are issued to the sellers of and are secured by all or part of the real or personal property so acquired.").

This provision differs from the Uniform Securities Act's, but its intent is probably similar. See the Opinion of the Georgia Attorney General, No. 74-153 (1974), where it is stated:

Since Section [10-5-8] of the Act designates "exempt securities" subsection [10-5-8(10)] exempts from registration not only the original mortgage transaction, but any subsequent transaction in the security created thereby. A mortgage thus continues to maintain its exemption from registration no matter how many times it is bought, sold or traded, and, so long as the mortgage being sold remains within the description of Section[10-5-8(10)], there is no requirement for registration.

If, however, the broker sells mortgages in such a way that they become investment contracts, the Section[10-5-8(10)] exemption is not available. Section [10-5-8(10)] exempts only the mortgage; it does not provide an exemption for an investment contract, one of the elements of which is an exempt mortgage.

In summary, it is my opinion that sales of mortgages described in Section [97-108(j)] of the Act are exempt from the registration requirement of Section 5 of the Act, but mortgage offerings which are structured or promoted in such a way that they become investment contracts must be registered pursuant to Section 5 unless they qualify for some exemption from registration other than Section [97-108(j)].

(n55)Footnote 55.

Minnesota: Minn. Stat. Ann. § 80A.15(2)(d).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17(II)(d).

(n56)Footnote 56.

Nebraska: Neb. Rev. Code § 8-1111(5).

(n57)Footnote 57.

Missouri: Mo. Code Regs. Ann. tit. 15, § 30-54.120(i).

(n58)Footnote 58.

Pennsylvania: 64 Pa. Code § 203.101.

(n59)Footnote 59.

Florida: Fla. Stat. Ann. § 517.061(10).

Iowa: Code § 502.203.5.

(n60)Footnote 60.

California: Cal. Corp. Code § 25102.5.

Iowa: Iowa Code § 502.203.5.

Louisiana: La. Rev. Stat. Ann. § 51:709(16).

Ohio: Ohio Rev. Code Ann. § 1707.03(h).

Oregon: Or. Rev. Stat. § 59.035(7)

South Dakota: S.D. Comp. L. § 47-31-A-402(b)(5).

Texas: Tex. Rev. Civ. Stat., Art. 581-5(J).

Virginia: Va. Code Ann. § 13.1-514(B)(4).

(n61)Footnote 61.

Vermont: 9 Vt. Stat. Ann. § 4204a(6).

(n62)Footnote 62.

Illinois: Ill. Comp. Stat. Ch. 815 § 513(J).

The first section refers to not more than ten bonds or notes secured by a first mortgage if the aggregate principal amount does not exceed \$500,000 and 75% of the fair market value of the property; the second section refers to not more than ten bonds or notes secured by a junior mortgage lien if the aggregate principal amount of the indebtedness does not exceed 50% of the amount of the outstanding prior lien and 90% of the fair market value of the property secured.

(n63)Footnote 63. *See Va. Code Ann. § 13.1-514(B)(12).*

(n64)Footnote 64. Unif. Sec. Act § 402(b)(5).

(n65)Footnote 65.

Illinois: Ill. Comp. Stats., ch. 815, § 5/3(I).

(n66)Footnote 66.

Texas: Tex. Rev. Civ. Stat., Art. 581-6(I).

(n67)Footnote 67.

California: Cal Corp. Code § 25102(e).

The exemption is available only to issuers or guarantors of the security. The exemption is unique in its wording only. The limited offering exemption in other states would probably cover this situation. Limited offerings are discussed in §8.06, *infra*.

Cal. Code Regs. tit. 10, § 260-102.2 describes non-public offering and sale for purposes of this exemption.

See Cal. Code Regs. tit. 10, § 260.102.3, which defines "evidence of indebtedness" for exemption purposes.

See also Cal. Code Regs. tit. 10, § 260.105.34, which provides an exemption for any evidence of indebtedness, whether secured or unsecured, that has been rated as an "investment grade security" by Standard and Poor's or Moody's Investment Service.

(n68)Footnote 68. See 2002 Unif. Sec. Act § 202(12).

(n69)Footnote 69. *N.H. Rev. Stat. Ann. § 421-B:17 (II)(e)*.

(n70)Footnote 70. *Me. Rev. Stat. Ann. § 10502(2)(G)*.

(n71)Footnote 71. *Ohio Rev. Code § 1707.03(C)*.

(n72)Footnote 72. Michigan is typical in providing this exemption for:

An offer or sale to a bank, savings institution, trust company, insurance company, investment company as defined in the Investment Company Act of 1940, the federal national mortgage association, the federal home loan mortgage corporation, or the government national mortgage association, pension or profit-sharing trust the assets of which are managed by an institutional manager, the treasurer of this state, other financial institution, broker-dealer, whether the purchaser is acting for itself or in some fiduciary capacity, or a lender approved by the federal housing administration and who has satisfied any additional requirements established by the administrator by rule or order. *Mich. Comp. Laws § 451.802(b)(8)*.

Some variations involve specific conditions or qualifications on the size of the permitted purchaser. Maryland, for example, qualifies availability of the exemption for sales to investment advisers with assets under management of at least \$1 million, and also to employee benefit plans with assets not less than \$1 million. See *Ann. Code Md. § 11-602(8)*.

(n73)Footnote 73. See "Offers and Sales to Accredited Investors," § 8.05, *infra* .

(n74)Footnote 74. *Me. Rev. Stat. Ann. § 10501(4)*.

(n75)Footnote 75.

Ohio: See, e.g., Ohio Rev. Code § 1707.01(S).

(n76)Footnote 76. See 2002 Unif. Sec. Act § 102(11)(A)-(K).

(n77)Footnote 77. 2002 Unif. Sec. Act § 102(11).

States imposing a minimum financial requirements on qualifying entities vary in amounts required, *see, e.g., Tennessee: Tenn. Code Ann. § 48-2-102(9)* (minimum \$1 million net worth requirement); *Massachusetts: Code. Mass. Regs. § 14.401* (\$5 million total assets unless entity meets certain other criteria); *Maine: Me. Rev. Stat. § 10501(4)* (\$1 million or \$5 million total assets depending on type of entity).

(n78)Footnote 78. Draftmen's commentary to Unif. Sec. Act § 402(b)(8). ("The obvious justification for this exemption is that institutional investors and broker-dealers are 'sophisticated' buyers who do not need the protection of registration. At the same time, they do have the protection of the antifraud provisions. ...").

(n79)Footnote 79. *Id.*

(n80)Footnote 80. *See, e.g.:*

Alabama: Ala. Code § 8-6-11(a)(8).

Alaska: Alaska Stat. § 45.55.900(b)(4).

Delaware: 6 Del. Code Ann. § 7309(b)(8).

Indiana: Ind. Code § 23-2-1-2(b)(8).

Iowa: Iowa Code § 502.203(8).

Kentucky: Ky. Rev. Stat. Ann. § 292.4101(h).

Maine: Me. Rev. Stat. Ann. tit. 32, § 10502.

Maryland: Md. Code Ann. § 11-602(8).

Massachusetts: Mass. Gen. Laws Ann., Ch. 110A, § 402(b)(8).

Michigan: Mich. Comp. L. § 451.802(b)(8).

Minnesota: Minn. Stat. Ann. § 80A.15(2)(g).

Mississippi: Miss. Code Ann. § 75-71-203(8).

Montana: Mont. Rev. Code Ann. § 30-10-105(7).

Nebraska: Neb. Rev. Code § 8-1111(8).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17(II)(g).

New Jersey: N.J. Stat. Ann. § 49:3-50(b)(8).

New Mexico: N.M. Stat. Ann. § 58-13B-27(I).

Oklahoma: 71 Okla. Stat. § 401(b)(9).

South Carolina: S.C. Rev. Stat. § 35-1-320(8).

Utah: Utah Code Ann. § 61-1-14(2)(h).

Washington: Wash. Rev. Code § 21-20.320(8).

West Virginia: W. Va. Code Ann. § 32-4-402(b)(8).

Wyoming: Wyo. Stat. Ann. § 17-4-114(b)(viii).

(n81)Footnote 81.

Arizona: Ariz. Rev. Stat. Ann. § 44-1844(8).

California: Cal. Corp. Code §§ 25102(i), 25104(c).

Florida: Fla. Stat. Ann. § 517-061(7).

Illinois: Ill. Comp. Stat. Ch. 815, Sec. 4[514]C.

Illinois has a specific sophisticated investor exemption for sales of oil, gas or mineral lease interests which covers, among other investors, an association that purchases this type of interest "in frequent operations, for its own account." Ill. Rev. Stat. Sec. 4 [514]O. The "frequent operations" clause, according to the Seventh Circuit, refers to operations that have actually occurred, not merely the authorization of frequent operations by the association's charter. *McConnell v. Surak*, Blue Sky L. Rep. (CCH) P 72,306 (7th Cir. 1985).

Kansas: Kan. Gen. Stat. Ann. § 17-1262(f).

Louisiana: La. Rev. Stat. Ann. § 51:709(7).

North Carolina: N.C. Gen. Stat. § 78A-17(8).

North Dakota: N.D. Cent. Code § 10-04-06(5).

Oregon: Or. Rev. Stat. § 59.035(4). In addition, Oregon has an exemption for transactions with accredited investors as defined in § 2(15)(i) of the Federal Securities Act of 1933 or rules of the Commissioner. Or. Rev. Stat. § 59.035(5). See Securities Rule § 441-35-010.

Rhode Island: R.I. Rev. L. Ann. § 7-11-402(9).

South Dakota: S.D. Comp. L. § 47-31-A-402(b)(8).

Tennessee: Tenn. Code Ann. § 48-2-103(b)(3), § 48-2-102(6) (definition of "institutional investor").

Texas: Tex. Rev. Civ. Stat., Art. 58-1-5(H).

Wisconsin: Wis. Stat. Ann. § 551.23(8).

Wisconsin has excluded Keogh plans and individual retirement accounts from the sophisticated investor exemption unless they are administered by a qualifying institution that has investment control. *Id.* (c).

(n82)Footnote 82. Note that the term "broker-dealer" is used here broadly. Not all states apply it under their securities laws, opting instead for the single word "broker" or "dealer". General discussion of state licensing requirements for broker-dealers can be found in ch. 11 *infra*.

Arizona: Ariz. Rev. Stat. Ann. § 44-1844(8).

California: Cal. Code Regs. tit. 10, § 260.105.2.

Florida: Fla. Stat. Ann. § 517.0761(7).

Illinois: Ill. Comp. Stat. Ch. 815 Sec. 4[514]C.

Kansas: Kan. Gen. Stat. Ann. § 17-1262(f).

North Carolina: N.C. Gen. Stat. § 78A-17(8).

Ohio: Ohio Rev. Code Ann. § 1707.03(D).

Oregon: Or. Rev. Stat. § 59.035(4).

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(c).

Rhode Island: R.I. Rev. L. Ann. § 7-11-402(9).

South Dakota: S.D. Comp L § 47-31A-402(b)(8).

Tennessee: Tenn. Code Ann. § 48-2-103(b)(3).

Virginia: Va. Code Ann. § 13.1-514(B)(6).

Wisconsin: Wis. Stat. Ann. § 551.23(8).

(n83)Footnote 83. Unif. Sec. Act § 402(b)(8).

(n84)Footnote 84.

Texas: Tex. Rev. Civ. Stat. art. 581-5(H).

See also the following Texas cases holding that the main course of business requirement is crucial if the exemption is to apply: *Development Investment Corporation v. Diversa, Inc.*, 393 S.W.2d 653 (Tex. Ct. App. 1965) ; *Dunnam v. Dillingham*, 345 S.W.2d 314 (Tex. Civ. App. 1961) ; *Gerchsheimer v. American Heritage Bank and Trust Co.*, 437 F.2d 1332 (10th Cir. [Tex.] 1971).

(n85)Footnote 85. The statutes and regulations of the individual states should be consulted to determine who qualifies as a "sophisticated" or "institutional" investor.

(n86)Footnote 86. See, e.g.:

Alabama: Ala. Code § 8-6-11(a)(8).

Alaska: Alaska Stat. § 45.55.900(b)(4).

Delaware: 6 Del. Code Ann. § 7309(b)(8).

Indiana: Ind. Code § 23-2-1-2(b)(8).

Iowa: Iowa Code § 502.203(8).

Kentucky: Ky. Rev. Stat. Ann. § 292.4101(L).

Maine: Me. Rev. Stat. Ann. tit. 32, § 105022I.

Maryland: Md. Code Ann. § 11-602(8).

Massachusetts: Mass. Gen. Laws Ann., Ch. 110A, § 402(b)(8).

Michigan: Mich. Comp. L. § 451.802(b)(8).

Minnesota: Minn. Stat. Ann. § 80A.15(2)(g).

Mississippi: Miss. Code Ann. § 75-71-203(8).

Montana: Mont. Rev. Code Ann. § 30-10-105(7).

Nebraska: Neb. Rev. Code § 8-1111(8).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17(II)(g).

New Jersey: N.J. Stat. Ann. § 49:3-50(b)(8).

New Mexico: N.M. Stat. Ann. § 58-13B-27(I).

Oklahoma: 71 Okla. Stat. § 401(b)(9).

South Carolina: S.C. Rev. Stat. § 35-1-320(8).

Utah: Utah Code Ann. § 61-1-14(2)(h).

Washington: Wash. Rev. Code § 21-20.320(8).

West Virginia: W. Va. Code Ann. § 32-4-402(b)(8).

Wyoming: Wyo. Stat. Ann. § 17-4-114(b)(viii).

(n87)Footnote 87. *See, e.g.:*

California: Cal. Corp. Code §§ 25102(i), 25104(c).

Kansas: Kan. Gen. Stat. Ann. § 17-1262(f).

Oregon: Or. Rev. Stat. § 59.035(4). In addition, Oregon has an exemption for transactions with accredited investors as defined in § 2(15)(i) of the Federal Securities Act of 1933 or rules of the Commissioner. *Or. Rev. Stat. § 59.035(5).* *See* Securities Rule § 441-35-010.

Rhode Island: R.I. Rev. L. Ann. § 7-11-402(9).

South Dakota: S.D. Comp. L. § 47-31-A-402(b)(8).

Wisconsin: Wis. Stat. Ann. § 551.23(8).

See also:

Ohio: Ohio Rev. Code Ann. § 1707.03(D).

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(c).

(n88)Footnote 88. Official comment to Unif. Sec. Act § 1-203(c).

The term "institutional buyer" is broad enough to cover, for example, a college purchasing for its endowment fund or perhaps a labor union investing its surplus funds on a substantial scale. The term may be either left to *ad hoc* interpretation or defined by an interpretative rule under § 412(a).

(n89)Footnote 89. Loss & Cowett, Blue Sky Law 368 (1958).

Incorporation, of course, is not a badge of sophistication so far as securities are concerned. Whatever else Mr. and Mrs. John Doe achieve when they organize Doe, Inc., to run their corner grocery, it is not investment "know-how." It seems considerably more logical to make the test turn on whether the investor is a "financial institution or institutional buyer," whether or not incorporated, than on whether the investor is incorporated, whether or not a financial institution or institutional buyer.

(n90)Footnote 90. *Id.*

(n91)Footnote 91.

Illinois: Ill. Comp. Stat. Ch. 815 Sec. 5/4(C).

North Carolina: N.C. Gen. Stat. § 78A-17(8). A corporation must have a net worth in excess of \$1 million to qualify under the exemption.

Virginia: Va. Code Ann. § 13.1-514(B)(6).

California has an exemption which allows a corporation organized under the laws of a foreign country to sell all of its shares to another corporation. At the completion of the sale the purchaser must directly or indirectly own 100% of the common stock of the foreign corporation. *See* Cal. Code Regs. tit. 10, § 260.105.22.

(n92)Footnote 92.

Illinois: Ill. Comp. Stat. Ch. 815 Sec. 5/4(C).

North Dakota: N.D. Cent. Code § 10-04-06(5).

(n93)Footnote 93.

North Dakota: N.D. Cent. Code § 10-04-06(5).

(n94)Footnote 94. *Id.*

(n95)Footnote 95.

Arizona: Ariz. Rev. Stat. Ann. § 44-1844(8).

See ch. 11 *infra* for the states' definitions of "person."

(n96)Footnote 96. *Stein v. Twilight Motel, Inc. of Florida*, 29 Ill. App. 2d 131, 172 N.E.2d 642 (1961) .

(n97)Footnote 97. 172 N.E.2d at 644 , 645. The court opined:

The history of the syndicate operations shows a series of patently sophisticated investments. It was formalized by a joint venture agreement. They were represented by able counsel. It is true that the individual members are not engaged in the securities or investment business. However, as a group they formed an association which engaged as a substantial part of its business or operation in purchasing or holding securities. To look to the principal business of each member of the syndicate to determine the nature of the syndicate's business would tell us about the business of each member, but not about the business of the syndicate...

(n98)Footnote 98. See Unif. Sec. Act § 402(b)(8).

(n99)Footnote 99. *Feinberg v. Automobile Banking Corporation*, 304 F. Supp. 147 (E.D. Pa. 1969) , interpreting Illinois law.

See also *Maddox v. Flato*, 423 S.W.2d 371 (Tex. Civ. App. 1967) (business did not constitute a trust company for exemption purposes).

(n100)Footnote 100. *Baroco v. Community National Life Insurance Company*, 427 F.2d 333 (5th Cir. [Fla.] 1970).

(n101)Footnote 101.

Oregon: Or. Rev. Stat. § 59.035(4).

(n102)Footnote 102. *State v. Hayes*, 317 So. 2d. 764 (Fla. 1975) .

This statute specifically states that delivery of securities to a bank results in the transaction being exempt. It does not require, as the State urges, that the securities be sold to the bank in the bank's name for the bank's use. While the Legislature may have intended such an interpretation, the statute is criminal, and it is elementary that criminal laws are to be strictly construed.

(n103)Footnote 103.

Illinois: Ill. Comp. Stats., ch. 815, § 5/4(C), (D).

See also Cal. Code § 25102(j), which exempts the offer and sale of oil and gas securities to purchasers primarily engaged in the business of drilling, producing, or refining oil and gas.

See also:

Lambrect v. Bartlett, 656 P.2d 269, 3 Blue Sky L. Rep. (CCH) P 71,787 (Okla. 1982) (in sale of an interest in an oil and gas lease, all purchasers must be "sophisticated" to qualify for exemption).

(n104)Footnote 104. Unif. Sec. Act § 402(b)(8)

(n105)Footnote 105.

California: Cal. Corp. Code §§ 25102(i), 25104(c).

North Carolina: N.C. Gen. Stat. § 78A-17(8).

South Dakota: S.D. Comp. L. § 47-31A-402(b)(8).

Texas: Monthly Securities Bulletin, March, 1970, April, 1970.

Wisconsin: Wis. Stat. Ann. § 551.23(8).

(n106)Footnote 106.

Pennsylvania: 64 Pa. Code § 203.031.

(n107)Footnote 107.

California: Cal. Corp. Code §§ 25102(i), 25104(c).

Texas: Monthly Securities Bulletin, March, 1970, April, 1970.

(n108)Footnote 108. *15 U.S.C. § 77d(2).*

"The provisions of section 77e of the title [requiring registration of securities] shall not apply to "... transactions by an issuer not involving any public offering."

(n109)Footnote 109.

New York: N.Y. Gen. Bus. L. § 359-ff(5)(a), (b).

See also N.Y. Comp. Codes R. & Regs. tit. 13, § 80.6, which governs intrastate offerings:

In lieu of the prospectus called for by the New York Intrastate Financing Act, an issuer proposing an offering to a group of persons whose net worth, financial background and experience would be such as to enable them to evaluate a prospective investment solely on the basis of original documentation, without other offering literature, may submit to the Department of Law an application for exemption from the prospectus requirements and the Attorney General may grant said application on finding that such action is not inconsistent with the public interest or the protection on investors.

(n110)Footnote 110. See ch. 9 *infra*.

(n111)Footnote 111. Victor & Bedrick, *Private Offering: Hazards for the Unwary*, 45 Va. L. Rev. 869, 871 (1959).

(n112)Footnote 112. See note 109 *supra*.

(n113)Footnote 113.

Alaska: 3 AAC 08.910(5).

New York: N.Y. Comp. Codes R. & Regs. tit. 13, §§ 80.6, 80.10, 80.11. Filing fees are required as well.

(n114)Footnote 114.

Indiana: Ind. Code § 23-2-1-2(b)(9)(i).

(n115)Footnote 115. *Id.*

Under the same conditions, the exemption also extends to offers, sales, and issuances to any affiliate of the issuer. *See Ind. Code § 23-2-1-2(b)(9)(ii).*

(n116)Footnote 116.

Pennsylvania: 64 Pa. Code § 203.184, adopted pursuant to 70 Pa. Stat. § 1-203(r) (Commission may exempt additional transactions by rule).

(n117)Footnote 117.

Illinois: Ill. Comp. Stats., ch. 815, § 5/4(S).

(n118)Footnote 118.

Indiana: Ind. Code Ann. § 23-2-1-2(b)(9).

(n119)Footnote 119.

Pennsylvania: 70 Pa. Stat. § 1-202(7).

(n120)Footnote 120.

Wisconsin: Wis. Stat. Ann. § 551.22(7).

(n121)Footnote 121.

Pennsylvania: 64 Pa. Code § 202.080.

Wisconsin: Wis. Adm. Code § 2.01(6).

(n122)Footnote 122.

Pennsylvania: 64 Pa. Code § 202.080.

(n123)Footnote 123.

Wisconsin: Wis. Adm. Code § 2.01(7)(b).

(n124)Footnote 124. *See* § 8.03[1], *supra*.

(n125)Footnote 125. Unif. Sec. Act § 402(b)(11). The exemption is carried into the 2002 Uniform Securities Act, *see* 2002 Unif. Sec. Act § 202(15). However, in the 2002 Uniform Act exemption the prohibition on payment of commissions or other remuneration for solicitation is absolute. In light of NSMIA preemption, there is no provision for submission to and approval by the administrator.

(n126)Footnote 126. 15 U.S.C. § 77c(a)(9).

(n127)Footnote 127. *See* Securities Act § 18(b)(4)(C), 15 U.S.C. § 77r(b)(4)(C).

(n128)Footnote 128. The definition of "covered security" in NSMIA, Securities Act § 18(b)(4)(C) specifically provides that subject to certain exceptions, a security is a covered security with respect to a transaction that is exempt from federal registration pursuant to section 3(a) of the Act.

(n129)Footnote 129. *See* § 8.03[7][e], *infra*.

(n130)Footnote 130. *See, e.g., Florida: Fla. Stat. § 517.061(6)*.

(n131)Footnote 131. *See* § 8.03[1], *supra*.

(n132)Footnote 132. *See* ch. 3 *supra*.

(n133)Footnote 133.

Delaware: *Gottlieb v. Heyden Chemical Corp.*, 32 Del. Ch. 231, 83 A.2d 595 (1951) , *rev'd on other grounds*, 33 Del. Ch. 82, 90 A.2d 660 (1952), 33 Del. Ch. 283, 92 A.2d 594 (1952) .

Maryland: *Ross Transport, Inc. v. Crothers*, 185 Md. 573, 45 A.2d 267 (1946) .

Wisconsin: *Ruller v. Krogh*, 15 Wis.2d 412, 113 N.W.2d 25 (1962) .

(n134)Footnote 134. Unif. Sec. Act § 402(b)(11).

(n135)Footnote 135. Draftmen's commentary to Unif. Sec. Act § 402(b)(11).

(n136)Footnote 136. Similarly stock dividends are distributions without consideration although technically there is consideration if they are offered in lieu of cash or property dividends. However, in spite of such a choice, most states exempt or exclude stock dividends. *See* ch. 3 and § 8.03[1][a] *supra* .

(n137)Footnote 137. Loss & Cowett, Blue Sky Law 377 (1958):

Some exemption along these lines is essential--perhaps even constitutionally so under the commerce clause--in order to accommodate corporations whose stockholders have preemptive rights. Today such a corporation is sometimes in the unenviable position of ignoring either its stockholders' preemptive rights or some of the blue sky laws which have no suitable exemption.

(n138)Footnote 138.

1-8 Blue Sky Regulation § 8.03

Arizona: Ariz. Rev. Stat. Ann. § 44-1844(5)-(7), (9).

California: Cal. Corp. Code § 25103.

(n139)Footnote 139. In addition to the Uniform Securities Act states listed earlier, other states have a general exemption for transactions with existing security holders which would probably allow most cash sales.

Illinois: Ill. Comp. Stat. Ch. 815 § 5/4(B).

Oregon: Or. Rev. Stat. § 59.035(3).

In Oregon, the sale must be made pursuant to a pro rata offering to existing security holders and is further conditioned by the stipulation that the issuer has not had an effective registration in Oregon within a period of five years prior to the date of the offering or sale.

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(N). In Pennsylvania, the exemption is limited to "existing equity security holders."

Texas: Tex. Rev. Civ. Stat., Art. 581-5(E).

Wisconsin: Wis. Stat. Ann. § 551.23(12).

In the above states, there are few limitations on the types of securities which may be in the hands of holders or sold by the issuer. As under Uniform Securities Act § 402(b)(11), there is often a provision which excludes from the exemption holders of certain transferable warrants or rights.

Other states allow cash sales but may have limitations on the nature of the entity issuing the securities, the type of securities in the hands of holders and/or the type of securities being offered to holders.

Florida: Fla. Stat. Ann. § 517.061(6).

Iowa: Iowa Code § 502.203(11).

The securities held by the offeree must consist of specified rights or warrants or securities carrying preemptive rights.

North Dakota: N.D. Cent. Code § 10-04-06(4).

The issuer must be a corporation selling or distributing additional capital stock to or among its own stockholders.

Ohio: Ohio Rev. Code Ann. § 1707.03(I).

The sale must be pursuant to the exercise of subscription rights, warrants or options which at the time they were granted were registered or specifically exempt.

1-8 Blue Sky Regulation § 8.03

The issuer must be a corporation selling increased capital stock of its stockholders.

The limitations in these states are important since they will affect the availability of the exemption. In a case where the statute exempted exchanges with security holders by corporations, it was held that a trust exchanging newly issued securities to present holders of other securities did not qualify for the exemption. *Maddox v. Flato*, 423 S.W.2d 371 (Tex. Civ. App. 1967) . Similarly, where the statute exempted sales and exchanges with stockholders, the exemption was not available where the purchaser held debentures. See *Hofer v. General Discount Corporation*, 86 S.D. 133, 192 N.W.2d 718 (1971) , and *Wipf v. General Discount Corporation*, 86 S.D. 148, 192 N.W.2d 727 (1971) .

(n140)Footnote 140. *Iowa Code § 502.203(11), (13), (15).*

(n141)Footnote 141. *Iowa Code § 502.203(13).*

(n142)Footnote 142. *Iowa Code § 502.203(14).*

(n143)Footnote 143. *Iowa Code § 502.203(15).*

(n144)Footnote 144. See §§ 8.03[1][d] and 8.03[7][c] *infra* .

(n145)Footnote 145. *Iowa Code § 502.203(11).*

Compare this provision with Uniform Securities Act § 402(b)(11). Note the similarity in the two, but whereas the Uniform Securities Act is inclusionary in mentioning conversions and non-transferable warrants, the Iowa statute uses the situations to limit the exemption. No doubt the specific mention of preemptive rights was due to the draftmen's commentary See Loss & Cowett, Blue Sky Law 377(1958).

(n146)Footnote 146. *Livens v. William D. Witter, Inc.*, 374 F. Supp. 1104 (D. Mass. 1974) (applying a former Massachusetts statute).

(n147)Footnote 147. *Spruce & Green Chemical Co. v. Mouer*, 510 S.W.2d 620 (Tex. Civ. App. 1974) .

(n148)Footnote 148. 5 Cavitch, *Business Organizations with Tax Planning* § 92.01[1] (Matthew Bender).

(n149)Footnote 149. *Id.*, § 92.02[3].

(n150)Footnote 150. *Id.*, § 92.03.

(n151)Footnote 151. See ch. 3 *supra*.

(n152)Footnote 152. It should be stressed that the exemption applies only to the exchange of the convertible security. The sale of the original security must be of a registered security unless a separate exemption can be found. A number of the states below provide that the exchange is not exempt unless the original sale of the convertible security was registered or exempt. Even in states having no such stipulation, it is not unreasonable to assume that the exemption would not be allowed unless the original security were sold according to law. The problem is tangentially covered in *Livens v. William D. Witter, Inc.*, 374 F. Supp. 1104 (1974) , and *Spruce & Green Chemical Co. v. Mouer*, 510 S.W.2d 620 (Tex. Civ. App. 1974) .

Examples of states that exempt the exchange of a convertible security are:

Arizona: Ariz. Rev. Stat. Ann. § 44-1844(9).

Illinois: Ill. Comp. Stat. ch. 815 § 5/4(B).

Indiana: Ind. Code § 23-2-1-2(b)(11).

Iowa: Iowa Code § 502.203(11).

Kansas: Kan. Gen. Stat. Ann. § 17-1262(h).

Massachusetts: Mass. Gen. Laws Ann., Ch. 110A, § 402(b)(11).

Missouri: Mo. Ann. Stat. § 409.402(b)(11).

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(n).

Texas: Tex. Rev. Civ. Stat., Art. 581-5(E).

Vermont: 9 Vt. Stat. Ann. § 4204a(4).

Virginia: Va. Code Ann. § 13.1-514(B)(8).

Washington: Wash. Rev. Code § 21.20.320(11), (14).

West Virginia: W. Va. Code Ann. § 32-4-402(b)(11).

Wisconsin: Wis. Stat. Ann. § 551.23(12).

Wyoming: Wyo. Stat. Ann. § 17-4-114(b)(xi).

(n153)Footnote 153. Unif. Sec. Act § 402(b)(11).

(n154)Footnote 154. *Id.*

See also Wisconsin: Sec. Bull. Dec. 1988, Blue Sky L. Rep. (CCH) 64,957 (exemption not available to cover common stock subject to transferable warrants exercisable at incremental prices over several years if the warrant holder was not at the time of exercise a holder of the company's securities in addition to the warrants).

(n155)Footnote 155. *See note 152 supra.*

(n156)Footnote 156.

Illinois: Ill. Comp. Stat. ch. 815, § 5/4(B).

(n157)Footnote 157. *See §§ 8.03[1][d]; 8.03[2], supra .*

(n158)Footnote 158.

Florida: Fla. Stat. Ann. § 517.061(1).

Kansas: Kan. Gen. Stat. Ann. § 17-1262.

Vermont: 9 Vt. Stat. Ann. § 4204a(5).

See also the states listed at note 152 *supra* which exempt "any transaction" pursuant to a number of different types of reorganizations.

(n159)Footnote 159. See note 152 *supra* for statutory citations.

(n160)Footnote 160.

Arizona: Ariz. Rev. Stat. Ann. § 44-1844(7).

California has a special provision applicable to changing the rights of outstanding debt securities (see *Cal. Corp. Code* § 25103(g)).

(n161)Footnote 161. Unif. Sec. Act § 402(b)(11).

(n162)Footnote 162. See, e.g.:

Alabama: Ala. Code § 8-6-11(a)(10).

Alaska: Alaska Stat. § 45.55.900(b)(7).

Colorado: Colo. Rev. Stat. § 11-51-308(1)(l).

Connecticut: Conn. Gen. Stat. Ch. 662 § 36-b-21.

Delaware: 6 Del. Code Ann. § 7309(b)(11).

Hawaii: Haw. Rev. Stat. Ann. § 485-6(11).

Illinois: Ill. Comp. Stat. ch. 815 § 5/4(B).

Indiana: Ind. Code § 23-2-1-2(b)(11).

Kansas: Kan. Gen. Stat. Ann. § 17-1262(h).

Kentucky: Ky. Rev. Stat. Ann. § 292.410(1)(k).

Maryland: Md. Code Ann. § 11-602(11).

Massachusetts: Mass. Gen. Laws Ann., Ch. 110A, § 402(b)(11).

Michigan: Mich. Comp. L. § 451.802(b)(11).

Mississippi: Miss. Code Ann. § 75-71-203(11).

Missouri: Mo. Ann. Stat. § 409.402(b)(11).

Montana: Mont. Rev. Code Ann. § 30-10-105(10).

Nebraska: Neb. Rev. Code § 8-1111(11).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17(II)(p).

New Jersey: N.J. Stat. Ann. § 49:3-50(b)(11).

North Carolina: N.C. Gen. Stat. § 78A-17(11).

Oklahoma: 71 Okla. Stat. § 401(b)(12).

Oregon: Or. Rev. Stat. § 59.035(3).

South Carolina: S.C. Code Ann. § 35-1-320.

Tennessee: Tenn. Code Ann. § 48-2-103(b)(12)

Texas: Tex. Rev. Civ. Stat., Art. 581-5(E).

Utah: Utah Code Ann. § 61-1-14(2)(j).

Virginia: Va. Code Ann. § 13.1-514(B)(8).

Washington: Wash. Rev. Code § 21.20.320(11).

West Virginia: W. Va. Code Ann. § 32-4-402(b)(11).

Wisconsin: Wis. Stat. Ann. § 551-23(12).

Wyoming: Wyo. Stat. Ann. § 17-117.14(b)(xi).

(n163)Footnote 163. *See, e.g.* Florida, Iowa, North Dakota, Ohio, Pennsylvania *supra*.

(n164)Footnote 164. *Id.*

See also Cal. Code Regs. tit. 10, § 260.105.15, which exempts the offer and sale of shares in exchange for shares issued by another corporation subject to certain conditions.

(n165)Footnote 165. *See* note 50, *supra*.

(n166)Footnote 166. Unif. Sec. Act § 402(b)(11).

(n167)Footnote 167. Alaska, Idaho, Kansas, Kentucky, Montana, Nebraska, New Mexico, Virginia and Washington all have exemptions based on the Uniform Securities Act for transactions with existing security holders. However, each of these states, in addition, has exemptions specifically applicable to reorganizations. In all of these states, except Kansas, the exemption is for "Any transaction incident to a right of conversion or a statutory or judicially approved reclassification, recapitalization, reorganization, quasi-reorganization, stock split, reverse stock split, merger, consolidation or sale of assets."

Note that the scope of this exemption goes into several areas. In so far as conversions and exchanges with the issuers own security holders pursuant to one of the reorganizational methods, such transactions are already covered by the exemption based on the one in the Uniform Securities Act. Since the provision also refers to "any transaction" it would seem also to apply to securities exchanged with shareholders of another corporation in a merger, consolidation or sale of assets situation. The exemption also applies to judicially approved reorganizations which are usually separately

provided for in most states. *See* § 8.03[1][d] *supra*.

The Kansas exemption is limited to stockholder approved reorganizational transactions, but here again overlaps the exemption based on the Uniform Securities Act when it comes to exchanges with the issuer's own securities holders. *See Kan. Stat. Ann. § 17-1262(l)*.

(n168)Footnote 168. *See, e.g.:*

Florida: Fla. Stat. Ann. §§ 517.061(5), (9).

Illinois: Ill. Comp. Stat. ch. 815 § 5/4.

Indiana: Ind. Code Ann. § 23-2-1-2(b)(15).

Iowa: Iowa Code § 502.203(13).

Kansas: Kan. Gen. Stat. Ann. § 17-1262(k).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17(II)(l).

Ohio: Ohio Rev. Code Ann. § 1707.03(K)(2).

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(n).

Texas: Tex. Rev. Civ. Stat., Art. 581-5(F), (G).

Vermont: 9 Vt. Stat. Ann. § 4204a(5).

Virginia: Va. Code Ann. § 13.1-514(B)(15).

Washington: Wash. Rev. Code § 21.20.320(14).

Wisconsin: Wis. Stat. Ann. § 551.23(12).

(n169)Footnote 169. *See, e.g.:*

Alaska: Alaska Stat. § 45.55.900(b)(13), (15).

California: Cal. Corp. Code § 25103.

Florida: Fla. Stat. § 517.061(9).

See also § 517.061(8). This subsection provides an exemption for the sale of securities from one corporation to another provided that the total sale price of the securities is equal to or greater than \$50,000 and the buying and selling corporations each have assets equal to or greater than \$500,000.

Illinois: Ill. Comp. Stat. ch. 815 § 5/4(I).

Iowa: Iowa Code § 502.203(13).

Kansas: Kan. Gen. Stat. Ann. § 17-1262(lk).

Minnesota: Minn. Stat. Ann. § 80A.15(2)(l).

Nebraska: Neb. Rev. Code § 8-1111(14).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17(II)(l), (p).

Oregon: Or. Rev. Stat. § 59.035(13).

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(o).

Texas: Tex. Rev. Civ. Stat., Art. 581-5(F), (G).

Vermont: 9 Vt. Stat. Ann. § 4204a(4), (6).

Virginia: Va. Code Ann. § 13.1-514(B)(15).

Washington: Wash. Rev. Code § 21-20.320(14).

Wisconsin: Wis. Stat. Ann. § 551.23(13).

(n170)Footnote 170. *Cal. Corp. Code § 25103(a).*

(n171)Footnote 171. *Cal. Corp. Code § 25103(b).*

Section 25103(d) provides that for the purpose of determining the percentage of security holders, securities held to the knowledge of the issuer in the name of broker-dealers and those controlled by any one person who controls fifty percent or more of the affected class shall not be considered outstanding.

(n172)Footnote 172. *Cal. Corp. Code § 25103(e).*

Actually the statute spells out a series of results which, if put into effect as a consequence of the change, would render the exemption inapplicable. These are changes which with respect to outstanding securities would (1) authorize the levying of assessments, (2) change dividend rights, (3) change redemption provisions, (4) make the securities redeemable, (5) change the amount payable on liquidation, (6) change conversion rights, (7) change voting rights, (8) change preemptive rights, (9) change sinking fund provisions, (10) rearrange relative priorities of outstanding shares, (11) impose or change restrictions on the transfer of shares in the articles of incorporation or by-laws, (12) change the right of shareholders to call special shareholders or members of a mutual water company.

The Corporation Commissioner has ruled that neither the authorization, issuance and sale of a new class of stock nor the issuance and sale of additional shares of a previously outstanding class constitutes a change in rights, preferences, privileges or restrictions of or on previously outstanding shares even where the new shares have priority over or dilute the voting power or preferences of such outstanding shares. However, the exemption does not extend to the offer or sale of the new securities. See Cal. Code Regs. tit. 10, § 260.103.1.

(n173)Footnote 173. *Cal. Corp. Code § 25103(a).*

(n174)Footnote 174. *Cal. Corp. Code § 25103(c).*

The rules for determining the count of California security holders are the same as those for making such a determination when there are changes in rights, preferences, privileges or restrictions. Cal. Code Regs. tit. 10, § 260.103.1.

(n175)Footnote 175. *See, e.g.:*

Alabama: Ala. Code § 8-6-11(a)(10)(a).

Alaska: Alaska Stat. § 45.55.900(b)(7).

Arizona: Ariz. Rev. Stat. Ann. § 44-1844(7).

Delaware: 6 Del. Code Ann. § 7309(b)(11).

Florida: Fla. Stat. Ann. § 517.061(6).

Hawaii: Haw. Rev. Stat. Ann. § 485-6(11).

Illinois: Ill. Comp. Stat., Ch. 815 § 5/4(B).

Indiana: Ind. Code § 23-2-1-2(b)(11).

Iowa: Iowa Code § 502.203(11).

Kansas: Kan. Gen. Stat. Ann. § 17-1262(h).

Maryland: Md. Code Ann. § 11-602(11).

Massachusetts: Mass. Gen. Laws Ann., Ch. 110A, § 402(b)(11).

Michigan: Mich. Comp. L. § 451.802(b)(11).

Mississippi: Miss. Code Ann. § 75-71-203(11).

Missouri: Mo. Ann. Stat. § 409.402(b)(11).

Montana: Mont. Rev. Code Ann. § 30-10-105(10)(a).

Nebraska: Neb. Rev. Code § 8-1111(11).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17(II)(p).

New Jersey: N.J. Stat. Ann. § 49:3-50(b)(11).

North Carolina: N.C. Gen. Stat. § 78A-17(11).

Ohio: Ohio Rev. Code Ann. § 1707.03(k)(2).

Oklahoma: 71 Okla. Stat. § 401(b)(12).

Oregon: Or. Rev. Stat. § 59.035(6).

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(n).

South Carolina: S.C. Rev. Stat. § 35-1-320(11).

Texas: Tex. Rev. Civ. Stat., Art. 581-5(E).

Utah: Utah Code Ann. § 61-1-14(2)(j).

Vermont: 9 Vt. Stat. Ann. § 4204a(4).

Virginia: Va. Code Ann. § 13.1-514(B)(8).

Washington: Wash. Rev. Code § 21.20.320(11).

West Virginia: W. Va. Code Ann. § 32-4-402(b)(11).

Wisconsin: Wis. Stat. Ann. § 551.23(12).

Wyoming: Wyo. Stat. Ann. § 17-4-114(b)(xi)(A).

(n176)Footnote 176. Official comment to Unif. Sec. Act § 402(b)(11).

(n177)Footnote 177. Unif. Sec. Act § 402(b)(11).

(n178)Footnote 178. See note 175, *supra*.

(n179)Footnote 179. See Weiss, Registration and Regulation of Brokers and Dealers 150 (1965).

Most rights offerings ... involve a "stand-by" arrangement with an underwriter under which the underwriter agrees to purchase for resale the unsubscribed portion of the issue. Moreover, even though an underwriter may not be obtained by an issuer for a standby underwriting, the issuer frequently enlists the assistance of brokers and dealers in bringing about the exercise of the rights, and on occasion, may make arrangements with a particular broker-dealer to manage such a program.

For the 'standby' underwriter, a rights offering poses the special problem that he has no idea as to the size of his commitment, and throughout the entire rights period, he is in a highly exposed position, subject to the fluctuations of the market. The standby underwriter will therefore want to purchase as many outstanding rights as possible. The more rights he purchases, the more control he has over his commitment. Accordingly, he goes into the market to acquire rights. He then exercises the rights and arranges for "layoffs" of the offered security among brokers and dealers. In turn, they will dispose of the securities to their customers.

See also the official comment to § 402(b)(11) of the Uniform Securities Act, Loss & Cowett, Blue Sky Law 377 (1958), where it is stated that the allowance of a standby commission "is designed to permit payment to an underwriter for his risk and services in connection with his commitment to take down any portion of the offering which is not taken down by the security holders."

(n180)Footnote 180. Most of the states listed in note 175 *supra* simply state that standby commissions are permitted. *But see* the following statute, which defines the type of commission allowed:

Illinois: Ill. Comp. Stat. Ch. 815 § 5/4(B) ("a fee paid directly to underwriters based on their undertaking to purchase any securities not purchased by security holders in connection with such sale or exchange").

(n181)Footnote 181.

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(n).

Wisconsin: Wis. Stat. Ann. § 551.23(12).

(n182)Footnote 182.

Kansas: Kan. Gen. Stat. Ann. § 17-1262(h).

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(o).

(n183)Footnote 183.

Wisconsin: Wis. Adm. Code § 2.02(9)(d).

(n184)Footnote 184. *See, e.g.*:

Alaska: Alaska Stat. § 45.55.900(b)(13).

Idaho: Idaho Code § 30-1435(n).

(n185)Footnote 185.

Idaho: Idaho Code § 30-1435(n).

(n186)Footnote 186.

Alaska: Alaska Stat. § 45.55.900(b)(13); Letter of Division of Banking, Securities, Small Loans & Corporations.

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(q).

(n187)Footnote 187.

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(q).

(n188)Footnote 188. *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 94, 62 S. Ct. 546, 86 L. Ed. 789 (1942). In this case the Supreme Court indicated that capitalization involved a "reshuffling of a capital structure within the framework of an existing corporation." While no precise definition was set down by the Court, it seems clear that recapitalization refers to action within a single corporation.

(n189)Footnote 189. *Id.*

(n190)Footnote 190. In 1972 the SEC adopted Rule 145 under the Securities Act of 1933, which abandoned the earlier "no sale" doctrine regarding mergers and similar transactions that involved shareholder approval procedures, and made those transactions subject to federal registration requirements.

(n191)Footnote 191. 2002 Unif. Sec. Act § 202(18).

(n192)Footnote 192. Rev. Unif. Sec. Act § 402(17). The exemption was newly added to the Revised Uniform Act. The original Uniform Securities Act contained no such exemption, reflecting the prevailing "no sale" theory in regard to mergers and corporate reorganization transactions that prevailed until 1972. The Uniform Act simply excluded any act incident to a class vote by stockholders pursuant to a certificate of incorporation or applicable statute, *see* Unif. Sec. Act § 401(j)(6)(C).

(n193)Footnote 193. Off. Code Ga. Ann. §10-5-9(12).

(n194)Footnote 194.

Connecticut: See, e.g., Gen. Stat. Conn. § 36b-3(15)(g). Statutory exclusions are discussed in § 8.03[1], *supra*.

(n195)Footnote 195. Draftsmen's commentary to Unif. Sec. Act § 401(j)(6)(C).

(n196)Footnote 196. *See, e.g.:*

Alaska: Alaska Stat. § 45.55.990(12).

Arizona: Ariz. Rev. Stat. Ann. § 44-1801(23).

California: Cal. Corp. Code § 25019.

Indiana: Ind. Code § 23-2-1-1(k).

Iowa: Iowa Code § 502.102(14).

Kansas: Kan. Stat. Ann. § 17-1252(j).

Kentucky: Ky. Rev. Stat. Ann. § 292.310(13).

Maryland: Md. Code Ann. § 11-101(8)(1)(ix).

Massachusetts: Mass. Gen. Laws Ann., Ch. 110A § 401(k).

Michigan: Mich. Comp. L. § 451.801(l).

Minnesota: Minn. Stat. Ann. § 80A-14(18).

Missouri: Mo. Ann. Stat. § 409.401(o).

Montana: Mont. Code Ann. § 30-10-103(22)(a).

North Carolina: N.C. Gen. Stat. § 78A-2(11).

Oregon: Or. Rev. Stat. § 59.015(19)(a).

Pennsylvania: 70 Pa. Stat. Ann. § 1-102(t).

Texas: Tex. Rev. Civ. Stat. art. 581-4(A).

Virginia: Va. Code Ann. § 13.1-501.

Washington: Wash. Rev. Code § 21.20.005(12).

West Virginia: W. Va. Code Ann. § 32-4-401(n).

Wisconsin: Wis. Stat. Ann. § 551.02(13)(a)

Wyoming: Wyo. Stat. Ann. § 17-4-113(a)(xi).

The term used in most of the above statutes is preorganization certificate or preorganization subscription. On its face, the term is not limited to use by a corporation, but some states require that preorganization subscriptions be issued by a corporation.

Maine, New Hampshire, New York, Rhode Island, South Dakota and Vermont do not include preorganization subscriptions in their "security" definitions. This does not necessarily mean that such interests would not be considered securities. See Chapter 2 *supra*, particularly § 2.08 on investment contracts and § 2.09[2] on any interest commonly known as a security.

(n197)Footnote 197. Unif. Sec. Act § 402(b)(10).

(n198)Footnote 198. Official comment to Unif. Sec. Act § 402(b)(10).

(n199)Footnote 199. *Id.*

(n200)Footnote 200. See, e.g.:

Colorado: Colo. Rev. Stat. § 11-51-308(1)(k). Twenty-five subscribers.

Idaho: Idaho Code § 30-1435(1)(j)(ii). Ten subscribers.

Kansas: Kan. Gen. Stat. Ann. § 17-1262(g). There is no statutory limit on the number of subscribers.

Massachusetts: Mass. Gen. Laws Ann., Ch. 110A, § 402(b)(10). Ten subscribers.

Mississippi: Miss. Code Ann. § 75-71-203(10). Thirty-five subscribers.

New Hampshire: N. H. Rev. Stat. Ann. § 421-B:17(II)(k). Ten subscribers. The provision is for limited offerings and includes, but is not limited to, offers and sales pursuant to preorganization subscriptions.

North Carolina: N. C. Gen. Stat. § 78A-17(10). Ten subscribers and twenty-five offerees.

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(f). Five subscribers.

Washington: Wash. Rev. Code § 21.20.320(10). Ten subscribers.

Wyoming: Wyo. Stat. Ann. § 17-4-114(b)(x). Fifteen subscribers.

(n201)Footnote 201. *See, e.g.:*

Arkansas: Ark. Stat. Ann. § 67-1248(b)(10).

Connecticut: Conn. Gen. Stat. Ch. 662 § 36-490(b)(10).

Idaho: Idaho Code § 30-1435(1)(j).

Iowa: Iowa Code § 502.203(10).

Kansas: Kan. Gen. Stat. Ann. § 17-1262(g).

Massachusetts: Mass. Gen. Laws Ann., Ch. 110A, § 402(b)(10).

Michigan: Mich. Comp. L. § 451.802(b)(10).

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(e), (f).

South Carolina: S.C. Rev. Stat. § 35-1-320(10).

Wisconsin: Wis. Stat. Ann. § 551.23(9).

Wyoming: Wyo. Stat. Ann. § 17-4-114(b)(x).

The official comment to § 402(b)(10) of the Uniform Securities Act indicates that payment is prohibited until such time as there is an "effective registration." This would not bar payment, however, if the securities to which the subscriptions apply come under another exemption. A few states make payment contingent on registering the securities. In South Carolina, payment is prohibited until articles of incorporation are filed with the Secretary of State. Wisconsin bars payment "until the securities subscribed for may legally be sold."

(n202)Footnote 202.

New Mexico: N.M. Stat. Ann. § 58-13B-27(I).

In New Mexico, escrow is required in all cases in which payment is made.

(n203)Footnote 203.

Kansas: Kan. Gen. Stat. Ann. § 17-1262(g).

Wisconsin also provides that the subscription may not be binding. *See* Wis. Stat. Ann. § 551.23(9).

(n204)Footnote 204. *See, e.g.:*

Connecticut: Conn. Gen. Stat. Ch. 662 § 36-490(b)(10).

Idaho: Idaho Code § 30-1435(1)(j).

Iowa: *Iowa Code* § 502.203(10).

Kansas: Kan. Gen. Stat. Ann. § 17-1262(g).

Massachusetts: *Mass. Gen. Laws Ann., Ch. 110A, § 402(b)(10).*

Michigan: Mich. Comp. L. § 451.802(b)(10).

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(e), (f).

South Carolina: S.C. Rev. Stat. § 35-1-320(10).

Wisconsin: Wis. Stat. Ann. § 551.23(9).

Wyoming: Wyo. Stat. Ann. § 17-4-114(b)(x).

(n205)Footnote 205. Draftsmen's commentary to Unif. Sec. Act § 402(b)(10), Loss & Cowett, Blue Sky Law 375 (1958). Official comment to Unif. Sec. Act § 402(b)(9), Loss & Cowett *supra*, pp. 368, 369.

(n206)Footnote 206. Unif. Sec. Act § 402(b)(10).

(n207)Footnote 207. *See, e.g.:*

Connecticut: Conn. Gen. Stat. Ch. 662 § 36-490(b)(10).

Idaho: Idaho Code § 30-1435(1)(j).

Iowa: *Iowa Code* § 502.203(10).

Kansas: Kan. Gen. Stat. Ann. § 17-1262(g).

Massachusetts: *Mass. Gen. Laws Ann., Ch. 110A, § 402(b)(10).*

Michigan: Mich. Comp. L. § 451.802(b)(10).

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(e), (f).

South Carolina: S.C. Rev. Stat. § 35-1-320(10).

Wisconsin: Wis. Stat. Ann. § 551.23(9).

Wyoming: Wyo. Stat. Ann. § 17-4-114(b)(x).

Comparable language exists in a few other states.

Pennsylvania: See, e.g., 70 Pa. Stat. Ann. § 1-203(f) ("Any offer or sale of a preorganization subscription or securities of a newly-formed person as part of its initial capitalization. ...").

(n208)Footnote 208.

Hawaii: This was the wording of a former statute under Hawaii Rev. L. § 199.5(j).

(n209)Footnote 209.

Hawaii: Anzai v. Kawai, 50 Haw. 406, 441 P.2d 345 (1968) .

(n210)Footnote 210. *441 P.2d at 349 .*

(n211)Footnote 211. *Id.*

(n212)Footnote 212.

Hawaii: Haw. Rev. Stat. Ann. § 485-6(10). As enacted by Act No. 70, Laws of 1971.

(n213)Footnote 213. *See, e.g.:*

Ohio: Ohio Rev. Code Ann. § 1707.03(K)(3). "The sale of preorganization subscriptions for shares of stock of a corporation prior to the incorporation of the corporation. ..."

Vermont: 9 Vt. Stat. Ann. § 4204a(8). "Subscriptions for shares of the capital stock of a corporation prior to the incorporation thereof under the laws of this state. ..."

(n214)Footnote 214.

Michigan: Mich. Comp. L. § 451.802(b)(10).

(n215)Footnote 215. Arizona, California, Georgia, Indiana, Missouri, Nevada, New York, North Dakota, Tennessee, Texas and Virginia.

(n216)Footnote 216. *Guyann v. Shulters, 223 Miss. 232, 78 So. 2d 114 (1955) .*

(n217)Footnote 217.

Arizona: Ariz. Rev. Stat. Ann. § 44-1844(10).

Virginia: Va. Code Ann. § 13.1-514(B)(11).

(n218)Footnote 218.

Arizona: Trump v. Badet, 84 Ariz. 319, 327 P.2d 1001 (1958) .

(n219)Footnote 219.

Texas: Sibley v. Horn Advertising, Inc., 505 S.W.2d 417 (Tex. Civ. App. 1974) , cert. denied, 420 U.S. 929, 95 S. Ct. 1129, 43 L. Ed. 2d 400 .

California particularly has two provisions which could affect preorganization subscriptions. The exemptions are under *Cal. Corp. Code § 25102(a)* and *§ 25102(c)*. These provisions, respectively, exempt:

(a) Any offer (but not a sale) not involving any public offering and the execution and delivery of any agreement for the sale of securities pursuant to such offer if (1) the agreement contains substantially the following provision:

The sale of the securities which are the subject of this agreement has not been qualified with the Commissioner of Corporations of the State of California and the issuance of such securities or the payment or receipt of any part of the consideration therefor prior to such qualification is unlawful...

(c) Any offer (but not a sale) and the execution and delivery of any agreement for the sale of securities pursuant to such offer as may be permitted by the commissioner upon application. Any negotiating permit under this subdivision shall be conditioned to the effect that none of the securities may be issued and none of the consideration therefor may be received or accepted until the sale of such securities is qualified under this law.

Limited offering exemptions are discussed in *§ 8.06 infra*.

(n220)Footnote 220.

Tennessee: See, e.g., Tenn. Code Ann. § 48-2-103.

(n221)Footnote 221. 2002 Unif. Sec. Act § 202(21).

(n222)Footnote 222. 17 C.F.R. §230.701.

(n223)Footnote 223.

Hawaii: See, e.g. Haw. Rev. Stat. § 485-6(18).

(n224)Footnote 224. As discussed in Chapter 7, *supra*, with only minor variations, the exemption is available for offers and sales issued by:

[a] person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, social, athletic, or reformatory purposes, or as a chamber of commerce, and not for pecuniary profit, not part of the net earnings of which inures to the benefit of a private stockholder or other person... . 2002 Unif. Sec. Act § 201(7).

(n225)Footnote 225. See Unif. Sec. Act § 402(a)(9); Rev. Unif. Sec. Act § 401(b)(10); 2002 Unif. Sec. Act § 201(7).

(n226)Footnote 226. *See, e.g., Wisconsin: Wis. Stat. § 551.23(15)* (Offers and sales of any evidence of debt by a qualifying non-profit organization).

In a reverse application, Texas provides a transaction exemption for offers or sales to a qualifying non-profit, *see Tex. Rev. Civ. Stat. § 581-5(U)*.

(n227)Footnote 227.

North Dakota: See, e.g., N.D. Cent. Code § 10-04-06(19).

(n228)Footnote 228.

Washington: See, e.g., Rev. Code Wa. § 21.20.320(16) (Qualifying mutual or cooperative association meeting requirements of state law and for which a claim of exemption is made).

(n229)Footnote 229. *See, e.g., Montana: Mont. Code Ann. § 30-10-105(16)* (Transactions in securities of a certified "capital company" or a certified Montana small business investment company").

(n230)Footnote 230. During the waiting period, special rules with regard to the offer and sale of the securities apply. Although sales of the securities are prohibited during the waiting period, certain communications that constitute offers are allowed. Because of the apparent difficulty in regulating oral offers, all non-written offers during the waiting period are allowed. However, offers made in writing must conform to certain guidelines.

The first type of permitted written offer is commonly known as a "tombstone ad." The tombstone is a notice, circular, advertisement, letter or other type of written communication which states from whom a formal prospectus may be obtained, identifies the securities, gives their price and names by whom orders will be executed. If the ad goes beyond this point, the information included must meet the requirements of the SEC rules which allow the ad to contain, among other limited information, the name of the issuer, the title of the security and the amount being offered, a brief description of the issuer's business, the selling price, the names of the managing underwriters and the approximate date of public sale. If the expanded form of tombstone ad is used, it must be preceded or accompanied by a prospectus or summary prospectus or the ad must contain a notice announcing the pending registration and stating that the ad shall not be considered an offer to sell or a solicitation of an offer to buy.

Another form of written solicitation that may be used during the waiting period is the preliminary prospectus. This type of prospectus contains substantially the same information as that in the full prospectus, but omits items that bear on the offering price of the securities, conversion rates, call prices, and discounts and commissions to underwriters and dealers. The cover of the preliminary prospectus must state in red ink that it is a preliminary prospectus and contain a legend of notification of the pending registration.

A summary prospectus, prepared and filed as part of a registration statement, may be used during the waiting period. Generally, a summary prospectus will not be permitted unless the issuer is subject to the reporting requirements of Exchange Act Sections 13 or 15(d). The summary prospectus must not include any information not contained in the registration statement, except for information specified in Rule 134(a). Every summary prospectus must contain a statement indicating that copies of a more complete prospectus may be obtained and from whom. When used prior to the effective date of the registration statement, the summary prospectus must be captioned "Preliminary Summary Prospectus." It must also comply with the applicable requirements relating to a preliminary prospectus.

(n231)Footnote 231. 2002 Unif. Sec. Act § 202(16).

(n232)Footnote 232.

Arkansas: See, e.g., Ark. Code § 23-42-504(11); Georgia: Off. Code Ga. §10-5-9(10); Idaho: Id. Code § 30-1435(l).

(n233)Footnote 233. 2002 Unif. Sec. Act § 202(16)(A)-(B).

(n234)Footnote 234. *See, e.g.:*

Alabama: Ala. Code § 8-6-11(a)(11).

Alaska: Alaska Stat. § 45-55.900(b)(8).

Arkansas: Ark. Stat. Ann. § 23-42-504(a)(11).

Colorado: Colo. Rev. Stat. § 11-51-142(2)(1).

Connecticut: Conn. Gen. Stat. Ch. 662 § 36-b-21(b)(12).

Hawaii: Haw. Rev. Stat. Ann. § 485-6(12).

Idaho: Idaho Code § 30-1435(1)(l).

Indiana: Ind. Code § 23-2-1-2(b)(12).

Kansas: Kan. Gen. Stat. Ann. § 17-1262(i).

Kentucky: Ky. Rev. Stat. Ann. § 292.410(1)(l).

Massachusetts: Mass. Gen. Laws Ann., Ch. 110A, § 402(b)(12).

Michigan: Mich. Comp. L. § 451-802(b)(12).

Minnesota: Minn. Stat. Ann. § 80A.15(2)(i).

Mississippi: Miss. Code Ann. § 75-71-203(12).

Missouri: Mo. Ann. Stat. § 409.402(b)(12).

Montana: Mont. Rev. Code Ann. § 30-10-105(11).

Nebraska: Neb. Rev. Code § 8-1111(12).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17(II)(i). New Hampshire has adopted the Uniform Securities Act exemption, and in addition exempts "any offer of a security if the sale of such security is or would be exempt under this section." The commissioner may also by rule or order exempt other offers, but not sales, of securities for which a registration statement has been filed.

New Mexico: N.M. Stat. Ann. § 58-13B-27(N).

North Carolina: N.C. Gen. Stat. § 78A-17(12).

Oklahoma: 71 Okla. Stat. § 401(b)(13).

South Carolina: S.C. Rev. Stat. § 35-1-320(12).

Utah: Utah Code Ann. § 61-1-14(2)(k).

Washington: Wash. Rev. Code § 21.20.320(12).

West Virginia: W. Va. Code Ann. § 32-4-402(b)(12).

Wisconsin: Wis. Stat. Ann. § 551.23(16).

Wyoming: Wyo. Stat. Ann. § 17-4-114(b)(xii).

(n235)Footnote 235.

California: Cal. Corp. Code §§ 25102(b), 25104(g).

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(h).

Virginia: Va. Code Ann. § 13.1-514(B)(9).

(n236)Footnote 236.

Oregon: Or. Rev. Stat. § 59.035(11).

(n237)Footnote 237.

South Carolina: S.C. Code Ann. § 35-1-320.

(n238)Footnote 238.

Delaware: 6 Del. Code Ann. § 7309(b)(12).

(n239)Footnote 239. *See § 8.02, supra.*

(n240)Footnote 240.

District of Columbia: See, e.g.: D.C. Code § 31-5604.02(16)(B).

The District of Columbia blue sky law provision typifies the modern approach of combining the coordinate exemptions into one provision, *see also Hawaii: Haw. Rev. Stat. § 485-6(12).*

(n241)Footnote 241. 2002 Unif. Sec. Act § 202(17)(B).

(n242)Footnote 242.

Colorado: See, e.g., Colo. Rev. Stat. § 11-51-308(n).

(n243)Footnote 243.

Connecticut: See, e.g., Gen. Stat. Conn. § 36b-21(b)(10)(A);
Colorado: Colo. Rev. Stat. § 11-51-308(i);

Ohio: Ohio Rev. Code § 1707.03(Q);

Utah: Utah Code Ann. § 61-4-14(n).

(n244)Footnote 244. *Ohio Rev. Code § 1707.03(Q)(1)-(5).*

(n245)Footnote 245. State and federal coordination for a particular limited offering is available in California. SEC Rule 1001 under the federal Securities Act of 1933 was adopted to coordinate a federal exemption with the specific California limited offering exemption provided by § 25102(n) of the *California Corporations Code*. This particular state-federal coordination is discussed in § 8.06[6][c], *infra*.

(n246)Footnote 246. *See, e.g.:*

Hawaii: Haw. Rev. Stat. Ann. § 485-4(14).

New Jersey: N.J. Stat Ann. § 49:3-60(f).

New York: N.Y. Gen. Bus. L. § 359-ff(5)(a).

Policy Statement 102, superseding "Instructions for § 352-g Exemptions," covers requests for exemptions from state registration for real estate syndication offerings fully registered with the SEC.

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(i).

(n247)Footnote 247. Securities Act of 1933 § 5, 15 U.S.C. § 77e.

(n248)Footnote 248. Securities Act of 1933 § 3, 15 U.S.C. § 77c.

(n249)Footnote 249. Securities Act of 1933 § 4, 15 U.S.C. § 77d.

(n250)Footnote 250.

New York: N.Y. Gen. Bus. L. § 359-ff(5)(a), (b).

(n251)Footnote 251. Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11).

(n252)Footnote 252.

New York: N.Y. Gen. Bus. L. § 359-ff.

(n253)Footnote 253. See comment, "Blue Sky Laws in the Empire State and the Uniform Securities Act," 22 SYR. L. REV. 925 (1971) at 934. Exemptions from filing the further state notice are listed in § *N.Y. Gen. Bus. L.* 359-~~f~~(1).

(n254)Footnote 254.

Georgia: Ga. Code Ann. § 10-5-9(5).

(n255)Footnote 255.

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(b).

Non-issuer transactions that are exempt by virtue of federal registration are discussed in ch. 9 *infra*.

(n256)Footnote 256.

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(i), which states that "[a]ny sale of a security registered under section 5 of the Securities Act of 1933 or exempt from registration under section 3(b) of such act."

(n257)Footnote 257.

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(i).

(n258)Footnote 258.

Georgia: See, e.g., Ga. Code Ann. § 10-5-9(5).



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Blue Sky Regulation

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CHAPTER 8 Exempt Issuer Transactions

1-8 Blue Sky Regulation § 8.04

§ 8.04 Special Purpose Statutory Exemptions

In *section 8.03 above* the common array of blue sky statutory exemptions is presented. In nearly identical form these transaction exemptions are included in every state blue sky law, whether or not the law is based on the Uniform Act. Beyond the common array, states include a variety of statutory exemptions best characterized as special purpose exemptions. Some are included in one form or another in several states. Others are the product of state-specific policy objectives. While it is not possible to address each of these special purpose exemptions in detail, they are identified in each State Guide in Volumes 3 and 4. Some common special purpose exemption categories are outlined below.

[1] Cooperatives Several states provide exemptions for the offer and sale of securities of housing or agricultural cooperatives. Exemptions relating to agricultural cooperatives are understandably common in those states that are major producers of agricultural commodities. The exemptions typically allow the offer, sale or issuance of securities for patronage, or as patronage refunds or dividends, in connection with marketing agreements by cooperative associations organized exclusively for agriculture, producer, marketing or consumer purposes, and the sale of subscriptions for or shares of stock in cooperative associations organized for such purposes.ⁿ¹ In many instances the exemption is conditioned on there being no commission or other remuneration paid or given for solicitation, and in some cases limitations on the amount of issued securities that may be owned by any one purchaser. In most states the cooperative association must be organized under the particular state's law, or specifically in accordance with another state's laws, and in most cases the offer and sale of the securities may be made only to members of the co-op, or when the purchase of the securities is necessary or incidental to establishing membership.ⁿ²

[2] Sale of an Enterprise Some states exempt sales of securities to the buyer of an enterprise or business, or the assets and liabilities of a business, if the transfer of stock to the buyer is solely incidental to the sale of the enterprise.ⁿ³ These exemptions are not common, but where provided they negate, for purposes of state securities laws, the impact of federal case law rejecting the sale-of-business doctrine and applying securities law protections involving corporate "stock" regardless of the context.ⁿ⁴ Various conditions are also imposed. In Kentucky, for example, the offer or sale of 100% of the ownership interest of a corporation is exempt if 100% of the corporation is either offered or sold, and the stock is sold to one individual or pre-existing entity.ⁿ⁵

[3] Local Development and Venture Capital Enterprises Among special purpose exemptions a common category involves those aimed at specific development, redevelopment or venture capital enterprises. In Illinois, for example, the offer, sale or issuance of securities by an Illinois business corporation issuer is exempt when the purpose is to provide capital and supervision for the redevelopment of blighted urban areas located in a municipality in the state.ⁿ⁶

In Kansas the offer or sale of securities issued by "Kansas Venture Capital, Inc." or any of its successors is exempt.ⁿ⁷ And in Iowa the offer or sale of securities by a small business investment company organized under the federal Small Business Investment Act of 1958 is exempt when certain conditions are satisfied.ⁿ⁸ As with cooperative associations, some states deal with local development or venture capital enterprises as issuers of exempt securities rather than providing a transaction exemption. In either case the objective is to encourage investment in local economies or meet special needs as, for example, the construction of low income housing.ⁿ⁹

FOOTNOTES:

(n1)Footnote 1.

Illinois: See, e.g., 815 Ill. Comp. Stat. § 4/4(K);
Michigan: Mich. Comp. Laws § 451.802(b)(16).

In several states the blue sky law exempts securities issued by cooperative associations rather than providing a transactional exemption, *see, e.g., Iowa: Iowa Code § 502.202(12)-(13); Kentucky: 808 Ky. Admin. Regs. § 10:170 § 2.*

(n2)Footnote 2.

Minnesota: See, e.g., Minn. Stat. § 80A.15(2)(j).

(n3)Footnote 3.

Alaska: See, e.g., Alas. Stat. § 45.55.900(b)(5)(D); Arkansas: Sec. Comm. Rules § 504.01(l) (Any transaction pursuant to the 100% sale of securities of a business entity);

(n4)Footnote 4. *See Landreth Timber Co. v. Landreth, 471 U.S. 681, 105 S.Ct. 2297, 85 L.Ed.2d 692 (1985) . Landreth and the meaning of "stock" in the context of a sale of an entire business are discussed in Chapter 2, § 2.02, supra .*

(n5)Footnote 5. 808 Ky. Admin. Regs. 10:240.

(n6)Footnote 6. 815 Ill. Comp. Laws § 5/4(P); *see also* 14 Ill. Admin. Code §§ 130.490 -130.491.

(n7)Footnote 7. *Kan. Stat. Ann. § 17-1262(o).*

(n8)Footnote 8. Code Iowa § 502.203(17).

(n9)Footnote 9. Other states providing such transaction exemptions include:

Michigan: Mich. Comp. Laws § 451.802(b)(15) (Any offer or sale of securities by a qualifying Michigan non-profit development corporation);

Montana: Mont. Code Ann. § 30-10-105(16) (Transactions in securities of a certified Montana capital company or certified Montana small business investment company);

North Carolina: N.C. Gen. Stat. § 78A-17(15) (Offer and sale of interests in North Carolina limited partnerships formed for the purpose of constructing low and moderate income housing in the state);

Virginia: Va. Code § 13-1-514(B)(12) (Any offer or sale of an interest in a partnership, corporation,

association or other entity created solely to provide residential housing located in the state);

Wisconsin: Wis. Admin. Code DFI-Sec. 2.02(k) (Offers, but not sales, made by presentation at a "venture capital fair" or other investment forum designated by the administrator).



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Blue Sky Regulation

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CHAPTER 8 Exempt Issuer Transactions

1-8 Blue Sky Regulation § 8.05

§ 8.05 Offers and Sales to Accredited Investors

As part of the Small Business Investment Incentive Act of 1980,ⁿ¹ Congress added the "accredited investor" concept to the federal securities laws through the enactment of section 4(6) of the Securities Act of 1933. That legislative action followed the historical evolution of case law under section 4(2) of the federal act--the "private offering" exemption--that recognized there are types of purchasers, based on criteria indicating financial sophistication and ability to fend for themselves, that do not require the protections of registration. Congress determined that companies offering and selling securities in non-public transactions solely to these investors should be exempt from Securities Act registration. Section 4(6) of the federal Securities Actⁿ² thus provides issuers an exemption for offers and sales of securities to "accredited investors" if they offer no more than \$5 million of securities and do not engage in general solicitation. Congress established several categories of "accredited investors" by definition in section 2(a)(15)(i) of the Securities Act, and also authorized the SEC to adopt additional categories based on such factors as financial sophistication, net worth, knowledge, and experience in financial matters.

In Regulation D under the federal Securities Act, adopted in 1982, the SEC made accredited investors an important part of the safe harbor offering regimen in Rules 505 and 506. While limiting the number of unaccredited investors in offerings under them, these rules exclude accredited investors from the numbers limitations, and also do not require issuers to provide disclosure to accredited investors. The Regulation D definition of accredited investor is contained in Rule 501(a), which includes the statutory categories of accredited investors plus additional categories the SEC created. The definition accredits investors based on their income, net worth, and assets. Natural persons qualify as accredited investors if they meet certain income or net worth tests. As defined in Rule 501(a) of Regulation D accredited investors include natural persons with individual incomes in excess of \$200,000 (or joint spousal incomes of \$300,000) for the two most recent years, if they reasonably expect to earn at least the same amount in the current year. Natural persons with individual (or joint, with a spouse) net worth in excess of \$1 million are also within the definition of accredited investor. Other investors are accredited if they have more than \$5 million of assets. These generally include state or ERISA employee benefit plans, charitable organizations or business entities if they were not formed for the specific purpose of investing in the securities offered, and trusts if they were not formed for the purpose of acquiring the securities offered and their purchase is directed by a sophisticated person.ⁿ³

At the state level, the Uniform Securities Act made no provision for an accredited investor transaction exemption, and as discussed earlier,ⁿ⁴ transaction exemptions for offers and sales to institutional or financial investors do not encompass sales to natural persons. As part of a continuing initiative to promote uniformity not only among state blue sky laws but also to harmonize state and federal securities laws, NASAA--the North American Securities Administrators Association--in 1997 adopted the "Model Accredited Investor Exemption."ⁿ⁵ Subject to certain

qualifications, the Model Accredited Investor Exemption applies to any offer or sale of a security by an issuer to persons who are or the issuer reasonably believes are accredited investors, as the term is defined in Rule 501(a) of Regulation D under the federal Securities Act of 1933. The accredited investor exemption is not available for an issuer that is in the development stage that either has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies, or other entity or person. It is also not available to an issuer if the issuer, any of the issuer's predecessors, any affiliated issuer, or any of the issuer's directors, officers, general partners, beneficial owners of 10% or more of any class of its equity securities, or any of the issuer's promoters, any underwriter, or any partner, director or officer of an underwriter is subject to a "bad boy" disqualification. The same set of "bad boy" disqualifications is now common in connection with several types of limited offerings available under state laws and regulations. They focus on whether within the last five years the issuer or a covered person has been the subject of certain administrative, criminal or enforcement proceedings, or is the subject of any civil injunctive order or a judgment relating to fraud or deceit.

Most states have adopted the Model Accredited Investor Exemption, or a particular state exemption analog,ⁿ⁶ by rule or administrative order.ⁿ⁷ In operation, the exemption permits a general announcement of the proposed offering to be made by any means. However, the content of the general announcement is limited to prescribed information, and must include a statement that sales will be made only to accredited investors. No money or other consideration may be solicited or accepted by way of the general announcement. The issuer may provide information in addition to the general announcement if that information is delivered through an electronic database that is restricted to persons who have been pre-qualified as accredited investors, or it is delivered after the issuer reasonably believes that the prospective investor is an accredited investor. The same restriction is placed on telephone solicitations. Note, however, that dissemination of the permitted general announcement of the proposed offering to persons who are not accredited investors will not disqualify the issuer from claiming the exemption. States adopting the Model Accredited Investor Exemption also require a notice filing with the administrator, including filing the general announcement, and there is a filing fee.

The exemption for offers and sales to accredited investors facilitates capital formation and benefits small business issuers in particular by allowing access to electronic databases and Internet resources that operate to match issuers and accredited investors. An important limitation, however, is that all purchasers must purchase the securities for investment, and not with a view to or for sale in connection with a distribution of the securities. This requirement is expressly included in the Model Accredited Investor Exemption, which also provides that any resale of the securities within 12 months otherwise than pursuant to a registration or to another accredited investor is presumed to be with a view to distribution and not for investment. The model exemption makes clear that the issuer must reasonably believe that all purchasers take the securities with the requisite investment intent. Accordingly, issuer compliance with the exemption includes the responsibility reasonably to assure that the holding period requirement is satisfied, and to police any resales. This is typically accomplished by placing an appropriate legend on stock certificates or other instruments, and implementing transfer restrictions. Subscription or other purchase documentation should also include appropriate representations and covenants.

FOOTNOTES:

(n1)Footnote 1. Pub. L. 96-477 (Oct. 21, 1980).

(n2)Footnote 2. 15 U.S.C. § 77d(6).

(n3)Footnote 3. 17 C.F.R. § 230.501(a).

(n4)Footnote 4. See § 8.03[6], *supra*.

(n5)Footnote 5. The complete text of the NASAA Model Accredited Investor Exemption is included among NASAA Statements of Policy reproduced in Volume 3 of this treatise.

(n6)Footnote 6. *See, e.g.*

District of Columbia: D.C. Code § 31-5604.02(11A);

Hawaii: Haw. Rev. Stat. 485-6(16);

Illinois: Ill. Comp. Stat. Ch. 815 § 5/4(H);

Indiana: Ind. Code § 23-2-1-2(b)(10)(G)(i);

North Dakota: N.D. Cent. Code § 10-04-06(17);

Ohio: Ohio Rev. Code § 1707.03(Y);

Pennsylvania: Pa. Code § 203.201;

Tennessee: Tenn. Code Ann. § 48-2-103(b)(14);

Texas: Tex. Admin. Code § 109.13(a) ("Well Informed and Sophisticated Investor Offering")

(n7)Footnote 7. *See, e.g.:*

Arizona: Ariz. Admin Code Sec. R14-4-140;

Colorado: Sec. Div. Rules § 51-3.19;

Connecticut: Admin. Order (April 14, 1998)

Delaware: Sec. Act Regs. § 503;

Kansas: Kan. Admin. Regs. § 81-5-13;

Kentucky: 808 Ky. Admin. Regs. § 10:340;

Maine: 537 OFI Rules §§ 1-4;

Maryland: Admin. Order (Jan. 18, 2000);

Mississippi: Sec. State Rule 719;

Nevada: Nev. Admin. Code § 90.536;

New Jersey: Admin. Order (Mar. 24, 1998);

New Mexico: N.M. Admin. Code Rule 12.11.12.20;

Oregon: Ore. Admin. Code Rule 441-35-010;

Rhode Island: Sec. Div. Rule 403(c)(1);

South Carolina: Sec. Comm. Order No. 97019;

South Dakota: Admin. Regs. § 20:08:07:29;

Utah: Sec. Div. Rules R161-14-2n;

Vermont: Admin. Order No. 00-037-S;

Virginia: Va. Admin. Code § 5-40-140;

Washington: Wash. Admin. Code § 460-44A-300;

West Virginia: Admin. Order (Mar. 25, 1999);

Wisconsin: Wis. Admin. Code DFI-Sec. 2.02(n);

Wyoming: Sec. Div. Regs. Ch. 9, § 3).



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Blue Sky Regulation

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CHAPTER 8 Exempt Issuer Transactions

1-8 Blue Sky Regulation § 8.06

§ 8.06 Limited Offering Exemptions

[1] In General In addition to widespread adoption of an accredited investor exemption, all states make provision for other forms of limited offerings without compliance with registration or qualification requirements. A form of limited offering exemption has been a part of the Uniform Securities Act since its inception,ⁿ¹ and the 2002 Uniform Act retains such a provision that today identifies the elements of the most common forms of limited offering. Section 202(14) of the 2002 Uniform Act exempts:

[a] sale or an offer to sell securities of an issuer, if part of a single issue in which

(A) not more than 25 purchasers are present in this State during any 12 consecutive months, other than [institutional investors];

(B) a general solicitation or general advertising is not made in connection with the offer to sell or sale of the securities;

(C) a commission or other remuneration is not paid or given, directly or indirectly, to a person other than a broker-dealer registered under this [Act] or an agent registered under this [Act] for soliciting a prospective purchaser in this State; and

(D) the issuer reasonably believes that all the purchasers in this State other than [institutional investors] are purchasing for investment.ⁿ²

There are numerous variations among basic limited offering exemptions, but all states provide for at least one form of limited offering that restricts sales to a small number of non-institutional (and in some cases non-accredited) persons during any period of 12 consecutive months, and in which commissions are paid only to licensed persons. There are several other forms of limited offering provisions, and the most common among them are discussed in this section. The most common form of limited offering exemption, however, is the widely adopted NASAA Uniform Limited Offering Exemption (ULOE), which was developed to coordinate blue sky laws with Regulation D under the federal Securities Act of 1933. The significance of the ULOE has diminished in the wake of NSMIA, and federal preemption of state regulation of offerings carried out today in conformity with Rule 506 of Regulation D. Nevertheless, it continues to play a role in connection with certain other types of offerings, and full consideration follows in subpart [2] below.

Although not limited offering "exemptions" as such, there are also commonly adopted provisions that provide for a lesser form of registration. These procedures, available to small business issuers, are the product of another NASAA initiative in response to the Uniform Limited Offering Registration (ULOR) that produced SCOR--the Small Company Offering Registration procedure³-- for the uniform treatment of registrations of small company offerings that are exempt from federal registration requirements under Rule 504 of Regulation D or Regulation A, or which qualify as intrastate offerings under section 3(a)(11) of the Securities Act of 1933. SCOR, which is based on a user-friendly Form U-7 as both a registration statement and offering document, is discussed more particularly in Chapter 10--Regulation of Small Business Capital Formation. However, because it is an important limited offering alternative to regular registration and qualification requirements under blue sky laws, SCOR is briefly introduced here along with small business offerings generally in *section 8.06 below*. All of the limited offering alternatives in blue sky laws or the regulatory structures under them have paramount importance today in local or regional small business capital formation initiatives for which state investor protection authority remains intact.

[2] The Uniform Limited Offering Exemption ("ULOE") The Small Business Investment Incentive Act of 1980⁴ created new Section 19(c) of the federal Securities Act,⁵ which, among other things, authorized the SEC to work with state securities administrators to achieve greater uniformity in federal and state securities regulation. Section 19(c) specifically provided for the development of a uniform exemption from registration for small issuers to be agreed on by the states and the federal government. The goal in all of this was to eliminate barriers to capital formation. At the time, state blue sky laws imposed registration and qualification requirements on capital formation activities that were increasingly national in character. Significant progress had been made on an uncoordinated basis to harmonize state requirements with SEC Rule 146, which established a safe harbor exemption for "private" offerings, but with the adoption of Regulation D under the federal Securities Act a uniform state exemption was needed more than ever to accommodate, and to balance, regulatory and economic objectives. The North American Securities Administrators Association, Inc. ("NASAA") responded with the ULOE, which was adopted in final form in September 1983 to coordinate with Regulation D. With the enactment of NSMIA in 1996 federal and state regulatory roles were realigned, and the scope of state authority to regulate offerings within the ambit of federal Regulation D was also redefined, and with it the role of the ULOE. To fully understand the role of the ULOE in the post-NSMIA environment it is necessary therefore briefly to review the elements an operation of Regulation D.

[a] Regulation D Generally Regulation D was adopted by the SEC in 1982 as part of its program to assist small business capital formation and to reduce the burdens imposed by the federal securities laws on small business. Regulation D streamlined the requirements for private offers and sales of securities without registration under the federal Securities Act,⁶ replacing the limited offering and small offering exemptions previously available under Securities Act Rules 146, 240, and 242.⁷ The rules under Regulation D (other than Rule 506 after NSMIA) do not provide an exemption from any applicable state law relating to the offer and sale of securities.⁸

Rule 501 of Regulation D defines common terms used in Regulation D, as for example, the term "accredited investor" discussed earlier in connection with the accredited investor exemptions under state laws. Rule 502 sets forth the general conditions relating to integration, information requirements, limitations on manner of offering, and limitations on resale that apply to all exempt offers and sales effected pursuant to Rules 504, 505, and 506. Key conditions or elements under Regulation D include:

(a) **Integration.** Rule 502(a) requires integration of all sales that are part of the same Regulation D offering.⁹ A safe harbor, however, is provided for all offers and sales that take place at least six months before the start of, or six months after, the termination of the Regulation D offering, so long as during the six-month periods there are no offers or sales of securities by or for the issuer of the same or a similar class as those offered or sold under Regulation D other than under an employee benefit plan as defined in Rule 405.

(b) **Information Requirements.** If an issuer sells securities under Rule 504, Rule 505, or Rule 506 only

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to accredited investors, then Regulation D does not require any specific disclosure. If, in a Rule 505 or Rule 506 offering, securities are sold to nonaccredited purchasers, then Rule 502(b)(1)(ii) requires the information required under Rule 502(b) be delivered to nonaccredited purchasers and recommends furnishing the information to all purchasers in view of the antifraud rules.

The nonfinancial information requirements depend upon an issuer's eligibility to use a particular form of registration statement or Regulation A, rather than the dollar amount of the offering. An issuer that is not subject to the reporting requirements of Section 13 or Section 15(d) of the Exchange Act to furnish information to the purchaser and to the extent material to an understanding of the issuer, its business and the securities being offered. If the issuer is eligible to use Regulation A, the issuer must provide the same kind of information as would be required in Part II of Form 1-A. If the issuer is not eligible to use Regulation A, the issuer must provide the same kind of information as required in Part I of a registration form the issuer is entitled to use.

As to financial statement information for a nonreporting issuer:

(1) For offerings up to \$2 million, the issuer must provide the information required in Item 310 of Regulation S-B, except that the issuer's balance sheet (which must be dated within 120 days of the offering) must be audited;

(2) For offerings up to \$7.5 million, the financial statement information must be that required in Form SB-2 (which replaced old Form S-18). If the issuer (other than a limited partnership) cannot obtain audited financials without unreasonable effort and expense, then only the balance sheet (dated within 120 days of the offering) must be audited.

(3) For offerings over \$7.5 million, the issuer must provide the financial statement required in a registration statement on the form the issuer would be entitled to use. The financial statement information requirement for issuers subject to reporting requirements of Section 13 or Section 15(d) of the 1934 Act is either (a) the issuer's most recent annual report (if it meets the requirements of Section 14a-3 or Section 14c-3), the proxy statement and, if requested by the purchaser in writing, Form 10-K and Form 10-KSB; or (b) the information contained on Form 10-K or Form 10-KSB or in a registration statement on Form S-1, Form SB-1, Form SB-2, or Form S-11 or on Form 10 or Form 10-SB (whichever filing is most recent).

(c) **Limitations on Manner of Offering.** Rule 502(c), applicable to all transactions under Regulation D except certain offers and sales made pursuant to Rule 504, prohibits the offer or sale of securities by any form of general solicitation or general advertising.

(d) **Limitations on Resale.** Rule 502(d), applicable to all transactions under Regulation D except certain offers and sales made pursuant to Rule 504, provides that securities acquired in a transaction under Regulation D have the status of securities acquired in a transaction under Securities Act Section 4(2) and cannot be resold without registration or an exemption from registration.

(e) **Notice of Sales.** Rule 503 provides one uniform notice of sales, Form D, for offerings pursuant to Regulation D. Only one filing, which is due within fifteen days after the first sale of securities under Regulation D, is required.ⁿ¹⁰

Rule 504, "Exemption for Limited Offerings and Sales of Securities Not Exceeding \$1,000,000," replaced Securities Act Rule 240ⁿ¹¹ and provides an exemption for offers and sales of securities by an issuer not subject to the reporting

provisions of the Exchange Act that satisfy the terms and conditions of Rules 501 through 503 and do not exceed an aggregate offering price of \$1,000,000, less the aggregate offering price for all securities sold within the twelve months before the start of and during the offering under Rule 504 in reliance on any exemption under Section 3(b) of the Securities Act¹² or in violation of Section 5(a) of the Securities Act.¹³ While the Rule originally provided for the purchasers to receive freely tradeable securities, it now provides that purchasers receive restricted securities under the Securities Act except for sales that satisfy certain state-accredited investor provisions.

Rule 505, "Exemption for Limited Offers and Sales of Securities Not Exceeding \$5,000,000," replaced Securities Act Rule 242¹⁴ and provides an exemption for offers and sales of securities not exceeding an aggregate offering price of \$5 million, less the aggregate offering price for all securities sold within the twelve months before the start of the offering and during the offering under Rule 505, in reliance on any exemption under Section 3(b) of the Securities Act or in violation of Section 5(a) of the Securities Act. In addition, offers and sales of securities must satisfy the terms and conditions of Rules 501 through 503, and the issuer must reasonably believe that there are no more than thirty-five nonaccredited purchasers of securities from the issuer in any offering, though an unlimited number of accredited purchasers is permitted.¹⁵

Rule 506, "Exemption for Limited Offers and Sales Without Regard to Dollar Amount of Offering," replaced Rule 146 under the Securities Act of 1933 and provides an exemption from registration if the terms and conditions of Rules 501 through 503 have been satisfied and the issuer reasonably believes that there are no more than thirty-five nonaccredited purchasers of securities from the issuer in any offering under Rule 506. In addition, the issuer must reasonably believe immediately prior to making any sale that each purchaser who is not an accredited investor either alone or with his or her purchaser representative has sufficient knowledge and experience in financial and business matters to be able to evaluate the merits and risks of the prospective investment. Rule 506 does not limit the aggregate dollar amount of the offering or the number of accredited investors who may purchase securities, subject, however, to the prohibition on general advertising or solicitation.

Rule 507 (added in March 1989) establishes "bad boy" disqualifications for an issuer from the use of Rule 504, Rule 505, or Rule 506 exemptions if a court has enjoined the issuer or its predecessors or affiliates from reliance on the exemptions because of a failure to comply with Rule 503 filing requirements. The issuer may seek to have the disqualification waived by the SEC upon a showing of good cause that is not necessary.

Rule 508 (added in March 1989) is a substantial compliance provision. The exemption will not be lost if, with respect to a particular offer or sale, the issuer can show that (1) the provision violated was not intended to protect that particular person, and (2) the failure was insignificant in the context of the total offering (note that any violation relating to the dollar ceilings, number of purchasers or general advertising is, by definition, not significant), and (3) a good faith attempt was made to comply.

[b] ULOE Coordination with Regulation D The ULOE consists of a statute section, three preliminary notes, a rule, and footnotes, which in some cases represent alternative applications. The statute section authorizes the state securities administrator to create by rule a limited offering transactional exemption which shall further the objectives of compatibility with federal exemptions and uniformity among the states.¹⁶

The three notes provide that:

- (1) nothing in the ULOE relieves issuers or persons acting on behalf of issuers from complying with state antifraud requirements;
- (2) the exemption is not available for transactions in technical compliance with it which are part of a plan or scheme to evade registration or the conditions of the exemption; and

(3) nothing in the ULOE is intended to relieve broker-dealers or agents from due diligence, suitability, or know your customer standards or other requirements applicable to such registered persons.

The exemption in the rule applies to offerings that satisfy Rule 505 under Securities Act Regulation D (offerings not exceeding \$5,000,000 to accredited investors¹⁷ and up to 35 nonaccredited investors) where the requirements of Rules 501-503 under Regulation D are satisfied, subject to certain additional conditions relating to the registration of persons receiving compensation, the absence of disqualifying factors, the filing of a notice on Form D, and a suitability or a sophistication standard for nonaccredited investors.

The ULOE includes Rule 506 offerings as an alternative in footnote 1. That footnote states the concerns of state securities administrators that private placements under the rule, which are not subject to a dollar limit or a limit on the number of accredited investors, comply with Rule 506. That concern was particularly acute with respect to abusive tax shelters. However, the adoption of NSMIA preempted state regulation of Rule 506 offerings, making them subject only to the states' rights to require notice filings and collect fees.

Rule 504, which exempts offerings of not more than \$1,000,000 from federal registration requirements, represents a delegation of federal regulation to the states and is not part of the ULOE. Rule 504 offerings remain subject to registration and qualification requirements of blue sky laws, although a few states have brought Rule 504 offerings expressly within the coverage of the ULOE. In Indiana, for example, any offer or sale of securities made in compliance with Rules 504, 505 or 506 of Regulation D is exempt.¹⁸ As applied to Rule 504 and Rule 505 offerings, ULOE and Regulation D conditions are imposed. Thus, among other things, a suitability requirement applies to all sales to nonaccredited purchasers, and commissions may be paid only to intermediaries who are licensed in the state.

In the majority of states that continue to require compliance with registration or qualification provisions for Rule 504 offerings the utility of the ULOE today is limited to offerings conducted in accordance with Rule 505 under Regulation D which, although meaningful, is not practically significant because many issuers would elect to proceed in compliance with Rule 506 of Regulation D for which state regulation is preempted. The advantage in proceeding under Rule 505, however, is that there are no qualifications on the "nature" of the 35 non-accredited purchasers permitted by the rule. Rule 506, which allows for 35 non-accredited purchasers, nevertheless requires that each purchaser who is not an accredited investor must either alone or with a purchaser representative have such knowledge and experience in financial and business matters as to be capable of evaluating the merits and risks of the prospective investment.¹⁹

[c] "Bad Boy" Disqualifications Availability of the ULOE is conditioned upon the issuer having no "bad boy" disqualification. The disqualifications were imported from SEC rules applicable to Regulation A under the Securities Act of 1933, and which were then incorporated into Regulation D. The disqualifications apply to securities of an issuer if the issuer, its officers, underwriters or related persons:

1. Has filed a registration statement that is the subject of a currently effective registration stop order entered pursuant to any state's securities law within five years prior to the filing of the notice required under this exemption;
2. Has been convicted within five years prior to the filing of the notice required under this exemption of any felony or misdemeanor in connection with the offer, purchase or sale of any security or any felony involving fraud or deceit, including but not limited to forgery, embezzlement, obtaining money under false pretenses, larceny or conspiracy to defraud;
3. Is currently subject to any state administrative enforcement order or judgment entered by that state's securities administrator within five years prior to the filing of the notice required under this exemption or is subject to any state's administrative enforcement order or judgment in which fraud or deceit, including but not limited to making untrue statements of material facts and omitting to state material facts, was

found and the order or judgment was entered within five years prior to the filing of the notice required under this exemption;

4. Is subject to any state's administrative enforcement order or judgment which prohibits, denies or revokes the use of any exemption from registration in connection with the offer, purchase or sale of securities; or

5. Is currently subject to any order, judgment, or decree of any court of competent jurisdiction temporarily or preliminarily restraining or enjoining, or is subject to any order, judgment or decree of any court of competent jurisdiction, permanently restraining or enjoining, such party from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security or involving the making of any false filing with the state entered within five years prior to the filing of the notice required under this exemption.

The disqualifications generally apply to events occurring within the five years preceding the filing of the ULOE notice, except for enforcement orders or judgments under item 4. The disqualifications do not apply (except for item 4) if the person subject to the disqualification is licensed to conduct securities-related business in the state that took the action or if the broker-dealer employing the person is licensed in the offering state and the basis of the disqualification is disclosed in Form BD, the broker dealer registration form. Any disqualification can also be waived by the state which took the action, or, under section 3 of ULOE, the administrator of the offering state may waive a disqualification. There is also a "no reasonable belief defense" for the disqualification provisions.

[d] Investor Qualifications The ULOE does not impose any qualification requirements on accredited investors beyond the accreditation criteria. Non-accredited investors, however, must meet either a suitability or a sophistication standard. Suitability can be presumed if the investment does not exceed 10% of an investor's net worth. The suitability test is relevant only in the case of Rule 505 offerings, since non-accredited investors must meet sophistication standards under Rule 506 in any event. The 10% of net worth presumption would be applicable only to sales to a non-accredited investor up to \$100,000 since, above that amount, the investor would need a net worth in excess of \$1 million to be qualified as an accredited investor.

The sophistication test for non-accredited investors requires that the purchaser alone or with a purchaser representative has the knowledge and experience to evaluate the merits and risks of the investment. This is the same test applied under Rule 506. A reasonable belief test applies to the issuer and anyone acting on its behalf.

[e] Filing Requirements The ULOE requires the filing of a notice on Form D ten days prior to the receipt of consideration or the delivery of a subscription agreement from an investor. Footnote 4 provides an alternative post-sale notice patterned after the notice requirements of Rule 503 of Regulation D as then in effect. While Regulation D required a notice to be filed within ten days after the first sale,ⁿ²⁰ this requirement has been interpreted by the Commission in a way consistent with the ULOE requirement.ⁿ²¹ Rule 503 presently requires the filing of a Form D not later than 15 days after the first sale of securities. The notice is required to contain an undertaking by the issuer to furnish to the state securities administrator, upon written request, the information furnished by the issuer to offerees, except where the state administrator pursuant to regulation requires that the information be filed at the same time with the filing of the notice. Footnote 5 to the ULOE states that the pre-sale notice or the filing of offering material is not intended to form the basis for a fairness review of the offering.

[f] Other Conditions The ULOE exempts offers and sales if offered and sold in compliance with Regulation D Rules 505 and/or 506 and which satisfy the following further conditions and limitations. First, no commission or other remuneration is to be paid, directly or indirectly, to any person for soliciting any prospective purchaser in the state in connection with the offer or sale in reliance on the regulation unless such person is appropriately registered in the state. The states also have the option of allowing such persons to register as a broker-dealer or agent, pursuant to a simplified

registration procedure that as a minimum would be sufficient to grant the state jurisdiction and the ability to police the persons offering and selling within the state.

The ULOE adds to the disqualification provisions of Rule 505, pertaining to the issuer, underwriter, and certain persons affiliated with them, currently effective stop orders relating to the registration of securities entered pursuant to any state's law within the past five years; the conviction within the past five years for any felony involving fraud or deceit, including forgery, embezzlement, and larceny; being subject to state administrative order or judgment entered within the past five years by the state's securities administrator; being subject to a restraining order (in addition to those set forth in Rule 505) involving the making of any false filing with any state. The state administrator can on showing of good cause waive any ground for disqualification by finding that it is not necessary under the circumstances that the exemption be denied.

The issuer must file a Form D with the state generally within the time frames of Regulation D, except that the state has the option to require it to be filed ten days before receipt of any consideration by the issuer or delivery of subscription agreement by an investor. The ULOE also requires the filing of a consent to service of process, payment of a filing fee, and an undertaking by the issuer to furnish the administrator, upon request, with a copy of the information furnished to offerees.

[3] The Federal Section 4(2) "Private Offering" Exemption Section 4(2) of the Securities Act of 1933ⁿ²² exempts "transactions by an issuer not involving any public offering." In one form or another many states have a section 4(2) coordinate or tracking exemption in their blue sky laws. These exemptions may explicitly refer to Section 4(2) of the Securities Actⁿ²³ or may simply exempt non-public offerings.ⁿ²⁴

In the application and enforcement of "private offering" exemptions states have looked to federal administrative and judicial interpretations of section 4(2) for guidance. Historically, five factors have been used to determine availability of the exemption:

1. Ability of offerees to fend for themselves,
2. Availability of information,
3. Manner of offering,
4. Number of offerees and purchasers, and
5. Absence of redistribution.

Each of these factors that continue to control availability of the exemption is discussed further below. When the "private offering" exemption is available it operates wholly apart from restrictions or conditions applicable to other forms of limited offering exemptions. There is no "safe harbor" however, and these criteria remain fully exposed to challenge in administrative or enforcement actions, or in litigation brought under the civil liability provisions of blue sky laws.

[a] Ability of Offerees to Fend for Themselves The legislative history of the federal section 4(2) exemption referred, among other things, to circumstances "where there is no practical need for [the bill's] application."ⁿ²⁵ The absence of the need for the protections provided by registration under the Securities Act, i.e., the ability of offerees to fend for themselves, has been a touchstone of judicial interpretation of the exemption. The seminal case of *SEC v. Ralston Purina Co.* ⁿ²⁶ focused on the ability of the offerees to fend for themselves, i.e., whether they needed the protection of the Act. The Supreme Court also referred to "access" to the "kind of information which registration would disclose."ⁿ²⁷ Access was not defined, however. *Ralston Purina* involved a sale of securities under a key executive

stock option plan with several hundred eligible participants. Since many of the participants appeared to have neither economic bargaining power nor a relationship to the company that would give them the ability to obtain necessary information, the Court held that the exemption was unavailable.

The cases since *Ralston Purina* have not definitively outlined the required access. Some courts have found the requirement satisfied where the offeree has a close personal family or employment relationship to the issuer.ⁿ²⁸ In *Gilligan, Will & Co. v. SEC*,ⁿ²⁹ the Second Circuit held that a sale to three purchasers did not qualify as a private offering because the purchasers lacked the required relationship to the issuer and the knowledge needed to evaluate the offering. The Securities and Exchange Commission's litigating position in its appellate brief in the infamous *Continental Tobacco* caseⁿ³⁰ maintained that economic bargaining power was not enough to convey access, and that a permitted private placee had to be virtually an insider with respect to the issuer. In such circumstances where the offerees have a close relationship to the issuer, the public benefits of requiring registration would be viewed as too remote.ⁿ³¹

In 1974, the SEC promulgated Securities Act Rule 146ⁿ³² to provide more objective standards for the application of the limited offering (or "private placement") exemption. Since the adoption of former Rule 146, "ability to fend for themselves" has sometimes been divided into two components: ability to bear the risk (which the SEC may construe as the investor's ability to afford the loss of an entire investment, although commentators urge that the probability of loss also be considered)ⁿ³³ and "sophistication." The precise definition of sophistication is not clear, but it has been generally interpreted to mean the ability to understand the risks of the particular investment.ⁿ³⁴

Rule 506 under Regulation D eliminated the economic risk test of Rule 146 but maintains the requirement of a subjective sophistication determination for nonaccredited investors as to whether such a purchaser, either alone or with a purchaser representative, is able to evaluate the merits and risks of the investment.ⁿ³⁵ This notion will continue to guide applications of section 4(2) independently of Rule 506, and likewise guide state administrators.

[b] Availability of Information Establishing the federal section 4(2) exemption requires proof that the offerees had access to registration-type information through economic bargaining position, family or personal relationship, employment, or by some other means.ⁿ³⁶ Former Rule 146(e) required information or access.ⁿ³⁷ Regulation D requires the delivery of information rather than access to information for investors other than accredited investors.ⁿ³⁸

Despite judicial suggestions to the contrary,ⁿ³⁹ the better view is that the information provided need not be the same as registration would provide but should be the same kind of information, i.e., basic information concerning the issuer's financial condition, results of operations, business, property, and management.ⁿ⁴⁰ Information should also be given as to the use of proceeds and, to the extent material, tax considerations and risk factors. In *Livens v. William D. Witter, Inc.*,ⁿ⁴¹ the exemption was held available, although the purchaser did not receive financial statements because the issuer lacked records from which such statements could be prepared. The court concluded that, since the purchaser was informed of the deficiency in the information available (although no one appreciated the significance of such unavailability) and was willing to proceed with the transaction, the material information had been given and, under the circumstances, the omission was not material.

[c] Manner of Offering The manner of offering is an important element in determining the availability of the statutory exemption. Generally, the issuer should offer its securities through direct communications to offerees or their representatives. No general solicitation or advertising is permitted. In addition, the number of offers should be limited as discussed below.

A few courts have deemphasized the manner of offering element and replaced it with requirements that focus on the type of offeree being solicited. For example, in *SEC v. Universal Major Industries Corp.*,ⁿ⁴² the court stated that it was not the manner of offering but the class of offerees to whom the offering was made that determined the availability of the exemption.ⁿ⁴³ It has been suggested that the issue of the class of offeree (i.e., a person who has the ability to fend for herself) should be a separate requirement in addition to that prescribing the manner of offering.ⁿ⁴⁴

[d] Number of Offerees and Purchasers The number of offerees and purchasers has always been another significant factor affecting the availability of the federal section 4(2) exemption and it is no less significant at the state level for any non-public offering exemption. The section 4(2) exemption, unlike Rule 506, is tested against both the number and qualifications of offerees rather than the number and qualifications of purchasers. However, the existence of a large number of purchasers in fact (excluding, however, large institutional investors) makes it less likely that each offeree met the qualification criteria and may also be indicative of a general solicitation.

The *Ralston Purina* n45 decision states that there is no absolute maximum number of offerees which would, if exceeded, result in the loss of the exemption. It is also clear that no permissible minimum number of offerees exists; an offering to even one person, if that person lacks the requisite qualifications, may result in a public offering.ⁿ⁴⁶ Nevertheless, securities practitioners long followed, at least until the advent of former Rule 146, the "Rule of 25" derived from an early opinion of the SEC's General Counsel,ⁿ⁴⁷ which viewed 25 qualified offerees as the appropriate ceiling for a statutory private placement. Former Rule 146 focused attention more on the manner of offering, to which the numbers of offerees and purchasers may be relevant. The manner of offering continues to be relevant under Rule 506, although the elimination of offeree qualification requirements makes the nature of the offerees less significant. Outside of the institutional private placement situation,ⁿ⁴⁸ most experienced counsel find their comfort level diminishing as the number of offerees and purchasers increases, since the likelihood of all offerees and purchasers meeting the qualification criteria decreases as their numbers grow.

[e] Absence of Redistribution If the purchaser in an offering immediately resells the securities in a manner that would transform the overall transaction into a public offering (i.e., if such purchaser effects a public distribution of the securities), the federal section 4(2) exemption is lost.ⁿ⁴⁹ Normally, issuers should obtain an investment letter from private purchasers of their securities. That letter should state that the securities are being acquired for the purchaser's own account and should also state the purchaser's intention and agreement not to effect a distribution or public resale of the securities except as permitted by law, e.g., under Securities Act Rule 144.ⁿ⁵⁰ Some consideration of the subjective intent of the purchaser is unavoidable because of the category of statutory underwriter created by section 2(a)(11) of the Securities Act of 1933,ⁿ⁵¹ which makes someone who purchases from an issuer with "a view to distribution" an underwriter. However, the section 4(2) exemption does not preclude a private resale of privately placed securities.

The section 4(2) exemption does not require any particular enforcement devices to prevent distributions, such as the placement of restrictive legends on certificates or the issuance of stop transfer instructions to transfer agents.ⁿ⁵² However, those procedures and receipt of an investment letter buttress the claim that the transaction was exempt in the view of both the SEC and the courts.ⁿ⁵³

[4] State "Private Offering" Exemptions As noted above, states that do not simply incorporate federal section 4(2) by reference may nonetheless provide a statutory "private" or "non-public" offering counterpart, although more commonly a generalized limited offering exemption fashioned in accordance with the Uniform Act model discussed in subpart [5][a] below is provided as the basic "private offering" counterpart. In any case, state private or limited offerings typically focus on the common elements described below.

The Number of Sales. In most states, the availability of the limited offering exemption depends upon the number of purchasers during a specific time period. As with states counting the number of offers, the designated count of permitted sales varies from state to state.ⁿ⁵⁴ In addition, since a few of these jurisdictions define "sale" to include "offers to sell,"ⁿ⁵⁵ it would appear that the number of offers would also be considered when determining the number of sales. The states that consider the number of sales as the basis of their limited offering exemption recognize that, for the public to receive the protection otherwise available through registration, limitations must be placed on the offering itself and on the manner in which the offering is made.ⁿ⁵⁶ Most states, for instance, require that the issuer or seller reasonably believe that the purchaser is buying for investment,ⁿ⁵⁷ and not with a view to resale or distribution.

In Colorado, North Dakota and Pennsylvania, limits are placed on the number of offerees that may be solicited in the

twelve-month period.ⁿ⁵⁸ Several states prohibit commissions or other remuneration to be paid or to be given in connection with any solicitations or sales for which the limited offering exemption is available,ⁿ⁵⁹ and most states preclude the use of all public advertising or other public solicitation.ⁿ⁶⁰

The Number of Securities Holders. An exemption based on the number of security holders differs from an exemption based on the number of offers or sales. An exemption based on the number of offerees or purchasers may be used repeatedly in different time periods. Thus, if the limited offering exemption permits twenty sales in twelve months and the offeror makes twenty sales in twelve months, the count begins again when the next twelve-month period commences. A limited offering exemption based on the number of security holders, however, precludes use of the exemption once the maximum number of security holders is reached. The states are not uniform in the number of final security holders permitted for the exemption to be available.ⁿ⁶¹

General Restrictions on Limited Offerings. Consistent with the basic regulatory format of blue sky law, states have imposed restrictions on the use of the limited offering exemption so that investors in offerings made in reliance on such exemption will not need the protection otherwise offered by securities registration. Such restrictions on the limited offering exemption have been established by the states regardless of whether a particular jurisdiction counts offerees, purchasers, or security holders for the availability of the exemption.

The Offeror. The limited offering exemption is generally considered an exemption to assist issuers, such as a small corporation with a few shareholders who all have a personal relationship with the issuer and all are owners of the issuer's securities.ⁿ⁶² The Uniform Securities Act does not bar non-issuers from using the exemption.ⁿ⁶³ Many states, however, prescribe that only issuers may use the exemption,ⁿ⁶⁴ and some states require that the issuer be a particular type of entity, such as a corporation or partnership.ⁿ⁶⁵ The issuer exemption is sometimes made available to affiliatesⁿ⁶⁶ or to controlling personsⁿ⁶⁷ of the issuer.

The Offeree. Few states restrict the nature of the offeree. While the Uniform Securities Act provisionⁿ⁶⁸ has no specific requirements regarding the investor, regulations have been promulgated in several states delineating the character of the offeree. The general limited offering exemption in California places conditions on who may be a purchaser,ⁿ⁶⁹ and a regulation places similar limits on offerees whose transactions may be subject to two of the state's other limited offering exemptions.ⁿ⁷⁰ A few states permit the limited offering exemption only if the sale is made to incorporators.ⁿ⁷¹

Persons Included and Excluded from the Count of Offerees or Purchasers. Regardless of whether a limited offering exemption is based on the number of offers, sales, or security holders, there are some general rules governing who is counted as an offeree or purchaser under the exemption. The Uniform Securities Act excludes financial and institutional investors from the count of offerees,ⁿ⁷² and a similar exclusion has been adopted in most states whether or not the balance of the Uniform Securities Act exemption has been followed.ⁿ⁷³ Some states go further than the Uniform Securities Act exclusion and also except from the count persons who acquire securities that are exempt from registration or persons who acquire registered securities.ⁿ⁷⁴

The Uniform Securities Act exemption applies to offers made in the state whether or not the offeror or any of the offerees are then present in the state. This "in the state" provision is intended to cover not only the situation where both offeror and offeree are in the state but also when the offeror is in one state and the offeree in another.ⁿ⁷⁵ In a case litigating this point under the Uniform Securities Act exemption, it was held that offers made by a domestic corporation from the state of organization or incorporation to residents of another state located in the other state would not be counted as offers for exemption purposes in the state where the offeror is organized.ⁿ⁷⁶ However, a different result would probably be reached if the offeree were domiciled in the same state as the offeror and received the offer while temporarily out of state.ⁿ⁷⁷ Similarly, if the offeror were domiciled in State X and the offeree in State Y, but temporarily in State Z when he received the offer, the offer would probably count for State Y's exemption.ⁿ⁷⁸ Whether State Z would also use the offer as part of its count is uncertain.

Many states include the Uniform Securities Act requirement that *offers* be made in the state.ⁿ⁷⁹ Similarly, states measuring sales within a time period for their limited offering exemption refer to *sales* to persons or purchasers in the state.ⁿ⁸⁰ Several states that count the number of sales made in a twelve-month period require that the *sales* occur in the state whether or not any of the purchasers are then present in the state at the time of sale.ⁿ⁸¹

Most states that have exemptions based on the final number of security holders are silent on whether all security holders are counted or only security holders present in the state. Husbands and wives are generally counted as one person,ⁿ⁸² regardless of whether the count is of offerees, purchasers, or security holders. Corporations and other organizational entities are also counted as one person unless the purpose of organizing was to acquire the securities of the issuer claiming the exemption.ⁿ⁸³ In California, if the purchaser is a corporation that has already claimed the exemption for a limited number of security holders in issuing its own securities, each security holder of the purchasing corporation is separately counted.ⁿ⁸⁴

Virginia and Wisconsin exclude from the count of security holders the security holders of any other corporation, partnership, unincorporated association or trust unless that entity was organized to raise capital for the issuer.ⁿ⁸⁵

The Securities. It is unusual for states to prescribe the type of securities that may be the subject of a limited offering. Even when there is a requirement that the offering consist of securities issued by a particular entity, a corporation, for example, there is usually no restriction on the type of securities to be offered. A close corporation, for instance, would typically offer stock pursuant to the limited offering exemption. However, the offering of other securities, such as general or limited partnership interests, may also be permitted.ⁿ⁸⁶ Nevertheless, a few states impose restrictions on the securities subject to the exemption. Limitations necessarily exist on the kind of securities involved when the nature of the issuer is specified. And California applies one of its exemptions strictly to offers or sales of voting common stock.ⁿ⁸⁷

Restrictions on securities that may be part of a limited offering are usually exceptions to the general limited offering exemption. For example, securities consisting of oil, gas, or mining interests cannot be sold pursuant to the limited offering exemption in Iowa.ⁿ⁸⁸ A few states, however, permit the sale of these interests under a limited offering exemption, or a specific subject matter exemption, if certain requirements are met.ⁿ⁸⁹

Interests in foreign partnerships cannot be offered or sold pursuant to the limited offering exemption in Iowa.ⁿ⁹⁰

Investment Intent. Almost every state that has a limited offering exemption requires that the purchaser's purpose in buying the securities be for investment and not for resale.ⁿ⁹¹ There are a number of ways to show investment intent. Under the Uniform Securities Act, for example, the only requirement for showing that the buyer has no present intention of reselling the securities is a showing that the seller reasonably believes the buyer is purchasing for investment,ⁿ⁹² although it is suggested that the seller obtain an investment letter from the buyer.ⁿ⁹³ This investment letter serves as protection for the seller's claim of exemption. The letter, however, is not meant to protect the buyer, and the seller's failure to obtain the letter is not sufficient grounds for the buyer to void the sale.ⁿ⁹⁴ Even if the seller obtains an investment letter, however, the purchaser is still not prevented from reconsidering and reselling the securities, on the claim that his or her intent at the time of purchase was for investment.ⁿ⁹⁵ Of course, the shorter the time period between purchase and resale, the harder for the seller to prove investment intent.ⁿ⁹⁶

Under the Uniform Securities Act provision, if the buyer is a "sophisticated investor," the investment intent requirement is not applicable.ⁿ⁹⁷ At the time the Uniform Securities Act was originally drafted, the exception for sophisticated investors from the investment intent requirement was omitted. The drafters stated that this omission was an inadvertence and recommended that the exception be inserted at the time technical amendments were added.ⁿ⁹⁸ The "technical amendment" excepting sophisticated investors from the investment intent requirement was made, and subsequently, many states, including non-Uniform Securities Act states, adopted the exception.ⁿ⁹⁹

While many states require, for a showing of investment intent, that the seller have no more than a reasonable belief in the buyer's investment purpose, some states have specific requirements in their statutes and regulations that expressly provide how the seller can protect itself regarding a buyer's investment purpose. These provisions include investment letters, restrictive transfer legends placed on the securities, and time restrictions imposed on the period for which the securities must be held before resale.ⁿ¹⁰⁰

Payment of Commissions. The payment of commissions or other remuneration in connection with the solicitation of buyers in a limited offering is often prohibited,ⁿ¹⁰¹ unless administrative permission is obtained.ⁿ¹⁰² The prohibition of the payment of commissions is not intended to bar directors, officers, and employees who are paid for other services from selling securities, but it is intended to preclude the payment of additional compensation for any transactions initiated by directors, officers, or employees.ⁿ¹⁰³ The prohibition encompasses the payment "directly or indirectly" of any commissions.ⁿ¹⁰⁴

Under the Uniform Securities Act, the payment of commissions is prohibited unless the commissions are paid for solicitation of financial and institutional investors.ⁿ¹⁰⁵ Similarly, a number of states that otherwise disallow the payment of commissions without administrative approval do permit the payment of remuneration for the solicitation of financial and investors.ⁿ¹⁰⁶

A few states allow commissions to be paid to registered broker-dealers for the solicitation of buyers in a limited offering. Alaska, Florida, and Nebraska place no further restrictions on the commissions than can be paid registered broker-dealers,ⁿ¹⁰⁷ while Michigan requires that the broker-dealer not be affiliated with the issuer or the issuer's affiliates.ⁿ¹⁰⁸ Minnesota, New Hampshire and South Dakota require that the commission paid be "reasonable and customary."ⁿ¹⁰⁹ Montana permits a commission to be paid to a registered broker-dealer only if the securities are registered under the Securities Act of 1933.ⁿ¹¹⁰ Pennsylvania prohibits the payment of commissions only to a promoter.ⁿ¹¹¹ Illinois and Ohio allow the payment of commissions that do not exceed a statutory percentage of the amount of the offering.ⁿ¹¹²

Advertising. Many states prohibit advertising and/or general solicitation of prospective purchasers in connection with an exempt limited offering.ⁿ¹¹³ However, many state limited offering exemptions do not define either the term "advertising" or the term "general solicitation" and leave such definitions to decisional law.ⁿ¹¹⁴ In determining what constitutes "public solicitation or advertisements," the courts of one state have developed a test that requires "public distribution" of a communication in order for it to be considered an "advertisement;"ⁿ¹¹⁵ and, while distribution of a four-page "confidential memorandum" to no more than twenty selected acquaintances has been held not to constitute an "advertisement,"ⁿ¹¹⁶ a brochure, to aid in the selling of the securities, exhibited to two hundred and fifty "prospects" not previously known to the salesman was held to constitute an "advertisement."ⁿ¹¹⁷ Presently, it is not possible to describe any useful or concise definition of advertising or general solicitation which would apply in all jurisdictions.

Filings. The availability of the limited offering exemption is often contingent upon a filing requirement. Many jurisdictions require that a document be filed with the securities commissioner whenever securities are to be sold pursuant to the limited offering exemption.ⁿ¹¹⁸ For example, Massachusetts requires a filing only when commissions are paid,ⁿ¹¹⁹ Missouri when there is an increase in the number of permitted transactions or a waiver of other statutory conditions,ⁿ¹²⁰ Mississippi when there are ten or more purchasers,ⁿ¹²¹ and Ohio when an exemption is claimed under Securities Act Section 4(2) or any rule promulgated thereunder.ⁿ¹²² Delaware and Maryland look to the amount of the offering and do not require a filing if the aggregate price of the securities offered does not exceed \$50,000.ⁿ¹²³

When filings are required, specific forms are sometimes prescribed or the contents of the filing or notice are set forth in the state's statutory exemption or regulationⁿ¹²⁴ and fees may be required to accompany the filing. NSMIA specifically preserves the rights of states to require notice filings and to collect fees in Rule 506 transactions.

Even though a state does not have a formal filing requirement, or does not limit the filing requirement to certain conditions, it does not necessarily mean that the exemption is automatically available. State administrative opinion on the eligibility of the offering for exemption should be considered before effecting transactions under the exemption.ⁿ¹²⁵

[5] The Uniform Act Model The limited offering exemption provided in Section 402(b)(9) of the Uniform Securities Act covers:

[a]ny transaction pursuant to an offer directed by the offeror to not more than ten persons [other than financial or institutional investors] in this state during any period of twelve consecutive months, whether or not the offeror or any of the offerees is then present in this state, if (A) the seller reasonably believes that all the buyers in this state [other than financial or institutional investors] are purchasing for investment, and (B) no commission or other remuneration is paid or given directly or indirectly for soliciting any prospective buyer in this state [other than financial or institutional investors]; but the [Administrator] may by rule or order as to any security or transaction or any type of security or transaction, withdraw or further condition this exemption, increase or decrease the number of offerees permitted, or waive the conditions in Clauses (A) and (B) with or without the substitution of a limitation on remuneration.ⁿ¹²⁶

The 2002 Uniform Act retains the basic limited offering exemption, modifying the original Uniform Act provision to provide for a 25 rather than 10 purchaser limit, and without restriction on the number of offerees except to prohibit any general solicitation or advertising.ⁿ¹²⁷

Uniform Act and non-Uniform Act states alike have almost universally adopted a limited offering exemption based on the Uniform Act model, providing for at least a 10 purchaser limitation, although sometimes modifying the provision further to require a notice filing.ⁿ¹²⁸ The 2002 Uniform Act expansion also reflects the fact that many states have significantly increased the maximum number of purchasers, in some cases to as many as 35 purchasers,ⁿ¹²⁹ although particular conditions or restrictions may vary from the Uniform Act model. The most common limited or "non-public" offering exemption based upon the Uniform Act model(s) permits up to 25 purchasers during any 12 consecutive months.ⁿ¹³⁰ As seen above, section 402(b)(9) of the Uniform Securities Act is complemented by Section 402(b)(8) of the Act, which recognizes that the protection offered by securities registration is unnecessary for sales to sophisticated institutional investors.

The buyer's intent to redistribute the purchased securities is a factor that must be considered in determining the availability of limited offering exemption based on the Uniform Act model. The seller must reasonably believe that the buyer is purchasing for investment and not resale.ⁿ¹³¹ Moreover, the selling effort permitted by the exemption is limited since the exemption is not available if any commission or other remuneration is paid for soliciting prospective buyers.ⁿ¹³²

Substantial flexibility is provided in the Uniform Securities Act provision by allowing the state administrator, by rule or order, regarding any security, any transaction, any type of security, or any type of transaction to:

- (1) withdraw or further condition the limited offering exemption,
- (2) increase or decrease the number of permitted offerees, or
- (3) waive any of the conditions regarding investment intent or payment of commissions or other remuneration.ⁿ¹³³

Additionally, the availability of the exemption is always subject to the authority of the administrator to suspend or revoke it in particular circumstances through administrative proceedings, or summarily for a limited period of time pending administrative proceedings.

Note that the Uniform Securities Act does not restrict the limited offering exemption to particular offerors. On its face the exemption may be used by issuers and non-issuers alike. Nevertheless, since non-issuers may take advantage of the isolated transaction exemption,ⁿ¹³⁴ the limited offering exemption is usually thought of as an issuer's exemption,ⁿ¹³⁵ and the 2002 Uniform Act makes specific reference to sales or offers to sell securities "of an issuer." Most states make this clear as well, without regard to what Uniform Act model is involved.ⁿ¹³⁶

[6] Other Limited Offerings

[a] "Local" Issuer Limited Offerings Several states, either by statute or rule, have crafted issuer exemptions for the offer and sale of securities by any corporation or limited liability company, or any offer and sale of limited partnership interests by an issuer organized or to be organized under the law of that state, and which satisfies certain other conditions. New Mexicoⁿ¹³⁷ is typical of these states in providing an exemption when the total offering does not exceed \$1.5 million and the following conditions are satisfied:

- (1) The issuer has its principal office and a majority of its full time employees in the state or, if the issuer is a limited partnership or limited liability company, its principal place of business and 80% of its assets are located in the state;
- (2) No commission or other remuneration is paid to any person other than a licensed broker-dealer or sales representative;
- (3) An offering document is delivered to each purchaser or prospective purchaser prior to a sale; and
- (4) The issuer claiming the exemption makes a filing with the administrator, pays a filing fee and complies with such other reporting or information requirements that the administrator may impose.

Variations among states having a local issuer exemption include a limitation on the number of beneficial holders of securities of the issuer before and after the offering, and limits on the number of purchasers. In Maryland, for example, a qualifying local issuer must have 50 or fewer beneficial owners of its securities immediately before and immediately after the offering, and no more than 10 purchasers are permitted during any 12 month period.ⁿ¹³⁸ Missouri requires the use of an offering document meeting the form and content requirements of Form U-7, and imposes advertising restrictions.ⁿ¹³⁹ In some instances there is no requirement that sales of the securities be made solely to residents of the state, but in others that restriction is included.ⁿ¹⁴⁰ Pennsylvania makes the exemption available to an issuer that is organized under Pennsylvania law or which has its principal place of business in the state, when the issuer has not sold securities in or outside the state to more than 10 persons, and has not made offers to sell to more than 90 persons in the state in a period of 12 consecutive months.ⁿ¹⁴¹ Tennessee places no limitation on the number of purchasers, but limits the amount of any offering by the Tennessee issuer to \$250,000 to non-institutional purchasers during any 12 month period.ⁿ¹⁴² In addition to other requirements Vermont requires that at least 40% of the proceeds of the offering must be used by the issuer for operations in the state.ⁿ¹⁴³ Many of the states with local issuer exemptions also impose "bad boy" disqualifications on its availability.ⁿ¹⁴⁴ But subject to this limitation some local issuer exemptions are extremely broad. The Texas Intrastate Limited Offering Exemption, for example, requires only that all offers and sales must be made and entirely completed in the state, although there can be no public solicitation or advertising, and there may be no more than 35 new security holders of the issuer who are not "well informed and sophisticated investors" or accredited investors.ⁿ¹⁴⁵

Some state exemptions which are functionally local issuer exemptions are expressly aimed at "small business" issuers.ⁿ¹⁴⁶ The offering size limits typically placed on these exempt offerings suggest that their greatest utility is in fact in small business capital formation. Further consideration of these specific small business offering exemptions is undertaken in § 8.05[1][c] below.

[b] Isolated or *De Minimis* Issuer Offering Exemptions Blue sky laws contain a variety of issuer exemptions premised on very small offerings that are isolated or otherwise marked by *de minimis* characteristics that eliminate concern for investor protection beyond basic antifraud provisions. There is no model or common approach to such exemptions, and all states do not have one. Washington, however, offers an example of one approach in those states that do have a provision. Under the Washington blue sky law up to three sales of an outstanding by or on behalf of an issuer inside or outside the state during the prior 24 month period are exempt. There are no other restrictions or limitations on the exemption.ⁿ¹⁴⁷ Pennsylvania exempts sales made to no more than two persons in the state during a period of 12 months, but imposes a number of other conditions including a limit on the number of offers and control over the manner of offering.ⁿ¹⁴⁸ Several states simply permit sales by an issuer to no more than 10 purchasers other than financial and institutional investors during a 12 month period.ⁿ¹⁴⁹ These provisions are in most cases based directly on section 402(b)(9) of the original Uniform Securities Act discussed above. In Wisconsin, any transaction pursuant to an offer to existing security holders of the issuer and to no more than 10 other persons in the state during a 12 month period is exempt.ⁿ¹⁵⁰ In many cases the isolated or *de minimis* offering exemptions are self-executing, although notice filing or other filing requirements are prescribed in some states.

A common approach to *de minimis* offering exemptions is to provide the exemption for total offerings up to \$500,000, including sales both within and outside the state, within a particular period of time. Although there is often no limitation on the number of purchasers,ⁿ¹⁵¹ other conditions may be imposed. In Alabama, for example, availability of the exemption is conditioned on no person other than an accredited investor purchasing more than \$15,000 of the securities offered. Additionally, a disclosure document containing prescribed information must be used.ⁿ¹⁵² The State Guides contained in Volumes 3 and 4 describe particular variants and aspects of these offering exemptions in each state.

Some states have taken the further step to provide a specific issuer exemption for offers and sales of securities that a part of organizational or pre-incorporation activities. North Dakota, for example, allows for the issuance of common stock, limited liability company membership interests or limited partnership interests to as many as 10 subscribers when the offer and sale of the securities is for the sole purpose of organization of the entity in the state.ⁿ¹⁵³ In Arizona the issuance of securities by a corporation to 10 or less persons who are the original incorporators is exempt, if the securities are not acquired for the purposes of resale, and there is no direct or indirect resale to a third party within 24 months in the absence of a bona fide change in financial circumstances.ⁿ¹⁵⁴ In Virginia the issuance of not more than three shares of common stock to one or more incorporators of a corporation is exempt.ⁿ¹⁵⁵ In most instances one form or another of a *de minimis* or limited offering exemption would apply to the issuance of securities to incorporators or organizing members of a business organization. In the states with particular provisions, however, there is added flexibility and a level of assurance that is helpful to small business organization and capital formation.

[c] California Coordinate Limited Offering Exemption: SEC Rule 1001 SEC Rule 1001 under the federal Securities Act of 1933 provides a federal exemption for transactions which are exempt from qualification in California under section 25102(n) of the *California Corporations Code*. This exemption is adopted under the statutory authority of section 3(b) of the 1933 Act, and is applicable only in coordination with the California limited offering exemption.

The California exemption's chief differences from the Regulation D framework are that it permits distribution of a summary term sheet in the proposed offering, and it requires securities to be sold only to "qualified purchasers". The exemption permits offers and sales of up to \$5 million, which is the federal section 3(b) statutory limit. This limit is not calculated on an annual basis, but rather on a case-by-case basis. Only issuers that are organized in California, or those organized outside, but which meet certain requirements, can use the exemption. The exemption is available when more than 50% of property, payroll and sales can be attributed to California and more than 50% of the issuer's outstanding voting securities are held of record by persons having California addresses. The exemption may not be used for rollup transactions, blind pool offerings or investment companies subject to the Investment Company Act of 1940.

Sales may be made only to the following qualified purchasers who purchase for investment:

1-8 Blue Sky Regulation § 8.06

1. Designated professional or institutional purchasers or persons affiliated with the issuer. (This includes officers and directors, general partners, trustees, entities comprised of accredited investors, banks, savings and loans, non-issuer pension or profit-sharing trusts, non-profit organizations with more than \$5 million in assets, and individuals with a net worth of \$1 million or annual income of more than \$200,000.);
2. Certain relatives residing with qualified purchasers;
3. Promoters;
4. Any person purchasing more than \$150,000 of securities in the offering, provided each alone, or together with the assistance of an adviser, has the capacity to protect his own interest; each has the ability to bear the economic risk of the investment; or the investment does not exceed 10 percent of each person's net worth of over \$1 million or annual income exceeding \$200,000;
5. Entities whose equity owners are limited to officers, directors and any affiliate of the issuer;
6. Reporting companies under the 1934 Act if the transaction involves the acquisition of all an issuer's capital stock for investment;
7. A natural person whose net worth exceeds \$500,000, or a natural person whose net worth exceeds \$250,000, if such purchaser's annual income exceeds \$100,000--provided, that in either case, (1) the transaction involves only one class of voting stock (or preferred stock establishing the same voting rights), (2) the amount purchased represents no more than 10% of the purchaser's net worth, and (3) a purchaser is able to protect his or her interests (alone, or together with an adviser). (The adviser must be unaffiliated with the issuer. California interprets this to mean that a qualified investor must have business or financial experience or rely on a professional adviser.);
8. Pension and profit-sharing trusts, 401(k) plans and IRAs of individual qualified purchasers.

A disclosure document complying with Regulation D information requirements (Rule 502) must be provided to natural persons five days prior to sale or a commitment to purchase. Oral or written offers must be limited to qualified purchasers. However, general announcements of a proposed offering may be widely published and circulated so long as the announcement is limited to: the issuer's identity; the full title of the securities offered; the suitability standards for prospective investors; a statement that no money is being sought or will be accepted and that an indication of interest involves no commitment to purchase; and the name, address, and telephone number of a person who can provide further information. At its option, an issuer may also briefly describe its business, its geographical location and the offering price method of determination.

A notice of the offering must be provided to the California Corporations Commissioner at the time of the initial offer, or with the publication of a general announcement of the proposed offering, together with a filing fee. An additional filing is required within ten business days after the close or abandonment of the offering, and in no case later than 210 days after the filing of the initial notice. No SEC filing is required.

Securities acquired in a Rule 1001 transaction are "restricted securities" for purposes of Rule 144, and may be resold only in a registered offering or if an exemption is available.

[7] Integration of Limited Offerings As seen above, many limited offering exemption alternatives include specific temporal limitations, allowing for a maximum range of transactions that is defined in terms of 12 or 24 month time periods. Limited offering exemptions are in all cases intended to cover transactions that are part of a single issue.

Indeed in several instances particular blue sky law exemptions expressly make the point. There is, however, no definition of a single issue or single offering. The "single issue" concept simply means that a distribution of securities that would otherwise be subject to registration or qualification requirements may not be carried out by means of a series of exempt transactions. A series of transactions that are in fact part of a single issue or plan of financing may be integrated, such that no valid exemption applies to any of the separate transactions undertaken to carry it out. By imposing specific consecutive month time limitations on transactions that are carried out in reliance on a particular exemption blue sky law provisions or rules establish certainty as to the scope of integration. Integration is a broader concept, however, and does not always involve a simple timing determination for issuers that engage in multiple transactions. In the context of the federal securities laws the SEC has identified particular factors to be taken into consideration in determining whether offers and sales should be integrated for purposes of exemptions. Those factors are:

- (1) Whether the sales are part of a single plan of financing;
- (2) Whether the sales involve issuance of the same class of securities;
- (3) Whether the sales have been made at or about the same time;
- (4) Whether the same type of consideration is received; and
- (5) Whether the sales are made for the same general purpose.ⁿ¹⁵⁶

Integration impacts limitations contained in limited offering exemptions both as to the size of a permitted offering and the maximum number of purchasers. Offerings made in reliance on separate, independent transaction exemptions may be integrated into a single transaction without regard to the independent availability of separate exemptions for the transactions as undertaken. Integration operates prospectively and retrospectively. Transactions carried out both before and after an offering or transaction carried out in reliance on a limited offering exemption may be integrated with that limited offering if any of the above factors are present. The limited offering exemptions in blue sky laws that deal specifically with time limitations do so only with respect to utilization of the particular exemption involved. The allowable ranges in a particular exemption do not protect an issuer against integration of transactions carried out in reliance on another exemption. It is essential, therefore, that the integration factors be carefully considered in connection with any intended series of transactions, or what turns out to be a series of transactions carried out over a relatively short period of time with the same capital formation objective.

FOOTNOTES:

(n1)Footnote 1. See Unif. Sec. Act § 402(b)(9). The Uniform Act limited offering exemption covers:

[a]ny transaction pursuant to an offer directed by the offeror to not more than ten persons (other than those designated in paragraph (8)) in this state during any period of twelve consecutive months, whether or not the offeror or any of the offerees is then present in this state, if (A) the seller reasonably believes that all the buyers in this state (other than those designated in paragraph (8)) are purchasing for investment, and (B) no commission or other remuneration is paid or given directly or indirectly for soliciting any prospective buyer in this state (other than those designated in paragraph (8)); but the Administrator may by rule or order, as to any security or transactions or any type of security or transactions, withdraw or further condition this exemption, or increase or decrease the number of offerees permitted, or waive the conditions in Clauses (A) or (B) with or without the substitution of a limitation on remuneration.

(n2)Footnote 2. 2002 Unif. Sec. Act § 202(14).

(n3)Footnote 3. SCOR is actually the product itself of a prior initiative of a committee of the American Bar Association that produced the "Uniform Limited Offering Exemption (ULOR)" as a specific response to coordinate with

Rule 504 under Regulation D. NASAA formalized adoption of the ULOR and SCOR procedures with its *Statement of Policy Regarding Small Company Offering Registrations*, on April 28, 1996.

(n4)Footnote 4. Pub. L. No. 96-477, 94 Stat. 2275 (codified in scattered sections of 15 U.S.C.).

(n5)Footnote 5. 15 U.S.C. § 77s(c).

(n6)Footnote 6. Sec. Act Rel. No. 6389 (Mar. 8, 1982).

(n7)Footnote 7. Securities Act Rules 146, 240, and 242 were rescinded effective June 30, 1982.

(n8)Footnote 8. Preliminary Note 2, Regulation D.

(n9)Footnote 9. Integration and the factors that determine its application to limited offerings generally are discussed in § 8.06[6], *infra*.

(n10)Footnote 10. The SEC has continued the obligation to file under Rule 503 but no longer makes this a condition of the availability of a Regulation D exemption. Instead, the failure to timely file a Form D serves as the basis for disqualifying the issuer from future use of Regulation D. Sec. Act Rel. No. 6825, Fed. Sec. L. Rep. (CCH) P 84,404 (1989).

(n11)Footnote 11. Sec. Act Rel. No. 6389 (1982). Securities Act Rule 240 was rescinded effective June 30, 1982.

(n12)Footnote 12. Securities Act § 3(b) gives the Commission the authority to exempt from registration a securities offering with an aggregate offering price not exceeding \$5 million.

(n13)Footnote 13. Securities Act § 5(a) prohibits the sale of securities unless a registration statement is in effect.

(n14)Footnote 14. Rule 242 was rescinded effective June 30, 1982. Sec. Act Rel. No. 6389 (1982).

(n15)Footnote 15. For the definition of "accredited investor," see the discussion of Rule 501 *supra*.

(n16)Footnote 16. In the interest of furthering compatibility with the federal exemptions, on April 22, 1988 NASAA adopted for the ULOE the SEC amendments to Regulation D contained in Securities Act Rels. Nos. 6437, Fed. Sec. L. Rep. (CCH) P 72,407 (1982); 6663, Fed. Sec. L. Rep. (CCH) P 84,032 (1986); and 6758, Fed. Sec. L. Rep. (CCH) P 84,221 (1988). NASAA further directed its Small Business Capital Formation Committee to formulate ULOE changes conforming with the 1989 SEC amendments to Regulation D, see NASAA Reports (CCH) P 7024 at 7027 (Oct. 12, 1988), and states have responded by incorporating the changes into their respective versions of the ULOE, see, e.g., *Minnesota*: Minn. R. 2875.0145; *New Mexico*: 12 N.M. Admin. Code § 11.4.7.2.11; *Texas*: 7 Tex. Admin. Code § 109.13(k).

(n17)Footnote 17. In Massachusetts, unlike the recommended ULOE provision, officers, directors and general partners are not within the definition of accredited investors for the state's ULOE, and so must be counted as nonaccredited investors. Interp. Rel., Mass. Securities Quarterly, Spring 1987. Cf. Statement of Policy, Mass. Sec. Div. (6-1-97) (coordinating with NSMIA).

(n18)Footnote 18. 710 Ind. Admin. Code §1-13-6.

(n19)Footnote 19. Rule 506(b)(ii), 17 C.F.R. §230.506(b)(2)(ii) ("Nature of Purchasers").

(n20)Footnote 20. Iowa allows fifteen days following the first sale in the state for filing the notice. Regulation 191-50.16(2)c.(1). A filing fee of \$100 is charged. *Id.*

Texas also allows fifteen days after first sale in the state for filing the notice. 7 Tex. Admin. Code § 109.13(k)(5)(A). The filing fee is 1.10 of 1% of the aggregate amount of securities being offered, but not more than \$500. *Id.* § 109.13(k)(5)(D).

(n21)Footnote 21. *See* Sec. Act Rel. No. 6455 (1983), Question and Answer No. 82.

(n22)Footnote 22. 15 U.S.C. § 77d(2).

(n23)Footnote 23. *See, e.g.:*

Connecticut: Conn. Agencies Regs. § 36b-31-21b-9a.

Louisiana: La. Admin. Code tit. 64, § 705.

Ohio: Ohio Rev. Code Ann. § 1707.03(Q).

(n24)Footnote 24.

Hawaii: Haw. Rev. Stat. Ann. § 485-6(19).

Utah: Utah Code Ann. § 61-1-14(2)(n).

(n25)Footnote 25. H.R. Rep. No. 85, 73d Cong., 1st Sess. 5-7, 15-16 (1933).

(n26)Footnote 26. 346 U.S. 119, 73 S. Ct. 981, 97 L. Ed. 1494 (1953) .

(n27)Footnote 27. 346 U.S. at 127 .

(n28)Footnote 28. *See, e.g., Garfield v. Strain*, 320 F.2d 116 (10th Cir. 1963) ; *Woodward v. Wright*, 266 F.2d 108 (10th Cir. 1959) .

(n29)Footnote 29. 9267 F.2d 461 (2d Cir. 1959) , *cert. denied*, 361 U.S. 896 (1959) .

(n30)Footnote 30. *SEC v. Continental Tobacco Co.*, 463 F.2d 137 (5th Cir. 1972) .

(n31)Footnote 31. H.R. Rep. No. 85, 73d Cong., 1st Sess. 5-7, 15-16 (1933).

(n32)Footnote 32. 39 Fed. Reg. 15,261 . Rule 146 was rescinded in 1982 and replaced by Securities Act Rule 506.

(n33)Footnote 33. *See, e.g., Schneider, The Statutory Law of Private Placements*, 14 Rev. Sec. Reg. 869, 873 (Aug. 26, 1981).

(n34)Footnote 34. *See, e.g., Swenson v. Engelstad*, 626 F.2d 421 (5th Cir. 1980) ; *SEC v. Asset Management Corp.*, Fed. Sec. L. Rep. (CCH) P 97,278, 1979 U.S. Dist. LEXIS 8080 (S.D. Ind. 1979) .

(n35)Footnote 35. Rule 506(b)(2)(ii), 17 C.F.R. § 230.506(b)(2)(ii).

(n36)Footnote 36. *SEC v. Ralston Purina Co.*, 346 U.S. 119, 73 S. Ct. 981, 97 L. Ed. 1494 (1953) .

(n37)Footnote 37. Rule 146(c), (d).

(n38)Footnote 38. Rule 502(b)(1), 17 C.F.R. § 230.502(b)(1). Rule 502 is discussed in § 8.06[2][a] *supra*.

(n39)Footnote 39. *See, e.g., Doran v. Petroleum Management Corp.*, 545 F.2d 893 (5th Cir. 1977) ; *Gilligan, Will & Co. v. SEC*, 267 F.2d 461 (2d Cir.) , *cert. denied*, 361 U.S. 896, 80 S. Ct. 200, 4 L. Ed. 2d 152 (1959) .

(n40)Footnote 40. *See SEC v. Ralston Purina Co.*, 346 U.S. 119, 73 S. Ct. 981, 97 L. Ed. 1494 (1953) .

(n41)Footnote 41. 374 F. Supp. 1104 (D. Mass. 1974) .

(n42)Footnote 42. 546 F.2d 1044 (2d Cir. 1976) .

(n43)Footnote 43.

Nebraska: Cf. Neb. Rev. Stat. § 8-1111(16)(b) (amendment permitting payment of commissions in nonpublic offerings to registered agents of registered broker-dealers).

(n44)Footnote 44. *Section 4(2) and Statutory Law*, 31 Bus. Law. 483, 497 (1975).

(n45)Footnote 45. *SEC v. Ralston Purina Co.*, 346 U.S. 119, 73 S. Ct. 981, 97 L. Ed. 1494 (1953) .

(n46)Footnote 46. *See, e.g., SEC v. Ralston Purina Co.*, 346 U.S. 119, 73 S. Ct. 981, 97 L. Ed. 1494 (1953) ; Sec. Act Rel. No. 5487 (1974).

(n47)Footnote 47. Sec. Act Rel. No. 285 (1935).

(n48)Footnote 48. *See Institutional Private Placements Under the Section 4(2) Exemption of the Securities Act of 1933*, 31 Bus. Law. 515 (1975).

(n49)Footnote 49. *See, e.g., Swenson v. Engelstad*, 626 F.2d 421 (5th Cir. 1980) .

(n50)Footnote 50. 17 C.F.R. § 230.144. For discussion of Securities Act Rule 144, *see* Federal Securities Act of 1933, A.A. Sommer, Jr., General Editor, § 6.05 (Matthew Bender).

(n51)Footnote 51. 15 U.S.C. § 77b(a)(11). For discussion of Securities Act Section 2(a)(11), *see* Federal Securities Act of 1933, A.A. Sommer, Jr., General Editor, §§ 4.02[2], 6.02 (Matthew Bender).

(n52)Footnote 52. *See, e.g., Livens v. William D. Witter, Inc.*, 374 F. Supp. 1104, 1110-11 (D. Mass. 1974) .

(n53)Footnote 53. *See, e.g., SEC v. Management Dynamics Ltd.*, 515 F.2d 801 (2d Cir. 1975) ; Sec. Act Rel. No. 5121 (1970).

(n54)Footnote 54. *Statutory time period of twelve consecutive months:*

Alaska: Alaska Stat. § 45.55.900(b)(5)(A), (B). The first exemption applies to sales by an issuer to no more than ten persons whether or not the seller or buyer is present in the state. The second exemption applies to sales by an issuer to no more than twenty-five persons provided the sales are made solely in the state.

Florida: Fla. Stat. § 517.061(11). Thirty-five purchasers. Any purchaser who invests \$100,000 or more is excluded from the count if he is provided with or has access to full disclosure of all material information in connection with the offering.

Illinois: Ill. Comp. Stats., ch. 815, § 5/4(G). Thirty-five purchasers. Alternatively, the exemption is also available if the aggregate sales price of all sales does not exceed \$1,000,000. Sales may be to non-residents or residents alike.

Michigan: Mich. Comp. L. § 451.802(b)(9).

The number of permitted purchasers varies depending on the circumstances. The number of sales ordinarily permitted to purchasers in the state is fifteen. Only ten sales, however, can be made to promoters, individuals actively (or expected to be actively) engaged in the management of the issuer, those acting in a professional capacity to the issuer, or those directly related by blood or marriage to the promoter or those engaged in the management of the issuer. Likewise, ten sales pursuant to offers to not more than fifteen persons may be made by a person other than the issuer if the offering is not part of a distribution of the issuer's securities. Sales to thirty-five purchasers are permitted under specific conditions: the filing of an application and offering circular and the payment of a filing fee; the delivery of the offering circular to each purchaser; and the administrator's order and declaration that the exemption is effective.

Mississippi: Miss. Code Ann. § 75-71-203(9). Ten purchasers in the state.

No time period indicated:

California: Cal. Code Ann. § 25102(f). Thirty-five purchasers.

Connecticut: Conn. Gen. Stat. § 36b-21(b)(15). Ten purchasers.

Indiana: Ind. Code § 23-2-1-2(b)(10). Thirty-five purchasers, including those outside the state, or twenty purchasers in the state.

(n55)Footnote 55.

Ohio: Ohio Rev. Code Ann. § 1707.01(C)(1).

Texas: Tex. Rev. Civ. Stat. Ann. art. 581-4(E).

(n56)Footnote 56. See *State v. Garrette*, 699 S.W.2d 468 (Mo. App. 1985) (upholding conviction of manager for associated companies selling unregistered investment contracts where the companies were allegedly structured to avoid the sales limitation of the limited offering exemption).

(n57)Footnote 57. See § 8.06[3][c] *supra* for discussion of investment intent generally.

(n58)Footnote 58.

Colorado: Colo. Rev. Stat. Ann. § 11-51-308(1)(j). Twenty offers are permitted.

North Dakota: N.D. Cent. Code § 10-04-06(.9.a). Note that North Dakota has two limited offering exemptions, this provision (limited offeree exemption--35 offers permitted) and N.D. Cent. Code § 10-04-06(.9.b) (limited sales exemption).

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(e). Fifty offers are permitted.

Ninety offers are allowed under Pennsylvania's "small issuer exemption." See 64 Pa. Code § 203.187.

(n59)Footnote 59.

Connecticut: Conn. Gen. Stat. § 36b-21(b)(14).

Kansas: Kan. Stat. Ann. § 17-1262(l).

Missouri: Mo. Rev. Stat. Ann. § 409.402(b)(10).

Oklahoma: Okla. Stat. tit. 71, § 401(b)(10)(A).

Oregon: Or. Rev. Stat. § 59.035(12)(a)(C).

(n60)Footnote 60.

Iowa: Iowa Code Ann. § 502.203(9)(e).

Maryland: Md. Code Ann. § 11-602(9).

North Dakota: N.D. Cent. Code § 10-04-06.9.b(4).

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(d).

South Dakota: S.D. Codified Laws Ann. §§ 47-31A-402(b)(9).

Texas: Tex. Rev. Civ. Stat. Ann. art. 581-5(I), (Q).

(n61)Footnote 61.

Arizona: Ariz. Rev. Stat. Ann. § 44-1844(A)(10). Ten security holders who must be incorporators.

California: Cal. Code Ann. § 25102(f), (h). Thirty-five security holders.

Missouri: Mo. Rev. Stat. Ann. § 409.402(b)(9). Twenty-five security holders.

New Mexico: N.M. Stat. Ann. § 58-13B-27(K). Twenty-five security holders.

Ohio: Ohio Rev. Code Ann. § 1707.03(O). Ten security holders.

Virginia: Va. Code Ann. § 13.1-514(B)(7), (10). The first exemption permits thirty-five security holders. The second exemption applies to the issuance of not more than three shares of common stock to one or more of the incorporators of a corporation.

Wisconsin: Wis. Stat. Ann. § 551.23(10). Fifteen security holders.

(n62)Footnote 62. Draftmen's commentary to Unif. Sec. Act § 402(b)(9):

It seems quite clear that some exemption along these lines is essential in any well-ordered blue sky law, if for no other reason than to permit the incorporated corner grocery store or gasoline station to raise additional capital from a few relatives and friends without going through registration or--as is more likely today--violating the statute in complete oblivion of the possibility that anything like a blue sky law might be applicable. This situation is one of the sources of the innocently assumed contingent civil liabilities which is one of the purposes of this Act to remove or minimize.

(n63)Footnote 63. *See, e.g.:*

Colorado: Colo. Rev. Stat. Ann. § 11-51-308(1)(j).

Kentucky: Ky. Rev. Stat. Ann. § 292.410(1)(i).

Massachusetts: Mass. Gen. Laws Ann., ch. 110A, § 402(b)(9).

In a Massachusetts private placement offering where the minimum number of shares are not sold prior to the firm closing date, the Securities Division usually will permit a reoffering subject to specified conditions including return of the escrowed funds. Mass. Sec. Bull. No. 2, January 1988, Blue Sky L. Rep. (CCH) P 31,622.

North Dakota: N.D. Cent. Code Ann. § 10-04-06(9).

(n64)Footnote 64.

California: Cal. Corp. Code § 25102(f), (h).

The first exemption does not specify that it is for the use of issuers, but a release commenting on the exemption states that it is available only to issuers. *See* Release No. 67-C, Commissioner of Corporations, issued October 20, 1981, 1 Blue Sky L. Rep. (CCH) P 12,558. The second exemption is available only to corporations.

Connecticut: Conn. Gen. Stat. Ann. § 36b-21(b)(14).

Maryland: Md. Code Ann. § 11-602(9).

Missouri: Mo. Rev. Stat. Ann. § 409.402(b)(9), (10).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17(II)(h).

Ohio: Ohio Rev. Code Ann. § 1707.03(O).

(n65)Footnote 65. *See, e.g.:*

Arizona: Ariz. Rev. Stat. Ann. § 44-1844(A)(10).

California: Cal. Corp. Code § 25102(f), (h).

Wisconsin: Wis. Stat. Ann. § 551.23(10).

(n66)Footnote 66.

Georgia: Ga. Code Ann. § 10-5-9(13).

Tennessee: Tenn. Code Ann. § 48-2-103(b)(4).

See ch. 9 *infra* for a discussion of "affiliates".

(n67)Footnote 67.

Illinois: Ill. Comp. Stats., ch. 815, § 5/4(G).

See ch. 9 *infra* for a discussion of "control persons".

(n68)Footnote 68. Unif. Sec. Act § 402(b)(9).

(n69)Footnote 69.

California: Cal. Corp. Code § 25102(f)(2).

Purchasers must either have a preexisting personal or business relationship with the offeror or by reason of their business or financial experience could be reasonably assumed to have the capacity to protect their own interests.

(n70)Footnote 70.

California: Cal. Code Regs. tit. 10, § 260.102.2. The rule applies to Section 25102(e) (the exemption for non public offerings of evidence of indebtedness) and (g) (the exemption for non-public offerings of equipment trust certificates).

(n71)Footnote 71. See, e.g.:

Arizona: Ariz. Rev. Stat. Ann. § 44-1844(A)(10).

South Dakota: S.D. Codified Laws § 47-31A-402(b)(10). The exemption allows offerings to original incorporators or subscribers.

(n72)Footnote 72. Unif. Sec. Act § 402(b)(9).

For discussion of the exemption for financial and institutional investors, see § 8.03[6] *supra*.

(n73)Footnote 73.

California: Cal. Corp. Code § 25102(f); Cal. Code Regs. tit. 10, § 260.102.2. The rule applies the exclusion of sophisticated investors from the count of purchasers to the exemptions in § 25102(e) (non-public offerings of evidences of indebtedness), (g) (non-public offerings of equipment trust certificates), and § 25104(a) (transactions by a bona fide owner for his own account in a non-public offering).

Cal. Code Regs. tit. 10, § 260.102.13 excludes certain sophisticated investors from the count of purchasers for the purpose of the limited offering exemption claimed under Cal. Corp. Code § 25102(f)(1) (sales made to not more than 35 persons).

Massachusetts: Mass. Gen. Laws Ann., ch. 110A, § 402(b)(9).

Michigan: Mich. Comp. Laws Ann. § 451.802(b)(9).

North Carolina: N.C. Gen Stat. Ann. § 78A-17(9).

West Virginia: W. Va. Code Ann. § 32-4-402(b)(9).

Wyoming: Wyo. Stat. Ann. § 17-4-114(b)(ix).

(n74)Footnote 74. *See, e.g.:*

Illinois: Ill. Comp. Stats., ch. 815, § 5/4(G)(2).

Indiana: Ind. Code Ann. § 23-2-1-2(b)(10)(A).

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(d).

Texas: Tex. Rev. Civ. Stat. art. 581-5(I)(c).

(n75)Footnote 75. Draftsmen's commentary to Unif. Sec. Act §§ 402(b)(9), 414(a)-(f).

(n76)Footnote 76. *In re Information Resources Corp.*, 126 N.J. Super. 42, 312 A.2d 671 (1973) .

An interpretation of the statutory provision that was at issue in *Information Resources Corp.* (N.J. Rev. Stat. Ann. § 49:3-50(b)(9)) released by the Securities Bureau on May 20, 1974, states, as amended:

Only offers made to persons in the State of New Jersey need be included in determining the number of offers allowable under section 50(b)(9). Offers made to New Jersey residents no matter where located may be counted in determining the number of offers allowable if such offers were made as part of a scheme to avoid the ten person limit contained in section 50(b)(9).

Offers to "persons in this State" should not be confused with "offers made in this State" or other terms defined in section 51.

(n77)Footnote 77. *See* Draftsmen's commentary to Unif. Sec. Act §§ 402(b)(9), 414(a)-(f).

(n78)Footnote 78. *Id.*

(n79)Footnote 79.

Delaware: Del. Code Ann. tit. 6, § 7309(b)(9).

Hawaii: Haw. Rev. Stat. Ann. § 485-6(9).

Massachusetts: Mass. Gen. Laws Ann., ch. 110A, § 402(b)(9).

Montana: Mont. Code Ann. § 30-10-105(8).

(n80)Footnote 80.

Florida: Fla. Stat. Ann. § 517.061(11).

Illinois: Ill. Comp. Stats. ch. 815, § 5/4(G)(1)(a). The provision requires that all sales be made to "residents of this State".

Michigan: Mich. Comp. Laws Ann. § 451.802(b)(9).

Ohio: Ohio Rev. Code Ann. § 1707.03(O), (P).

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(d).

(n81)Footnote 81.

Colorado: Colo. Rev. Stat. Ann. § 11-51-308(1)(j).

Maryland: Md. Code Ann., Corps. & Ass'ns § 11-602(9).

Oklahoma: Okla. Stat. tit. 71, § 401(b)(10)(A). The statute provides that the number of sales permitted by the exemption includes sales whether or not the *seller* as well as the purchaser is then present in the state at the time of sale.

South Dakota: S.D. Codified Laws Ann. §§ 47-31A-402(b)(9).

(n82)Footnote 82.

California: Cal. Code Regs. tit. 10, § 260.102.1(a)(3) (applies to exemptions claimed under *Cal. Corp. Code § 25102(a)*); *Cal. Code Regs. tit. 10, § 260.102.2* (applies to exemptions claimed under *Cal. Corp. Code § 25102(e), (g)*).

Any relative, spouse, or relative of the spouse of the purchaser who shares the same principal residence as the purchaser is excluded from the count of purchasers from exemption claimed under *Cal. Corp. Code § 25102(f)(1)* (sales made to not more than 35 persons). *Cal. Code Regs. tit. 10, § 260.102.13(c)(1).*

Florida: Fla. Securities Rule 3E-500.004(1)(a). Any relative, spouse, or relative of the spouse of the purchaser who shares the same principal residence as the purchaser is excluded from the count of purchasers for exemptions claimed under *Fla. Stat. Ann. § 517.061(11)* (offers or sales made to not more than 35 purchasers).

Massachusetts: Interp. Rel. Mass. Securities Quarterly Spring 1987, 2 Blue Sky L. Rep. (CCH) P 31,612A. For purposes of the ULOE provision, a joint purchase by a husband and wife living in the same home is counted as only one sale.

(n83)Footnote 83.

California: Cal. Corp. Code § 25102(f). Any corporation or other organization of which the purchaser and any relative, spouse, or relative of the spouse of the purchaser sharing the same principal residence as the purchaser who collectively are beneficial owners of more than 50 percent of the equity shares (excluding director's qualifying shares) or equity interests is excluded from the count of purchasers for

exemptions claimed under *Cal. Corp. Code § 25102(f)(1)* (sales made to not more than 35 persons). Cal. Code Regs. tit. 10, § 260.102.13(c).

Under Cal. Code Regs. tit. 10, § 260.102.13(d), any person who is a promoter of the issuer is excluded from the count of purchasers for exemptions claimed under § 25102(f)(1).

Ohio: Ohio Rev. Code Ann. § 1707.03(O).

(n84)Footnote 84.

California: Cal. Corp. Code § 25102(h).

(n85)Footnote 85.

Virginia: Va. Code Ann. § 13.1-514(B)(7)(b).

Wisconsin: Wis. Admin. Code § [SEC] 2.02(5)(a).

(n86)Footnote 86.

New Mexico: N.M. Stat. Ann. § 58-13B-27(K). The provision exempts the offer or sale of limited partnership interests.

(n87)Footnote 87.

California: Cal. Corp. Code § 25102(h).

(n88)Footnote 88.

Iowa: Iowa Code § 502.203(9).

(n89)Footnote 89.

Minnesota: Minn. R.2875.0180 subpar. 3(A). The rule provides that the limited offering exemption is not applicable to the sale of interests in oil or gas for investment or exploration unless the security is sold in compliance with Securities Act Rule 506. For discussion of Rule 506, *see § 8.06[2][a] supra*.

New Mexico: N.M. Stat. Ann. § 58-13B-27(T). The exemption applies to limited offerings involving not more than twenty-five sales and includes requirements relating to suitability standards, disclosure documents, advertisements, and registration of agents.

For discussion of subject matter exemptions generally, and oil, gas and mineral interests specifically, *see § 8.08[5], infra*.

(n90)Footnote 90.

Iowa: Iowa Code Ann. § 502.203(9).

(n91)Footnote 91. *See, e.g.:*

Alabama: Ala. Code § 8-6-11(a)(9).

Alaska: Alaska Stat. § 45.55.900(b)(5)(A), (B).

Delaware: Del. Code Ann. tit. 6, § 7309(b)(9).

Hawaii: Haw. Rev. Stat. Ann. § 485-6(9).

Massachusetts: Mass. Gen. Laws Ann., ch. 110A, § 402(b)(9).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17(II)(h).

New Jersey: N.J. Stat. Ann. § 49:3-50(b)(9).

Oklahoma: Okla. Stat. tit. 71, § 401(b)(10)(A).

South Dakota: S.D. Codified Laws Ann. §§ 47-31A-402(b)(9).

(n92)Footnote 92. Unif. Sec. Act § 402(b)(9).

(n93)Footnote 93. Official comment to Unif. Sec. Act § 402(b)(9).

(n94)Footnote 94. *James v. Thurn*, 265 Md. 501, 290 A.2d 490, 3 Blue Sky L. Rep. (CCH) P 71,047 (1972).

However, in states such as Indiana, which require the buyer to submit an investment letter (*Ind. Code Ann. § 23-2-1-2(b)(10)(C)*), the exemption is not valid unless the seller obtains the written document. The seller's failure to obtain the letter, under ordinary circumstances, would permit the buyer to rescind the sale. *Theye v. Bates*, 337 N.E.2d 837, 3 Blue Sky L. Rep. (CCH) P 71,262 (Ind. App. 1975).

(n95)Footnote 95. *See* Official Comment to Unif. Sec. Act § 402(b)(9).

(n96)Footnote 96. *Id.*

(n97)Footnote 97. *See* Unif. Sec. Act § 402(b)(9). *See* § 8.03[6] *supra* for discussion of the exemption for financial and institutional investors.

(n98)Footnote 98. Draftsmen's commentary to Unif. Sec. Act § 402(b)(9).

(n99)Footnote 99. *See, e.g.:*

Alabama: Ala. Code § 8-6-11(a)(9).

Alaska: Alaska Stat. § 45.55.900(b)(5)(A), (B).

Delaware: Del. Code Ann. tit. 6, § 7309(b)(9).

Hawaii: Haw. Rev. Stat. Ann. § 485-6(9).

Massachusetts: Mass. Gen. Laws Ann., ch. 110A, § 402(b)(9).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17(II)(h).

New Jersey: N.J. Stat. Ann. § 49:3-50(b)(9).

Oklahoma: Okla. Stat. tit. 71, § 401(b)(10)(A).

South Dakota: S.D. Codified Laws Ann. §§ 47-31A-402(b)(9).

(n100)Footnote 100. *See, e.g.:*

California: Cal. Corp. Code § 25102(h); Cal. Code Regs. tit. 10, §§ 260.102.6, 260.141.11.

Delaware: Delaware Sec. Div. Rules Section 502.

Indiana: Ind. Code Ann. § 23-2-1-2(10)(C).

Michigan: Mich. Comp. Laws Ann. § 451.802(b)(9)(A).

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(d)(i).

See, however, Pa. Sec. Reg. tit. 64, § 204.011, providing for instances of waiver of the 12-month restriction on resale under the state's limited offering exemption.

(n101)Footnote 101. Mofsky, Blue Sky Restrictions on New Business Promotions 22 (1971):

The prohibition against commissions or other remuneration in connection with a limited offering is intended to prevent the dilution of investor's funds. If promoters and investment bankers were permitted to take commissions in effecting private placements of securities, the equity of capital-contributing shareholders would be diminished in direct relation to the size of such commissions.

See, e.g.:

Arizona: Ariz. Corp. Comm'n Regs. § R14-4-102(A)(2).

The provision prohibiting the payment of commissions or other remuneration applies to offerings with an aggregate amount not exceeding \$100,000.

Connecticut: Conn. Gen. Stat. § 36b-21(b)(14).

Kansas: Kan. Stat. Ann. § 17-1262(l).

Massachusetts: Mass. Gen. Laws Ann., ch. 110A, § 402(b)(9).

Missouri: Mo. Rev. Stat. Ann. § 409.402(b)(9), (10).

West Virginia: W. Va. Code Ann. § 32-4-402(b)(9).

Wisconsin: Wis. Stat. Ann. § 551.23(10), (11). *But see* Wis. Admin. Code § [SEC] 2.02(5)(c) where reasonable commissions are permitted to be paid to licensed broker-dealers.

See also Wis. Admin. Code § [SEC] 2.02(9)(c), which provides for the exemption of any transaction pursuant to an offer to existing security holders of the issuer and to not more than ten other persons in the state less the number of persons in the state with whom the issuer has effected transactions during the previous twelve months, provided no commission or other remuneration other than a standby commission is paid for soliciting any security holder in the state.

Wyoming: Wyo. Stat. Ann. § 17-4-114(b)(ix).

(n102)Footnote 102. Uniform Securities Act § 402(b)(9) and those states following the Uniform Securities Act provision empower the administrator to waive the no commission requirement. Several other states grant similar discretion to their administrators. *See, e.g.:*

Iowa: Iowa Code § 502.203(9)(d).

Missouri: Mo. Rev. Stat. Ann. § 409.402(b)(10).

Oklahoma: Okla. Stat. tit. 71, § 401(b)(10).

Vermont: Vt. Stat. Ann. tit. 9, § 4204a(a)(9).

In any event, before securities are sold under conditions not completely in accord with the statute, administrative permission regarding the eligibility for use of the exemption should be sought. The regulations in some states have filing procedures for requesting this permission.

(n103)Footnote 103. Official comment to Unif. Sec. Act § 402(b)(9).

(n104)Footnote 104. In *Upton v. Trinidad Petroleum Corp.*, 652 F.2d 424, 3 Blue Sky L. Rep. (CCH) P 71,645 (5th Cir. 1981), a corporation that offered interests in an oil well and collected funds from investors in excess of the drilling costs was held to have received prohibited remuneration that barred use of the limited offering exemption.

In *Petroleum Resources Development Corp. v. State of Oklahoma*, 585 P.2d 346, 3 Blue Sky L. Rep. (CCH) P 71,467 (Okla. 1978), even though oil and gas well unit sales were made without the payment of commissions, the retention by an issuer of a "supervisory fee" from the money invested constituted an indirect remuneration that precluded the application of the exemption.

In *Schultz v. Rector-Phillips-Morse, Inc.*, 552 S.W.2d 4, 3 CCH Blue Sky L. Rep. P 71,357 (Ark. 1977), the receipt by a corporation of "consulting fees" as part of the purchase price of joint venture investment units in an apartment complex constituted both direct and indirect remuneration and barred qualification for exemption.

In *Caldwell v. Trans-Gulf Petroleum Corp.*, 322 So. 2d 171, 176 (La. Sup. 1975), defendants argued that the statute prohibited commissions paid for solicitation of investors and that since they paid commissions for consummation of sales, the exemption should not be denied. However, the court reasoned, "at a very minimum, the commission paid on a sale is an indirect remuneration for the solicitation of a prospective buyer."

(n105)Footnote 105. Unif. Sec. Act. § 402(b)(9).

See § 8.03[6] *supra* for discussion of the exemption for financial and institutional investors.

(n106)Footnote 106. See, e.g.:

Massachusetts: Mass. Gen. Laws Ann., ch. 110A, § 402(b)(9).

West Virginia: W. Va. Code Ann. § 32-4-402(b)(9).

Wisconsin: Wis. Stat. Ann. § 551.23(10),(11).

Wyoming: Wyo. Stat. Ann. § 17-4-114(b)(ix).

The original draft of the Uniform Securities Act exemption did not permit the payment of commissions for soliciting sophisticated investors. The draftsmen recommended that the omission be cured with a "technical amendment." See Loss & Cowett, Blue Sky Law 374 (1958). The amendment was made to the Uniform Securities Act but a number of states with exemptions based on the Uniform Securities Act's exemption did not enact the amendment permitting the commissions. Whether the failure to adopt the amendment was also an inadvertence or a deliberate move not to allow the payment of commissions is not clear.

(n107)Footnote 107.

Alaska: Alaska Stat. Ann. § 45.55.900(b)(5)(B).

Florida: Fla. Stat. Ann. § 517.061(11).

Nebraska: Neb. Rev. Stat. Ann. § 8-1111(9), (16).

(n108)Footnote 108.

Michigan: Mich. Comp. Laws Ann. § 451.802(b)(9)(C).

(n109)Footnote 109.

Minnesota: Minn. Stat. Ann. § 80A.15(2)(a)(2).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17(II)(h)(2).

Commissions paid for soliciting sophisticated investors are not subject to any limitation.

South Dakota: S.D. Codified L. Ann. § 47-31A-402(b)(9); (13); S.D. Admin. R. 20:08:06:13.

(n110)Footnote 110.

Montana: Mont. Rev. Code Ann. § 30-10-105(8)(b).

(n111)Footnote 111.

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(d)(iii); Securities Rule § 203.041(g).

(n112)Footnote 112.

Illinois: Ill. Comp. Stats., ch. 815, § 5/4(G).

All discounts, commissions, or other remuneration may not exceed 20% of the initial offering price.

Ohio: Ohio Rev. Code Ann. § 1707.03(O)(1)(e), (P)(3). In the first exemption, all discounts, commissions, and other remuneration may not exceed 10% of the initial offering price. In the second exemption covering oil and gas interests, the total of all commissions, compensation, costs, and expenses may not exceed 25% of the aggregate oil and gas interests.

(n113)Footnote 113. *See, e.g.:*

Alaska: Alaska Stat. Ann. §§ 45.55.900(b)(5)(A), 45.55.900(b)(5)(B).

Arkansas: Securities Rule 504.01(A)(9)(a)(x).

But cf. J&C Investments v. Mid-South Drilling, Inc., 286 Ark. 320, 691 S.W.2d 853 (1985) (giving letters endorsing the offering only to prospective offerees who specifically asked to see them did not contravene the Arkansas prohibition against advertising).

California: Cal. Code Ann. §§ 25102(f)(4), 25102(h)(2).

(n114)Footnote 114.

Arkansas: See, e.g., Securities Rule 504.01(A)(9)(a)(x).

(n115)Footnote 115. *Sibley v. Horn Advertising, Inc., 505 S.W.2d 417 (Tex. Civ. App. 1974) , cert. denied, 420 U.S. 929, 95 S. Ct. 1129, 43 L. Ed. 2d 400 (1975) .*

(n116)Footnote 116. *Sibley v. Horn Advertising, Inc., 505 S.W.2d 417, 420 (Tex. Civ. App. 1974) , cert. denied, 420 U.S. 929, 95 S. Ct. 1129, 43 L. Ed. 2d 400 (1975) .*

(n117)Footnote 117. *Tumblewood Bowling Corp. v. Matise, 388 S.W.2d 479 (Tex. Ct. App. 1965) .*

(n118)Footnote 118. *See, e.g.:*

Alabama: Ala. Code § 8-6-11(c).

Alaska: Alaska Stat. Ann. § 45.55.900(b)(5)(A),(B), Securities Rule § 3 AAC 08.910(5).

Arkansas: Ark. Code Ann. § 23-42-504(b).

California: Cal Code Reg. tit. 10, §§ 260.102.8, 260.102.14. The first rule applies to the filing required for the exemption under § 25102(h); the second rule applies to the filing required under § 25102(f).

Under either § 25102(f) or (h), however, the failure to file the required notice of transactions will not affect the availability of the exemption. Within 15 days after demand by the Commissioner, the issuer may file the notice and pay the qualification fee.

Illinois: Ill. Rev. Stats., ch. 815, § 5/4(G).

Indiana: Ind. Code Ann. § 23-2-1-2(b)(10).

Kentucky: Securities Rule 808 Ky. Admin. Regs. 10:210.

Michigan: Mich. Comp. Laws Ann. § 451.802(b)(9)(C).

Minnesota: Minn. Stat. Ann. § 80A.15(2)(h).

Mississippi: Miss. Code Ann. § 75-71-203(9).

Nebraska: Neb. Rev. Stat. Ann. § 8-1111(9), (16).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17(I)(h).

Ohio: Ohio Rev. Code Ann. § 1707.03(0)(7); Ohio Rev. Code Ann. § 1707.03(Q)(4) if the exemption is claimed under Section 4(2) of the Securities Act of 1933 or any rule promulgated thereunder.

Oklahoma: Okla. Stat. tit. 71, § 401(b)(10)(B), Securities Rule Sec. 660:10-11-43.

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(d); 64 Pa. Code § 203.041.

However, an issuer filing SEC Form D with the Securities and Exchange Commission, may file that form and a brief supplementary statement under Pennsylvania's limited offering exemption. 64 Pa. Code § 203.041(a).

(n119)Footnote 119.

Massachusetts: Mass. Gen. Laws Ann. § 402(b)(9).

(n120)Footnote 120.

Missouri: Mo. Code Regs. Ann. tit. 15, § 30-54.210.

(n121)Footnote 121.

Mississippi: Miss. Code Ann. § 75-71-203(9).

(n122)Footnote 122.

Ohio: Ohio Rev. Code Ann. § 1707.03(Q)(4).

(n123)Footnote 123.

Delaware: Del. Sec. Div. Rules Section 502.

Maryland: Md. Securities Rule .10.

See also Wisconsin Securities Rule 2.02(5)(d)(1), which requires a filing for exemptions claimed under Wis. Stat. Ann. § 551.23(11) regarding interest in limited partnerships, investment contracts, or certificates of interest or participation in an oil, gas, or mining title or lease if the aggregate offering price exceeds \$100,000.

(n124)Footnote 124. *See, e.g.:*

Alaska: Alaska Stat. Ann. § 45.55.900(b)(5)(A),(B), Securities Rule § 3 AAC08.910(5).

Arkansas: Ark. Code Ann. § 23-42-504.

California: Cal Code Reg. tit. 10, §§ 260.102.8, 260.102.14. The first rule applies to the filing required for the exemption under § 25102(h); the second rule applies to the filing required under § 25102(f).

Under either § 25102(f) or (h), however, the failure to file the required notice of transactions will not affect the availability of the exemption. Within 15 days after demand by the Commissioner, the issuer may file the notice and pay the qualification fee.

Illinois: Ill. Rev. Stats., ch. 815, § 5/4(G).

Indiana: Ind. Code Ann. § 23-2-1-2(b)(10).

Kentucky: Securities Rule 808 Ky. Admin. Regs. 10:210.

Michigan: Mich. Comp. Laws Ann. § 451.802(b)(9)(C).

Minnesota: Minn. Stat. Ann. § 80A.15(2)(h).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17(I)(h).

Ohio: Ohio Rev. Code Ann. § 1707.03(0)(7); Ohio Rev. Code Ann. § 1707.03(Q)(4) if the exemption is claimed under Section 4(2) of the Securities Act of 1933 or any rule promulgated thereunder.

Oklahoma: Okla. Stat. tit. 71, § 401(b)(10)(B), Securities Rule Sec. 660:10-11-43.

Pennsylvania: 70 Pa. Stat. Ann. § 1-203(d); 64 Pa. Code § 203.041.

However, an issuer filing SEC Form D with the Securities and Exchange Commission, may file that form and a brief supplementary statement under Pennsylvania's limited offering exemption. 64 Pa. Code § 203.041(a).

(n125)Footnote 125. In states that have formal filing requirements, the exemption can be lost if there is

noncompliance with the statutory requirements. *See Getter v. R.G. Dickinson & Co.*, 366 F. Supp. 559, 577 (S.D. Iowa 1973) .

(n126)Footnote 126. Unif. Sec. Act § 402(b)(9).

(n127)Footnote 127. 2002 Unif. Sec. Act § 202(14).

(n128)Footnote 128.

Alaska: See, e.g., Alas. Stat. § 45.55.900(b)(5)(A), (C).

(n129)Footnote 129.

Florida: See, e.g., Fla Stat. § 517.061 (11);

Indiana: Ind. Code § 23-2-1-2(b)(10);

Iowa: Iowa Code § 502.203(9);

Mississippi: Miss. Code § 75-71-203(9),(13);

New Jersey: N.J. Stat. § 49:3-50(b)(12).

(n130)Footnote 130. *See, e.g.*,

Rhode Island: R.I. Gen. L. § 7-11-402(10);

South Carolina: C.L. So. Car. § 35-1-320(9);

Vermont: Ver. Code Ann. § 4204a(9).

(n131)Footnote 131. All the states substantially adopting the Uniform Securities Act provision have included this provision concerning investment intent.

For discussion of "investment intent" generally, *see* § 8.06[3][e] *supra*..

(n132)Footnote 132. All the states substantially adopting the Uniform Securities Act provision have included a similar provision concerning the payment of a commission or other remuneration.

(n133)Footnote 133. All the states substantially adopting the Uniform Securities Act provision have included a similar provision concerning the administrator's rulemaking authority with respect to the limited offering exemption.

(n134)Footnote 134. *See* ch. 9 *infra* for discussion of the isolated transaction exemption as applicable to non-issuers.

The isolated transaction exemption may also be used by issuers in some states. *See* § 8.06[6][b] *infra*.

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(n135)Footnote 135. For discussion of the characteristics of an offeror in a limited offering exemption, *see* § 8.03[9][a] *infra*.

(n136)Footnote 136.

Minnesota: See, e.g., Minn. Stat. § 80A.15(2)(a).

(n137)Footnote 137. *N.M. Stat. Ann. § 58-13B-27(J).*

(n138)Footnote 138. 04 Md. Div. Sec. Rules.11; *see also Wisconsin: Wis. Stat. § 551.23(10).*

(n139)Footnote 139. Mo. Code. State Regs. § 30.54.240.

(n140)Footnote 140.

Nebraska: See, e.g., Bur. Sec. Rules Ch. 18.

(n141)Footnote 141. Pa. Code § 203.187.

South Dakota limits sales to no more than 5 persons in the state during any consecutive 12 month period, *see* S.D. Con. Laws § 47-31A-402(b)(9)..

(n142)Footnote 142. *Tenn. Code Ann. § 48-2-103(B)(6).*

(n143)Footnote 143. Vt. Admin. Order No. 96-4-SE (May 13, 1996).

(n144)Footnote 144.

Virginia: See, e.g., 21 Va. Admin. Code § 5-40-100.

(n145)Footnote 145. Tex. Admin. Code § 109.13(l).

(n146)Footnote 146.

Vermont: See, e.g. Vt. Admin. Order No. 96-4-SE (May 13, 1996).

(n147)Footnote 147. Rev. Code Wash. § 20.21.20(1); Wash. Admin. Code § 460-44A050(1)(d).

South Dakota: See also S.D. Cod. Laws § 47-31A-402(b)(9) (Sales to no more than 5 persons in the state during a 12 month period).

(n148)Footnote 148. Pa. Code § 203.189; *see also New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17(II)(h).*

(n149)Footnote 149. *See, e.g.*

Alaska: Alas. Stat. § 45.55.900(b)(5)(A).

Arizona: Ariz. Admin. Code Sec. R14-4-102. In Arizona, however, the aggregate amount of the offering

may not exceed \$100,000.00, and there are other qualifying conditions.

Colorado: Colo. Rev. Stat. § 11-51-308(1)(j).

Connecticut: Conn. Gen. Stat. § 36b-21(b)(14)(B).

Maine: 32 Me. Rev. Stat. § 10502(P).

Minnesota: Minn. Stat. § 80A.15(2)(a).

Mississippi: Miss. Code § 75-71-203(9).

Montana: Mont. Code Ann. § 30-10-105(8)(a).

New Jersey: N.J. Stat. § 49:3-50(b)(9).

New Mexico: N.M. Stat. Ann. § 58-13B-27(U).

Ohio: Ohio Rev. Code § 1707.03(O).

Oregon: Ore. Rev. Stat. § 59.035(12)(a)(A).

Puerto Rico: Laws. P.R. Ann. § 882(b)(9).

South Carolina: Con. Laws. S.C. § 35-1-320(9).

West Virginia: W.V. Code § 402(b)(9).

(n150)Footnote 150. Wis. Admin. Code DFI-Sec.2.02(9)(c).

(n151)Footnote 151.

Utah: But see Utah Code Ann. § 61-1-14(2)(q) (including a limitation of 15 non-financial or institutional purchasers).

(n152)Footnote 152. Code Ala. § 8-6-11(a)(14).; *see also Indiana: Ind. Code § 23-2-1-2(b)(10)(G)(ii).*; *Kentucky: Ky. Rev. Stat. § 292.410(i); Missouri: Mo. Code State Regs. § 30-54.240.*

(n153)Footnote 153. *N.D. Cent. Code § 10-04-06(16).*

(n154)Footnote 154. *Ariz. Rev. Stat. § 44-1844 A 10.*

South Dakota: See also S.D.Cod. Laws §47-31A-402(b)(10).

(n155)Footnote 155. *Va. Code § 13.1-514(10).*

(n156)Footnote 156. Securities Act Rel. No. 33-4552, 27 F.R. 11316 (Nov. 6, 1962) .



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Blue Sky Regulation

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CHAPTER 8 Exempt Issuer Transactions

1-8 Blue Sky Regulation § 8.07

§ 8.07 Small Business Offerings

State legislatures and securities administrators have made significant strides in the elimination of unnecessary burdens on small business capital formation. Many of the limited offerings discussed in the previous section are products of that commitment. There remain for consideration, however, certain specific issuer exemptions in blue sky laws that are designed for the particular benefit of small business. There are two approaches in evidence among the states. The first is to provide a specific small business issuer exemption that is in many cases specifically designed to coordinate with the federal exemption under Rule 505 of Regulation D under the Securities Act of 1933 to permit offerings up to \$5 million. The second, and more common, approach is to establish a special mechanism for small business issuers to comply with registration requirements for offerings up to \$1 million that are exempt from federal registration under Rule 504 of Regulation D. This approach is based upon the Uniform Limited Offering Registration (ULOR) procedure, and has produced SCOR--the Small Company Offering Registration--process that is now adopted in most states. SCOR is not an exemption, but rather a lesser form of registration requirement. Because they are considered in more detail in Chapter 10, the ULOR and SCOR are only briefly introduced here along with consideration of small business offering provisions generally.

[1] Small Business Offering Exemptions

[a] Rule 505 Coordinate Exemptions Rule 505 of Regulation D¹ under the federal Securities Act of 1933 provides an exemption from federal registration requirements for offers and sales of securities not exceeding an aggregate offering price of \$5 million during a 12 month period, the calculation of which is prescribed in the rule. Only 35 non-accredited purchasers are permitted, and the issuer must not be subject to any "bad boy" disqualification. The application of state registration and qualification requirements to Rule 505 offerings was not preempted by NSMIA, and unless an exemption is available in blue sky laws they remain fully applicable. As discussed at length earlier, however,² most states have, through adoption of the Uniform Limited Offering Exemption or its equivalent, provided a coordinate exemption such that Rule 505 federally exempt offerings will also be exempt at the state level. Other conditions, such as a prohibition on the payment of commissions, finders fees or other remuneration for soliciting prospective investors may be included, and there is generally a notice filing requirement utilizing SEC Form D.³ For the most part, states have adopted the Uniform Limited Offering Exemption (ULOEE), which specifically encompasses SEC Rule 505 offerings, and which imposes these conditions. In addition, the ULOEE imposes a suitability requirement for sales to non-accredited investors.⁴

[b] Section 4(2) Coordinate Exemptions In an earlier discussion⁵ statutory exemptions in blue sky laws

specifically tailored to encompass transactions exempt from federal registration requirements by section 4(2) of the Securities Act of 1933 were considered. Later the elements of section 4(2) itself as applied through these blue sky exemptions were outlined in the general context of limited offering exemptions.ⁿ⁶ The availability of section 4(2) outside of SEC Rule 506 under Regulation D can be an important consideration for small business issuers. Rule 506 operates as a safe harbor for reliance on the section 4(2) "private offering" exemption, it does not, however, foreclose reliance on the exemption in any circumstances in which for one reason or another a particular element of Rule 506 could not be met but the requirements of the exemption as established through case law and administrative interpretations can nevertheless be satisfied. Some states have retained statutory exemptions to coordinate specifically with offerings exempt under federal section 4(2) and exempt any transaction not involving a "public offering" within the meaning of section 4(2),ⁿ⁷ although in many instances there are notice filing or other qualification requirements attached. In Louisiana, for example, the blue sky law specifically exempts offers and sales of securities in transactions carried out in compliance with section 4(2) of the federal Securities Act of 1933, but also imposes conditions such as the prohibition on payment of commissions, fees or remuneration for solicitation, and against general advertising, as well as requiring adequate disclosure.ⁿ⁸ Limitations on the payment of commissions, discounts or fees are common, as well as providing for a notice filing.ⁿ⁹

Particular "private" or "nonpublic" offering exemptions in state blue sky laws may afford the greatest utility to small business issuers without the uncertainties of compliance with the more generalized federal section 4(2) criteria. Nevertheless, in those states which do provide a general exemption to coordinate with federal section 4(2) where greater flexibility is needed as, for example, when a state private offering exemption limits the amount of securities that may be sold, the alternative is meaningful.

[c] Other "Small Business" Offering Exemptions In some states a specific "small business" offering exemption has been adopted to permit offerings of securities in varying and relatively small amounts without compliance with registration or qualification provisions. The Vermont Small Business Offering Exemption, for example, permits an aggregate offering up to \$500,000 by an in-state issuer that uses at least 40% of the proceeds of the offering in the state.ⁿ¹⁰ There are reasonable limits on the number of purchasers and other basic qualifications apply. It presents a particularly useful mechanism for small business issuers to raise seed capital necessary to undertake or support early operations, and the state is a clear beneficiary of the economic contribution that is locked-in to qualifications for the exemption. Arkansas provides an exemption from its blue sky law for small business offerings in an aggregate amount not exceeding \$1 million during a 12 month period. There are, however, specific disclosure requirements, and in some states the exemption is conditioned on approval by the administrator under a claim of exemption procedure. Arkansas, for example, exempts a single offering of securities not exceeding \$1 million, or in separate offerings aggregating \$1 million during any 12 month period, whichever comes first. Transactions must satisfy requirements addressing, among other things, the use of a prospectus or offering circular, financial disclosures, and certain undertakings by executive officers, directors and controlling persons of the issuer. The availability of the exemption is conditioned upon approval of the administrator through a prescribed "proof of exemption" procedure.ⁿ¹¹

These examples are true exemptions from registration requirements rather than lesser forms of registration such as the SCOR offering process that is discussed below. However, it is also apparent that qualifying conditions, as in the case of the proof of exemption procedure in Arkansas for example, may functionally amount to a registration procedure. A special small issuer registration procedure rather than an outright exemption is the more common approach to meeting the needs of small business and to facilitate small business capital formation. As a practical matter it is also apparent from consideration of the various local issuer and *de minimis* exemption alternatives, there are several possibilities for a small business exemption from blue sky registration and qualification requirements regardless of whether a blue sky law contains a specific "small business" exemption.

[2] Hybrid Exemptions: Small Business Limited Registration Procedures

[a] Uniform Limited Offering Registration (ULOR) Although, as discussed above, some states provide specific

exemptions for small business issuers to support capital formation activities, the most common initiative to accomplish both investor protection and capital formation objectives has been through adoption of either the Uniform Limited Offering Registration (ULOR) or, more commonly, SCOR--the Small Company Offering Registration. Where adopted, the ULOR establishes a lesser registration procedure when the aggregate amount of the offering does not exceed \$5 million in any 12 month period, although in many cases the ULOR specifically encompasses state registrations of offerings eligible for federal exemption under Rule 504 of Regulation D under the Securities Act of 1933, but subject to the lower amount limit on such an offering. ULOR is a procedure for registration by qualification in those states providing for such registration. The difference between ULOR and normal registration is mechanical. Offerings eligible for the ULOR procedure are registered on Form U-7--the Uniform Small Corporate Offering Registration Form. Form U-7 is a simplified registration statement that also serves as a disclosure document.

ULOR is not available for certain offerings, and there are issuer qualification requirements. As adopted in Vermont, for example, ULOR requirements include:

- 1) The issuer must be a corporation organized under the laws of a U.S. state or possession, and may not be an investment company, a "blind pool" or engaged in petroleum exploration or mining or any other extractive industry;
- 2) The aggregate offering price of securities covered by the ULOR procedure must conform to the limits imposed by Rule 504 or Regulation A under the Securities Act of 1933, whichever is greater, less the aggregate offering price of all securities sold within 12 months before the start of, and during the offering of, the securities in reliance on any exemption under the Securities Act of 1933;
- 3) The offering price must be at least \$5.00 per share, except that the Commissioner may waive the minimum price requirement unless it is determined to be necessary for the protection of investors;
- 4) The issuer may not split its common stock or declare a stock dividend for a period of two years from the date of effectiveness; and
- (5) The issuer is not disqualified by "bad boy" criteria.¹²

The incorporation of either Rule 504 or the SEC Regulation A (now Rule 505) amount limitation, whichever is greater, in Vermont allows for application of the ULOR to an offering up to \$5 million. In that aspect of its application ULOR is more flexible than SCOR which, as will be seen below, is limited to offerings not exceeding \$1 million. ULOR itself, however, was not widely adopted,¹³ as states instead implemented the NASAA Statement of Policy Regarding Small Company Offering Registrations adopted in 1996 to provide for the uniform treatment of registrations of small company offerings of securities exempt under Regulation D, but still subject to state registration and qualification,¹⁴ SCOR is a product of the ULOR initiative, but today stands alone as the almost universally adopted procedure for registration of small company offerings.

[b] Small Company Offering Registrations (SCOR) SCOR is not an exemption from blue sky registration and qualification requirements. It is, however, a simplified registration procedure based on a question and answer registration form (U-7) that companies also use as the disclosure document for investors. SCOR is in effect a hybrid exemption. SCOR is a form of registration by qualification, but in most instances merit standards used by administrators in those states that engage in merit review are more relaxed than those applied to larger public offerings. Overall, SCOR allows qualifying issuers to raise up to \$1 million at a considerable cost savings over otherwise applicable registration procedures. Any type of investor, and any number of investors, may purchase the securities and SCOR imposes no limitations on the manner of offering securities. Unless otherwise proscribed, as with Rule 504 offerings, general solicitation and advertising is permitted. As discussed further below, this is a particularly useful consideration for small business issuers that elect to proceed in reliance on the federal section 3(a)(11) intrastate offering exemption.

SCOR is available in most states for an issuer that:

- (1) Is a corporation or centrally managed limited liability company organized under the laws of the United States or Canada or any state, territory, or province thereof, or the District of Columbia, and which has its principal place of business in one of the foregoing;
- (2) Is not subject to the reporting requirements of section 13 or 15(d) of the Securities Exchange Act of 1934;
- (3) Is not an investment company registered or required to be registered under the federal Investment Company Act of 1940;
- (4) Is not engaged in and does not propose to engage in petroleum exploration and production, mining or other extractive industries;
- (5) Is not a development stage company that either has no specific business plan or purpose, or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies or other entity or person; and
- (6) Is not disqualified by "bad boy" criteria.ⁿ¹⁵

Other conditions include a minimum share price and, like the ULOR requirement, issuers are typically required to agree that there will be no stock split or stock dividend for a specific period following the effective date of the registration. Commissions, fees or other remuneration paid for soliciting any prospective purchaser may be paid only to licensed broker-dealers or agents in the state, and there are specific financial statement requirements. Offerings pursuant to SCOR must be made in compliance with Rule 504 of Regulation D, Regulation A, or section 3(a)(11)--the intrastate offering exemption--under the federal Securities Act of 1933.

SCOR is today primarily utilized by issuers for offerings exempt under federal law pursuant to Rule 504 of Regulation D. In February 1999, the SEC adopted amendments to Rule 504 intended to prevent microcap fraud. The rule as amended makes exempted securities restricted securities and prohibits general solicitation and general advertising, unless the conditions for a public Rule 504 offering are met. These conditions are: 1) the transactions are registered under a state law requiring filing and delivery of a disclosure document to investors before sale. For sales in states without these provisions, the transactions must be registered in a state with such a requirement and the disclosure documents must be delivered to all purchasers before sale in both states; or 2) the securities are issued under a state law exemption that permits general solicitation and advertising, so long as sales are made only to accredited investors as defined in Regulation D.ⁿ¹⁶ The 1999 amendment assures that the Rule 504 federal exemption will not be available for an offering carried out solely in reliance on a single coordinate state exemption. Rule 504 offerings must be subject to registration requirements in one or more states, and those requirements must make provision for use of a disclosure document.

Although much of the attention with SCOR is focused on offerings carried out pursuant to federal Rule 504, its utility for small business issuers electing to rely on the federal section 3(a)(11) exemption --the Intrastate Offering Exemptionⁿ¹⁷-- and SEC Rule 147 under the Actⁿ¹⁸ cannot be overlooked. The section 3(a)(11) federal exemption is a securities exemption rather than a transaction exemption, and imposes no limitations on the numbers or types of investors to whom the securities are offered and sold. SCOR was specifically designed to encompass federally exempt intrastate offerings as well as Rule 504 exempt offerings. Although the maximum offering size remains limited, use of SCOR for an offering exempt from federal registration by reason of the intrastate offering exemption means that none of the limitations applicable to Rule 504 as to manner of offering, limitations on resale and the specific integration

provision apply. To be sure, compliance with section 3(a)(11) entails its own residency limitations and is subject to general integration criteria. However, the ability to engage in general solicitation and general advertising, and to utilize the Form U-7 registration statement and disclosure document, presents a clear advantage to small business issuers who engage in capital formation in a localized setting. Here again, it is possible in some states that a \$1 million offering carried out locally would qualify for one or more local issuer or other forms of exemption from any registration or qualification requirement. In many other cases, however, the need for greater flexibility and the ability to reach out to greater numbers of potential investors makes SCOR and the federal section 3(a)(11) combination clearly superior.

To further encourage and facilitate the use of SCOR, the North American Securities Administrators Association adopted the *NASAA Small Company Offering Registration Manual*, n19 which contains extensive instructions and guidance for completing the items in Form U-7.

FOOTNOTES:

(n1)Footnote 1. *17 C.F.R. § 230.505.*

(n2)Footnote 2. *See § 8.06[2], supra.*

(n3)Footnote 3.

District of Columbia: See, e.g., D.C. Mun. Regs. § 1944. Other states including a specific exemption for SEC Rule 505 compliant offerings include:

Delaware: Del. Sec. Act Regs. § 502(a).

Hawaii: Haw. Admin. Rules § 16-38-23.

Minnesota: Minn. Stat. § 80A.15(2)(h).

Pennsylvania: Pa. Stat. § 203(s).

(n4)Footnote 4.

Illinois: See, e.g., 14 Ill. Admin. Code §130.420.

(n5)Footnote 5. *See § 8.03[13], supra.*

(n6)Footnote 6. *See § 8.06[3], supra.*

(n7)Footnote 7.

Connecticut: See, e.g., Conn. Banking Comm. Regs. § 36b-31-21b-9a;
Maine: 32 Me. Rev. Stat. § 10502(2)(R).

(n8)Footnote 8. *10 La. Admin. Code § 705.*

(n9)Footnote 9.

Ohio: See, e.g. Ohio Rev. Code § 1707.03(Q).

(n10)Footnote 10. Vt. Admin. Order No. 96-4-SE (May 13, 1996).

(n11)Footnote 11. *Ark. Code § 23-42-503(b)*; Sec. Comm. Rules § 503.01(B).

(n12)Footnote 12. Vt. Sec. Reg. S-92-1; *see also Arizona: Ariz. Rev. Stat. § 44-1902*; Ariz. Admin. Code Sec. R14-4-134.

(n13)Footnote 13. ULOR requirements in those states that did adopt it, and which retain it, are summarized in the applicable State Guide section --Forms of Registration-- for each state that are contained in Vols. 3 and 4.

(n14)Footnote 14. *See, e.g.:*

Alaska: Alaska Admin. Code tit. 3, § 08.600.

California: Cal. Code Regs. tit. 10, § 260.113.1.

Colorado: Colo. Div. Sec. Rule § 51-3.2.

Connecticut: Conn. Unif. Sec. Act Reg. Rule § 368-31-18b.

Delaware: Del. Sec. Div. Rules § 402.

Florida: Fla. Div. Sec. Rule 3E-301.002.

Georgia: *Ga. Code Ann. § 10-5-5.*

Idaho: Idaho Dep't Fin. Rule 161.

Illinois: Ill. Admin. Code § 130.525.

Indiana: *Ind. Code § 23-2-1-5.5.*

Iowa: Iowa Code § 502.207A.

Kansas: Kan. Admin Regs. § 81-4-2.

Kentucky: 808 Ky. Admin. Regs. 10:010.

Louisiana: *La. Rev. Stat. § 51:705.*

Maine: Revised Me. Sec. Act § 10404; Sec. Div. Rule ch. 525 Sec. 1-8.

Maryland: Md. Regs. Code tit. 03, § 12.

Massachusetts: Mass. Regs. Code tit. 950, § 13.303.

Michigan: Mich. Comp. L. § 451.704a.

Mississippi: Miss. Sec. Rule 703.

Missouri: Mo. Code Regs. Ann. tit. 15, § 30-5.2.271.

Montana: Mont. Securities Act § 30-10-205.

Nevada: Nev. Admin. Code § 90.403.

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:15-a.

New Jersey: N.J. Stat. Ann. § 40.604.

New Mexico: N.M. Admin. Code tit. 12, § 11.4.6.1.

North Carolina: N.C. Admin. Code tit. 18, r. 6.1303.

North Dakota: N.D. Sec. Comm. Reg. § 73-02-01-01.

Ohio: Ohio Admin. Code § 1301:6-.3-09.

Oklahoma: Okla. Sec. Comm. Sec 660:10-9-12.

Oregon: Oredmin. R. 441-65-170.

Pennsylvania: Rel. 48,685G Pa. Sec. Comm'n.

Rhode Island: R.I. Sec. Div. Rule 304(c)-1.

South Carolina: S.C. Code § 35-1-870.

South Dakota: S.D. Cod. Laws § 47-31A-304.

Tennessee: Tenn. Div. Sec. Rule 0780-4-1.04.

Texas: 7 Tex. Admin. Code § 133.33.

Utah: Utah Sec. Comm. R 164-10-2.

Vermont: Vt. Stat. Ann. V4208.

Virginia: Va. Code § 13.1-510.

Washington: Wash. Admin. Code § 460-17A-010.

West Virginia: W. Va. Code § 32-3-304.

Wisconsin: Wis. Stat. § 551.26.

Wyoming: Wyo. Sec. Div. § 26.

Washington: See, e.g., Wash. Admin. Code Ch. 460-17A.

(n16)Footnote 16. Release 33-7644 (February 25, 1999).

(n17)Footnote 17. Although it is not a transaction exemption, section 3(a)(11) of the Securities Act of 1933, 15 U.S.C. § 77c(11), exempts:

Any security which is part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory.

(n18)Footnote 18. 17 C.F.R. § 230.147.

(n19)Footnote 19. The NASAA Manual is published in *CCH NASAA Reports* at P 416, and is also available through the NASAA web site at www.nasaa.org.



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Blue Sky Regulation

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CHAPTER 8 Exempt Issuer Transactions

1-8 Blue Sky Regulation § 8.08

§ 8.08 Subject Matter Issuer Exemptions Subject Matter Issuer Exemptions

Although there is no Uniform Act guidance, and no uniformity in availability among state blue sky laws, numerous states have singled-out certain specific subject matters or areas as deserving specific transactional exemptions. Several, for example, devote specific attention to transactions in commodities futures contracts or commodity-related options, to make clear, for example, that transactions falling within the exclusive jurisdiction of the U.S. Commodities Futures Trading Commission, as determined as a matter of federal law, are exempt from registration and qualification requirements of blue sky laws. Other particular areas of focus in some states involve professional corporations, real estate interests, or oil, gas and mineral interests. Although all of these areas may involve interests within the scope of blue sky "security" definitions, particular policy or other considerations have led to the creation of transaction exemptions to remove them from coverage of registration or qualification requirements. These and other particular areas are discussed further below.

[1] Commodity Futures Contracts and Options on Commodity Futures The scope of state securities regulation in the area of commodity futures contracts and options in such contracts is discussed in more detail in Chapter 2.ⁿ¹ The Commodity Futures Trading Commission has exclusive regulatory jurisdiction over interstate trading in commodity futures. Some areas related to commodities transactions are unclear, however, as, for example, state authority in regard to commodity investment contracts between persons engaged in producing, processing, using or commercially handling as merchants each commodity that is subject to such a contract. Transactions involving the purchase of precious metals or other commodities for future delivery might in some circumstances fall within the ambit of blue sky laws. Other forms of commodity investment contracts could likewise be subject to state securities regulation, and thus, the states retain some authority in the area, at least in the case of intrastate trading. A few states provide specific transaction exemptions from registration for these commodity-related interests.

The states with exemptions in this category generally apply them to the commodity futures contract.ⁿ² Hawaii, however, has a security exemption applicable to "any option on a commodity futures contract subject to regulation under the Commodity Exchange Act."ⁿ³

[2] Other Options Options to purchase securities are, of course, separate securities from the securities themselves.ⁿ⁴ In the absence of an exemption applicable to the options, they must be registered whether or not the underlying security is registered or exempt. Very few states have general exemptions for options, and even when such exemptions do exist they are usually narrow in scope.

California has an exemption for any offer or sale of an option on the condition that the vendor is not the issuer of the underlying securities and that if the offer or sale had been of the underlying securities, such offer or sale would not be in violation of the registration provisions for non-issuer sales.ⁿ⁵ Note that this exemption, on its face, does not prohibit the vendor from being the issuer of the options, but only from being the issuer of the underlying securities.

In Florida, the exemption for transactions in options is elaborate. First, the sale must be by a broker/dealer registered under the Federal Securities Exchange Act of 1934, and the terms of the option must be guaranteed by such broker-dealer. Second, the transaction must be cleared through a clearing house recognized by the state. Third, the underlying security may be purchased or sold on a recognized securities exchange or is quoted on the National Association of Securities Dealers Automated Quotations System. Fourth, the sale of the option cannot be by or for the benefit of the issuer of the underlying security. Fifth, the sale may not be for the purpose of providing or furthering any scheme to violate or evade the Florida Securities Act.ⁿ⁶

Under the Massachusetts exemption, no cash payment may be required to obtain the option or right and the issuer, its parent corporation, or its subsidiaries must grant the option or right to an employee pursuant to a plan approved by the stockholders of the entity whose securities are offered.ⁿ⁷

The most general exemption for offers or sales of options is in effect in Wisconsin. Here there are two exemptions applicable to rights to purchase securities. The first is available to offers or sales of options where transactions in the underlying security are eligible for a non-issuer exemption under one of the following circumstances.

- (1) The issuer of the underlying security has any securities registered under Section 12 of the Securities Exchange Act of 1934.
- (2) The issuer is an investment company registered under the Investment Company Act of 1940.
- (3) Securities of the same class have been registered under the Wisconsin blue sky law within the preceding two years and such registration has been revoked or suspended.
- (4) Securities of the same class have been registered under the Securities Act of 1933.ⁿ⁸
- (5) The underlying securities are exempt in non-issuer transactions pursuant to an exemption allowed by the administrator based on documents filed with him.

A second Wisconsin exemption is applicable to the offer or sale of warrants or other rights to subscribe to any security on the condition that at the time the warrant or right is exercised the deliverable security is in compliance with the Wisconsin blue sky law.ⁿ⁹

Finally, Texas has an exemption for sales of options sold by dealers registered in the state.ⁿ¹⁰ To be eligible for exemption the option must meet the following standards:

- (1) Its performance must be guaranteed by a broker-dealer registered under the Securities Exchange Act of 1934.
- (2) The sale of the option may not be by or for the benefit of the issuer of the underlying security.
- (3) The underlying security must be (a) exempt from registration in Texas due to the fact that it is registered on national securities exchange recognized by the State for purposes of the state's security exchange exemption, or (b) quoted on the NASDAQ and (i) the vending dealer is not participant in the issuer's distribution, (ii) the right to sell the securities has not been enjoined by a court nor revoked or

suspended by the administrator and (iii) the issuer is a going concern.

(4) The sale of the option is not part of a scheme to violate or evade the Texas blue sky law.

[3] Professional Corporation Most states have statutes allowing doctors, lawyers and other licensed professionals to form corporations for purposes of practicing their craft. One of the characteristics of the professional corporation is that, with limited exceptions,ⁿ¹¹ stockholders must be licensed by the state to render the specific professional service for which the corporation was formed.ⁿ¹² The effect of such a rule immediately and substantially limits the number of persons eligible to hold corporate shares, and because a professional buying an interest in such a corporation is also likely to be investing in a relatively small operation in which he will be participating on a day to day basis, it would seem logical to provide a registration exemption for shares in such corporations.

Interestingly, however, very few states provide for such an exemption.ⁿ¹³ These states are divided as to whether the exemption should be for the security itself,ⁿ¹⁴ or for the transaction.ⁿ¹⁵ But, as a practical matter, there is no difference since, in any case, the persons to whom the securities may be sold are limited by the professional corporation law.

A further requirement for the exemption is that the corporation be domestically organized in the state in which the exemption is claimed.ⁿ¹⁶ Several of the states specify that the securities involved in the exemption be capitalⁿ¹⁷ or common stockⁿ¹⁸ of the corporation. Only Kentucky applies this exemption to any security issued by a professional service corporation, but there is a concomitant requirement that the securities be sold to professional persons.ⁿ¹⁹

[4] Real Estate Interests As previously discussed, sales of real estate can take on aspects of securities transactions,ⁿ²⁰ and particular emphasis has been placed on interests in residential cooperativesⁿ²¹ and condominiums.ⁿ²² A few states, while retaining blue sky jurisdiction over these interests, provide registration exemptions for them, although this may be due to the fact that regulation is imposed under other laws.ⁿ²³ In most cases where the exemption is granted, the residential, rather than the commercial, purposes of the enterprise are stressed.ⁿ²⁴

In Florida, for example, the major requirement for exemption of sales of shares in a cooperative is that they represent residential units.ⁿ²⁵ The Massachusetts exemption is similar,ⁿ²⁶ but Massachusetts also requires that the cooperative housing corporation meets the criteria of such organizations described in *Section 216(b)(1) of the Internal Revenue Code*.ⁿ²⁷ Hawaii has a number of additional requirements for its cooperative housing exemption. The corporation issuing the interests must be organized in Hawaii and only real estate brokers or real estate salesmen licensed in Hawaii are permitted to offer or sell the securities.ⁿ²⁸ Further, the issuer is required to file an application with the Commissioner of Securities and may not use the exemption until a permit is issued by the Commissioner.ⁿ²⁹

Hawaii and Massachusetts also have exemptions for selling interests in condominiums. As with cooperative interests, Hawaii requires all offers and sales to be made by state licensed real estate brokers and salesmen, and requires that any rental management contract be offered simultaneously with the real estate interest.ⁿ³⁰

Massachusetts imposes different standards.ⁿ³¹ First, the seller of the condominium unit or units must reasonably believe that the purchaser intends to occupy the unit and that it will not be occupied by another as a tenant. Second, the seller must be either the developer of the project, a licensed real estate broker or a prior owner of the unit who actually occupied it. In any case, a seller may not act as a broker-dealer in connection with the sale of any units. Finally, activities of the developer with respect to the condominium as a whole, must be limited to ownership, sale of units, management and construction of properties for the holders of units and activities incidental to these functions.

California has a different type of exemption for real estate security interests in general. If the issuance of the security is subject to the authorization of the California Real Estate Commissioner, it is exempt, unless it is an interest in subdivided land or a real estate development.ⁿ³² However, such interests are exempt in any event if they are not offered or sold with or as part of an investment contract or offered or sold to a domestic use or irrigation use water supply

company unless such company is a public utility.ⁿ³³

Louisiana also has a different type of transactional exemption for real estate security interests in general. The exemption covers bonds or notes secured by a mortgage on real estate if the entire mortgage and all of the secured bonds or notes are sold to a single purchaser at a single sale.ⁿ³⁴

The North American Securities Administrators Association, Inc.(NASAA) has adopted a Statement of Policy Regarding Real Estate Programs (Real Estate Guidelines) in the form of limited partnerships.ⁿ³⁵ While the standards contained in the Real Estate Guidelines are primarily meant to apply to public real estate syndications, they are also applied to private syndications and may be applied by state securities commissioners in processing exemption requests. The NASAA Real Estate Programs Guidelines have been adopted in whole or in substantial part in several jurisdictions.ⁿ³⁶

The Real Estate Guidelines impose substantive requirements on the sponsor and the terms of the offering, including the following:

- (1) The sponsor or general partner must have at least two years' relevant real estate or other experience demonstrating the knowledge and experience to acquire and manage the type of properties being acquired and any such person or affiliate (as defined) must have four years' relevant experience.ⁿ³⁷
- (2) The sponsor liable for the debts of the program must have an aggregate minimum net worth, exclusive of home, automobiles, and home furnishings, of the greater of at least \$50,000 or an amount equal to at least five percent of the gross amount of all offerings sold within the preceding twelve months plus five percent of the gross amount of the current offering, but the sponsor need not have a net worth of more than \$1,000,000.ⁿ³⁸
- (3) Investors must meet suitability standards determined by the state securities administrator. An investor must be able to bear the economic risk of the investment. For purposes of determining ability to bear economic risk, unless the state securities administrator approves a lower suitability standard, investors must have a minimum annual gross income of \$45,000 and a net worth of \$45,000, or in the alternative, a net worth of \$150,000.ⁿ³⁹
- (4) The sponsor must make certain minimum investments of the proceeds of the offering in properties. In general, the sponsor must commit a percentage of capital contributions to investment in properties which is equal to the greater of
 - (a) 80 percent of the capital contributions reduced by .1625 percent for each 1 percent of financing of program properties; or
 - (b) 67 percent of the capital contributions.ⁿ⁴⁰
- (5) Program management fees may not exceed specified standards. A general partner of a program owning unimproved land is entitled to annual compensation not exceeding one-quarter of one percent of the cost of such unimproved land for operating the program until such time as the land is sold or improvement of the land by the limited partnership commences. In no event may this fee exceed a cumulative total of two percent of the original cost of the land regardless of the number of years held. A general partner of a program holding property in government-subsidized projects is entitled to annual compensation not exceeding one-half of one percent of the cost of such property for operating the program until such time as the property is sold. Program management fees other than these are prohibited.ⁿ⁴¹

(6) Limitations exist concerning the amount of any promotional interest received by the sponsor, general partner, or affiliates.ⁿ⁴²

(7) The Real Estate Guidelines also contain conflict of interest and investment restrictions.ⁿ⁴³

(8) The guidelines include special provisions relating to nonspecified property programs (blind pools), which require that the minimum gross proceeds of the offering be at least \$1 million and that the sponsor or one of its principals generally have had not less than five years' experience in the real estate business in an executive capacity and two years' experience in the management and acquisition of the type of properties to be acquired in the program.ⁿ⁴⁴

(9) The guidelines specify certain rights and obligations of participants in the programs, including the right to receive certain reports.ⁿ⁴⁵

(10) The guidelines regulate advertising and disclosure documents and the use of forecasts.ⁿ⁴⁶

(11) The guidelines require that an application for qualification and registration include a favorable opinion of the Internal Revenue Service or an opinion of counsel that the issuer will be taxed as a partnership and not as an association. The opinion of counsel must be unqualified except as permitted by the state securities administrator, but may be based on reasonable assumptions, such as

(a) facts or proposed operations as set forth in the offering circular or prospectus and organizational documents;

(b) the absence of future changes in applicable laws;

(c) the securities offered are paid for;

(d) compliance with certain procedures, such as the execution and delivery of certain documents and the filing of a certificate of limited partnership or an amended certificate; and

(e) continued maintenance of or compliance with certain financial ownership of other requirements by the issuer or sponsor.ⁿ⁴⁷

[5] Oil, Gas and Mineral Interests What constitutes an oil, gas or mineral interest security varies from state to state.ⁿ⁴⁸ For purposes of this section, it is presumed that such interests are in fact securities in the states under discussion.

Two special exemptions for oil, gas, and mineral securities have been discussed previously. In one state, the financial and institutional investor exemptionⁿ⁴⁹ may apply where the purchaser is engaged in the frequent buying and selling of such securities.ⁿ⁵⁰ In a second state, the same exemption may be applicable where the purchaser is engaged in or familiar with the actual business of drilling, producing or refining oil or gas.ⁿ⁵¹ Exemptions specifically applicable to oil, gas or mineral securities have also been noted where such interests are the subject of a limited offering.

Other states have a variety of specific exemptions applicable to various oil, gas, and mineral interestsⁿ⁵².

The North American Securities Administrators Association, Inc. adopted the Statement of Policy for Registration of Oil and Gas Programsⁿ⁵³ ("Oil and Gas Guidelines") in 1976. The Guidelines relate to the registration and qualification of oil and gas programs in the form of limited partnerships and apply to oil and gas programs in other forms by analogy.

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Some states apply the Guidelines to private placements in connection with issuing an exemption from registration or granting a permit. The Oil and Gas Guidelines are applied entirely or in substantial part in several states.ⁿ⁵⁴

The guidelines regulate the substantive terms of oil and gas offerings as well as disclosure documents with respect to them. Among the requirements of the Oil and Gas Guidelines are the following:

(1) The general partner or its chief operating officers must have at least three years of relevant oil and gas experience, demonstrating the knowledge and experience to carry out and manage the program. Additionally, the general partner or any affiliate rendering services to the program must possess at least four years of relevant experience in rendering that kind of service.

(2) The general partner must have a minimum aggregate net worth at all times equal to five percent of participants' (limited partners') capital in all existing programs organized by the general partner plus five percent of the subscriptions in the program being offered, with a minimum required net worth of \$200,000 and a maximum required net worth of \$2,000,000.

(3) The sponsor must obtain a ruling from the Internal Revenue Service or an opinion of qualified tax counsel concerning flow-through tax consequences and other tax consequences to the investor.

(4) Indemnification permitted the sponsors is limited.

(5) Compensation to broker-dealers is limited to a cash commission. Indeterminate compensation to broker-dealers, such as overriding interests and net profit interests, is prohibited, although this prohibition may be eliminated.

(6) Suitability standards are required for investors, including standards for sophistication, the ability to bear the risk of the program, and the ability to benefit from the program on the basis of net worth and taxable income. For purposes of determining ability to bear the economic risk and to reasonably benefit from the program, unless circumstances warrant and the state securities administrator allows another standard, a participant must have

(a) a net worth of \$225,000 or more (exclusive of home, furnishings, and automobiles),
or

(b) a net worth of \$60,000 or more (exclusive of home, furnishings, and automobiles) and have had during the last tax year, or must expect to have during the current tax year, taxable income as defined in § 63 of the *Internal Revenue Code* of \$60,000 or more, without regard to the investment in the program. Lower suitability standards are allowed for production purchase programs of \$60,000 or more without regard to investment in the program.

(7) For a drilling program, the minimum purchase may not be less than \$5,000 and the initial investment by a participant may not be less than \$5,000; for an income or production purchase program, the minimum purchase may not be less than \$2,500 and the initial investment may not be less than \$2,500, which minimums must be paid within 12 months from the date the program commences.

(8) Organization and offering expenses incurred to sell program units must be reasonable, and those expenses, plus any management fee to the sponsor, may not exceed 15 percent of the initial subscriptions.

(9) Participation in program revenues by the sponsor and any affiliate must be reasonable, taking into account all relevant factors. Overriding royalty interests are looked upon with disfavor. Sponsors' interests in revenues will be considered reasonable if they meet numerical standards. Any other combination of fees, working or net profits, interests, or interests subordinated to payout to the investors, which are justified in light of the entire offering, may be considered reasonable by the state securities administrator.

(10) Transactions with affiliates and transactions involving conflicts of interest are limited.

(11) Rights of participants to vote at meetings and to receive annual and periodic reports are specified.

[6] Viatical Settlement Contracts Viatical settlements are transactions or arrangements whereby one or more persons acquire an interest in the future death benefit of the life insurance policy of a terminally ill person in exchange for current payment of some discounted percentage of the future benefit. Emergent variations on traditional viatical settlements, such as "senior settlements" are all based upon the same concept. In Chapter 2 the widespread treatment of viaticals as investment contract securities under blue sky laws is explored.ⁿ⁵⁵ Notwithstanding the fact that viatical settlements are today expressly included within the definition of security in several state blue sky laws, and treated as such by administrators in many other states, some state provide a transaction exemption for them when they are subject to regulation under state insurance laws, or when they are subject to a specific viatical settlement law enacted in the state. Arkansas is typical in administratively providing a transaction exemption under the blue sky law for the offer and sale of viatical settlement contracts when the underlying transaction is in compliance with the state Viatical Settlements Act, and certain other requirements are met.ⁿ⁵⁶ There are specific disclosure requirements, and the exemption is subject to a "claim of exemption" procedure.ⁿ⁵⁷ Where available, this particular subject matter exemption is always subject to conditions and required procedures that assure regulatory scrutiny.

FOOTNOTES:

(n1)Footnote 1. See § 2.06 *supra*.

(n2)Footnote 2.

Arizona: Ariz. Rev. Stat. Ann. § 44-1844(13).

The exemption, which applies to the *security*, specifies that the contracts must be traded on a commodities exchange recognized by the Arizona Corporation Commission. See Securities Regulation Sec. R14-4-125 for recognized commodities exchanges.

Transactions within the jurisdiction of the Commodity Futures Trading Commission and transactions involving the purchase of one or more precious metals or involving a commodity investment contract are also designated as exempt transactions. *Ariz. Rev. Stat. Ann. § 44-1844(15)-(17).*

Indiana: Ind. Code § 23-2-1-2(b)(14).

Massachusetts: Mass. Regs. Code tit. 950, § 14.402(B)(13)(g).

Wisconsin: Wis. Stat. Ann. § 551.22(15).

(n3)Footnote 3.

Hawaii: Haw. Rev. Stat. Ann. § 485-4(12).

(n4)Footnote 4. *See § 2.06 supra.*

(n5)Footnote 5.

California: Cal. Corp. Code § 25102(1).

(n6)Footnote 6.

Florida: Fla. Stat. Ann. § 517.061(16).

(n7)Footnote 7.

Massachusetts: Mass. Regs. Code tit. 950, § 14.402(B)(13)(a).

(n8)Footnote 8.

Wisconsin: Wis Stat. Ann. § 551.22(13). The exemption refers to the transaction under Wis. Stat. Ann. § 551.23(3) applicable to certain non-issuer transactions.

(n9)Footnote 9.

Wisconsin: Wis. Stat. Ann. § 551.23(17).

(n10)Footnote 10.

Texas: Tex. Rev. Civ. Stat. art. 581-5(S).

(n11)Footnote 11. It is generally provided that "ancillary employees" may be shareholders. These are employees who do not render a professional service, such as clerks, secretaries, etc. or who perform all services under direct supervision and control of a person licensed to practice the profession. Provisions also exist which allow a non-professional to hold the shares for a limited time when he has obtained them by operation of law, such as through the death of the professional-owner.

(n12)Footnote 12. *See, e.g.:*

California: Cal. Corp. Code §§ 13406, 13407.

Florida: Fla. Stat. Ann. § 621.03(2).

Illinois: Ill. Comp. Stat. Ch. 805 § 10/3.4.

Kentucky: Ky. Rev. Stat. Ann. § 274.035.

Massachusetts: Mass. Gen. Laws Ann., Ch. 156A, §§ 7, 8.

Ohio: Ohio Rev. Code Ann. § 1785.05.

(n13)Footnote 13.

California: Cal. Code Regs. tit. 10, § 260.105.6.

Kentucky: Securities Rule 808 Ky. Admin. Regs. 10.150(2).

Oregon: Or. Rev. Stat. § 59.035(14).

Pennsylvania: 64 Pa. Code § 202.091(b)(1)(ii).

Wisconsin: Wis. Stat. Ann. § 551.22(11).

(n14)Footnote 14. *Id.*

(n15)Footnote 15. *Id.*

(n16)Footnote 16. *See, e.g.:*

California: The corporation must be organized pursuant to Cal. Corp. Code §§ 13400-13410.

Kentucky: Professional service corporations must be organized under Ky. Rev. Stat. Ch. 274 or substantially similar legislation of another state.

Michigan: Organization under Mich. Comp. L. §§ 450.221-450.235 is required.

North Carolina: Professional corporations are required to be organized pursuant to N.C. Gen. Stat., Ch. 55B.

Oregon: Oregon professional corporations are organized under Or. Rev. Stat., Ch. 58.

Pennsylvania: 64 Pa. Code § 202.091(b)(1)(ii).

(n17)Footnote 17. *See* note 13 *supra* for citations in California and Oregon.

(n18)Footnote 18. *See* note 13 *supra* for the Wisconsin citation.

(n19)Footnote 19. *See* note 13 *supra* for the Kentucky citation.

In Pennsylvania, the "shares" of the professional corporation are exempt. "Shares" are defined to include "the interest of an associate in a professional association." *See* 64 Pa. Code § 202.091(b)(1)(ii).

(n20)Footnote 20. *See* § 2.08[2][b] *supra*.

(n21)Footnote 21. *See* § 2.08[2][b][i] *supra*.

(n22)Footnote 22. *See* § 2.08[2][b][ii] *supra*.

(n23)Footnote 23. *See, e.g.:*

Florida: Fla. Stat. Ann. chs. 718, 719 *et seq.*

(n24)Footnote 24.

Florida: Fla. Stat. Ann. § 517.061(10), (14).

Hawaii: Haw. Rev. Stat. Ann. § 485-6(13).

Massachusetts: Mass. Regs. Code tit. 950, § 14.402(B)(13)(c)(iii).

Virginia: Va. Code Ann. § 13.1-514(B)(12).

(n25)Footnote 25.

Florida: Fla. Stat. Ann. § 517.061(14).

(n26)Footnote 26.

Massachusetts: Mass. Regs. Code tit. 950, § 14.402(B)(13)(c).

(n27)Footnote 27. The Internal Revenue Code provision states:

COOPERATIVE HOUSING CORPORATON.--The term "cooperative housing corporation" means a corporation--

(A) having one and only one class of stock outstanding,

(B) each of the stockholders of which is entitled, solely by reason of his ownership of stock in the corporation, to occupy for dwelling purposes a house, or an apartment in a building, owned or leased by such corporation,

(C) no stockholder of which is entitled (either conditionally or unconditionally) to receive any distribution not out of earnings and profits of the corporation except on a complete or partial liquidation of the corporation, and

(D) 80 percent or more of the gross income of which for the taxable year in which the taxes and interest described in subsection (a) are paid or incurred is derived from tenant-stockholders.

(n28)Footnote 28.

Hawaii: Haw. Rev. Stat. Ann. § 485-6(13).

(n29)Footnote 29.

Hawaii: Haw. Rev. Stat. Ann. § 485-7.

(n30)Footnote 30.

Hawaii: Haw. Rev. Stat. Ann. § 485-6(14).

(n31)Footnote 31.

Massachusetts: Mass. Regs. Code, § 14.402(B)(13)(d).

(n32)Footnote 32.

California: Cal. Corp. Code § 25100(e).

(n33)Footnote 33.

California: Cal. Corp. Code § 25100(f).

(n34)Footnote 34.

Louisiana: La. Rev. Stat. § 51:709(16).

(n35)Footnote 35. *Reprinted in Volume 4 infra; see also* 1 Blue Sky L. Rep. (CCH) (beginning at P 6211) and NASAA Reports (CCH) P 3601 at 2001.

(n36)Footnote 36. *See, e.g.:*

Arizona: 1 Blue Sky L. Rep. (CCH) at P 9605.

Iowa: 1 Blue Sky L. Rep. (CCH) at P 25,457 (modified).

Michigan: 1 Blue Sky L. Rep. (CCH) at P 32,569, 32,585 (modified).

Missouri: 1 Blue Sky L. Rep. (CCH) at P 35,468.

Nebraska: 1 Blue Sky L. Rep. (CCH) at P 37,420 (modified).

New Mexico: 1 Blue Sky L. Rep. (CCH) at P 41,530 (modified).

New York: 1 Blue Sky L. Rep. (CCH) at P 41,521J (modified).

See also Blue Sky Policy Statement 105, Blue Sky L. Rep. (CCH) P 42,580 (instructions for issuers of real estate

syndication offerings requesting "no filing" letter).

Ohio: 1 Blue Sky L. Rep. (CCH) at P 45,603.

Oklahoma: 1 Blue Sky L. Rep. (CCH) at P 46,500, 46,635.

Pennsylvania: 1 Blue Sky L. Rep. (CCH) at P 48,663, 48,667 (modified).

Tennessee: 1 Blue Sky L. Rep. (CCH) at P 54,426.

Texas: 1 Blue Sky L. Rep. (CCH) at P 55,601 (modified).

Utah: 1 Blue Sky L. Rep. (CCH) at P 57,406A (modified).

Virginia: 1 Blue Sky L. Rep. (CCH) at P 60,435B (modified).

Washington: 1 Blue Sky L. Rep. (CCH) at P 61,582B (modified).

West Virginia: 1 Blue Sky L. Rep. (CCH) at P 63,476.

Wisconsin: 1 Blue Sky L. Rep. (CCH) at P 64,543.

Wyoming: 1 Blue Sky L. Rep. (CCH) at P 66,435.

(n37)Footnote 37. *See* NASAA Reports (CCH) P 3601 at 2001.

(n38)Footnote 38. *Id.*

(n39)Footnote 39. *Id.*

(n40)Footnote 40. *Id.*

(n41)Footnote 41. *Id.*

(n42)Footnote 42. *Id.*

(n43)Footnote 43. *Id.*

(n44)Footnote 44. *Id.*

(n45)Footnote 45. *Id.*

(n46)Footnote 46. *Id.*

(n47)Footnote 47. *Id.*

(n48)Footnote 48. *See* ch. 2 *supra*.

(n49)Footnote 49. *See* § 8.03[6], *supra*.

(n50)Footnote 50.

Illinois: Comp. Stat. Ch. 815 § 5/4(O).

(n51)Footnote 51.

California: Cal. Corp. Code § 25102(j).

(n52)Footnote 52. *See, e.g.*:

Kansas: Kan. Gen. Stat. Ann. § 17-1262n.

Mississippi: Miss. Code Ann. § 71-75-203(13).

South Dakota: S.D. Comp. L. § 47-31A-402(b)(13).

(n53)Footnote 53. *Reprinted* in Volume 4 *infra*; *See also* 1 Blue Sky L. Rep. (CCH) (beginning at P 6211).

(n54)Footnote 54.

Arizona: 1 Blue Sky L. Rep. (CCH) P 9605.

Michigan: 1 Blue Sky L. Rep. (CCH) P 32,589.

Mississippi: 1 Blue Sky L. Rep. (CCH) P 34,429F.

Missouri: 1 Blue Sky L. Rep. (CCH) P 35,468, P 35,566 (modified).

New Mexico: 1 Blue Sky L. Rep. (CCH) P 41,531 (modified).

Oklahoma: 1 Blue Sky L. Rep. (CCH) P 46,500, P 46,638.

Pennsylvania: 1 Blue Sky L. Rep. (CCH) P 48,667 (modified).

Tennessee: 1 Blue Sky L. Rep. (CCH) P 54,426.

Texas: 1 Blue Sky L. Rep. (CCH) P 55,631 (modified).

Virginia: 1 Blue Sky L. Rep. (CCH) P 60,4435B.

Washington: 1 Blue Sky L. Rep. (CCH) P 61,582B (modified).

West Virginia: 1 Blue Sky L. Rep. (CCH) P 63,477.

Wisconsin: 1 Blue Sky L. Rep. (CCH) P 64,543 (modified).

Wyoming: 1 Blue Sky L. Rep. (CCH) P 66,435.

(n55)Footnote 55. *See* §. 2.08[2](g), *supra*.

(n56)Footnote 56. Ark, Sec. Comm. Rules §504.01(m).

(n57)Footnote 57. Arizona provides a general statutory exemption for viatical or life settlement contracts meeting specific conditions, *see Ariz. Rev. Stat. § 44-1850*. Conditions include filing requirements, disclosure, and advertising approval. The Arizona provision establishes a specific private remedy for purchaser, and the exemption is subject to denial or revocation.



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Blue Sky Regulation

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CHAPTER 8 Exempt Issuer Transactions

1-8 Blue Sky Regulation § 8.09

§ 8.09 Miscellaneous Issuer Exemptions

A number of exemptions exist that are best described as "miscellaneous." These are exemptions that, at best, have been enacted in only a few states. Some of them are highly specialized and will be available only in very limited circumstances. It is probably because these exemptions are not often used that interpretations of the provisions are scarce.

One of the more interesting aspects of these miscellaneous exemptions is that it is possible for an exemption to be available in a state lacking a statutory provision. Indiana, for example, is the only state providing a statutory exemption for the deposit of shares pursuant to a voting trust agreement and the issuance of voting trust certificates in exchange therefor.ⁿ¹ However, it is possible for an exemption similar to this one to arise in the absence of a statutory provision. In a North Dakota case,ⁿ² the problem was of a slightly different nature, but the effect of the decision raises an interesting question. In that case, the corporate issuer set up a voting trust. Trust certificates issued in exchange for the voting stock were duly registered under the state's blue sky law. The trust agreement provided that the trust would be extended after termination of the original period by mutual consent of the trustees and any certificate holders who wished to remain in the trust. Toward the end of the original period, certificate holders were solicited to extend the trust. A number of them agreed, and the trust was extended for an additional ten years. The renewal trust certificates were not registered under the North Dakota securities law and the renewal agreement came under attack for failure to comply with the statute. The court, however, looked at the North Dakota provision which exempted exchanges with existing security holders pursuant to a right of conversionⁿ³ and held that the holders of the original trust certificates were existing security holders who could be solicited for the exchange of securities without the need of registration.ⁿ⁴

It will be recalled that the Uniform Securities Act not only exempts exchanges pursuant to a right of conversion, but exempts "any transaction pursuant to an offer to existing security holders of the issuer. ..." ⁿ⁵ If this provision were applied to the above set of facts, would it not mean that exchange under the renewal agreement would similarly be exempt?

In a similar respect, Ohio exempts any interim certificate if the securities ultimately to be delivered are themselves exempt, are the subject of an exempt transaction or are appropriately registered under Ohio law.ⁿ⁶ Although a comparable provision is not contained in the Uniform Securities Act, it would seem likely that such an exemption would be implied, at least in a number of cases. For example, if a debt security issued by a bank is exempt, surely an interim certificate for such security issued by the bank would also be exempt under the provision making registration inapplicable to "any security issued by ... any bank."ⁿ⁷ Similarly, if an interim certificate is given to an existing security holder, the transaction remains one with an existing security holder and would probably be exempt under the Uniform

Securities Act.ⁿ⁸

To be sure, some problems in this area can arise. If, for example, an exemption is claimed for a non-issuer isolated transaction under the Uniform Securities Act,ⁿ⁹ it would appear unlikely that an interim certificate issued by the seller would also be eligible for the exemption even though the underlying security is not so issued. But the situation can be stretched even further. Suppose the seller is not yet in possession of the underlying security, and obtains an interim certificate for such security from the issuer. This, in turn, is turned over to the seller's vendee. The vendee returns to the seller, demands security, and the seller takes the interim certificate, exchanges it with the issuer for the underlying security and gives the latter to the vendee. There is still a non-issuer transaction, but interim certificates are defined as separate securities under the Uniform Securities Act.ⁿ¹⁰

So the question arises whether one or two sales have been made pursuant to the isolated transaction exemption.ⁿ¹¹ This situation, of course, is a bit farfetched, because it would be easier for the person who purchases the interim certificate from the non-issuer to demand the underlying security directly from the issuer. This transaction might even be exempt as a transaction with an existing security holder.ⁿ¹² Further, if the underlying security is, in fact, registered, wouldn't the interim certificate, being a separate security, also have to be registered under the Uniform Securities Act?

There are, of course, a number of miscellaneous exemptions. Many have been previously discussed in other sections,ⁿ¹³ and there is no pretense that all of the other exemptions are covered here. Nevertheless, there are a few that are of particular interest.

In Californiaⁿ¹⁴ and Ohio,ⁿ¹⁵ negotiable instruments such as checks, drafts and money orders may be sold without registration on the condition that the seller is properly licensed to engage in the business of selling such instruments.

Florida provides an exemption for transactions involving certificates of interest or participation in pooled income funds maintained and controlled by and for the ultimate benefit of charitable corporations.ⁿ¹⁶

Illinois allows an exemption for domestic corporations which issue securities for redevelopment of blighted urban areas.ⁿ¹⁷ The state also exempts securities sales to a government body.ⁿ¹⁸

Georgia exempts transactions involving the issuance of securities in connection with pooled income funds under certain conditions.ⁿ¹⁹

North Dakota has established a public venture capital corporation, whose securities enjoy both a transactional exemption and a securities exemption.ⁿ²⁰

The Pennsylvania Securities Commission deems no sale to have occurred for blue sky law purposes where a person (or persons) in connection with governmental filings for incorporation becomes an incorporating shareholder (or shareholders) with the intent to transfer all the shares to a promoter or principal of the issuer upon incorporation.ⁿ²¹ However, resale to the promoter or principal would involve a sale by the issuer. The staff would take the same position towards a "straw" limited partner being used in the context of a limited partnership formation.ⁿ²²

Texas provides an exemption from registration for the offer and sale of securities by an issuer or its selling agent to a non-Texas resident not present in Texas when the offer is made.ⁿ²³

Wisconsin exempts the offer or sale of debt securities by an issuer to its employees or agents provided a notice is filed with the state commissioner and the commissioner by order exempts the offering.ⁿ²⁴

The 2002 Uniform Securities Act includes two transaction exemptions that are new, and which reflect certain realities in the modern enforcement of blue sky laws. Section 202(19) of the Act exempts a rescission offer, sale, or purchase that is

made under section 510 of the Act--a specific rescission offer provision. Section 510 controls the civil liability provision in section 509 of the Act to the extent that no private civil remedy is permitted if a purchaser, seller or recipient of investment advice receives a rescission offer in accordance with section 510. Section 202(19) of the Act thus exempts the rescission offer made in accordance with section 510 from registration requirements. The specific treatment of rescission offers in the 2002 Uniform Act reflects the fact that rescission offers are commonly ordered as part of administrative enforcement actions based on violation of registration provisions (as well as licensing provisions for intermediaries). It also reflects the fact that whether ordered or not, issuers may undertake to make rescission offers voluntarily to address actual or potential violations of a blue sky law. A few states have previously incorporated an analog of the new Uniform Act provision for rescission offers into their blue sky laws, and also include a corresponding transaction exemption from registration requirements for the rescission offer.

The second new transaction exemption in the 2002 Uniform Act is section 202(20), which exempts:

[a]n offer or sale of a security to a person not a resident of this State and not present in this State if the offer or sale does not constitute a violation of the laws of the State or foreign jurisdiction in which the offeree or purchaser is present and is not part of an unlawful plan or scheme to evade this [Act].ⁿ²⁵

In Chapters 3 and 4 the scope of state investor protection authority was examined in detail, with particular focus on the meaning of "offer" or "sale" as key triggering events for application of a particular state's blue sky law, and the scope of individual state jurisdiction generally. The extent to which an issuer may be subjected to compliance requirements, and enforcement, under a state blue sky law for activity that is wholly directed outside the state is a matter of some uncertainty. The 2002 Uniform Act provision recognizes that a state does not have legitimate concern for investor protection when an offer and sale is not made to any person in the state, and is lawful in the jurisdiction where the offeree or purchaser is present. States have in fact exercised jurisdiction over issuers in those circumstances based on the simple activity of making an offer in the state, regardless of where the offer is directed outside of the state and without regard to whether the offer to a resident in another state or jurisdiction is impacted by the law in that other jurisdiction having the most direct interest in the transaction and the protection of the persons involved. The 2002 Uniform Act exemption signals a need for uniformity and a return to recognition of the fundamental investor protection objectives of blue sky laws.

FOOTNOTES:

(n1)Footnote 1.

Indiana: Ind. Code § 23-2-1-2(b)(13).

California, by regulation, exempts the offer or sale of beneficial interests in an *inter vivos* voting trust if the offer or sale is the result of a stock split or reverse stock split of underlying securities exempt from registration. *See Cal. Code Regs. tit. 10, § 260.105.9.* Stock splits and reverse stock splits are exempt under *Cal. Corp. Code § 25103(f)*.

(n2)Footnote 2. *Reserve Life Ins. Co. v. Provident Life Ins. Co.*, 499 F.2d 715 (8th Cir. [N.D.] 1974) , applying North Dakota law.

(n3)Footnote 3.

North Dakota: N.D. Cent. Code § 10-04-06(7).

(n4)Footnote 4. *499 F.2d at 723 .*

(n5)Footnote 5. Unif. Sec. Act § 402(b)(11).

(n6)Footnote 6.

Ohio: Ohio Rev. Code Ann. § 1707.02(D).

(n7)Footnote 7. Unif. Sec. Act. § 402(a)(3).

(n8)Footnote 8. Unif. Sec. Act. § 402(b)(11).

(n9)Footnote 9. Unif. Sec. Act. § 402(b)(1).

(n10)Footnote 10. Unif. Sec. Act. § 401(1).

(n11)Footnote 11. The question of whether one or two sales have been made is important in a few states where two successive sales are no longer deemed isolated. *See § 8.05 supra.*

(n12)Footnote 12. *See § 8.03[7] supra.*

(n13)Footnote 13. Exempt issuances of industrial development corporations, for example, are discussed as part of the section of exempt domestic governmental securities. *See ch. 7 supra.*

(n14)Footnote 14.

California: Cal. Code Regs. tit. 10, § 260.105.16.

(n15)Footnote 15.

Ohio: Rev. Code Ann. § 1707.03(R).

(n16)Footnote 16.

Florida: Securities Rule 3E-500.012.

(n17)Footnote 17.

Illinois: Ill. Comp. Stat. Ch. 815 § 5/4(P).

(n18)Footnote 18. *Id.* (C).

(n19)Footnote 19.

Georgia: Ga. Code Ann. § 10-5-9(15).

(n20)Footnote 20. *N.D. Cent. Code § 10-04-06(13)* (transactional exemption) and *§ 10-04-05(12)* (securities exemption).

(n21)Footnote 21. Pa. Sec. Bull. July/August 1988.

(n22)Footnote 22. *Id.*

(n23)Footnote 23.

Texas: 7 Tex. Admin. Code § 139.7.

(n24)Footnote 24.

Wisconsin: Wis. Admin. Code § [SEC] 2.02(9)(f).

(n25)Footnote 25. 2002 Unif. Sec. Act § 202(20).



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CHAPTER 8 Exempt Issuer Transactions

1-8 Blue Sky Regulation § 8.10

§ 8.10 General Compliance Considerations

[1] Combining Issuer Exemptions In states that have both an isolated transaction exemption available to issuersⁿ¹ and a limited offering exemption,ⁿ² the question arises whether issuers can rely on both exemptions to increase the size of their unregistered offering through the combination of the permitted number of offers or sales in the limited offering exemptions with those made under the isolated transaction exemption.ⁿ³

Kansas and New Hampshire have statutory provisions that require any sales made under the isolated transaction exemption to be included in the count for determining the availability of the limited offering exemption.ⁿ⁴ In Idaho, Nebraska and Vermont, however, where both exemptions are available, since the limited offering exemption excludes sophisticated investors from the count of permitted offerees, it can be argued that these states have provided a similar exclusion from the permitted number of offerees for the limited offering exemption for isolated transactions if it had been their intent to do so.ⁿ⁵ Oregon contains no restrictions on reliance upon both exemptions.ⁿ⁶ Michigan expressly permits offers and sales which are exempt under most transaction exemptions in its blue sky law to be combined so as to exempt an entire transaction or series of transactions.ⁿ⁷

In general, combining issuer exemptions is problematic by reason of integration principles. Implicit in every transaction exemption is the notion that it is applied to a single, discreet transaction or set of transactions that are all part of an issue. In previous analyses of private and limited offerings by issuers the importance of integration and the factors determining whether separate offerings are to be integrated has been addressed.ⁿ⁸ By reason of integration, attempts to combine exemptions would have the result of destroying the applicability of each exemption if the combined transactions would exceed allowable limits or violate other requirements applicable to any one of the exemptions. However, there is nothing in blue sky laws that precludes reliance on multiple exemptions for a series of transactions that are not part of a single issue and the separate elements of which are not subject to integration. In states that provide a mechanism for an administrative determination that a proposed sale or transaction is entitled to an exemptionⁿ⁹ an issuer may clarify whether reliance on separate exemptions for a series of transactions would escape integration, or whether a combination of exemptions would be permitted. Absent such a procedure, however, an issuer is clearly at risk of violating registration or qualification requirements if transactions are deemed to be part of a single issue.

In those states that by rule permit solicitations of interest ("testing the waters") procedures, by which an issuer may make an offer of a security for the sole purpose of soliciting an indication of interest in receiving a disclosure document,ⁿ¹⁰ offers made in reliance on that rule will not be integrated under the blue sky law with subsequent offers

and sales. However, the state procedure expressly does not preclude integration under federal securities laws.ⁿ¹¹

[2] Legend Requirements for Offering Materials As discussed throughout this chapter, the various issuer transaction exemptions, limited offerings or forms of limited registration procedures established under blue sky laws often require that a disclosure document be provided to prospective purchasers in an offering. So it is clear to prospective investors that stated reliance on an exemption or form of limited offering does not involve any administrative "approval" or endorsement of the offering. NASAA--the North American Securities Administrators Association--adopted a Statement of Policy prescribing uniform guidelines for cover page legends, requiring that a prominent legend and regulatory disclaimer in one of the specified forms appear on the face of an offering memorandum or subscription document for an exempt offering.ⁿ¹² NASAA prescribed legends for offering documents vary according to the circumstances of an offering. For example, if an offering is exempt from federal registration requirements, but subject to state registration or qualification, the following legend which, to the extent appropriate, must appear on the cover page:

IN MAKING AN INVESTMENT DECISION INVESTORS MUST RELY ON THEIR OWN EXAMINATION OF THE ISSUER AND THE TERMS OF THE OFFERING, INCLUDING THE MERITS AND RISKS INVOLVED. THESE SECURITIES HAVE NOT BEEN RECOMMENDED BY ANY FEDERAL OR STATE SECURITIES COMMISSION OR REGULATORY AUTHORITY. FURTHERMORE, THE FOREGOING AUTHORITIES HAVE NOT CONFIRMED THE ACCURACY OR DETERMINED THE ADEQUACY OF THIS DOCUMENT. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

If securities are offered or sold pursuant to the federal section 4(2) exemption, or under the provisions of Regulation D, the following statement, in addition to any other required legend must also appear on the cover page of any offering document utilized in connection with the offer and sale of the securities:

THESE SECURITIES ARE SUBJECT TO RESTRICTIONS ON TRANSFERABILITY AND RESALE AND MAY NOT BE TRANSFERRED OR RESOLD EXCEPT AS PERMITTED UNDER THE SECURITIES ACT OF 1933, AS AMENDED, AND THE APPLICABLE STATE SECURITIES LAWS, PURSUANT TO REGISTRATION OR EXEMPTION THEREFROM. INVESTORS SHOULD BE AWARE THAT THEY MAY BE REQUIRED TO BEAR THE FINANCIAL RISKS OF THIS INVESTMENT FOR AN INDEFINITE PERIOD OF TIME.ⁿ¹³

NASAA does not prescribe a standardized legend for use in offerings made subject to state exemptions generally. Individual states prescribe their own particular legends, often with specific reference to the issuer exemption involved.

Alaska

FOR ALASKA RESIDENTS:

THE SECURITIES OFFERED HAVE BEEN REGISTERED WITH THE ADMINISTRATOR OF SECURITIES OF THE STATE OF ALASKA UNDER PROVISIONS OF 3 AAC 08.500-3 AAC 08.506. THE INVESTOR IS ADVISED THAT THE ADMINISTRATOR HAS MADE ONLY A CURSORY REVIEW OF THE REGISTRATION STATEMENT AND HAS NOT REVIEWED THIS DOCUMENT SINCE THE DOCUMENT IS NOT REQUIRED TO BE FILED WITH THE ADMINISTRATOR. THE FACT OF REGISTRATION DOES NOT MEAN THAT THE ADMINISTRATOR HAS PASSED IN ANY WAY UPON THE MERITS, RECOMMENDED, OR APPROVED THE SECURITIES. ANY REPRESENTATION TO THE CONTRARY IS A VIOLATION OF AS 45.55.170. THE INVESTOR MUST RELY ON THE INVESTOR'S OWN EXAMINATION OF THE PERSON OR ENTITY CREATING THE SECURITIES AND THE TERMS OF THE OFFERING, INCLUDING THE MERITS AND RISKS INVOLVED, IN MAKING AN INVESTMENT DECISION ON THESE SECURITIES.

Florida

Investors are entitled to a three day right of rescission, triggered by the latest of the date on which he/she delivers a subscription, makes payment, or is informed of the statutory right. The legend need only be included in the front portion of the Confidential Memorandum.

FOR FLORIDA RESIDENTS

THE UNITS REFERRED TO HEREIN WILL BE SOLD TO, AND ACQUIRED BY, THE HOLDER IN A TRANSACTION EXEMPT UNDER § 517.061 OF THE FLORIDA SECURITIES ACT. THE UNITS HAVE NOT BEEN REGISTERED UNDER SAID ACT IN THE STATE OF FLORIDA. IN ADDITION, ALL FLORIDA RESIDENTS SHALL HAVE THE PRIVILEGE OF VOIDING THE PURCHASE WITHIN THREE (3) DAYS AFTER THE FIRST TENDER OF CONSIDERATION IS MADE BY SUCH PURCHASER TO THE ISSUER. AN AGENT OF THE ISSUER, OR AN ESCROW AGENT OR WITHIN THREE DAYS AFTER THE AVAILABILITY OF THAT PRIVILEGE IS COMMUNICATED TO SUCH PURCHASER, WHICHEVER OCCURS LATER.

New Hampshire

The following legend should be placed in the Confidential Memorandum.

NEW HAMPSHIRE RESIDENTS:

NEITHER THE FACT THAT A REGISTRATION STATEMENT OR AN APPLICATION FOR A LICENSE HAS BEEN FILED WITH THE STATE OF NEW HAMPSHIRE NOR THE FACT THAT A SECURITY IS EFFECTIVELY REGISTERED OR A PERSON IS LICENSED IN THE STATE OF NEW HAMPSHIRE CONSTITUTES A FINDING BY THE DIRECTOR OF THE OFFICE OF SECURITIES REGULATION THAT ANY DOCUMENT FILED UNDER RSA 421-b IS TRUE, COMPLETE AND NOT MISLEADING. NEITHER ANY SUCH FACT NOR THE FACT THAT AN EXEMPTION OR EXCEPTION IS AVAILABLE FOR A SECURITY OR A TRANSACTION MEANS THAT THE DIRECTOR OF THE OFFICE OF SECURITIES REGULATION HAS PASSED IN ANY WAY UPON THE MERITS OR QUALIFICATIONS OF, OR RECOMMENDED, OR GIVEN APPROVAL TO, ANY PERSON, SECURITY, OR TRANSACTION. IT IS UNLAWFUL TO MAKE OR CAUSE TO BE MADE, TO ANY PROSPECTIVE PURCHASER, CUSTOMER OR CLIENT ANY REPRESENTATION INCONSISTENT WITH THE PROVISIONS OF THIS PARAGRAPH.

New York

The Attorney General's office reviews only offerings involving interests in real estate, and in that connection, requires the following.

(1) A legend at the beginning of the Confidential Memorandum as follows:

THIS PRIVATE PLACEMENT MEMORANDUM HAS NOT BEEN REVIEWED BY THE ATTORNEY GENERAL PRIOR TO ITS ISSUANCE AND USE. THE ATTORNEY GENERAL OF THE STATE OF NEW YORK HAS NOT PASSED ON OR ENDORSED THE MERITS OF THIS OFFERING. ANY REPRESENTATION TO THE CONTRARY IS UNLAWFUL.

THIS PRIVATE OFFERING MEMORANDUM DOES NOT CONTAIN AN UNTRUE STATEMENT OF A MATERIAL FACT OR OMIT TO STATE A MATERIAL FACT NECESSARY TO MAKE THE STATEMENTS MADE IN LIGHT OF THE CIRCUMSTANCES UNDER WHICH THEY WERE MADE, NOT MISLEADING. IT CONTAINS A FAIR SUMMARY OF THE MATERIAL TERMS AND DOCUMENTS PURPORTED TO BE SUMMARIZED HEREIN.

(2) At the beginning of the Confidential Memorandum and in the Use of Proceeds section, a representation must be made that the proceeds of the offering will be received and held in trust for the benefit of the investors and will be retained in trust after closing to be used only for the purposes set forth in the Use of Proceeds section. In addition, state the name and location of the bank(s) where the proceeds will be deposited in trust.

(3) Purchasers who are offered the securities within or from the State of New York will be required to sign and submit the following statement before monies are received from them.

I UNDERSTAND THAT THIS OFFERING OF INTERESTS HAS NOT BEEN REVIEWED BY THE ATTORNEY GENERAL OF THE STATE OF NEW YORK BECAUSE OF THE OFFEROR'S REPRESENTATION THAT THIS IS INTENDED TO BE A NON-PUBLIC OFFERING PURSUANT TO SEC REGULATION D, AND THAT IF ALL OF THE CONDITIONS AND LIMITATIONS OF SEC REGULATION D ARE NOT COMPLIED WITH, THE OFFERING WILL BE RESUBMITTED TO THE ATTORNEY GENERAL FOR AMENDED EXEMPTION. I UNDERSTAND THAT ANY OFFERING LITERATURE USED IN CONNECTION WITH THIS OFFERING HAS NOT BEEN PRE-FILED WITH THE ATTORNEY GENERAL AND HAS NOT BEEN REVIEWED BY THE ATTORNEY GENERAL. THIS INTEREST IS BEING PURCHASED FOR MY OWN ACCOUNT FOR INVESTMENT, AND NOT FOR DISTRIBUTION OR RESALE TO OTHERS. I AGREE THAT I WILL NOT SELL OR OTHERWISE TRANSFER THESE SECURITIES UNLESS THEY ARE REGISTERED UNDER THE FEDERAL SECURITIES ACT OF 1933 OR UNLESS AN EXEMPTION FROM SUCH REGISTRATION IS AVAILABLE. I REPRESENT THAT I HAVE ADEQUATE MEANS OF PROVIDING FOR MY CURRENT NEEDS AND POSSIBLE PERSONAL CONTINGENCIES, AND THAT I HAVE NO NEED FOR LIQUIDITY OF THIS INVESTMENT.

The above statement may be placed in the subscription agreement.

Oregon

The following legend should appear in the Confidential Memorandum.

FOR OREGON RESIDENTS:

THE SECURITIES OFFERED HAVE BEEN REGISTERED WITH THE CORPORATION COMMISSIONER OF THE STATE OF OREGON UNDER PROVISIONS OF OAR 441-65-060 THROUGH 441-65-240. THE INVESTOR IS ADVISED THAT THE COMMISSIONER HAS MADE ONLY A CURSORY REVIEW OF THE REGISTRATION STATEMENT AND HAS NOT REVIEWED THIS DOCUMENT SINCE THE DOCUMENT IS NOT REQUIRED TO BE FILED WITH THE COMMISSIONER. THE INVESTOR MUST RELY ON THE INVESTOR'S OWN EXAMINATION OF THE COMPANY CREATING THE SECURITIES, AND THE TERMS OF THE OFFERING INCLUDING THE MERITS AND RISKS INVOLVED IN MAKING AN INVESTMENT DECISION ON THESE SECURITIES.

Pennsylvania

Investors are entitled to a two-day right of rescission for transactions which are exempt from registration under § 203(d) of the Pennsylvania Securities Act. Thus, the following legend should appear in the Confidential Memorandum.

FOR PENNSYLVANIA RESIDENTS:

UNDER PROVISIONS OF THE PENNSYLVANIA SECURITIES ACT OF 1972, EACH PENNSYLVANIA RESIDENT SHALL HAVE THE RIGHT TO WITHDRAW HIS ACCEPTANCE WITHOUT INCURRING ANY

LIABILITY TO THE SELLER, UNDERWRITER (IF ANY) OR ANY PERSON, WITHIN TWO (2) BUSINESS DAYS FROM THE DATE OF RECEIPT BY THE ISSUER OF HIS WRITTEN BINDING CONTRACT OF PURCHASE OR IN THE CASE OF A TRANSACTION IN WHICH THERE IS NO WRITTEN BINDING CONTRACT OF PURCHASE, WITHIN TWO BUSINESS DAYS AFTER HE MAKES THE INITIAL PAYMENT FOR THE SECURITIES BEING OFFERED.

In addition, each Pennsylvania investor is required to undertake to hold their investment for a twelve-month period. Accordingly, the following legend should appear in the Subscription Agreement:

FOR PENNSYLVANIA RESIDENTS:

EACH PENNSYLVANIA RESIDENT WHO SUBSCRIBES FOR THE SECURITIES BEING OFFERED HEREBY AGREES NOT TO SELL THESE SECURITIES FOR A PERIOD OF TWELVE MONTHS AFTER THE DATE OF PURCHASE.

UNDER PROVISION OF THE PENNSYLVANIA SECURITIES ACT OF 1972 (THE 1972 ACT), EACH PENNSYLVANIA RESIDENT SHALL HAVE THE RIGHT TO WITHDRAW HIS ACCEPTANCE WITHOUT INCURRING ANY LIABILITY TO THE SELLER, UNDERWRITER (IF ANY) OR ANY OTHER PERSON, WITHIN TWO BUSINESS DAYS FROM THE DATE OF RECEIPT BY THE ISSUER OF HIS WRITTEN BINDING CONTRACT OF PURCHASE OR IN THE CASE OF A TRANSACTION IN WHICH THERE IS NO WRITTEN BINDING CONTRACT OF PURCHASE, WITHIN TWO BUSINESS DAYS AFTER HE MAKES THE INITIAL PAYMENT FOR THE SECURITIES BEING OFFERED. TO ACCOMPLISH THIS WITHDRAWAL, A SUBSCRIBER NEED ONLY SEND A LETTER OR TELEGRAM TO THE SELLING AGENT AT THE ADDRESS SET FORTH IN THE TEXT OF THIS MEMORANDUM, INDICATING HIS OR HER INTENTION TO WITHDRAW. SUCH AFOREMENTIONED SECOND BUSINESS DAY. IT IS PRUDENT TO SEND SUCH LETTER BY CERTIFIED MAIL, RETURN RECEIPT REQUESTED, TO ENSURE THAT IT IS RECEIVED AND ALSO TO EVIDENCE THE TIME WHEN IT WAS MAILED. IF THE REQUEST IS MADE ORALLY (IN PERSON OR BY TELEPHONE, TO THE SELLING AGENT AT THE NUMBER LISTED IN THE TEXT OF THE MEMORANDUM), A WRITTEN CONFIRMATION THAT THE REQUEST HAS BEEN RECEIVED SHOULD BE REQUESTED.

Solicitations of Interest. As discussed at the outset of this chapter,ⁿ¹⁴ several states permit a "testing the waters" procedure in accordance with the NASAA *Proposed Statement of Policy on Solicitation of Interest (Test the Waters)*.ⁿ¹⁵ That process includes a requirement for a legend to appear on or be provided with any published notice or materials used in the solicitation. The prescribed legend is as follows:

1. NO MONEY OR OTHER CONSIDERATION IS BEING SOLICITED AND NONE WILL BE ACCEPTED;
2. NO SALES OF THE SECURITIES WILL BE MADE OR COMMITMENT TO PURCHASE ACCEPTED UNTIL DELIVERY OF AN OFFERING CIRCULAR THAT INCLUDES COMPLETE INFORMATION ABOUT THE ISSUER AND THE OFFERING;
3. THIS OFFER IS BEING MADE PURSUANT TO AN EXEMPTION FROM REGISTRATION UNDER FEDERAL AND STATE SECURITIES LAWS. NO SALE MAY BE MADE UNTIL THE OFFERING STATEMENT IS QUALIFIED BY THE SEC AND IS REGISTERED IN THIS STATE.ⁿ¹⁵

The legend requirement for solicitations of interest is part of the general requirements for content of any published note or broadcast script.

FOOTNOTES:

(n1)Footnote 1.

Kansas: Kan. Stat. Ann. § 17-1262(a).

Nebraska: Neb. Rev. Stat. Ann. § 8-1111(1).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17(II)(a).

Oregon: Or. Rev. Stat. Ann. § 59.035(2).

(n2)Footnote 2.

Kansas: Kan. Gen. Stat. Ann. § 17-1262.

Nebraska: Neb. Rev. Stat. Ann. § 8-1111(9).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17(II)(h).

Oregon: Or. Rev. Stat. Ann. § 59.035(12).

Vermont: Vt. Stat. Ann. tit. 9, § 4204a(a)(9).

(n3)Footnote 3. For discussion of the isolated transaction exemption, *see* § 8.06[6][b] *supra*.

(n4)Footnote 4.

Kansas: Kan. Gen. Stat. Ann. § 17-1262(l).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17.

(n5)Footnote 5.

Nebraska: Neb. Rev. Stat. Ann. § 8-1111(9).

Vermont: Vt. Stat. Ann. tit. 9, § 4204a(a)(9).

(n6)Footnote 6. *See* Or. Rev. Stat. Ann. § 59.035(12).

(n7)Footnote 7. *See* Mich. Com. Laws § 451.802(21)(d). Combination of exemptions to include a transaction exempt under the Michigan ULOE is not permitted.

(n8)Footnote 8. *See* § 8.06[7], *supra*.

(n9)Footnote 9.

Indiana: *See, e.g.,* Ind. Code § 23-2-1-2(c).

(n10)Footnote 10. *See* § 8.02, *supra*.

(n11)Footnote 11.

Virginia: See, e.g. Va. Admin. Code § 5-40-70.

(n12)Footnote 12. A NASAA legend requirement likewise applies for prospectuses used in the offer and sale of securities subject to registration under the federal Securities Act of 1933 and the blue sky law of one or more state in which the securities will be offered and sold. For these registered distribution settings the familiar appearing in bold-face capital letters is:

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION OR ANY STATE SECURITIES COMMISSION NOR HAS THE SECURITIES AND EXCHANGE COMMISSION OR ANY STATE SECURITIES COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

This particular language coordinates with an almost identical legend requirement specified by the SEC in Item 501(c)(5) of Regulation SK under the Securities Act of 1933 as applicable to federal registration statements, the only difference being the added reference to state securities commissions.

(n13)Footnote 13. NASAA Reports (CCH) P 1352 at 851.

(n14)Footnote 14. *See* § 8.02, *supra*.

(n15)Footnote 15. *CCH NASAA Guide* P 4001, at 2543. Individual states may expand the required legend. Virginia, for example, adds a fourth paragraph as follows:

REGISTRATION OF THE SECURITIES FOR SALE IN THIS STATE IS DEPENDENT ON COMPLIANCE WITH THE SECURITIES LAWS OF VIRGINIA. THEREFORE, THERE CAN BE NO ASSURANCE THAT THE SECURITIES WILL BE REGISTERED FOR SALE IN VIRGINIA.

See Va. Admin. Code § 5-40-70 C. 1(e).



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CHAPTER 8 Exempt Issuer Transactions

1-8 Blue Sky Regulation § 8.11

§ 8.11 2002 Uniform Securities Act

As referenced throughout this chapter, the National Conference of Commissioners on Uniform State Laws has adopted the 2002 Act to modernize the prior 1956 and 1985 versions of the Uniform Act to reflect federal preemption under NSMIA, as well as significant changes in the technology of securities trading and regulation and the increasingly interstate and international aspects of securities transactions.ⁿ¹ The 2002 Uniform Act does not replace any version of the Uniform Act already in place in any state, but will increasingly be considered by state legislatures for adoption to replace existing blue sky laws. References to the issuer exemption provisions in section 202 of the 2002 Uniform Act are particularly useful because they are an amalgam of the common transaction exemptions in place, in their current forms, and reflecting their current scope. Specific issuer exemptions in the 2002 Act are also broadened, and whether or not the Act is ever widely adopted *en toto*, the particular changes to exemptions will guide *ad hoc* initiatives to modernize existing state provisions.

Perhaps most significantly, in section 202(13) of the 2002 Uniform Act the transaction exemption for offers or sales to institutional investors now incorporates a definition of institutional investor that is based on the federal definition contained in Rule 501(a) of Regulation D under the Securities Act of 1933, but with \$10 million rather than \$5 million thresholds for employee pension, profit-sharing plans, other plans, trusts, and other organizations.ⁿ² Likewise, the definition of institutional investor under the Act includes any other person (other than an individual) with total assets in excess of \$10 million that is not organized for the specific purpose of evading the Act.ⁿ³ The definition of institutional investor also is broadened to reach "qualified institutional buyers" under Rule 144A of the Securities Act of 1933,ⁿ⁴ and "major U.S. Institutional Investors" as defined in Rule 15a-6(b)(4)(i) under the Securities Exchange Act of 1934.ⁿ⁵ These additions modernize state institutional investor exemptions by aligning them with federal exemptions that are particularly significant for international capital markets and cross border capital formation.

As discussed in detail earlier,ⁿ⁶ the basic limited offering exemption in the 2002 Uniform Act was broadened to permit sales to 25 persons in addition to those exempted by the institutional investor exemption. Here again, the new Uniform Act provision enhances the utility of a basic issuer exemption that is subject to considerable variation among the states. Because the emphasis today regarding state exemptions is on flexibility, the 2002 Uniform Act also assures that administrators have broad authority both to exempt other transactions, and to deny, suspend, condition or limit specific exemptions.ⁿ⁷

Federal preemption under NSMIA had a number of implications for blue sky transaction exemptions, and the 2002 Uniform Act harmonizes state exemption requirements with NSMIA preempted regulation. As a prime example, many states today retain an exemption for a transaction under an offer to existing security holders of the issuer that on its face

includes an advance notice procedure and opportunity for the administrator to disallow the exemption in some circumstances. NSMIA made the securities involved in such transactions that are within the scope of the federal exemption in section 3(a)(9) of the Securities Act of 1933 "covered securities" for purposes of NSMIA preemption. Section 202(15) thus eliminates the provision for state administrative review, although antifraud enforcement authority is preserved as to all exempt transactions.

For practitioners the 2002 Uniform Act is an exceptional resource because its provisions, particularly its exemptions, fully reflect the status of dual federal-state securities regulation after NSMIA, and supply guidance in the application of current provisions in blue sky laws.

FOOTNOTES:

(n1)Footnote 1. Prefatory Note, 2002 Unif. Sec. Act.

(n2)Footnote 2. *See* 2002 Unif. Sec. Act §§ 102(11)(F)-(K).

(n3)Footnote 3. 2002 Unif. Sec. Act § 102(11)(O).

(n4)Footnote 4. 2002 Unif. Sec. Act § 102(11)(M).

(n5)Footnote 5. 2002 Unif. Sec. Act § 102(11)(N).

(n6)Footnote 6. *See* § 8.06[5], *supra*.

(n7)Footnote 7. Unif. Sec. Act § 204.



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CHAPTER 9 Exempt Non-Issuer and Resale Transactions

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CHAPTER 9 Exempt Non-Issuer and Resale Transactions

1-9 Blue Sky Regulation § 9.01

§ 9.01 Exempt Non-Issuer Transactions Generally

The registration and qualification provisions in Blue Sky laws are intended to afford investor protection in the context of a *distribution* of securities, that is, in the process by which a security is created and ends up in the hands of the investing public. The role of the states in that process is today focused on distributions of securities that are not "federal covered" securities as defined by the National Securities Market Improvements Act of 1996 (NSMIA), the impact of which, in all areas of state securities regulation, is discussed throughout this treatise. Many localized, intrastate or regional distributions nevertheless remain subject to state registration or qualification authority, and in Chapter 8 the array of issuer exemptions in Blue Sky laws designed to permit capital formation activities without the intervention of registration requirements is considered in depth. Issuer exemptions from registration and qualification requirements are premised upon the absence of any need for Blue Sky law protections in particular circumstances, or as necessary to eliminate unreasonable burdens on small business capital formation.

Registration and qualification provisions in Blue Sky laws are not limited in their application to offers and sales of securities that are undertaken by issuers. To the contrary, all Blue Sky laws make it unlawful for *any person* to offer or sell a security in the state unless:

- (1) the security is a federal covered security;
- (2) the security, transaction, or offer is exempted from registration; or
- (3) the security is registered.ⁿ¹

Offers and sales by issuers or non-issuers are treated no differently. In the absence of an available exemption, both are subject to registration and qualification requirements.

In many circumstances non-issuer transactions do not evidence characteristics of a distribution of securities. They are typically *resales* of securities acquired previously from an issuer, the sales of which are not undertaken systematically as part of a capital formation process. These are secondary market, or trading, transactions involving securities that are already issued and outstanding in investor hands. To be sure, in some circumstances sales of securities by a non-issuer may evidence all the characteristics of an issuer distribution as, for example, when the sale of a large amount of securities is undertaken by a controlling person of the issuer and involves a systematic process or series of transactions.

In these circumstances such "secondary distributions" produce the same concerns for investor protection as any issuer, or "primary" distribution. But for simple, occasional resale transactions by true owners of securities who have no special relationship to the issuer and who are not effectively acting on behalf of or for the benefit of the issuer in making a sale, there is no reason to apply registration and qualification requirements, or indeed, to mandate compliance with private offering or other particular exemptions typically relied on by issuers. The consequences of not having a simple non-issuer exemption are, however, significant given blue sky law provisions affecting the validity of contracts and establishing civil liabilities. For buyers and sellers in non-issuer transactions these are far more important practical considerations than whether registration provisions should or should not apply.ⁿ²

The Federal Securities Act of 1933 includes a broad exemption from registration under that Act for transactions by any person who is not "an issuer, underwriter or dealer."ⁿ³ However, the definition of "underwriter" in the federal act expressly includes controlling persons or affiliates of an issuer who purchase securities from an issuer with a view to distribution.ⁿ⁴ The presence of a statutory "underwriter" is critical to identifying a distribution of securities under the federal act, and thus controls the availability of the federal section 4(1) non-issuer exemption. The federal exemption is intended to exempt only "trading" transactions between individual investors with relation to securities already issued, and not to exempt distributions by issuers.ⁿ⁵ It does not protect persons who by their transactions are engaged in steps necessary to the distribution of securities.

State Blue Sky laws do not have a counterpart broad-form non-issuer exemption from registration or qualification provisions, and thus do not have any comparable focus on "underwriter" status for determining the availability of an exemption for non-issuer transactions. Instead, a series of particular non-issuer exemptions is included among the entire array of exempt transactions. In most cases the non-issuer transaction exemptions follow those established by the original Uniform Securities Act,ⁿ⁶ all of which have been carried into and augmented by the 2002 Uniform Act, reflecting the expansion of non-issuer exemptions that has evolved through the years since introduction of the original Uniform Act.ⁿ⁷ The common non-issuer Blue Sky exemptions are: (1) for "isolated" transactions; (2) for sales of securities that are outstanding and which meet certain quality or performance criteria; and (3) for sales of securities by non-issuers in unsolicited brokerage transactions. There is no general non-issuer transaction exemption in any version of the Uniform Act. However, a few states do provide a broad form non-issuer exemption. California, for example, exempts:

"Any offer or sale of a security by the bona fide owner thereof for his or her own account if the sale (1) is not accompanied by the publication of any advertisement and (2) is not effected by or through a broker-dealer in a public offering."ⁿ⁸

With these exemptions it is clear that, like section 4(1) of the federal act, the focus is on continuing transactions in securities that are already issued and outstanding. As discussed in more detail below, the array of specific non-issuer exemptions in Blue Sky laws is premised entirely on the absence of a distribution of securities, regardless of whatever specific criteria are attached to a particular exemption. In that connection the first, and most fundamental, consideration is that the seller of the securities must actually be a "non-issuer." The Uniform Securities Act defines a "non-issuer transaction" as meaning one "not directly or indirectly for the benefit of the issuer."ⁿ⁹ A majority of states have substantially adopted the Uniform Act definition of "non-issuer."ⁿ¹⁰ Experience with section 4(1) of the Securities Act of 1933, with its critical emphasis on the term "underwriter," however, teaches that "non-issuer" status for purposes of state securities law exemptions may not be an entirely simple notion. Looking to California again, for example, a non-issuer transaction means any transaction not directly or indirectly for the benefit of the issuer. However, the definition further provides: "A transaction is indirectly for the benefit of the issuer if any portion of the purchase price of any securities involved in the transaction will be received indirectly by the issuer."ⁿ¹¹

Other state provisions expand the "non-issuer" transaction definition to encompass those directly or indirectly for the benefit of an affiliate of the issuer as well as the issuer itself. "Affiliate" in this context means any person directly or indirectly controlling, controlled by, or under common control with the issuer.ⁿ¹²

Indirect benefit to an issuer is not limited to monetary benefit. Any meaningful "value" to the issuer in a transaction or series of transactions is sufficient to create a distribution of securities that is subject to registration or qualification provisions of Blue Sky laws.ⁿ¹³ More importantly here, finding a distribution for the "benefit" of the issuer means that secondary or non-issuer exemptions will not be available to those persons who resell the securities. In *Capital General Corp. v. Utah Securities Division*,ⁿ¹⁴ the court affirmed the Utah state securities advisory board's suspension of all secondary trading exemptions in shares of stock that had been distributed as a "good faith gift" by a firm to hundreds of its clients, business associates and other contacts. The firm claimed that the distribution was done to create and maintain goodwill, and that it received no monetary or other direct financial consideration from those receiving the stock. Finding that the distribution was "for value" because it transformed the corporation into a publicly held company, the securities advisory board concluded that the firm should have registered the stock under the Utah Blue Sky law. Affirming that determination, the court of appeals concluded that the economic benefits to the company rendered the disposition "for value," even though those benefits flowed indirectly from the marketplace rather than directly from the transferees. In these circumstances, said the court, the securities advisory board acted properly and in accordance with its authority to suspend secondary trading exemptions as being consistent with the power to remedy violations of the registration provisions in the distribution.ⁿ¹⁵

Where a distribution of securities is in fact taking place the persons who resell the securities in ostensible secondary or trading transactions are in reality participants with the issuer in the distribution. Thus, those persons do not qualify as "non-issuers" and may not claim the benefit of non-issuer exemptions in Blue Sky laws. In a similar fashion, transactions by officers, directors, promoters and other insiders of an issuer may benefit the issuer, and may not qualify as non-issuer transactions. In these circumstances the insiders may be the functional equivalent of statutory underwriters as used in the federal regulatory scheme, and their control or affiliate relationship with the issuer coupled with the size and other characteristics of a particular transaction or series of transactions may produce the same concerns for investor protection as with the issuer itself undertaking the distribution.

The various non-issuer exemptions provided in Blue Sky laws are available only for non-issuer transactions. An issuer selling securities may not rely on any non-issuer exemption, although, as explored in Chapter 8, some states have established one or more issuer exemptions in applicable in similar circumstances as, for example, an isolated issuer transaction. On the other hand, although issuers may not rely on non-issuer exemptions, non-issuers may take advantage of an issuer exemption to the extent that it has general application. Section 202(13) of the 2002 Uniform Securities Act, for example, is a transaction exemption for any offer or sale to an institutional investor, a federal covered investment adviser, or to any other person exempted by rule.ⁿ¹⁶ This is a common provision in Blue Sky laws, and it is available to issuers and non-issuers alike.

The scope and application of non-issuer exemptions in Blue Sky laws was impacted by NSMIA and the preemption of state securities regulatory authority where federal "covered" securities are involved.ⁿ¹⁷ For example, NSMIA brought non-issuer transactions made in reliance upon section 4(1) of the Securities Act of 1933 ("transactions by persons other than an issuer, underwriter or dealer") within the definition of federal covered securities if the issuer is a reporting public company under sections 13 or 15(d) of the Securities Exchange Act of 1934.ⁿ¹⁸ Although states had widely adopted non-issuer transaction exemptions to accommodate secondary trading in outstanding securities of 1934 Act reporting companies, the exemptions included a minimum period during which the securities had been issued and outstanding, and also during which issuer had been subject to and was in compliance with the Exchange Act reporting requirements.ⁿ¹⁹ With NSMIA these kinds of restrictions were preempted because the federal definition of "covered security" to include non-issuer transactions in outstanding securities of a reporting company contains no such waiting period or compliance limitation. Thus, if the issuer of the security is a reporting company under sections 13 or 15(d) of the Securities Exchange Act of 1934, and the federal non-issuer exemption in section 4(1) of the Securities Act of 1933 applies, the transaction is preempted from state Blue Sky law provisions. The preemption extends only to non-issuer transactions in securities of issuers that are reporting companies. In the universe of non-issuer transactions in outstanding securities there continue to be circumstances in which the justification for an exemption based upon

compliance with federal securities law reporting mechanisms is presented despite an ineligible issuer. Thus in section 202(4) of the 2002 Uniform Securities Act a specific non-issuer transaction exemption is included for:

"a nonissuer transaction by or through a broker-dealer registered or exempt from registration under this [Act] in an outstanding security if the *guarantor* of the security files reports with the Securities and Exchange Commission under the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934."²⁰

As discussed in more detail throughout this chapter, a number of other nonissuer transaction exemptions focused specifically on trading in outstanding securities remain, and are meaningful in, state Blue Sky laws. These exemptions do not key on an issuer's compliance with federal reporting requirements, and thus provide added flexibility to non-issuers and intermediaries working with them.

The harmonizing approach is taken as well to non-issuer "brokerage" transactions. Under NSMIA transactions qualifying for exemption from federal registration by section 4(4) of the Securities Act of 1933,²¹ which exempts unsolicited brokerage transactions executed on an agency basis, are also now federal covered securities. Prior to NSMIA all states, and the Uniform Act, provided an exemption for unsolicited nonissuer transactions by or through a broker-dealer.²² With qualifying agency transactions now defined as federal covered securities under NSMIA, state brokerage transaction exemptions now address non-agency transactions by broker-dealers that are not within the scope of federal Securities Act section 4(4).

After NSMIA all states expressly exclude federal covered securities from Blue Sky registration or qualification requirements, and other regulatory requirements that would directly or indirectly subject such securities to prohibitions, limitations or conditions regarding the use of certain offering documents and other disclosure documents. Nevertheless, non-issuer transaction exemptions remain important for secondary trading and transactions in the universe of settings and situations that remain within the ambit of state Blue Sky registration or qualification provisions. The 2002 Uniform Securities Act presents the non-issuer and resale transaction exemptions that continue as central elements of state securities laws. They are:

(1) Isolated non-issuer transactions;²³

(2) Non-issuer transactions in certain securities of a class that has been outstanding in the hands of the public for at least 90 days, and which satisfies certain specific conditions regarding the business and business history of the issuer; when the sale price is reasonably related to the current market price; the security does not constitute part of an unsold allotment; and certain company and financial information is published in a nationally recognized securities manual or its electronic equivalent; or the issuer has a class of securities listed on a national securities exchange or the Nasdaq Stock Market and meets certain business history and asset requirements;²⁴

(3) Non-issuer transactions by or through a broker-dealer in a security of a foreign issuer that is a margin security under regulations of the Federal Reserve Board, or non-issuer transactions in certain foreign issuer securities that are traded on designated securities exchanges and are subject to certain reporting requirements;²⁵

(4) Non-issuer transactions by or through a broker-dealer in an outstanding security if the guarantor of the securities files reports with the SEC under the reporting requirements of sections 13 or 15(d) of the Securities Exchange Act of 1934;²⁶

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(5) Non-issuer transactions by or through a broker-dealer in a security that meets certain rating criteria, or has a fixed maturity, interest or dividend and which meets certain business criteria;n27

(6) Non-issuer transactions by or through a broker-dealer effecting an unsolicited order or offer to purchase;n28

(7) Non-issuer transactions by a bona fide pledgee without any purpose of evading the Blue Sky law;n29 and

(8) Non-issuer transactions by a federal covered investment adviser with investments under management in excess of \$100,000,000 acting in the exercise of discretionary authority in a signed record for the account of others.n30

The principal non-issuer transaction or resale exemptions are discussed further below. As a preliminary consideration, however, the essential "non-issuer" premise for the exemptions is examined in greater detail.

FOOTNOTES:

(n1)Footnote 1. *See, e.g.,* 2002 Unif. Sec. § 301.

(n2)Footnote 2. *See, e.g.,* *Watson v. Schaffner*, 893 F.2d 1336 (6th Cir. 1990) , in which the buyer alleged that a stock purchase agreement was void and unenforceable because the Kentucky Blue Sky Law non-issuer transaction exemption did not apply. The buyer was not successful, as the court found that the sale would qualify as an exempt non-issuer transaction in the absence of evidence of sufficient issuer benefit in the transaction. However, the Kentucky law, like all state blue sky laws, provides that a contract made in violation of the blue sky law is unenforceable. *See, e.g.,* 2002 Unif. Sec. Act § 509(k).

The availability of a non-issuer transaction exemption may also impact licensing requirements for intermediaries; *see, e.g., State v. Weissner*, 161 N.W.2d 360, 1968 N.D. LEXIS 84 (N.D. 1968) .

(n3)Footnote 3. *See* Securities Act of 1933, section 4(1), 15 U.S.C. § 77d(1).

(n4)Footnote 4. Section 2(a)(11) of the federal act, 15 U.S.C. § 77b(a)(11), provides:

"The term 'underwriter' means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking... As used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

(n5)Footnote 5. *SEC v. Chinese Consolidated Benevolent Association, Inc.*, 120 F.2d 738 (2d Cir. 1941) .

(n6)Footnote 6. *See* Unif. Sec. Act § 402(b)(1)-(3).

(n7)Footnote 7. 2002 Unif. Sec. Act § 202(1)-(8).

(n8)Footnote 8. *Cal. Corp. Code § 25104(a)*.

These exemptions are typically limited to transactions not effected through a broker-dealer. *See, e.g.,* *People v. Eddy*, 85 N.W. 2d (Mich. 1957); *Parrish v. Ben-Jon Oil Co.*, 1983 OK CIV APP 39, 666 P.2d 1308 (Okla. 1983) ; *see also* Ill. Comp. Stat., Ch. 815 §5/4(A); 70 Pa. Stat. § 1-203(a), which covers sales not directly or indirectly for the benefit of an affiliate of an issuer. However, as discussed further below, the broker-dealer limitation is more commonly stated in terms of solicited transactions rather than non-issuer transactions by or through a broker-dealer on an unsolicited order or offer to purchase.

(n9)Footnote 9. Unif. Sec. Act § 401(h); 2002 Unif. Sec. Act § 102 (18).

(n10)Footnote 10. *See, e.g.,*

Connecticut: Conn. Gen. Stat. § 36b-21(b)(1).

Maryland: Md. Code Ann. § 11-101(j).

Massachusetts: Mass. Gen. L. Ann. Chap. 110A, § 401(g).

(n11)Footnote 11. *Cal. Corp. Code § 25011*.

(n12)Footnote 12. *See, e.g.,*

Minnesota: Minn. Stat. Ann. § 80A.14(14).

New Hampshire: N.H. Rev. Stat. § 421-B:2(XIV).

New Jersey: N.J. Stat. § 49:3-49(o) ("Non-issuer" means secondary trading not involving the issuer of the securities nor any person in a control relationship with the issuer).

New Mexico: N.M. Stat. § 58-13B-2(p).

Virginia: Va. Code. § 13.1-501

(n13)Footnote 13. "Value" determinations for purposes of applying registration or qualification requirements to transfers of securities; that is, what constitutes an "offer" or sale" of securities under Blue Sky laws generally, are considered in depth in Chapter 3, *supra* . Traditional value assessments involved in identifying a sale for purposes of state securities law protections are given a different meaning through emphasis placed on value obtained by an issuer in a distribution process rather than a transaction supported by particular consideration.

(n14)Footnote 14. 1989 Utah App. LEXIS 118, 777 P.2d 494 (Utah App. 1989) .

(n15)Footnote 15. *See also Technomedical Labs, Inc. v. Utah Securities Division*, 1987 Utah App. LEXIS 562, 744 P.2d 320 (Utah App. 1987) The approaches to "value" by these Utah courts is consistent with federal case authority examining the economic consequences to corporate "spin-off" transactions, *see SEC v. Datronics Engineers, Inc.*, 490 F.2d 250 (4th Cir. 1973) ; *SEC v. Harwyn Industrial Corp.*, 326 F.Supp. 943 (S.D.N.Y. 1971) .

(n16)Footnote 16. 2002 Unif. Sec. Act § 202(13).

(n17)Footnote 17. NSMIA, the National Securities Markets Improvements Act, Pub. L. No. 104-290, 110 Stat.

3416 (1996), effective October 11, 1996, amended § 18 of the Securities Act of 1933, 15 U.S.C. § 77r, to preempt most state authority to regulate the distribution of federal covered securities through registration or qualification requirements. NSMIA and its impact are discussed throughout this treatise. "Covered securities" under NSMIA include: (1) securities listed or authorized to be listed on a qualifying national securities exchange or the Nasdaq Stock market, or which are equal or senior to such securities; (2) securities issued by an investment company that is registered or has filed a registration statement under the Investment Company Act of 1940; (3) securities sold to "qualified purchasers" as that term may be defined by the SEC; and (4) securities sold in transactions exempt from federal registration under certain provisions of the federal securities laws and rules thereunder, most particularly securities offered and sold in compliance with Rule 506 of SEC Regulation D under the Act.

(n18)Footnote 18. To become subject to Exchange Act reporting requirements an issuer must have an outstanding class of securities registered under section 12 of the Exchange Act, 15 U.S.C. § 1, thus meeting certain criteria. Exchange Act reporting involves the filing and dissemination of annual, quarterly and current reports by the issuer.

(n19)Footnote 19. Section 402(2) of the Revised Uniform Securities Act is representative of such provisions, in providing an exemption for:

"a nonissuer transaction in an outstanding security if the issuer has a class of securities subject to registration under Section 12 of the Securities Exchange Act of 1934 and has been subject to the reporting requirements of Sections 13 or 15(d) of the Securities Exchange Act of 1934 for not less than 90 days next preceding the transaction; or has filed and maintained with the [Administrator] for not less than 90 days next preceding the transaction information, in such form as the [Administrator] by rule specifies, substantially comparable to the information the issuer would be required to file under Section 12(b) or 12(g) of the Securities Exchange Act were the issuer to have a class of its securities registered under Section 12 of the Securities Exchange Act of 1934, and paid a fee with the filing of [\$150]" Rev. Unif. Sec. Act § 402(2).

Some states also imposed a "waiting period," requiring that the securities be issued and outstanding in the hands of the public for 90 days prior to the transaction. Arizona, Florida, Maine, North Dakota and Rhode Island, for example, imposed such restrictions.

(n20)Footnote 20. 2002 Unif. Sec. Act § 202(4) (Emphasis added).

(n21)Footnote 21. 15 U.S.C. § d(4).

(n22)Footnote 22. *See, e.g.*, Unif. Sec. Act § 402(b)(3). The Uniform Act exemption, like the one adopted in many states, empowered the administrator to impose upon the broker-dealer a written customer acknowledgment and record-keeping requirement.

(n23)Footnote 23. 2002 Unif. Sec. Act § 202(1).

(n24)Footnote 24. 2002 Unif. Sec. Act. § 202(2).

(n25)Footnote 25. 2002 Unif. Sec. Act §§ 202(3), 292(23).

(n26)Footnote 26. 2002 Unif. Sec. Act § 202(4).

(n27)Footnote 27. 2002 Unif. Sec. Act § 202(5).

(n28)Footnote 28. 2002 Unif. Sec. Act § 202(6).

(n29)Footnote 29. 2002 Unif. Sec. Act § 202(7).

(n30)Footnote 30. 2002 Unif. Sec. Act § 202(8).



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§ 9.02 "Non-Issuer" Status: Transactions by Affiliates and Others

As noted earlier, non-issuer transaction exemptions are intended for bona fide non-issuer *owners* of the securities, and not to permit transactions that benefit the issuer by constituting or facilitating a distribution of its securities. If the issuer is in fact making a distribution through ostensible "secondary" transactions by individuals, non-issuer exemptions should not be available.ⁿ¹ Issuer "gifts" and "spin-off" transactions referenced in *section 9.01 above* illustrate the point where the intent of the issuer is in fact to distribute its securities into the hands of the investing public without complying with registration requirements. In other situations the question whether the issuer is in fact engaged in a distribution in connection with transactions by others is often presented when the person engaging in a transaction has a close relationship to the issuer and the transaction involves a significant amount of securities. Transactions by controlling persons and affiliates of the issuer, as well as the notion of "insider" as it relates to non-issuer exemptions are examined below as a prelude to closer consideration of particular non-issuer exemptions and applications. In all of this, however, it is essential to bear in mind that the application of Blue Sky law registration and qualification provisions to non-issuer transactions has historically been described as one of the most ambiguous aspects of state securities regulation.ⁿ²

[1] Affiliates and Control Persons When a non-issuer seller is in a close relationship to the issuer the circumstances of the sale may manifest the same characteristics and produce the same concerns as if the issuer itself engaged in the sale. This is the premise underlying application of registration and qualification provisions to "secondary" distributions of securities that is most often applied to controlling persons of an issuer. Such persons may be deemed to be in control of the issuer simply by reason of the size of the seller's holdings. A major shareholder might also be an officer or director of the issuer, and even absent large share holdings an executive officer or director is typically deemed to be a "controlling person." At least one state statutorily prohibits any controlling persons from relying on non-issuer exemptions.ⁿ³ However, a sale by a controlling person does not automatically equate with one by the issuer. Circumstances may well support a conclusion that a sale should qualify as a non-issuer isolated transaction.ⁿ⁴

"Affiliate" is a broader term applied in some states and which is derived from SEC Rule 405 under the Securities Act of 1933. It includes a person controlling, controlled by or under common control with the issuer.ⁿ⁵ Affiliate relationships arise in parent-subsidiary and other corporate situations, and also involve the basic control relationship that is central to determining non-issuer status for purposes of blue sky law exemptions. Some states expressly deny non-issuer exemptions to affiliates.ⁿ⁶

The notion of "controlling person" for determining non-issuer status is not as straightforward as it may seem. For example, is a sole stockholder selling 100% of the shares of a corporation a controlling person and thus not entitled to rely on a non-issuer exemption to effect the transaction? A California court held that the sale of a business and all outstanding shares by the sole shareholder was not for the benefit of the issuer and was therefore exempt from registration.ⁿ⁷ The sale of the stock, said the court, was only incidental to the sale of the business.ⁿ⁸ On the other hand, the Eighth Circuit U.S. Court of Appeals, applying the Arkansas securities law, opined that an exemption for isolated non-issuer transactions is not intended to apply to persons holding 100% of the outstanding stock of the issuing corporation who sells those shares.ⁿ⁹ The Court relied on legislative history of the federal securities laws to conclude that the sale of stock by holders who are in control of the issuer should be treated no differently than if the original issuer was seeking to dispose of the shares. In these circumstances, said the Court:

"[t]o hold that a sale of 100% of the stock of a corporation by its parent to another is exempt from registration as an "isolated, non-issuer transaction" would, we think, be completely contrary to the remedial purposes of the [Arkansas] Act. The General Assembly has adopted the doctrine of caveat venditor for sellers of securities, and it was not the intent of the Act to allow sophisticated sellers of securities to unfairly benefit from such sales without fully complying with the Act's requirements."ⁿ¹⁰

Suffice it to say that there is a presumption that significant sales of securities by controlling persons or affiliates of the issuer will be deemed the equivalent of an issuer transaction, and thus outside the ambit of non-issuer exemptions. The "control" determination itself is more problematic. Several states have deemed persons owning as little as ten percent of any class of shares of the issuer to be in control as the issuer.ⁿ¹¹ In some other states the percentage owned can rise as high as twenty-five percent before a presumption of control arises.ⁿ¹² But the most common approach is that guided by SEC Rule 405 under the Securities Act of 1933, which looks to all factors to determine whether there is control in fact.ⁿ¹³

Federal courts have refused to limit how far the concept of control might extend, and have left the door open to go beyond substantial shareholders.ⁿ¹⁴ As a result, whenever the issuer is subject to the "management and policies" of a given person or group of persons a control relationship exists. The concept can extend to directors, officers, managers, and beyond.ⁿ¹⁵

Of the states adopting the Uniform Act isolated transaction exemption,ⁿ¹⁶ a few exclude or limit the availability of the exemption as to controlling persons. Massachusetts allows controlling persons to take advantage of the exemption within well defined limits.ⁿ¹⁷ The Tennessee exemption, however, goes further than the Uniform Act exemption by excluding underwriters as well as an issuer's affiliates, defined in the Tennessee Blue Sky law to include controlling persons.ⁿ¹⁸

The most complex regulation dealing with controlling persons and the isolated transaction exemption is in effect in Wisconsin.ⁿ¹⁹ If a controlling person seeks to use the exemption, the transaction must be in accordance with the brokers transaction provisions of Section 4(4) of the Securities Act of 1933ⁿ²⁰ and Rule 144 thereunder. This section of the federal law provides a registration exemption for "brokers' transactions executed on customers orders on any exchange or in the over-the-counter market but not solicitation of such orders."ⁿ²¹ In the alternative, isolated transactions by controlling persons, to be eligible for the Wisconsin exemption, must not be made through a broker-dealer and the total sales during the prior twelve months must not exceed one percent of the outstanding shares or units of the class sold.ⁿ²² Other regulatory provisions apply if the transaction is made by one who is not a controlling person.ⁿ²³

The statutory exemption in many non-Uniform Act states places particular emphasis in denying the non-issuer transactional exemption to underwriters.ⁿ²⁴ A few states also make dealers owning the securities ineligible for the exemption, although the exemption is available when the securities are sold by a dealer for a *bona fide* owner.ⁿ²⁵

Precluding availability of the isolated transaction exemption to underwriters and, in some circumstances dealers, is understood simply by the fact that an underwriter is presumed to be engaged in a distribution on behalf an issuer. Dealers selling for their own account are viewed in a similar light depending upon the circumstances of the dealer's original acquisition of the securities. With these intermediaries as seller the essential question is always whether distribution of the securities is in fact occurring. Intermediaries are generally not presumed to be bona fide owners/holders of securities, and either act for or with an issuer in making transactions, or themselves functionally become issuers in making resales. Their conduct is well outside the intended ambit of isolated sales exemptions in blue sky laws.

[2] Insiders In the application of non-issuer transaction exemptions one's status as an "insider" is sometimes addressed in the same context as controlling persons and affiliates. As a practical matter the terms are equivalent, but "insider" status may also extend to promoters who resell securities within a relatively short period of time following the organization of a company. Indeed some states specifically include a definition of "insider" as:

Every controlling person of another, including every officer, director, partner or trustee, or individual occupying similar status or performing similar functions, and every *promoter* if the organization took place within three years from date of application.ⁿ²⁶

The presumption involved in sales by promoters is the same as for controlling persons and affiliates. Simply by reason of the seller's close association with the issuer, the transaction has the same characteristics as if the issuer itself were distributing securities. With promoters the concern is amplified by the presumed intent of the promoter to redistribute shares acquired in the organization of the issuer that is evidenced by the timing of the sale in relation to the organization of the issuer. In these circumstances it is also much easier to find that transactions by insiders confer some meaningful benefit on the issuer, thus converting them into issuer transactions for purposes of precluding application of a non-issuer exemption. On the other hand, particular circumstances may lead to a different conclusion, such that a non-issuer transaction exemption would legitimately cover the sale of securities by a promoter who is not a controlling person at the time of the transaction. The key consideration is whether the "insider" acquired and held the securities for investment, and is thus a bona fide owner. Non-issuer status for purposes of transaction exemptions is reserved for persons who are not presumed to be engaged in a distribution as if an issuer.

FOOTNOTES:

(n1)Footnote 1. *See, e.g., Hild v. Woodcrest Ass'n*, 59 Ohio Misc. 13, 391 N.E.2d 1047, 1977 Ohio Misc. LEXIS 121 (Montgomery Co. Common Pleas, 1977) (Control person who purchased, and several weeks later sold, securities to meet minimum requirement for the release of funds held in escrow, held to have purchased for the benefit of the issuer in order to permit the issuer's distribution to be completed rather than as a bona fide owner of a security held for investment purposes).

(n2)Footnote 2. "In many statutes it is difficult or impossible to say with any certainty when registration is required in such a case [secondary distributions or other non-issuer transactions]; who must register; how many units of the security should be registered; who may sell once a registration becomes effective; and, as a result, who is civilly liable and when a contract to sell is enforceable." 1 Loss "Securities Regulation," 62 (2d ed. 1961, Supp. 1969).

(n3)Footnote 3.

New Jersey: N.J. Stat. Ann. § 49:3-49(o). The statute, however, does not define "control" or "controlling persons."

(n4)Footnote 4. *See Fox v. Ehrmantraut*, 28 Cal. 3d 127, 167 Cal. Rptr. 595, 615 P.2d 1383 (Cal. Sup. Ct. 1980)

; *Cain v. Solomon*, 213 So.2d 35 (Fla. App. 1968) . In both of these cases the fact that sellers had a control relationship with the issuer did not preclude reliance on non-issuer transaction exemptions.

(n5)Footnote 5. 17 C.F.R. § 230.405. Under Rule 405 the focus is on control in *fact* rather than specific indicia. Rule 405 provides:

"The term 'control' (including the terms 'controlling,' 'controlled by,' and, 'under common control with') means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract or otherwise."

(n6)Footnote 6.

New Hampshire: See, e.g., N.H. Rev. Stat. Ann. § 421-B:2(XIV); Minnesota: Minn. Stat. Ann. § 80A.14(14). However, Minnesota provides an exemption for offers or sales by the issuer's affiliate if a registration statement is in effect with respect to securities of the same class of the issuer and the offer or sale is approved by rule or order of the Commissioner; *See Minn. Stat. Ann. § 80A.15(2)(o).*

Another state exempts transactions by an affiliate (defined to include a controlling person) not acting as an underwriter, provided the securities are sold through a broker-dealer in "brokers' transactions" as defined by Securities and Exchange Commission Rule 144 under the Securities Act of 1933, *see Tenn. Code Ann. § 48-2-103(b)(5); § 48-2-102(1).*

(n7)Footnote 7. *Fox v. Ehrmantraut*, 28 Cal. 3d 127, 167 Cal. Rptr. 595, 615 P.2d 1383 (Cal. Sup. Ct. 1980) .

(n8)Footnote 8. *See also White v. Solomon*, 105 N.M. 366, 732 P.2d 1389 , Blue Sky L. Rep. (CCH) P 72,494 (N.M. App. 1986) (Sale of all the stock of a company by its four shareholders to three individual purchasers qualified for the isolated transaction exemption).

(n9)Footnote 9. *Cole v. PPG Industries, Inc.*, 680 F.2d 549 (8th Cir. 1982) .

(n10)Footnote 10. 680 F.2d at 555 .

(n11)Footnote 11. *See, e.g.:*

Alaska: Alaska Adm. Code 3 AAC 08.950(7).

Kansas: Securities Rule § 81-1-1.

Missouri: Code of State Regulations, § 30-50.010(1)(G).

Oregon: Ore. Rev. Stat. § 59.015(2).

(n12)Footnote 12. *See, e.g.:*

Hawaii: Securities Rule § 16-38-1.

Illinois: Ill. Comp. Stat. Ch. 815, § 512.4.

(n13)Footnote 13. The SEC definition has been substantially adopted in several states. *See, e.g.:*

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Florida: Fla. Stat. Ann. § 517.021(5).

Massachusetts: Securities Regulation 950 CMR § 14.401(f).

Pennsylvania: 70 Pa. Stat. Ann. § 1-102(g).

Tennessee: Tenn. Code Ann. § 48-2-102(5).

Texas: TAC Securities Rule §107.2(11).

(n14)Footnote 14. *Securities & Exch. Com'n. v. International Development Corp.*, 469 F.2d 20 (10th Cir. 1972) ; *Pennaluna & Company v. Securities & Exch. Com'n.*, 410 F.2d 861 (9th Cir. 1969) , cert. denied, 396 U.S. 1007, 90 S. Ct. 562, 24 L. Ed. 2d 499 (1970) ; *Klapmeier v. Telechech International, Inc.*, 315 F. Supp. 1360 (D. Minn. 1970) , rev'd on other grounds, 482 F.2d 247 (8th Cir. 1973) ; *SEC v. American Beryllium & Oil Corp.*, 303 F. Supp. 912 (S.D.N.Y. 1969) .

(n15)Footnote 15. *Pennaluna & Company v. Securities & Exch. Com'n.*, 410 F.2d 861 (9th Cir. 1969) , cert. denied, 396 U.S. 1007, 90 S. Ct. 562, 24 L. Ed. 2d 499 (1970) .

"Control" is not to be determined by artificial tests, but is an issue to be determined from the particular circumstances of the case ... Under Rule 405 ... it is not necessary that one be an officer, director, manager, or even shareholder to be a controlling person. Further, control may exist although not continuously and actively exercised. ...

(n16)Footnote 16. *See, e.g.,*

Alabama: Ala. Code § 8-6-11(a)(1).

Iowa: Iowa Code § 502.203(1).

Kentucky: Ky. Rev. Stat. Ann. § 292.410(1)(a).

Kentucky's non-issuer isolated transaction exemption is not available for separate sales by a large number of individual customers of an issuer who each received their stock from the issuer as a gift to create good will. Ky. Interp. Op. May 19, 1988, Blue Sky L. Rep. (CCH) P 27,578.

Michigan: Mich. Comp. L. § 451.802(b)(1).

New Mexico: N.M. Stat. § 58-13B-27(A).

North Carolina: N.C. Gen. Stat. § 78A-17(1).

(n17)Footnote 17. Mass. Sec. Rule § 14.402(b)(3)(B).

(n18)Footnote 18. *Tenn. Code Ann. § 48-2-103(b)(8); § 48-2-102(1)* (definition of "affiliate").

(n19)Footnote 19. Wis. Adm. Code § 2.02(1).

(n20)Footnote 20. *15 U.S.C. § 77d(4).*

(n21)Footnote 21. *15 U.S.C. § 77d(4).*

(n22)Footnote 22. *Wis. Adm. Code § 2.02(1)(b).*

(n23)Footnote 23. *Wis. Adm. Code § 2.02(1)(a).*

(n24)Footnote 24. *See, e.g.*

Florida: Fla. Stat. Ann. §517.061(3).

North Dakota: N.D. Cent. Code § 10-04-06(3).

Rhode Island: R.I. Rev. L. Ann. § 7-11-402(1).

(n25)Footnote 25.

Ohio: See Ohio Rev. Code Ann. § 1707.03(B).

In *State v. Allen*, 107 Ariz. 538, 490 P.2d 10 (1971) , it was held that the owner of securities is not considered a dealer by virtue of sales in an isolated transaction.

Note that a number of statutes require the transaction to be by or on behalf of the "owner" of the securities. This was the requirement under a former Iowa statute. The term "owner" for purposes of the exemption was deemed to mean non-issuer. *Getter v. R. G. Dickinson & Co.*, 366 F. Supp. 559 (S.D. Iowa 1973) (Applying Iowa law).

See also Prokop v. Krennek, 374 S.W.2d 265 (Tex. Civ. App. 1964) , for a discussion of the Texas provision which disallows the sale to be for the benefit of any other company or corporation.

(n26)Footnote 26. *See, e.g.,*

Hawaii: Securities Rule § 16-38-1.

Kansas: Securities Regulation § 81-1-1(m).

The Indiana definition is similarly worded with a few significant differences. *See Rules and Regulations of the Securities Division § 710 IAC 1-8-1(9).*



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Blue Sky Regulation

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CHAPTER 9 Exempt Non-Issuer and Resale Transactions

1-9 Blue Sky Regulation § 9.03

§ 9.03 Isolated Transactions

The exemption for isolated transactions is intended to allow a holder of securities to make occasional sales without registration. As discussed earlier, with few exceptions the exemption is available only to non-issuers.ⁿ¹ The most common form of isolated transaction exemption is that contained in the Uniform Securities Act for "any isolated non-issuer transaction, whether effected through a broker-dealer or not."ⁿ² Other forms of the exemption make clear that the covered transaction must not be one made in the course of repeated and successive transactions of a similar character. Ohio, for example, declares:

"A sale of securities made by or on behalf of a bona fide owner, neither the issuer nor a dealer is exempt, if such sale is made in good faith and not for the purpose of avoiding [the registration and qualification provisions] and is not made in the course of repeated and successive transactions of a similar character."ⁿ³

In stating the exemption more generally, Florida identifies the key considerations in its provision addressing:

"The isolated sale or offer for sale of securities when made by or on behalf of a vendor not the issuer or underwriter of the securities, who, being the bona fide owner of such securities, disposes of her or his own property for her or his own account, and such sale is not made directly or indirectly for the benefit of the issuer or an underwriter of such securities or for the direct or indirect promotion of any scheme or enterprise with the intent of violating or evading any provision of this chapter."ⁿ⁴

However the exemption is worded, application of the non-issuer isolated transaction exemption involves two key elements. The first is a "transaction" within the intended scope of coverage. Although typically thought of in terms of non-issuer resale transactions, the range of triggering events for registration or qualification provisions of state securities laws is such that offers and any attempt to dispose of a security for value must also fall within an available exemption. It is not always clear that "transaction" for purposes of the isolated transaction exemption includes the broad notions of offer as well as sale and to what extent, for example, repeated offers ultimately resulting in a single sale would qualify as an isolated transaction. This possibility also highlights the second critical element in the application of the isolated transaction exemption; namely, the meaning of "isolated." Each of these elements is examined more closely below.

[1] The Meaning of "Transaction" All states broadly define the terms "sale," "offer," or "offer to sell" so as to maximize the scope of investor protection under blue sky laws. An "offer to sell" includes every attempt or offer to dispose of, or solicitation of an offer to purchase, a security for value. "Sale" is separately defined to include every contract of sale, contract to sell, or disposition of a security for value.ⁿ⁵ Generally speaking, states do not, however, separately define "transaction." This leaves an open question whether the non-issuer isolated transaction exemption encompasses offers to sell in addition to actual isolated sales. The Indiana isolated transaction exemption is stated in terms of "any isolated non-issuer offer or sale,"ⁿ⁶ thus making clear that in assessing the availability of the exemption an offer is to be considered an eligible transaction addition to actual sales that may result. Indiana also provides a specific definition of "transaction" that incorporates the statutory definitions of "sale," "offer" and "offer to sell."ⁿ⁷ Given this construct, numerous solicitations or offers leading to an otherwise isolated sale may prove fatal to reliance on the isolated transaction exemption. In some cases it is made explicit. In Hawaii, for example, the number of persons solicited is by rule established as a determining factor for availability of the isolated transaction exemption.

ⁿ⁸ In Uniform Act states such emphasis on the extent of solicitations or offers is problematic because the non-issuer isolated transaction exemption is so simply stated, and "transaction" at least implies that a *completed* transaction, i.e., a sale, is all that matters.

In states where the exemption is not based on the Uniform Act, the problem takes on a different aspect. One state makes it clear that the exemption applies to both offers and sales, provided there are no more than five sales by the seller or an affiliate of the seller in a twelve month period in which the date of sale can be included.ⁿ⁹ But some states apply the exemption to "isolated sales"ⁿ¹⁰ or "sales of securities in isolated transactions."ⁿ¹¹ Whether or not these isolated sales include offers to sell is therefore dependent on how each state defines "sale."ⁿ¹² In three states the "sale" definition is based on the Uniform Act and does not include "offers" or "attempts to sell."ⁿ¹³ Two other states have comparable definitions, which would seem to eliminate the issue.ⁿ¹⁴ However, even in these states the problem may not be solved.ⁿ¹⁵ Other non-Uniform Act states include "an attempt to sell" securities as part of the definition of "sale,"ⁿ¹⁶ and it would appear that any offer of a security would be considered in determining whether or not transactions are isolated.ⁿ¹⁷

In all of this, however, it is well to consider an Oregon caseⁿ¹⁸ involving two actual sales of securities and one offer to sell. The court, over dissent, held that two sales of stock to two different individuals fell within the non-issuer isolated transaction exemption. The dissent objected on the ground that the majority did not take into consideration the "attempted sale" which constituted a sale of securities under the Oregon statute.ⁿ¹⁹

In sum, case law and administrative treatments of "transaction" for purposes of the non-issuer isolated sales transaction produce some degree of uncertainty from state to state. For the most part, however, the differences are in nuances only, and they are resolved by applying a common sense notion of isolated transaction, as a whole, consistent with the intent of the exemption. Occasional sales by a true non-issuer holder of securities may well involve the solicitation of purchasers before a sale is consummated. In context, multiple solicitations by a non-issuer holder leading to an otherwise isolated sale is entirely consistent with the objective of the exemption. Multiple solicitations carried out in a concerted effort intended to produce one or more sales to dispose of security holdings present a different picture. The context determines whether any transaction is in fact "isolated."ⁿ²⁰ States that define "transaction" to include offers as well as sales merely codify the essential notion that what amounts to a public solicitation of offers to buy is not the intended focus of the exemption. In context, the notion of an "isolated" transaction takes on the greatest meaning, and that essential element is discussed in greater detail below.

[2] Identifying "Isolated" Transactions Although the Uniform Act exemption is worded simply in terms of any "isolated" non-issuer transaction, as seen earlier several non-Uniform Act states expressly address the exemption to transactions that are not made in the course of "repeated and successive transactions of a similar character."ⁿ²¹ Prior to the advent of the Uniform Securities Act, the reference to "repeated and successive" was an integral part of the isolated transaction exemption in many states. It was explained in an early Massachusetts case:

The words "repeated and successive" are used by way of contrast to the word "isolated" employed earlier in the same sentence. In such context an "isolated" sale means one standing alone, disconnected from any other, and "repeated and successive" mean transactions undertaken and performed one after the other. We think that two sales of securities, made one after the other within a period of such reasonable time as to indicate that one general purpose actuates the vendor and that the sales promote the same aim and are not so detached and separated as to form no part of a single plan, would be "repeated and successive transactions."ⁿ²²

This is a useful explanation that remains meaningful today. However, even where the statute describes isolated as not being repeated and successive does not necessarily mean that the description of these terms will be adhered to. As previously discussed, Hawaii, for example, specifies how many transactions may be solicited or sold and within what period of time.ⁿ²³ Arizona has solved its problem uniquely through an interpretation of its statute which, in effect, does away with the isolated nature of non-issuer transactions. In Arizona, the number of transactions engaged in is immaterial as long as they are not in any way made for the benefit of the issuer or the underwriter.ⁿ²⁴

Most states, and most notably those having the Uniform Act exemption provision, do not base their statutes on the repeated and successive test. However, it is uncertain to what extent the courts of Uniform Act states will look to the "repeated and successive" criterion in interpreting the isolated transaction exemption. One Uniform Act state contrasts "isolated sales" with "repeated and successive sales" to prescribe a less rigid formula than one earlier prescribed in Massachusetts.ⁿ²⁵ Missouri, which also has the Uniform Act's isolated transaction exemption,ⁿ²⁶ defines "isolated" by regulationⁿ²⁷ as "standing alone, disconnected from any other transactions." According to the regulation, the definition is based on a caseⁿ²⁸ decided under a prior exemption provision which described an isolated transaction as "not being made in the course of repeated and successive transactions." Similarly, Massachusetts' regulation is based on the previously mentioned case decided under prior law.ⁿ²⁹ Nevertheless, another Uniform Act state has stated that it would be inappropriate to look to interpretations in states whose statutes refer to repeated and successive sales of securities since the variance in language "necessitates that we look and rely upon the interpretation of such an exemption under statutes similar to that in the Uniform Act as adopted by Indiana."ⁿ³⁰ Interestingly, the court then looked to an Oklahoma case which had adopted a liberal interpretation of "repeated successive sales."ⁿ³¹

The problem of judicial interpretation of "isolated" and "repeated and successive" has been avoidedⁿ³² in a number of states that prescribe the number of transactions in a given security that will be deemed isolated and the time period during which such transactions may be made. In two states, this has been accomplished by statute.ⁿ³³ In other states, regulations have been issued delineating the rule.ⁿ³⁴ In some states, the rules and regulations serve as more of a general guideline rather than setting hard and fast rules.ⁿ³⁵ This latter approach has also been taken by courts, which usually decline to state a maximum number of permissible transactions, and prefer instead to decide in the particular circumstances whether transactions are isolated or not.ⁿ³⁶

It should also be noted that in determining the number of transactions, there is authority to the effect that only those transactions made within a given state are considered,ⁿ³⁷ and the count includes only securities of the same issuer.ⁿ³⁸

Although the meaning of "isolated transaction" has largely been left developing through case law,ⁿ³⁹ some states have by rule imposed objective criteria. In Kansas, for example, a transaction will be deemed to be isolated if: "no twelve month period in which the date of the sale can be included contains more than five sales of the securities in Kansas by the seller or affiliates, or by or for the benefit of the issuer," although certain other conditions regarding the manner of sale must also be met.ⁿ⁴⁰ In the main, however, the number of transactions is not itself dispositive. Relevant factors include the type of offer made, the number of units offered, the manner of offering, the relationship of the seller to the offerees, and the length of time for which securities have been held prior to the resale transaction.ⁿ⁴¹

[3] Issuer "Benefit" Apart from examining particular relationships between sellers and issuers, courts have also examined use of the non-issuer isolated transaction exemption in terms of issuer benefit. As introduced in *section 9.01*

above, if a meaningful direct or indirect benefit inures to the issuer in the circumstances of an ostensible "non-issuer" sale, the transaction may be transformed into a non-exempted issuer transaction. For example, shares of stock sold by a holder for the purpose of channeling cash into a failing corporation is a transaction for the benefit of the issuer.ⁿ⁴²

"Benefit" in these circumstances means something more than incidental benefit. A Florida appellate court, for example, concluded that a sale of stock by a holder with the stipulation that the buyer would lend money to the issuing corporation in addition to the purchase price to be paid to the seller was not such a benefit as to preclude reliance on the isolated sales exemption by the seller.ⁿ⁴³ The court reasoned that the availability of a non-issuer exemption does not mean that the issuer cannot receive any benefit whatsoever. It means, said the Court:

"[t]hat a sale shall not be exempt when an individual makes the sale apparently for his own benefit but in reality for the benefit of the corporation. It does not follow that because a corporation receives some benefit (in this instance a loan of money) from a sale of stock by an individual that the corporation is the real party in interest.

We hold that the provision in the contract that the purchaser make a loan to the corporation is a factor to be considered in determining whether the sale is for the benefit of the corporation. We also hold that the provision for the loan does not as a matter of law make the present sale a sale for the benefit of the corporation.ⁿ⁴⁴

A federal appeals court applying Kentucky law similarly concluded that two holders' sale of securities to an individual as part of an agreement that included a provision that the purchaser would become employed by the issuer corporation did not represent a benefit to the issuer sufficient to transform the sales into issuer transactions.ⁿ⁴⁵

An Arizona appellate court examined a situation in which the corporation's president instigated a transfer of stock held by another shareholder. The transferee was to receive the stock in exchange for partnership assets to be turned over to the corporation. The corporation issued a promissory note to the selling shareholder and took the stock to act as conduit in the final transfer. The shares were then re-transferred by the corporation in exchange for the partnership assets. The court concluded that the transaction was undertaken as a whole for the benefit of the issuer and disallowed the exemption.ⁿ⁴⁶ These are conduit transactions structured to benefit the issuer. In most instances in which the non-issuer isolated transaction exemption is disallowed the intent to benefit the issuer will be apparent in light of all the circumstances.ⁿ⁴⁷

Here again, the availability of the non-issuer isolated transaction exemption where there is some "benefit" to the issuer from the non-issuer transaction is a case by case assessment guided by common sense and the objective of blue sky laws. Non-issuer transactions that are plainly structured and undertaken in order to benefit or facilitate a benefit to the issuer will not be eligible. There are no objective "benefit" criteria, but the purposes for a non-issuer transaction, particularly one by a non-issuer in a control person or affiliate relationship with the issuer, may be inferred from the evidence, and will ultimately control.

FOOTNOTES:

(n1)Footnote 1. Isolated transactions as an issuer exemption are discussed in ch. 8, § 8.06[6][b], *supra* .

A few states specifically make the exemption applicable to issuers and non-issuers. *See, e.g.:*

Minnesota: Minn. Stat. Ann. § 80A.15(2)(a).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17(II)(a).

Washington: Wash. Rev. Code § 21.20.320(1).

(n2)Footnote 2. Unif. Sec. Act. § 402(b)(1); *see also* 2002 Unif. Sec. Act § 202(1).

(n3)Footnote 3. *Ohio Rev. Code § 1707.03(B),*

(n4)Footnote 4. *Fla. Stat. § 517.061(3).*

(n5)Footnote 5. *See, e.g.,* 2002 Unif. Sec. Act § 102(26).

(n6)Footnote 6. *Ind. Code § 23-2-1-2(b)(l).*

(n7)Footnote 7. *Ind. Code § 23-2-1-1(i)(3).*

(n8)Footnote 8. *Haw. Sec. Rules § 16-38-1.*

(n9)Footnote 9. *Kan. Sec. Regs. § 81-5-3.*

(n10)Footnote 10. *See* n.24 *supra* for statutory provisions in Florida, North Dakota and Rhode Island.

(n11)Footnote 11. *See* *Ariz. Rev. Stat. Ann. § 44- 844(4).* *See* n.25 *supra* for a comparable citation in Ohio.

(n12)Footnote 12. The discussion here is only an outline of the basic provisions of the states involved. Reference should be made to ch. 3 *supra* for statutory provisions and discussion of what constitutes "offers" and "sales" of securities generally.

(n13)Footnote 13.

Maine: See 32 *Me. Rev. Stat. Ann. § 1050(15).*

Minnesota: Minn. Stat. Ann. § 80A.14(m)(17).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:2(XIX)(a).

(n14)Footnote 14.

Arizona: Ariz. Rev. Stat. Ann. § 44-1801(9).

North Dakota: N.D. Cent. Code § 10-04-02(13).

(n15)Footnote 15. *See* n.8 *supra* and text applicable thereto regarding regulations in Hawaii.

(n16)Footnote 16.

Ohio: See *Ohio Rev. Code Ann. § 1707.01(C)(1).*

Rhode Island: R.I. Rev. L. Ann. § 7-11-101(17).

Texas: Tex. Rev. Civ. Stat., Art. 581-2(E).

(n17)Footnote 17. In fact, one Ohio court counted the number of persons "solicited." See *Bronaugh v. R. & E. Dredging Co.*, 16 Ohio St. 2d 35, 242 N.E.2d 572 (1968) .

(n18)Footnote 18. *Tarsia v. Nick's Laundry & Lines Supply Co.*, 239 Ore. 562, 399 P.2d 28 (1965) .

(n19)Footnote 19. 399 P.2d at 30 .

See also *Redhouse v. Preferred Properties*, Blue Sky L. Rep. (CCH) P 72,669 (Ore. App. 1987), in which a single purchase of securities was not an exempt isolated transaction where two other solicitations of an offer that were not acted on were made on behalf of the issuer at about the same time as the purchase. (At the time of the purchase and the solicitations, solicitations of offers were statutorily deemed sales.) Summary judgment for the purchaser was affirmed since the three transactions as a matter of law evidenced a "general purpose" to sell the securities. The Oregon statute has since been amended to remove solicitations or attempts from the definition of "sale." See *Ore. Rev. Stat. § 59.015(15)(a)*.

(n20)Footnote 20. See, e.g., *Commonwealth v. Allen*, 441 S.W.2d 424 , a969 Ky. LEXIS 319 (Ky. App. 1969). In *Allen* the defendant contacted at least 30 prospective purchasers and actually sold stock to about 10 of them. As a matter of law, the sales could not be considered isolated sales. Evidence of all sales was admissible to rebut the inference that the transactions in question were isolated and to establish a course of dealing.

(n21)Footnote 21. See n.24 *supra* for statutory provisions in North Dakota, and Rhode Island. See n.25 *supra* for statutory provision in Ohio.

(n22)Footnote 22. *Kneeland v. Emerton*, 280 Mass. 371, 183 N.E. 155, 163(1932) .

(n23)Footnote 23. See Haw. Sec. Rules § 16-38-1.

In *Bronaugh v. R. & E. Dredging Co.*, 16 Ohio St. 2d 35, 242 N.E.2d 572 (1968) , nine solicitations were found to be "repeated and successive transactions of a similar character."

(n24)Footnote 24. *State v. Allen*, 107 Ariz. 538, 490 P.2d 10 (1971) . See also *Riffle v. Robert L. Parker Co.*, 19 Ariz. App. 100, 505 P.2d 268 (1973) and *Kalav v. Pitt*, 18 Ariz. App. 478, 503 P.2d 833 (1972) .

The application of the Arizona rule as laid down in *Allen*, *Riffle* and *Kalav* would seem to have the effect of exempting all non-issuer transactions. A comparable result may come out of the Connecticut statute which incorporates by reference the exemption under § 4(6) of the Securities Act of 1933 which exempts "transactions by any person other than an issuer, underwriter or dealer." Conn. Gen. Stat., Ch. 662 § 36-490(b)(13). For a discussion of the federal exemption, see *Federal Securities Act of 1933*, A.A. Sommer, Jr., General Editor, § 4.01 (Matthew Bender).

In *Butler v. American Asphalt & Contracting Co.*, 25 Ariz. App. 26, 540 P.2d 757 (Ariz. App. 1975) , the plaintiff purchased 51% of a corporation in a single sale from the individual owner of the corporation. The court found the transaction to be within the isolated transaction exemption available to non-issuers on the grounds that the seller was the owner of the securities and the plaintiff, an experienced stockbroker, did not need the protection of the blue sky law.

(n25)Footnote 25. See *Nelson v. State*, 1960 OK CR 65, 355 P.2d 413, 420 (Okla. Crim. App. 1960) :

An "isolated sale" means one standing alone, disconnected from any other; "repeated successive sales" means transactions undertaken and performed one after the other, and sales made within a period of such reasonable time as to indicate that one general purpose actuates the vendor and that such sales

promote the same aim and are not so detached and separated as to form no part of a single plan. ... Stated differently, "isolated sales" are those of a non-recurring nature engaged in by persons not engaged in the security business. ... The word isolated is not a word of art or technical meaning, but is a term the application of which must depend upon the facts of each case.

(n26)Footnote 26. *Mo. Ann. Stat. § 409.402(b)(1)*.

(n27)Footnote 27. 15 CSR § 30-50.010(1)(J).

(n28)Footnote 28. *Gales v. Weldon*, 282 S.W.2d 522 (Mo. Sup. 1955) .

(n29)Footnote 29. Massachusetts Securities Rules § 14.402(B)(1)(a).

(n30)Footnote 30. *Hippensteel v. Karol*, 159 Ind. App. 146, 304 N.E.2d 796 (Ind. App. 1973) , footnote 4 at p. 801 .

(n31)Footnote 31. *See* n.25 *supra*.

(n32)Footnote 32. Two states have indicated a preference for reliance on administrative regulations, at least with respect to isolated transactions. In *Allen v. Schauf*, 202 Kan. 348, 449 P.2d 1010 (1969) , it was said:

[W]here statutory enactments create a situation where official duties which must be performed which are not clearly defined or prescribed in detail, the operative interpretation given thereto by the officers and official boards whose duties are to carry the legislative policy into effect is helpful, and may be entitled to controlling significance. ... The general rule is sound and in this case the securities commissioner was directed by the Legislature to adopt regulations to carry the Act into effect. As indicated, the Act expressly provides that none of its provisions imposing any liability applies to any act done or omitted on good faith in reliance upon the commissioner's regulations notwithstanding they may later be determined to be invalid. We do not pass upon the wisdom of Regulation 81-1-1, but if it is applicable to the transactions in question, we are of the opinion the defendants were entitled to rely upon its provisions defining an "isolated transaction."

See 449 P.2d at 1017 , 1018. *See* Kan. Sec. Rel. § 81-5-3.

In *Hippensteel v. Karol*, 159 Ind. App. 146, 304 N.E.2d 796 (Ind. App. 1973) , the court noted that there was no regulation such as the one relied on in *Allen supra* , and said that it would return to interpretations of other states since it did not have "the aid of such a definitive regulation." 304 N.E.2d at 801 .

(n33)Footnote 33. *See, e.g.,*

Minnesota: Minn. Stat. Ann. § 80A.15(2)(a). Five sales in twelve consecutive months.

South Dakota: S.D. Comp. L. § 47-31A-402(b)(1). One sale in twelve consecutive months.

See also Mont. Code Ann. § 30-10-105(1) (creating a presumption that a transaction is isolated if it is one of no more than three transactions during the prior 12 months; a transaction is defined to include the meanings of the terms sale, sell and offer. *Id.*, § 30-10-103(21).

(n34)Footnote 34. *See, e.g.,*

Hawaii: Securities Rule § 16-38-1. Twenty-five persons solicited in twelve month period.

Kansas: Securities Regulation § 81-5-3. Five sales during twelve months.

Wisconsin: Wis. Adm. Code § 2.02(1)(a). Five transactions in twelve months.

(n35)Footnote 35. *See, e.g.,* Massachusetts Securities Rules § 14.402(B)(1)(a).

"The term 'isolated' for the purposes of Section 402(b)(1), means not in the course of repeated and successive transactions of like character. Two sales of securities made one after the other within such a period of time and in such circumstances as to indicate that they involve the same plan of financing are not isolated from one another."

See also Michigan Securities Bulletin, October, 1968.

"[W]e wish to point out that if a broker-dealer acts as agent for a seller, and then sells the stock in a number of transactions close in point of time insofar as any one owner is concerned, the transactions are no longer isolated."

(n36)Footnote 36. *See, e.g., Rucker v. La-Co., Inc.*, 496 F.2d 850 (8th Cir. [Ark.] 1974), (decided under Arkansas law, five transactions in six months).

See also Creager v. Berger, 97 Ore. App. 338, 775 P.2d 918, Blue Sky L. Rep. (CCH) P 73,000 (Ore. App. 1989)(remanded for further evidence on the number of solicitations the defendant made).

See also Hippensteel v. Karol, 159 Ind. App. 146, 304 N.E.2d 796 (Ind. App. 1973) (Nine sales within six months); *Commonwealth v. Allen*, 441 S.W.2d 424 (Ky. App. 1969) (Thirty offers and ten actual sales within two months); *Commonwealth v. David*, 365 Mass. 47, 309 N.E.2d 484 (Mass. Sup. 1974) (Five transactions in several months).

A few cases have been decided on the basis of only a single transaction. *See Shepherd v. State*, 246 Ark. 744, 439 S.W.2d 627 (1969). *Dohhen v. Minnesota-Ohio Oil Corp.*, 232 So. 2d 200 (1970), *cert. denied* 240 So.2d 638; *Cain v. Solomon*, 213 So. 2d 35 (Fla. App. 1968).

(n37)Footnote 37. *Dohhen v. Minnesota-Ohio Oil Corp.*, 232 So. 2d 200 (Fla. App. 1970), *cert. denied*, 240 So. 2d 638. *See* n.34 *supra* for regulations in Hawaii and Kansas.

(n38)Footnote 38. *See* S.D. Comp. L. § 47-31A-402(b)(1).

(n39)Footnote 39. *See, e.g., Nelson v. State*, 1960 OK CR 65, 355 P.2d 413 (Okla. Crim. App. 1960) ("[a]n isolated sale means one standing alone, disconnected from any other"); *Allen v. Schauf*, 202 Kan. 348, 449 P.2d 1010 (Kan. 1969).

(n40)Footnote 40. Kan. Admin. Regs., Office of the Sec. Comm'r § 81-5-3.

See also:

New Mexico: N.M. Admin. Code Rule 12.11.12.8 (A transaction is isolated if it does not occur more frequently, with respect to the same offeror or seller, more than three times during any 12 month period, and satisfies certain other requirements).

Washington: Wash. Admin. Code § 460-44A-050 (A sale by one who is neither a controlling person nor

affiliate will qualify for the exemption if it is effected through a broker-dealer and is one of not more than three such transactions effected in the state during the prior twelve months).

Wisconsin: Wis. Admin Code, DFI-Sec. 2.02(1) ("Isolated non-issuer transaction" is limited to one of not more than five transactions effected through a broker-dealer during the prior twelve months).

(n41)Footnote 41. The significance of a holding period is evidenced in the Florida isolated transaction exemption which provides, as to promoters or affiliates, that one who has beneficially owned the securities for at least one year will not be deemed to be an underwriter, issuer or person acting for the direct or indirect benefit of an issuer or underwriter; *see Fla. Stat. § 517.061(3)*.

(n42)Footnote 42. *See Strom v. Black*, 22 Ariz. App. 102, 523 P.2d 1339 (1974) .

See also Arkansas Real Estate Co. v. Fullerton, 232 Ark. 713, 339 S.W.2d 947 (1960) (The sale of securities by a holder for the purpose of promoting the issuer's warehousing business were held to be for the benefit of the issuer and thus nonexempt); *Bronaugh v. R. & E. Dredging Co.*, 16 Ohio St.2d 35, 242 N.E.2d 572 (1968) (Sale was in fact made by the issuer, even though the issuer acted only as a conduit in repurchasing securities from existing holders for resale to others).

(n43)Footnote 43. *Cain v. Solomon*, 213 So.2d 35 (Fla. App. 1968) .

(n44)Footnote 44. *Cain v. Solomon*, 213 So.2d 35 (Fla. App. 1968) , at n.38.

But see Bellerue v. Business Files Institute, Inc., 61 Cal.2d 488, 39 Cal. Rptr. 201, 393 P.2d 401 (1964) .

(n45)Footnote 45. *Watson v. Shaffner*, 893 F.2d 1336 (6th Cir. 1990) .

(n46)Footnote 46. *Riffle v. Robert L. Parker Co.*, 19 Ariz. App. 100, 505 P.2d 268 (1973) .

In *Rucker v. La-Co., Inc.*, 496 F.2d 850 (8th Cir. 1974) , decided under Arkansas law, the court held that a sale of its own stock to an insider by a corporation would not be deemed a sale for the benefit of the issuer where the insider was the "knowledgeable comptroller" of the corporation and "was well acquainted with the financial operations of [the company]." 496 F.2d at 853 .

(n47)Footnote 47. *See, e.g., Hild v. Woodcrest Association*, 59 Ohio Misc. 13, 391 N.E.2d 1047 (Ohio Com. Pleas 1977) (General partner of the issuer who purchased remaining unsold securities in order to permit the issuer to break escrow, and soon thereafter sold the securities was not entitled to non-issuer isolated transaction exemption because his actions overall were clearly intended to benefit the issuer in accessing proceeds of the offering).



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Blue Sky Regulation

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CHAPTER 9 Exempt Non-Issuer and Resale Transactions

1-9 Blue Sky Regulation § 9.04

§ 9.04 The Manual Exemption

The "Manual" exemption in Blue Sky laws for non-issuer transactions is designed to permit sales of securities of a class that has been outstanding in the hands of the public for a requisite period of time, and as to which certain qualifying criteria are met, including the requirement that a nationally recognized securities manual (or today its electronic equivalent) that is publicly available contains certain business and financial information of the issuer. As originally designed in the Uniform Securities Act and Revised Uniform Securities Act the manual exemption provided for otherwise unrestricted sales by a non-issuer.ⁿ¹ In 1996, however, the North American Securities Administrators Association (NASAA) amended the Uniform Act provisions to add, among other things, a provision that the non-issuer transaction must be made by a registered agent of a registered broker-dealer, or be a resale transaction by a sponsor of a unit investment trust registered under the federal Investment Company Act of 1940.ⁿ² Most states adopted the NASAA amendment to make the exemption applicable to non-issuer trades through a broker-dealer, and that provision was carried into section 202(2) of the 2002 Uniform Securities Act.ⁿ³ Some, however, continue to make the manual exemption available for any non-issuer transaction, whether or not effected through a broker-dealer.ⁿ⁴

In most states today the requirements for the manual exemption now include, in addition to securities being outstanding in the hands of the public for at least 90 days, the issuer must actually be engaged in business. The issuer may not be in the organizational stage, or in bankruptcy or receivership. It may not be a "blank check", blind pool or shell company that has no specific business plan or purpose.ⁿ⁵ Nor may it be a company that has indicated that its [primary business purpose is to engage in a merger or combination of the business with, or an acquisition of, an unidentified person. There are essential transaction criteria as well, including that the security must be sold at a price "reasonably related to its current market price,"ⁿ⁶ and the security does not constitute the whole or part of an unsold allotment to, or a subscription or participation by, the broker-dealer as an underwriter of the security or a redistribution.

Any variations among the states involve primarily the minimum period of time in which the issuer has been engaged in business, or in which the subject securities have been outstanding in the hands of the public.ⁿ⁷ Otherwise, if these criteria are met, and requisite information is contained in a qualifying "nationally recognized securities manual," the non-issuer transaction (either directly or through a broker-dealer, as the case may be) exemption will be allowed. But as also reflected in the 2002 Uniform Securities Act, the manual exemption has been considerably modernized since its first introduction. Today in many states there are alternatives to the "manual" requirement available. The non-issuer exemption may also be available, for example, if the issuer has a class of equity securities listed on a national securities exchange or designated for trading in the Nasdaq Stock Market, or if the issuer meets certain other business history or

total asset requirements.ⁿ⁸ Where the issuer files publicly available records or reports with the SEC containing the same prescribed information as would be contained in a qualifying securities manual the exemption is also available in some states. Provisions for alternative eligibility for this non-issuer transaction exemption have in some states effectively merged the "manual" exemption with the "quality" exemption that is discussed in *section 9.05* below.ⁿ⁹

The key to the manual exemption is the availability in the marketplace of adequate information without the need for a registration statement. The modern versions of the manual exemption now in place go further to recognize certain qualitative criteria that would otherwise be addressed by blue sky qualification requirements, and those criteria significantly broaden the scope of the exemption from that created by the original Uniform Securities Act. As a practical matter, the alternative qualifying criteria supplant the original "manual" listing as a basis for the exemption. Nevertheless, a recognized manual listing remains meaningful and continues as an element in all Blue Sky laws.

[1] Recognized Securities Manual Manual exemptions in Blue Sky laws refer to listing in a publicly available "recognized," or more commonly today, a "nationally recognized" securities manual. Although the essential information that must be included in the manual listing is provided, the statutes generally do not identify particular qualifying manuals.ⁿ¹⁰ The specification of any particular qualifying manual is left to administrative rules or orders.ⁿ¹¹ Almost without exception today, administrators have designated any Mergent's securities manuals, Standard and Poor's securities manuals, and Fitch's securities manuals that contain, in whatever format, the information specified in the exemption as qualifying the exemption. As specified today in the 2002 Uniform Securities Act, the information required to be included in an issuer's manual listing consists of:

- (a) a description of the business and operations of the issuer;
- (b) the names of the issuer's executive officers and the names of the issuer's directors, if any;
- (c) an audited balance sheet of the issuer as of a date within 18 months before the date of the transaction or, in the case of a reorganization or merger when the parties to the reorganization or merger each had an audited balance sheet, a pro forma balance sheet for the combined organization; and
- (d) an audited income statement for each of the issuer's two immediately previous fiscal years or for the period of existence of the issuer, whichever is shorter, or, in the case of a reorganization or merger when each party to the reorganization or merger had audited income statements, a pro forma income statement.ⁿ¹²

Importantly, today designations of recognized manuals for purposes of the exemption also typically provide that "manual" includes all commonly recognized formats of publications, including CD-ROM and electronic dissemination over the Internet.ⁿ¹³

There are some variations in the manual information content requirement. For example, a few states have different requirements for the date of the profit and loss statementⁿ¹⁴ In all cases, of course, there are additional requirements that the selling price of the security bear a reasonable relationship to the current market price.ⁿ¹⁵ Some states also specify that any commission collected by a broker-dealer must not be in excess of usual and customary commissions collected with respect to securities and transactions having comparable characteristics.ⁿ¹⁶ One state specifies certain securities which are not eligible for the manual exemption under any circumstances.ⁿ¹⁷

Some variations also exist in regard to assuring "non-issuer" status for the manual exemption. All states deny the exemption to a broker-dealer when the securities constitute an unsold allotment to or subscription by the dealer as a participant in the distribution of the securities by the issuer or by or through an underwriter.ⁿ¹⁸ However, in two states an underwriter of the securities may use the exemption if it is no longer acting as the underwriter.ⁿ¹⁹ Other states specifically deny the exemption to controlling persons, or at least limit the extent to which such persons may use the

exemption.ⁿ²⁰ One stateⁿ²¹ has a separate exemption for securities maintaining a rating approved by the securities administrator in a recognized securities manual. This exemption is available to issuers and non-issuers alike.

[2] Alternatives to "Manual" Qualification Modernization of the manual exemption has produced practical, meaningful alternatives to a securities manual listing as the basis for a non-issuer transaction exemption where outstanding securities are involved. Although baseline qualifications regarding length of time securities are outstanding and issuer business requirements are not changed, states have recognized that today there other publicly available information resources that provide the same, indeed much more, information as any securities manual. Thus in New Jersey, for example, the "manual" exemption for non-issuer transactions by a registered broker-dealer is available when:

"[t]he securities are of an issuer for which all reports required to be filed by section 13 or 15(d) of the Securities Exchange Act of 1934, 15 U.S.C. Section 78m or Section 78o(d) have been filed."ⁿ²²

Another modern approach, illustrated in Delaware, is to provide that requisite information be contained in a nationally recognized securities manual *or* be contained in a document filed with the SEC that is publicly available through the SEC's Electronic Data Gathering and Retrieval System (EDGAR).ⁿ²³ This approach implemented the 1996 NASAA amendment to section 402(2) of the original Uniform Securities Act, and is today a part of many state exemptions. Still another approach, taken wholly outside the "manual" exemption but based on the same rational, is to provide a separate exemption for non-issuer transactions by a broker-dealer in securities of an issuer that is subject to reporting requirements of the Securities Exchange Act of 1934, and has filed required reports during the ninety day period immediately preceding the sale, and the broker-dealer reasonably believes the issuer is current in all of its filings.ⁿ²⁴ The exemption based on an issuer's compliance with 1934 Act reporting requirements is meaningful today only in those states which make the exemption specifically applicable to secondary trading transactions by a broker-dealer. Individual transactions by a non-issuer in securities of a qualifying issuer pursuant to section 4(1) of the federal Securities Act of 1933 are now "covered securities" under NSMIA and are not subject to state registration requirements at all.

The alternative to manual listing contained in the 2002 Uniform Securities Act is actually an amalgam of two modernized approaches in Blue Sky laws. Section 202(2)(E) of the 2002 Uniform Act first recognizes that the listing of a class of securities on a national securities exchange, or designation for trading in the Nasdaq Stock Market, involves meeting listing standards and criteria, including the generation and dissemination of current information by an issuer. The 2002 Uniform Act manual alternative thus allows the exemption for non-issuer transactions by a registered broker-dealer in a security of an issuer that has a class of equity securities listed. With the focus being on the issuer qualification for listing, the actual securities involved in the transaction need not be listed so long as the issuer has a class of equity securities that is listed.

The second manual alternative for qualification reflected in the 2002 Uniform Securities Act is that the issuer of the security, including its predecessors, has been engaged in continuous business for at least three years, *or* the issuer has total assets of at least \$2,000,000 based on an audited balance sheet as of a date within eighteen months before the date of the transaction. This provision in the 2002 Uniform Act is also a product of the 1996 NASAA amendment to section 402(b)(2) of the original Uniform Securities Act, and is aimed at addressing the problem of "penny stock" fraud.ⁿ²⁵ This provision was generally not adopted by states as part of their "manual" exemptions, but so-called "blue chip" or quality exemptions are functionally equivalent. However, in those states that have now enacted the 2002 Uniform Securities Act the provision is included in its entirety.ⁿ²⁶

Several states provide still another alternative to listing in a recognized manual when specified information concerning the issuer, including financial information, is filed with the administrator. In Indiana, for example, information filed with the Commissioner consisting of the names of the issuer's officers and directors, a balance sheet of the issuer as of a date not more than sixteen months prior to the date of the sale, and a profit and loss statement for either the fiscal year preceding that date or the most recent year of operations will qualify the exemption. A specific form for filing the information is prescribed, and there is a fee.ⁿ²⁷

FOOTNOTES:

(n1)Footnote 1. *See* Unif. Sec. Act § 402(b)(2); Rev. Unif. Sec. Act § 402(3).

(n2)Footnote 2. Unif. Sec. Act § 402(b)(20), NASAA Amendments (1996), CCH NASAA Reports P 4882.

(n3)Footnote 3. *See, e.g.,*

Arkansas: Ark. Code § 23-42-504(2);

Connecticut: Conn. Gen. Stat. § 36b-21(b)(2);

District of Columbia: D.C. Code § 31-5604.02(2);

Indiana: Ind. Code § 23-2-1-2(b)(3);

Nevada: Nev. Rev. Stat. § 90.530(3).

(n4)Footnote 4.

North Carolina: *See, e.g.,* Gen. Stat. N.C. § 78A-17(2).

(n5)Footnote 5. Official Comments to section 202(2) explain the meaning of the terms:

"Rule 419 issued under the Securities Act of 1933 defines 'blank check company' to be a company that 'is a development stage company that has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies, or other entity or person.' A 'blind pool' is similar and would involve an investment in a blank check or other entity with no identified business plan or purpose. A 'shell company' is also similar and would involve an entity which, to date, has no significant business assets, plan, or purpose." Off. Comments, 2002 Unif. Sec. Act § 202(2).

(n6)Footnote 6. 2002 Unif. Sec. Act § 202(2)(B).

(n7)Footnote 7. In Michigan, for example, the exemption is available for the non-issuer distribution of an outstanding security whose issuer and any predecessors have been in continuous operation for at least five years, see *Mich. Comp. Laws* § 451.802(b)(2).

(n8)Footnote 8. As stated in section 202(2)(E) of the 2002 Uniform Securities Act, the exemption is available without regard to any "manual" listing if:

"the issuer of the security has a class of equity securities listed on a national securities exchange registered under the Securities Exchange Act of 1934 or designated for trading on the National Association of Securities Dealers Automated Quotation System, unless the issuer of the security is a unit investment trust registered under the Investment Company Act of 1940; or the issuer of the security, including its predecessors, has been engaged in continuous business for at least three years; or the issuer of the security has total assets of at least \$2,000,000 based on an audited balance sheet as of a date within

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18 months before the date of the transaction or, in the case of a reorganization or merger when the parties to the reorganization or merger each had the audited balance sheet, a pro forma balance sheet for the combined organization."

Alternatives to manual listing are discussed in *section 9.04[2]* below, and also include, in some states, publicly available information in records filed with the SEC

(n9)Footnote 9. In some states the "manual" and quality exemptions have actually been combined, *see, e.g.*, Miss. Code § 75-71-203(2).

(n10)Footnote 10.

Hawaii: But see Haw. Rev. Stat. § 485-6(2) (Specifically identifying the manual of Hawaiian securities in addition to any other recognized securities manual).

New Hampshire: See also N.H. Rev. Stat. § 421-B-17(II)(b) (Specifying Moody's, Fitch's or Standard and Poor's securities manuals). Moody's manuals were commonly specified as well in administrative rules or orders, but are today known under the Mergent's name, which most states have substituted for Moody's references.

(n11)Footnote 11. *See, e.g.*, 2002 Unif. Sec. Act § 202(2)(D).

(n12)Footnote 12. 2002 Unif. Sec. Act § 202(2)(D)(i)-(iv).

See *Roger v. Lehman Brothers Kuhn Loeb, Inc.*, Blue Sky L. Rep. (CCH) P 72,300 (S.D. Ohio 1985) (adopting a strict compliance posture, the court held that manual listed securities, otherwise within the exemption, did not satisfy the information requirements where no profit and loss statement was included in the listing, even though the issuer was a developmental company without operating profits or losses.

(n13)Footnote 13. *See, e.g.*, Del. Sec. Rules Sec. 508(b).

(n14)Footnote 14. Florida, for example, requires that the profit and loss statement be dated not less than two years next prior to the date of the balance sheet. If the issuer is in existence for less than two years, the statement is to be for the period as of the date of the balance sheet, *see Fla. Stat. Ann. § 517.061(20)(a)(5)(b)*. In Texas, the profit and loss statement must be dated not more than three years prior to the date of the published balance sheet. If the period of existence is less than three years, the statement must cover the period of existence, *see* Tex Rev. Stat. Art. 581-5(O)(9)(b). Minnesota requires that, in all cases, the profit and loss statement be for the fiscal year preceding the date of the balance sheet, *see Minn. Stat. Ann. § 80A.15(2)(b)(1)*.

In all the above states, the balance sheet is to be as of a date not more than eighteen months prior to the date of sale of the security.

(n15)Footnote 15. *See, e.g.*,

Indiana: Ind. Code § 23-2-1-2(b)(3).

Kansas: Kan. Gen. Stat. Ann. § 17-1262(b).

North Dakota: N.D. Cent. Code § 10-04-06(8)(a).

Oregon: Ore. Rev. Stat. § 59.035(10)(a).

South Dakota: S.D. Comp. L. § 47-31A-402(b)(2).

Texas: Tex. Rev. Civ. Stat., Art. 581-5(O)(3).

(n16)Footnote 16. This is the case in Indiana, North Dakota, and Oregon.

(n17)Footnote 17. *See N.D. Cent. Code § 10-04-06(8)(d), (e).* Securities of issuers not organized under the laws of a state, territory or insular possession of the United States. Securities of open-end management companies, mutual funds, unit investment trusts, contractual plans and face amount certificate companies.

(n18)Footnote 18. *See, e.g.,*

Arizona: Ariz. Rev. Stat. Ann. § 44-1844(A)(11).

Florida: Fla. Stat. Ann. § 517.061(20). The Florida provision has the same general purpose but states that the exemption does not apply to a dealer acting as underwriter of the securities.

North Dakota: N. D. Cent. Code § 10-04-06(8)(b).

Oregon: Ore. Rev. Stat. § 59.035(10)(b).

Texas: Tex. Rev. Civ. Stat., Art. 581-5(O)(1). The Texas provision does not refer to distributions made by or through an underwriter.

The statutes in Arizona and North Dakota also deny the exemption to dealers distributing unsold allotments in participation with the issuer's officers and directors.

(n19)Footnote 19. *See n.18 supra* for statutory citation in Arizona.

(n20)Footnote 20. Alaska, for example, provides by rule:

"The distribution of large blocks of securities by controlling persons in firmly underwritten offerings will ordinarily be presumed to be for the direct or indirect benefit of the issuer, and not within the provisions of the manual exemption." Alaska Adm. Code, 3A.A.C.08.910(3)(B).

See also Massachusetts: Securities Rules § 14.402(B)(1)(b).

(n21)Footnote 21. *Ore. Rev. Stat. § 59.035(10).*

(n22)Footnote 22. *N.J. Stat. § 49:3-50(b)(2).*

(n23)Footnote 23. *Del. Code § 7309(b)(2)(d).*

(n24)Footnote 24.

New Mexico: See, e.g., N.M. Stat. § 58-13B-27(B).

(n25)Footnote 25. *See* NASAA Comments to § 402(b)(2), CCH NASAA Reports P 4882, at 3594.

(n26)Footnote 26. The 2002 Uniform Securities Act is now in place in Missouri, Oklahoma, South Dakota, Idaho, Iowa, Kansas and the U.S. Virgin Islands.

(n27)Footnote 27. Ind. Code § 23-2-1-2(b)(3)(C)(iii).



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Blue Sky Regulation

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CHAPTER 9 Exempt Non-Issuer and Resale Transactions

1-9 Blue Sky Regulation § 9.05

§ 9.05 The Quality Exemption

[1] Fixed Income or Fixed Maturity Securities Many states provide a non-issuer transaction exemption where fixed income securities are involved and the issuers have a proven record of paying interest or dividends. The exemption is rooted in section 402(b)(2)(B) of the original Uniform Securities Act, and is today contained in section 202(5) of the 2002 Uniform Securities Act. Baseline requirements for exempt non-issuer transactions in these "quality" securities are that:

- The security has a fixed maturity or a fixed interest or dividend provision, and
- There has been no default in the payment of principal, interest, or dividends on the security during the current fiscal year or within the three preceding fiscal years. (If the issuer has been in existence less than three years, there must be no default at any time during the period of existence of the issuer and any predecessors.)ⁿ¹

As a practical matter, "fixed maturity" and "fixed income" are equivalent terms, as the key characteristic of any security that is eligible for the transaction exemption is the provision for fixed interest or dividends. Transactions involving common stock are not eligible for the exemption, although a broader form of quality exemption discussed in *section 9.05[2]* below may be available.ⁿ²

As noted earlier in section 9.04, the common approach is to combine the "quality" exemption with the "manual" exemption, so as to make a non-issuer transaction exempt if either specified information about the issuer is currently contained in a recognized securities manual, or the security has a fixed maturity or fixed interest or dividend provision and there has been default within the prescribed period of time.ⁿ³

Some states address quality in terms of a security that is senior in rank to the common stock of the issuer both as to payment of dividends and interest and upon liquidation or dissolution, in addition to being outstanding for a requisite period of time with no history of default.ⁿ⁴ As carried into the 2002 Uniform Securities Act, the quality exemption reflects the fact that some states also alternatively allow the exemption for non-issuer transactions through a broker-dealer in a security that is highly rated by a nationally recognized statistical rating organization.ⁿ⁵

A few of the states adopting this exemption have included the stipulation that it is applicable only to transactions made

by registered broker-dealers.ⁿ⁶ An additional condition in one state is that the issuer and any predecessors be in continuous operation for at least five years preceding the date of sale.ⁿ⁷ Regarding business history, the 2002 Uniform Securities Act reflects the modern approach to this and a number of transaction exemptions in Blue Sky laws by conditioning the exemption on the issuer of the quality fixed maturity or fixed income security not being a blank check, blind pool or shell company with no specific business plan or purpose.ⁿ⁸

The rationale underlying the exemption is that the absence of default, together with the dividend or liquidation preference of the securities, provides the investor with a modicum of protection. This modicum of investor protection is increased by the permissive nature of the exemption in most states.ⁿ⁹ In some cases a filing may be required before the exemption can be used.

Requirements for the quality exemption for non-issuer transactions vary in some states. In Virginia, for example, the exemption applies to transactions by registered broker-dealers trading in securities that have been outstanding for at least five years if the issuer, in each of its last three fiscal years, has lawfully paid dividends on its common stock aggregating at least 4 percent of its current market price.

In sum, the "quality" exemption, as such, for non-issuer transactions is available only for fixed income securities, and may or may not be limited further to transactions effected by a broker-dealer. Moreover, the exemption is not available at all in some states. Vermont and Wisconsin, for example, have no quality exemption for non-issuer transactions. The most common modern approach for those states that do, however, is to combine a simplified quality exemption with the manual exemption, allowing for a non-issuer distribution if either criterion is met, and without further restrictions. Thus, as exemplified by the Maryland exemption, any non-issuer distribution of an outstanding security is exempt if:

"(i) A recognized securities manual contains the names of the officers and directors of the issuer, a balance sheet of the issuer as of a date within 18 months, and a profit and loss statement for either the fiscal year preceding that date or the most recent year of operations; or

(ii) the security has a fixed maturity or a fixed interest or dividend provision and there has been no default during the current fiscal year or within the three preceding fiscal years, in the payment of principal, interest or dividends on the security."ⁿ¹⁰

[2] Previously Sold and Distributed Securities A few states provide a separate, broader, non-issuer "quality" exemption for transactions in *any* securities previously issued in compliance with state Blue Sky laws, and which are outstanding in the hands of the public. These exemptions are available for sales of any security when qualifying criteria are met. In Washington, for example, the offer or sale by a registered broker-dealer, or a person exempt from broker-dealer registration requirements, of securities previously sold and distributed to the public is exempt if:

(a) The securities are sold at prices reasonably related to the current market price at the time of the sale, and, if the broker-dealer is acting as agent, the commission collected by the broker-dealer is not in excess of usual and customary commissions collected with respect to securities and transactions having comparable characteristics;

The securities do not constitute part of an unsold allotment to or subscription or participation by the broker-dealer in the distribution of the securities; and

(c) The security has been lawfully sold and distributed in this or any other state under an act regulating the sale of such securities.ⁿ¹¹

In most cases this non-issuer transaction exemption is stated as one covering an offer or sale by a licensed broker-dealer, without specific reference to a non-issuer.ⁿ¹² The key consideration in applications of this exemption is

the prior Blue Sky law compliant distribution of the securities. The historical assumption is that securities which have already demonstrated their marketability and have passed administrative scrutiny at the time of original issue do not require further scrutiny provided the baseline resale criteria are met.ⁿ¹³ Oregon thus provides that the offer or sale by a licensed broker-dealer of any security acquired in the ordinary and usual course of business is exempt when the security is part of an issuer which has previously been registered in whole or in part, provided the registration has not been revoked and that the continued sale of the security has not been enjoined.ⁿ¹⁴

There is little uniformity among those states providing the exemption. In fact, the only uniform requirement in all the states offering the exemption is that the transaction be a non-issuer transaction.ⁿ¹⁵ Thus, the exemption is usually unavailable to controlling persons,ⁿ¹⁶ and is not available at all to broker-dealers selling any part of an unsold allotment or otherwise participating in a distribution by the issuer.ⁿ¹⁷ Although the exemption is commonly denied to underwriters,ⁿ¹⁸ one state allows an underwriter of the securities no longer acting as an underwriter to take advantage of the exemption.ⁿ¹⁹

Insistence that the transaction be by or through a broker-dealer is a usual requirement.ⁿ²⁰ On occasion there is also a requirement that commissions paid to the broker-dealer for the transaction not be in excess of usual and customary amounts paid for transactions in securities having comparable characteristics.ⁿ²¹ A further requirement in some states is that the price charged for the securities must be reasonably related to the current market price.ⁿ²²

As noted above, a rationale for this exemption is previous administrative scrutiny of the securities.ⁿ²³ The question then arises as to what criteria must be met with regard to registration at the time the securities were originally issued. Many of the statutes are silent on the question.ⁿ²⁴ A few states, however, provide that the non-issuer exemption applies if the securities have been previously sold and distributed in accordance with the securities act of any state.ⁿ²⁵ More commonly, previous registration is required in the state in which the exemption is sought.ⁿ²⁶

The lack of uniformity in the provisions for this exemption necessitates (1) reference to specific statutory provisions and (2) requests for administrators' opinions with respect to particular issues. Some states have unique provisions. For example, Alabama requires that before the exemption applies, the securities must be outstanding for at least three years;ⁿ²⁷ Virginia requires that they be outstanding for five years;ⁿ²⁸ and Indiana requires the issuer to designate a qualified transfer agent.ⁿ²⁹

Because the potential effect of this exemption is so broad, tight administrative control is imposed. Most of the states having the exemption make it possible for the administrator to deny or revoke it.ⁿ³⁰ In some states a filing, approved by the administrator is required before the exemption can become effective.ⁿ³¹

[3] Related Securities Exemptions The "quality" exemptions discussed above are all transaction exemptions either provided for or available to non-issuers. In several states there are quality analogs establishing *securities* exemptions in addition to or instead of transaction exemptions. Securities exemptions are comprehensively addressed in Chapter 7 of this Treatise. It is important to note here, however, that some states treat "quality" characteristics of the security itself as justifying an exemption from registration and qualification requirements without regard to any particular transactional criteria or characteristics. Thus in North Dakota, for example, an exemption is provided for:

"Securities, other than common stock, providing for a fixed return, which have been outstanding and in the hands of the public for not less than five years and upon which no default has occurred during the five years next preceding the date of sale."ⁿ³²

While the language of these securities exemptions varies, the common criteria are:

- The security may not be common stock;

- The security must provide a fixed return on the investment;
- The security must be outstanding and in the hands of the public for not less than five years; and
- There must have been no default in payment of principal or interest for the immediately preceding five years.

Variations include Louisiana, which exempts securities not having a fixed return if they have been publicly held for at least three years and the issuer can show an after tax net income for the immediately preceding three year period.ⁿ³³ The Ohio exemption is couched in considerably broader terms in two respects. First, the exemption does not specify the exclusion of common stock. Second, the security need not have a fixed return, but if no amount of return is stated, the annual dividend or interest rate for the five year period preceding the sale must have been at least four percent of the aggregate selling price of the securities.ⁿ³⁴ In Kansas, all securities that have been sold and distributed to the public are eligible for exemption on resale, and there is no statutory minimum period during which the securities must have been outstanding. However, the resale must not directly or indirectly benefit the issuer and specific statutory conditions must be met including the filing of an offering prospectus by a registered broker-dealer.ⁿ³⁵

FOOTNOTES:

(n1)Footnote 1. For representative states that have adopted these requirements for the quality securities exemption, *see, e.g.,*

Deleware: Del. Code § 7309(b)(2);

Kentucky: Ky. Rev. Stat. § 292.410(b);

Massachussets: Mass. Gen. L. § 402(b)(2)(B);

North Carolina: N.C. Gen. Stat. § 78A-17(2)(c);

West Virginia: W. Va. Code § 32-4-402(b)(2)(B).

(n2)Footnote 2. *See* "Previously Sold and Distributed Securities," § 9.05[2], *infra* .

(n3)Footnote 3. *See, e.g.,* Utah Code § 61-1-14(2)(2).

(n4)Footnote 4. *See* Rev. Stat. Neb. § 8-1111(2)(b); Gen. Stat. N.C. § 78A-17(2).

See also Wash. Admin. Code § 460-44A-110.

(n5)Footnote 5. *See* 2002 Unif. Sec. Act § 202(5)(A) (Non-issuer transactions in a security that "is rated at the time of the transaction by a nationally recognized statistical rating organization in one of its four highest rating categories").

Drafters of the 2002 Uniform Act point out that the concept of a fixed income security rated by a nationally recognized statistical rating organization in one of its four highest rating categories is well established in the federal securities laws. Nationally recognized rating organizations have been identified by the SEC and include such organizations as Moody's and Standard and Poor's. Rating categories typically begin with AAA and would under the Uniform Act criteria include BBB as the fourth highest rating category. *Official Comments*, 2002 Unif. Sec. Act §

202(5).

(n6)Footnote 6. *See, e.g.,*

Alabama: Ala. Code § 8-6-11(a)(2)(b);

Idaho: Idaho Code § 30-1435(1)(c);

Kentucky: Ky. Rev. Stat. Ann. § 292-410(1)(b);

Nebraska: Neb. Rev. Code § 8-1111(2)(b).

(n7)Footnote 7. Mich. Comp. L. § 451.802(b)(2)(B).

Note that in Minnesota and New Hampshire, which also have a five year operational requirement, the quality standard is part of the manual exemption. The exemptions in Minnesota (*Minn. Stat. Ann. § 80A.15(2)(b)*) and New Hampshire (*N.H. Rev. Stat. Ann. § 421-B:17(II)(b)*), apply to: (1) non-issuer distributions; (2) when specified information about the issuer is contained in a recognized securities manual; (3) providing the issuer or its predecessor has been in active, continuous business operation for five years preceding the date of sale; and (4) if the security has a fixed maturity or fixed interest or dividend provision, the issuer has not defaulted in payment of principal, interest or dividends within the preceding three fiscal years.

(n8)Footnote 8. 2002 Unif. Sec. Act § 202(5)(B)(ii).

(n9)Footnote 9. *See, e.g., Md. Code § 11-603; S.C. Code § 35-1-330.*

(n10)Footnote 10. Code Md. § 11-602(2).

(n11)Footnote 11. *Rev. Code Wash. § § 21.20.320(15).*

There is no corresponding Uniform Securities Act non-issuer exemption for previously sold and distributed securities.

(n12)Footnote 12. *See, e.g., Ohio Rev. Code § 1707.03(M).*

(n13)Footnote 13. *See Loss & Cowett, Blue Sky Law 319 (1958):*

"These exemptions are apparently based not on a quality standard but on the dual theory that previous distribution is likely to connote marketability and that the administrator has at one time or another passed upon the security."

(n14)Footnote 14. *See, e.g., Ore. Rev. Stat. § 59.035(9).*

(n15)Footnote 15. *See, e.g.,*

Arizona: Ariz. Rev. Stat. Ann. § 1844(12);

Florida: Fla. Stat. Ann. § 517.061(18);

Ohio: Ohio Rev. Code Ann. § 1707.03(M);

Virginia: Va. Code Ann. § 13.1-514(b)(3).

(n16)Footnote 16. *See, e.g.,*

Maryland: Md. Ann. Code § 11-602(13);

Michigan: Mich. Comp. L. § 451.802(b)(17).

(n17)Footnote 17. *See, e.g.,*

Delaware: Del. Code Ann. § 7309(b)(13);

Indiana: Ind. Code § 23-2-1-2(b)(3)(B);

Texas: Tex. Rev. Civ. Stat. § 581-5(O)(1).

(n18)Footnote 18. *See, e.g.,*

Alaska: Alaska Stat. § 45.55.900(b)(16)(B);

Ohio: Ohio Rev. Code Ann. § 1707.03(M)(1);

Oregon: Ore. Rev. Stat. § 59.035(9).

(n19)Footnote 19. *See Ariz. Rev. Stat. Ann. § 44-1844(12).*

(n20)Footnote 20. *See, e.g., Ariz. Rev. Stat. Ann. § 44-2844(12); Fla. Stat. Ann. § 517.061(18); N.C. Gen. Stat. § 78A-17(2)(b).*

(n21)Footnote 21. *See, e.g., Ind. Code § 23-2-2(b)(3)(A); Wash. Rev. Code § 21.20.320(15)(A).*

(n22)Footnote 22. *See, e.g., Ky. Rev. Stat. Ann. § 292.410(1)(o); Mo. Rev. Stat. Ann. § 409.402(b)(15); Tex. Rev. Civ. Stat. § 581-5(O)(3).*

(n23)Footnote 23. *See Loss & Cowett, n.13 supra.*

(n24)Footnote 24. *See n.15 supra* for representative statutory citations in Florida and Virginia.

(n25)Footnote 25. *See Alaska Stat. § 45.55.140(b)(16)(C).*

Washington: Wash. Rev. Code § 21.20.320(15)(c).

(n26)Footnote 26. In New Mexico, Texas, and Wisconsin, if the securities have not been previously registered in the state, the exemption may still be available by application to the state securities administrator. *See N.M. Stat. Ann. § 58-13B-27(B).* Ohio provides that the non-issuer exemption does not apply to securities which were purchased outside the State within one year of the date of sale or which were brought into the State within one year of date of sale unless the securities were registered in Ohio in that period or are eligible for registration by description. *See Ohio Rev. Code §*

1707.03(M)(3)(b), (c). See ch. 5 *supra* for discussion of registration by description. It should be noted that, even if the securities were purchased outside of Ohio or transported into Ohio within one year of the date of sale, the transaction might still be exempt if it meets the criteria of the manual exemption, the isolated transaction exemption, the exemption for certain offers and distributions to existing security holders, or exempt transactions in preorganization subscriptions.

(n27)Footnote 27. *Ala. Code § 8-6-11(a)(2)(c)*.

(n28)Footnote 28. *Va. Code Ann. § 13.1-514(b)(3)*.

(n29)Footnote 29. *Ind. Code §§ 23-2-1-2(b)(3)(D), 23-2-1-6(k)*.

(n30)Footnote 30. See, e.g.,

Alabama: Ala. Code § 8-6-11(b);

Delaware: Del. Code § 7209(c);

Pennsylvania: 70 Pa. Stat. § 1-204(b);

Wisconsin: Wis. Stat. § 551.24.

(n31)Footnote 31. See, e.g., *Ind. Code § 23-2-1-2(b)(3)(C)(iii)*. Required information includes the names of the issuer's officers and directors, a balance sheet of the issuer as of a date not more than sixteen months prior to the date of sale and a profit and loss statement for the fiscal year preceding that date or the most recent fiscal year. The filing is valid for one year. Annual renewals may be applied for and are to be accompanied by a fee.

See also *N.C. Gen. Stat. § 78A-17(2)(b)*. The filing is to be made by a registered dealer and to contain such information relating to the issuer as the Secretary of State may require by rule or order.

See also *Wis. Stat. § 551.23(3)(d)*. Under Securities Regulation § 2.02(3)(b), a notice of the proposed sale is required that includes, *inter alia*, the prospectus, other information not contained in the prospectus, the trust indenture, if any, a balance sheet, and certain specified undertakings.

Note that the filing is not required if securities of the same class have been registered in Wisconsin under a registration statement becoming effective within two years preceding the sale and registration has not been revoked or suspended. *Wis. Stat. § 551.23(3)(b)*.

(n32)Footnote 32. *N.D. Cent. Code § 10-04-05(7); see also Fla. Stat. Ann. § 517.051(6)*.

(n33)Footnote 33. *La. Rev. Stat. Ann. § 51:7048(11)*.

(n34)Footnote 34. *Ohio Rev. Code Ann. § 1707.02(J)*.

(n35)Footnote 35. *Kan. Gen. Stat. Ann. § 17-1261(m)*.



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CHAPTER 9 Exempt Non-Issuer and Resale Transactions

1-9 Blue Sky Regulation § 9.06

§ 9.06 Unsolicited Brokerage Transactions

Nearly all Blue Sky laws contain a specific non-issuer exemption for unsolicited brokerage transactions. The 2002 Uniform Securities Act reflects state provisions in its exemption for:

"[a] non-issuer transaction by or through a broker-dealer registered or exempt from registration under this [Act] effecting an unsolicited order or offer to purchase."¹

There is almost no variation among the states in the basic exemption. However, many states added a specific qualification, either in the statute or by rule, that there be a written confirmation or acknowledgment delivered to the customer stating that the transaction was unsolicited. Record-keeping requirements for broker-dealers relating to such confirmations are also imposed.²

"Unsolicited" for purposes of the exemption is not a defined term in Blue Sky laws. However, by rule, California has established a presumption that an offer to buy a security is presumed not to be unsolicited if the broker-dealer knows or has reason to know that the order or offer to buy is in response to any of several identified activities in which the selling broker-dealer has engaged within the prior sixty days. These activities provide solid guidance for identifying a solicited transaction that will not qualify for the exemption generally, and involve the following:

- (a) Publicly quoting a bid or asked price for the security by a means other than an interdealer quotation system that is intended for broker-dealer use only;
- (b) Making a direct solicitation that customers purchase the security;
- (c) Recommending the purchase of the security to customers, either directly or in a manner which would bring the recommendation to the attention of customers;
- (d) Volunteering information about the issuer of the security either to a particular customer who then purchases the security or to customers generally; or
- (e) Executing a transaction to purchase or sell a security pursuant to discretionary authority for a customer in a customer account.³

There are two types of transactions effected by broker-dealers for their customers. "Principal" (or non-agency)

transactions involve the broker-dealer acting as dealer, purchasing from or selling to the customer as principal, for its own account. "Agency" trades or transactions are strictly brokerage transactions in this the broker-dealer acts as intermediary but is not itself a party to the transaction. As a matter of federal securities law, transactions effected by a broker-dealer on an agency basis are exempt from registration requirements by section 4(4) of the Securities Act of 1933ⁿ⁴ as brokerage transactions executed upon customer orders. In 1996 NSMIA amended the Federal Securities Act to provide in section 18(b)(4)(B) that "federal covered securities" include those that are subject to the federal section 4(4) exemption for brokerage transactions executed on customers' orders on any national securities exchange or in the over-the-counter market, but not the solicitation of such orders.ⁿ⁵ Thus, section 4(4) of the Federal Securities Act of 1933 preempts state brokerage exemptions that would impose any limitations or conditions where pure brokerage, or "agency," transactions are executed. However, non-agency, principal, transactions are not within the coverage of either the federal section 4(4) or state law brokerage transaction exemptions. A separate federal exemption is available,ⁿ⁶ but there is no corresponding separate Blue Sky law exemption for dealer transactions. Non-issuer unsolicited brokerage transaction exemptions therefore remain applicable for non-agency transactions effected for a customer, provided the transaction is unsolicited. Blue Sky exemptions, as illustrated by the 2002 Uniform Securities Act provision quoted above, encompass broker-dealer transactions without differentiating between agency and non-agency roles. Unsolicited non-issuer transactions effected by or through a licensed broker-dealer on a principal basis will thus qualify for the Blue Sky exemption.

There are a number of nuances in the application of the unsolicited brokerage transaction exemption. The exemptions do not, for example, specifically exempt the ultimate sale which may result pursuant to the unsolicited purchase offer, although a court has held that when a broker-dealer acts on an unsolicited order to buy securities, it acting as the purchaser's agent, and there cannot be a sale, as such, between principal and agent.ⁿ⁷ The fact that the transaction may be "by or through" a broker-dealer is significant. If a broker-dealer receives an unsolicited purchase order and does not have the requested securities, it must look for them elsewhere. Since the statute allows the exemption for transactions made *through* a broker-dealer, the exemption is available to the broker-dealer's vendor. If the exemption covered only transactions *by* the broker-dealer, the vendor would have to be sure that either the securities were registered or seek its own exemption.ⁿ⁸ This Uniform Act principle is incorporated by a handful of states that do not require non-issuer status for availability of the exemption.ⁿ⁹ Other state provisions grant the exemption only for a transaction *by* a broker-dealer, which would seem to deprive the vendor of the exemption.ⁿ¹⁰ The Georgia provision is unusual in that the exemption applies only to an affiliate of the issuer making a sale through a registered dealer where neither the affiliate nor the dealer has solicited the purchase order.ⁿ¹¹

Some states insist that the broker-dealer be acting as the purchaser's agent in order for the exemption to be available.ⁿ¹² The agency test is often coupled with requirements that the broker-dealer have no direct or indirect interest in the sale and receive no compensation other than normal commissions involved in the purchase and sale of the securities.ⁿ¹³ The principal-agent test is also relied upon in two states which exempt unsolicited purchases and sales of securities.ⁿ¹⁴ In these states, the statutory language would seem to offer the exemption only to the broker-dealer and not to the vendor.ⁿ¹⁵

Dealing with the question whether a non-issuer transaction is "unsolicited" is often a challenge. Although as discussed above, California has by rule established the elements of a presumption that a transaction is in fact solicited, and thus non-exempt, only a few states have any guidelines on "solicitation." The drafters of the original Uniform Securities Act suggested that such things as a broker-dealer hanging out its shingle, or advertising generally for business, or soliciting discretionary accounts from customers, should not be included as "solicitation" within the meaning of the exemption.ⁿ¹⁶ However, with regard to discretionary accounts, one state, while not ruling on the general solicitation of such accounts, has taken the position that transactions actually executed for existing accounts are not eligible for exemptions as unsolicited offers to buy.ⁿ¹⁷ Another state, by statute, defines "solicitation," for purpose of the exemption, as the soliciting of orders for specific securities, and not general solicitations or general advertising.ⁿ¹⁸

Drafters of the original Uniform Act expressed the further view that "solicitation" should not include the selling of

securities by a broker-dealer on the floor of a stock exchange pursuant to a sell order when the transaction is executed in the normal manner on the exchange. A similar situation may arise with respect to over the counter securities. If a broker-dealer with a sell order learns through a quotation service that another broker-dealer is interested in purchasing the same securities, may the first broker-dealer respond to such interest without being considered as soliciting an order to buy? Under a rule of the SEC,ⁿ¹⁹ issued pursuant to the Securities Act of 1933, the answer is yes, if the inquiry into buyer interest is made within sixty days of the date interest is expressed. An interpretation similar to this would seem to be acceptable to the Uniform Act's draftsmen.ⁿ²⁰ One state has, in fact, basically adopted the SEC view by statute.ⁿ²¹ There is, however, a difference of opinion in at least two states as to whether or not publishing quotations on the security is considered the solicitation of an offer to buy.ⁿ²²

In a situation where a customer calls his broker and places an order to buy without prior recommendation by the broker, there is little question of solicitation. However, the more usual circumstance is that the customer's call will initially request more information on the stock. How far a broker-dealer may go before the information is considered a solicitation is a question of fact that will have to be decided on a case by case basis,ⁿ²³ but a large number of claimed unsolicited transactions by any one broker-dealer may give rise to the presumption that the transactions were, in fact, solicited. The general activities of a broker-dealer surrounding the sale will be the determinative factor. One court has held that solicitation is based on active encouragement and that in an unsolicited transaction the seller does no more than take the order and act as the purchaser's agent.ⁿ²⁴ In a case where the broker-dealer originally solicited the purchase and subsequently cautioned his client not to buy any more of the stock, all sales made after the cautioning remark were deemed to be at the instigation of the purchaser and were transactions made pursuant to an unsolicited purchase order.ⁿ²⁵ As the court put it, "a solicitation may cease when the broker strongly and emphatically advises his customer not to make any further purchases of the particular stock."ⁿ²⁶

The unsolicited offer exemption is usually available only in non-issuer transactions,ⁿ²⁷ although a few states have no such limitation in their statutes.ⁿ²⁸ In Texas, the exemption may not be used until the entire initial offering of the securities has been completed,ⁿ²⁹ and it is incumbent on any broker-dealer accepting an unsolicited purchase order to ascertain that the initial offering has been sold.ⁿ³⁰

Although few states require any filing for the exemption,ⁿ³¹ records of the transaction may be required to be kept and made available to administrators in most states. The original Uniform Securities Act exemption provides that "the Administrator may by rule require that the customer acknowledge upon a specified form that the sale was unsolicited, and that a signed copy of each form be preserved by the broker-dealer for a specified period."ⁿ³² While most states substantially adopted this provision,ⁿ³³ none actually requires an affirmative written acknowledgment by the customer. Rather, in lieu of a customer acknowledgment, the broker-dealer may deliver to the purchaser a confirmation of sale which states that the transaction was executed pursuant to an unsolicited order. In some states the confirmation must also clearly identify all commissions and compensation paid to the broker-dealer in the transaction.ⁿ³⁴

FOOTNOTES:

(n1)Footnote 1. 2002 Unif. Sec. Act § 202(6); *see also* Unif Sec. Act § 402(b)(3); Rev. Unif. Sec. Act § 402(5).

(n2)Footnote 2. In Colorado, for example, the exemption is provided for:

"Any nonissuer transaction effected by or through a licensed broker-dealer pursuant to an unsolicited order or offer to buy, if either the confirmation of the transaction delivered to the customer clearly states that the transaction was unsolicited or the broker-dealer obtains a written acknowledgment signed by the customer that the transaction was unsolicited and a copy of the confirmation or the acknowledgment is preserved by the broker-dealer for such period as the securities commissioner may, by rule, require."
Colo. Sec. Act § 11-51-308(c).

(n3)Footnote 3. 10 Cal. Code. Regs., Rule 260.104.

(n4)Footnote 4. 15 U.S.C. § 77d(4).

(n5)Footnote 5. 15 U.S.C. § 77r(b)(4)(B).

(n6)Footnote 6. See section 4(3) of the Securities Act of 1933, 15 U.S.C. § 77d(3).

(n7)Footnote 7. See *Lane v. Griswold*, 273 N.C. 1, 159 S.E.2d 338 (1968) .

(n8)Footnote 8. Official comment to Unif. Sec. Act § 402(b)(3), Loss & Cowett, Blue Sky Law 363 (1958).

(n9)Footnote 9. See Va. Code Ann. § 13.1-514(b)(13).

The statute is substantially the same as the Uniform Securities Act provision except that the term "non-issuer" is omitted.

(n10)Footnote 10. See, e.g.,

New York: N.Y. Gen. Bus. L. § 359-ff(5)(b);

Texas: Tex. Rev. Civ. Stat. § 581-5(P).

(n11)Footnote 11. Ga. Code Ann. § 10-5-9(4).

(n12)Footnote 12. See, e.g.,

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:17(II)(c);

Ohio: Ohio Rev. Code Ann. § 1707.03(T).

See also Alaska Adm. Code, 3A.A.C.08.910(4). But note the draftsmen's commentary to § 402(b)(3) of the Uniform Securities Act, Loss & Cowett, Blue Sky Law 364 (1958), where it is stated that the anticipated under the Uniform Act exemption is lack of solicitation. The exemption "applies on that condition regardless of whether the broker-dealer acts as an agent (in the common-law sense) or as principal." *Id.*

(n13)Footnote 13. The Ohio statute does not have the commission requirement. In Alaska and Arkansas only the purchaser may be the source of compensation.

(n14)Footnote 14. See e.g.,

Florida: Fla. Stat. Ann. § 517.061(13);

Minnesota: Minn. Stat. Ann. § 80A.15(2)(c).

But see also n.10 *supra* for provisions in New York. The federal exemption upon which these state exemptions are based applies to both unsolicited offers and sales.

(n15)Footnote 15. *See* n.14 *supra*.

(n16)Footnote 16. Draftsmen's commentary to Unif. Sec. Act § 402(b)(3), Loss & Cowett, Blue Sky Law 364 (1958).

(n17)Footnote 17. Cal. Commissioner of Corporations, Release No. 18-C, May 15, 1970. This is now an express element of the California presumption adopted by rule.

(n18)Footnote 18. *Ohio Rev. Code Ann. § 1707.03(T)*.

(n19)Footnote 19. *17 C.F.R § 230.144(g)(2)*.

(n20)Footnote 20. Loss & Cowett, n.16 *supra*, at 364 , 365.

(n21)Footnote 21. *See Cal. Corp. Code § 25104(b)*.

"[A]n inquiry regarding a written bid for a security or a written solicitation of an offer to sell a security made by another broker-dealer within the previous 60 days, shall not be considered the solicitation of an order or offer to buy."

See California Securities Rule 260.104.

See also Massachusetts Securities Rule § 14.402(b)(3)(A).

(n22)Footnote 22. *See* Massachusetts Securities Rule § 14.402(b)(93)(A); *Ohio Rev. Code Ann. § 1707.03(T)*.

(n23)Footnote 23. In *Schmid v. Langenberg*, 526 S.W.2d 940 (Mo. App. 1975) , the transaction arose when plaintiff asked his broker about the latter's personal investments. The broker responded that he had invested in a stock which was not registered in the State and could therefore not discuss it but could answer specific questions about the investment. Plaintiff subsequently called the broker with a purchase order for the stock. The court, saying that the word "unsolicited" should be defined in a non-technical sense, held that a jury verdict finding the transaction to be pursuant to an unsolicited offer to buy would not be disturbed, especially in view of the fact that plaintiff testified that he would have signed a non-solicitation letter had one been presented to him.

(n24)Footnote 24. *Home Indemnity Co. v. Reynolds & Co.*, 38 Ill. App. 2d 358, 187 N.E.2d 274, 279 (1963) :

A solicited sale is one in which the salesman "actively encourages the purchase or sale of a security by a client." Unsolicited sales, in which a customer requests that a security be purchased for him and the salesman just takes the order and acts as agent for the purchaser, are not prohibited.

See also Schmid v. Langenberg, 526 S.W.2d 940 (Mo. App. 1975) , discussed at n.23 *supra*.

(n25)Footnote 25. *Martin v. Orvis Brothers & Co.*, 25 Ill. App. 3d 238, 323 N.E.2d 73 (1975) .

(n26)Footnote 26. *Id.*, 323 N.E.2d at 82 .

(n27)Footnote 27. All states adopting the Uniform Securities Act provision specify that this is a non-issuer exemption.

(n28)Footnote 28. *See, e.g.*,

Oregon: Ore Rev. Stat. § 59.035(8);

Virginia: Va. Code Ann. § 13.1-514(b)(4).

See also Wis. Adm. Code § 2.02(2). The Wisconsin regulation exempts an isolated sale for the benefit of an issuer of redeemable securities of an investment company registered under the Investment Companies Act of 1940. The transaction must be effected through a broker-dealer pursuant to an unsolicited purchase order. The broker-dealer is required to obtain a written acknowledgement from the buyer that the purchase was unsolicited or supply the buyer with a confirmation or memorandum confirming the unsolicited nature of the transaction.

(n29)Footnote 29. *See* Tex. Rev. Civ. Stat. § 581(5)(P).

(n30)Footnote 30. In Texas, the initial offering is deemed complete when the "non-exempt public distribution of such securities has been completely sold to the public." *See* Securities Rule § 109.8.

(n31)Footnote 31. *See* Iowa Securities Rule 50.10(502). The administrator requires written notice whenever a broker-dealer is executing more than six unsolicited orders or offers to buy which have been received during any three consecutive days. Notice need not be given if some other exemption may be relied upon.

(n32)Footnote 32. Unif. Sec. Act § 402(b)(3).

(n33)Footnote 33. *See, e.g.,*

Alaska: Alaska Stat. § 45.55.140(b)(11);

Conneticut: Conn. Gen. Stat. Ch. 662 § 36b-21(b)(4);

New Jersey: N.J. Stat Ann. § 49:3-50(b)(3).

(n34)Footnote 34. *See, e.g., Ohio Rev. Code § 1707.03(T).*



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CHAPTER 9 Exempt Non-Issuer and Resale Transactions

1-9 Blue Sky Regulation § 9.07

§ 9.07 Transactions by Fiduciaries and In Judicial Sales

When securities are sold under the supervision of a court of competent jurisdiction, the seller is held accountable to the court, and the court effectively policies the transactions. An executor, for example, may be required by the testator to liquidate all securities which are part of the estate. Before the executor may act as such, his appointment must be approved by an appropriate court, and, should the executor misuse his authority, he is subject to such penalties as the court may lawfully issue.ⁿ¹ Other court appointed or supervised persons who dispose of securities are likewise permitted to sell securities without restrictions. As summarized by the 2002 Uniform Securities Act, registration exemptions are provided for: "[a] transaction by an executor, administrator of an estate, sheriff, marshal, receiver, trustee in bankruptcy, guardian, or conservator."ⁿ²

Of the states adopting the Uniform Act provision,ⁿ³ two of them added the requirement that the person making the sale be acting in the performance of his official duties.ⁿ⁴ This stipulation is probably superfluous, for it is unlikely that the exemption would be allowed in any state under conditions where the seller is not acting in an official capacity. The lists of persons eligible for the exemption in non-Uniform Act states varies in some respects from the list in the states following the Uniform Act.ⁿ⁵ However, these states, in addition to naming eligible persons, apply the exemption to judicial sales generally.ⁿ⁶ Two states exempt judicial sales without further specification of eligible persons.ⁿ⁷

The exemption is not labeled specifically as a "non-issuer" exemption in Blue Sky laws, and would be available for dispositions of securities in circumstances that might otherwise be considered an issuer distribution, or one on behalf of the issuer but for the judicial process involved. As presented in Chapter 8, however, there are specific issuer transaction exemptions for judicially approved or supervised reorganizations.ⁿ⁸ The transaction exemption for fiduciaries and others acting in a judicially supervised capacity, however, is focused specifically on permitting the activities of those persons in their official capacities.

The fact that transactions by fiduciaries and other judicially supervised persons are exempt from registration requirements does not mean that the seller is relieved from responsibility under the antifraud provisions of Blue Sky laws.ⁿ⁹ A person making a fraudulent offer or sale of securities under these circumstances is subject to penalties of the court empowering him to make the sale and the Blue Sky law.

FOOTNOTES:

(n1)Footnote 1. *See, e.g.:* N.Y. Sur. Ct. Proc. Act §§ 711, 1414.

(n2)Footnote 2. 2002 Unif. Sec. Act § 202(12). This provision is identical to section 402(b)(6) of the original

Uniform Securities Act, and to section 402(8) of the Revised Uniform Securities Act.

(n3)Footnote 3. *See, e.g.,*

California: Cal. Corp. Code § 25104(f);

Michigan: Mich. Comp. L. § 451-802(b)(6);

North Carolina: N.C. Gen. Stat. § 78A-17(6);

Tennessee: Tenn. Code Ann. § 48-2-103(b)(1).

(n4)Footnote 4. *See, e.g.,*

Idaho: Idaho Code § 30-1435(1)(f);

Montana: Mont. Rev. Code Ann. § 30-10-105(5).

(n5)Footnote 5. In some states, sheriffs and marshals, for example, are not on the itemized list of eligible persons. *See Fla. Stat. Ann. § 517.061(1); N.Y. Gen. Bus. L. §§ 359-f(1)(L): 359ff-(5)(e).*

(n6)Footnote 6. *See, e.g.,*

Indiana: Ind. Code § 23-2-1-2(b)(6);

Rhode Island: R. I. Rev. L. Ann. § 7-11-402(7);

Virginia: Va. Code Ann. § 13.1-514(b)(5).

(n7)Footnote 7. *Minn. Stat. Ann. § 80A.15(2)(e); N.H. Rev. Stat. Ann. § 421-B:17(II)(e).*

(n8)Footnote 8. *See Chap. 8.03[1][d], supra .*

(n9)Footnote 9. *See ch. 7 supra.*



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CHAPTER 9 Exempt Non-Issuer and Resale Transactions

1-9 Blue Sky Regulation § 9.08

§ 9.08 Pledge Transactions

Securities pledged as collateral to secure a loan may be sold by the non-issuer pledgee pursuant to an exemption in all Blue Sky laws provided the underlying pledge and the transaction are bona fide. The 2002 Uniform Securities Act is representative in its provision exempting "a non-issuer transaction executed by a bona fide pledgee without the purpose of evading this [Act]."n1 The 2002 Uniform Act exemption is identical to the original Uniform Act provision,n2 and is substantially identical to that contained in the Revised Uniform Securities Act. It has been adopted in most states.n3 Similar, albeit somewhat more complex, provisions adopted in other statesn4 have the same result.

Most exemptions for pledge transactions do not prohibit the issuer from benefiting from the pledgee sale.n5 As a result, an issuer may pledge its own securities and have them sold, without registration, upon default. Note, however, that states require the transaction to be by a *bona fide* pledgeen6 or for recovery of a *bona fide* debt.n7 A further condition is that the transaction must be without any purpose of evading the securities act.n8 These provisions would obviously have the effect of denying the exemption where the issuer and the pledgee are in collusion to have the issuer default on the loan so that the securities could be sold to the public without registration.n9 In states where the pledgee exemption is limited to non-issuer transactions,n10 the exemption would, of course, not be applicable. Other conditions may apply. One state, for example, allows pledgee sales only if the amount of securities sold does not exceed two percent of the entire issue, and then only if the pledgee files a notice of exemption with the administrator and obtains his permission for the sale.n11

FOOTNOTES:

(n1)Footnote 1. 2002 Unif. Sec. Act § 202(7).

(n2)Footnote 2. See Unif. Sec. Act § 402(b)(7).

(n3)Footnote 3. See *e.g.*,

Hawaii: Hawaii Rev. L. § 485-6(7);

Pennsylvania: Pa. Stat. § 1-203(m);

Utah: Utah Code § 61-1-14(2)(g).

(n4)Footnote 4. See, *e.g.*, Ga. Code § 10-5-9(2); Nev. Rev. Stat. §§ 90.530(9).

(n5)Footnote 5. Only California, Georgia, Nevada and Virginia limit the pledgee exemption to non-issuer transactions. In addition, Virginia allows the exemption only when the pledgee sale constitutes an isolated transaction. *See § 9.03 supra.*

For a discussion of non-issuer exemptions generally and the relationship of control person to issuer for exemption purposes, *see § 9.02[1] supra.*

(n6)Footnote 6. *See* statutory citations at n.2 *supra.* *See also Cal. Corp. Code § 25104(e); N.C. Gen. Stat. § 78A-17(7).*

(n7)Footnote 7. *See Ariz. Rev. Stat. § 44-1844(3); Vt. Stat. § 42049(2).*

(n8)Footnote 8. *See* statutory citations at n.2 *supra.* *See also Fla. Stat. § 517.061(2); La. Rev. Stat. § 51:709(2).*

(n9)Footnote 9. *See* California Securities Regulations, Reg. 260.104.2.

"The phrase 'bona fide secured party,' as used in Subdivision (e) of Section 25104 of the Code, does not include a secured party who takes securities in pledge without any intention or expectation that they will be redeemed but merely as a step in the distribution thereof to the public."

See also Pennsylvania Securities Regulations § 203.131.

"The phrase 'bona fide pledgee' as used in subsection (m) of § 203 shall include a secured party who takes securities in pledge to secure a bona fide debt. Such phrase shall not include a secured party who takes securities in pledge either: (i) without any intention or expectation that they will be redeemed but merely as a step in the distribution thereof to the public, or, (ii) without having secured knowledge, in the exercise of reasonable diligence, prior to the consummation of the pledge that the securities taken in pledge are lawfully owned by the party making the pledge."

(n10)Footnote 10. *See* n.5 *supra.*

(n11)Footnote 11. *See N.D. Cent. Code § 10-04-06(2).*



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CHAPTER 9 Exempt Non-Issuer and Resale Transactions

1-9 Blue Sky Regulation § 9.09

§ 9.09 Outstanding Securities of Federal Reporting Issuers

Although they were directly impacted by the enactment of NSMIA in 1996, many state Blue Sky laws contain a non-issuer exemption for transactions in an outstanding security if the issuer has a class of securities subject to registration under section 12 of the Securities Exchange Act of 1934ⁿ¹ and has been subject to the reporting requirements of section 13 or 15(d) thereunder for some specified period of time before the transaction. These exemptions alternatively provide for the submission of information to the state administrator that is substantially comparable to the information which the issuer would be required to file under the federal securities laws if it had a class of securities registered.ⁿ²

As noted earlier in § 9.01, the creation of "federal covered securities" by NSMIA in 1996, and the related preemption of state securities laws in regard to them, directly impacted applications of certain non-issuer transaction exemptions in Blue Sky laws. After NSMIA, non-issuer transactions by or through a broker-dealer in outstanding securities of an issuer that files reports with the U.S. Securities and Exchange Commission under the reporting requirements of sections 13 or 15(d) of the Securities Exchange Act of 1934ⁿ³ are "covered securities" for which registration or qualification-related state regulation is preempted. Under the federal securities laws a transaction by one who is not an issuer, underwriter or dealer is exempt from federal registration by section 4(1) of the Securities Act of 1933.ⁿ⁴ There is, however, no specific counterpart exemption from state Blue Sky laws, although non-issuer isolated sales and unsolicited brokerage transaction exemptions would often apply. Where the issuer of the securities is a reporting company under the Securities Exchange Act of 1934 the states with a specific non-issuer transaction exemption based on that qualification permitted a broader range of transactions. NSMIA, however, removed non-issuer transactions in securities of federal reporting issuers from state registration or qualification requirements altogether.

While a state exemption for non-issuer transactions in securities of a federal reporting issuer is no longer necessary --providing the non-issuer is in fact not an issuer and is not deemed to be an underwriter or dealer in the particular circumstances-- some issuers eligible to become reporting issuers by registering a class of securities under section 12 of the Securities Exchange Act of 1934 may elect not to do so. Moreover, an issuer with a class of securities registered under section 12 and previously in compliance with reporting requirements may become eligible to de-register, and thus no longer be subject to reporting requirements. In either scenario a Blue Sky law exemption covering non-issuer transactions in securities of an issuer that is "eligible" for federal reporting is meaningful if that issuer, in order to trigger the exemption, elects the procedure to submit comparable information to the state administrator.

The common form of Blue Sky exemption for non-issuer transactions in securities of a reporting issuer refers only to the issuer having a class of securities registered under section 12 of the Securities Exchange Act of 1934, and not the

specific security that is the subject of the transaction.ⁿ⁵ Others simply refer to an "issuer that is required to file reports with the Securities and Exchange Commission" pursuant to the Securities Exchange Act of 1934.ⁿ⁶ Thus, the Blue Sky exemption extends to non-issuer transactions in all securities of the qualifying issuer.

In recognition of the fact that after NSMIA transactions in securities of federal reporting issuers that are exempt under section 4(1) of the Securities Act of 1933 are now federal covered securities, the 2002 Uniform Securities Act does not include a non-issuer transaction exemption based on a federal reporting issuer. It does, however, include an exemption for non-issuer transactions by or through a broker-dealer in an outstanding security when a *guarantor* of the security files reports under the Securities Exchange Act of 1934.ⁿ⁷ This provision has to date only been adopted in those states, and the U.S. Virgin Islands, that have enacted the 2002 Uniform Act. "Guarantor" involvement may be meaningful in regard to some types of debt securities for which non-issuer transactions and resales might occur. In the end, however, the 2002 Uniform Act provision simply illustrates that after NSMIA preexisting state law non-issuer transaction exemptions based upon a federal reporting issuer are no longer a significant consideration in practice under Blue Sky laws.

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 78l.

(n2)Footnote 2. Rhode Island is typical in providing an exemption for:

"[a] non-issuer transaction in an outstanding security if the issuer of the security has a class of securities subject to registration under § 12 of the Securities Exchange Act of 1934... and has been subject to the reporting requirements of § 13 or 15(d) of the Securities Exchange Act of 1934... for not less than ninety (90) days before the transaction; or has filed and maintained with the director for not less than ninety (90) days before the transaction information, in such form as the director, by rule, specifies, substantially comparable to the information which the issuer would be required to file under § 12(b) or § 12(g) of the Securities Exchange Act of 1934... were the issuer to have a class of its securities registered under § 12 of the Securities Exchange Act of 1934, and paid a fee with the filing of three hundred dollars (\$300). Gen. Laws R.I. § 7-11-402(2).

(n3)Footnote 3. 15 U.S.C. §§ 78m, 78o(d).

(n4)Footnote 4. 15 U.S.C. § 77d(1).

(n5)Footnote 5. See, e.g., Gen. Laws R.I. § 7-11-402(2), n.2, *supra*.

(n6)Footnote 6. see, e.g., Tenn. Code § 48-2-103(b)(7).

(n7)Footnote 7. 2002 Unif. Sec. Act § 202(4).



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CHAPTER 9 Exempt Non-Issuer and Resale Transactions

1-9 Blue Sky Regulation § 9.10

§ 9.10 Other Non-Issuer Exemptions

The 2002 Uniform Securities Act contains three additional non-issuer transaction exemptions that have no prior Uniform Act roots and are not yet common provisions in Blue Sky laws. Sections 202(3) and 203(23) of the 2002 Uniform Act exempt non-issuer transactions in certain foreign securities. Section 202(8) addresses transactions by non-issuers who are federal covered investment advisers and who effect transactions in the exercise of discretionary trading authority. All three provisions, and the extent to which they are a part of the current Blue Sky exemption landscape are discussed below.

[1] Transactions In Certain Foreign Securities The 2002 Uniform Securities Act contains two non-issuer transaction exemptions where specified foreign securities are involved. Section 202(3) of the 2002 Uniform Act establishes an exemption for:

"[a] non-issuer transaction by or through a broker-dealer registered or exempt from registration under this [Act] in a security of a foreign issuer that is a margin security defined in regulations or rules adopted by the Board of Governors of the Federal Reserve System."n1

Section 202(23) likewise establishes an exemption for:

"[A] non-issuer transaction in an outstanding security by or through a broker-dealer registered or exempt from registration under this [Act], if the issuer is a reporting issuer in a foreign jurisdiction designated by this paragraph or by a rule adopted or order issued under this [Act]; has been subject to continuous reporting requirements in the foreign jurisdiction for not less than 180 days before the transaction; and the security is listed on the foreign jurisdiction's securities exchange that has been designated by this paragraph or by rule adopted or order issued under this [Act], or is a security of the same issuer that is of senior or substantially equal rank to the listed security or is a warrant or right to purchase or subscribe to any of the foregoing...."n2

As noted above, there is no original Uniform Act antecedent for these provisions. The drafters of the 2002 Uniform Act point out that NASAA had recommended that specified foreign non-issuer transactions be exempt pursuant to a "manual" exemption when there was disclosure of certain information about the issuer in the issuer's country of domicile.n3 Two states, Arizona and New Mexico, had in fact crafted such non-issuer transaction exemptions. The Arizona exemption applies if the class of foreign securities has been outstanding in the hands of the public for at least

90 days preceding the transaction, and the foreign issuer meets specified business operation, listing, tangible asset and net income requirements, as well as either being listed in a specified manual containing requisite information or, alternatively, being subject to U.S. reporting requirements.ⁿ⁴ New Mexico, also by rule, provides a "world class" exemption for transactions by a broker-dealer in securities of a qualifying foreign issuer. Qualifications include listing in a designated securities manual and an exchange listing.ⁿ⁵ New Mexico also includes as a qualifying criterion securities that are approved for margin under Regulation T of the Board of Governors of the Federal Reserve System, and which appear in the Federal Reserve Board's most recent List of Foreign Margin Stocks as an alternative to a manual listing.ⁿ⁶ This qualification is the basis for the separate non-issuer transaction exemption in section 202(3) of the 2002 Uniform Act, quoted above, which uses margin securities to identify sufficiently seasoned foreign securities to justify the transaction exemption.ⁿ⁷

In 2002 NASAA recommended an amendment to section 402 of the original Uniform Securities Act to add a transaction exemption for:

"[A] non-issuer transaction in an outstanding security by a registered agent of a registered broker-dealer, provided that:

1. The issuer is a reporting issuer in a foreign country or jurisdiction designated in [the Act] or by rule [or order] of the Administrator, and has been subject to continuous reporting requirements in such foreign country for not less than 180 days before the transaction; and
2. The security is listed on such foreign country's securities exchange which has been designated in [the Act] or by rule [or order] of the Administrator, or is a security of the same issuer which is of senior or substantially equal rank to such listed security or is a warrant or right to purchase or subscribe to any of the foregoing."ⁿ⁸

ⁿ⁹ The NASAA addition to the Uniform Act was carried into the 2002 Uniform Securities Act as section 202(23), and the non-issuer exemption in this form is now available in Idaho,ⁿ¹⁰ Missouri,ⁿ¹¹ Oklahoma,ⁿ¹² South Dakota,ⁿ¹³ Utah,ⁿ¹⁴ and the U.S. Virgin Islands.ⁿ¹⁵ All but one of these states, and the U.S. Virgin Islands, have adopted the 2002 Uniform Securities Act. The 2002 Uniform Act specifically identifies Canada, together with its provinces and territories as a "designated foreign jurisdiction," and the Toronto Stock Exchange as a designated securities exchange for qualification under the exemption. These designations are also a part of the exemption as adopted in those states and the U.S.V.I. that have adopted the 2002 Uniform Act. The exemption separately provides authority for the administrator to designate by rule or order other specific foreign jurisdictions and their securities exchanges upon an adequate showing.ⁿ¹⁶ The exemption also provides authority for the administrator to revoke any designation if necessary or appropriate in the public interest and for the protection of investors.

[2] Transactions By Federal Covered Investment Advisers Section 202(8) of the 2002 Uniform Securities Actⁿ¹⁷ creates a new exemption for non-issuer transactions:

"[b]y a federal covered investment adviser with investments under management in excess of \$100,000,000 acting in the exercise of discretionary authority in a signed record for the account of others."

This exemption reflects the 1996 NSMIA division of state and federal regulatory authority as between investment advisers registered with the SEC pursuant to the Investment Advisers Act of 1940 and those advisers no longer eligible for federal registration who are now regulated under state Blue Sky laws. Thus, there is no prior Uniform Act antecedent.

The drafters of the 2002 Uniform Securities Act added the exemption in recognition that federal covered investment advisers are sophisticated financial professionals capable of determining the merits of a security and do not require the protections provided by registration and qualification provisions in a particular state.ⁿ¹⁸ There is a wide range of investment advisers eligible to become federal covered advisers, however, and the \$100,000,000 assets under management requirement operates to separate those advisers for whom the drafters' presumption is more confidently applied from the larger adviser community. The exemption is now a part of Blue Sky laws in those states that have adopted the 2002 Uniform Act. There is no specific counterpart or similar exemption in other states.

As a non-issuer transaction exemption intended to cover transactions by an intermediary, the investment adviser exemption remains open to the same scrutiny applicable to any other non-issuer transaction to assure that it not be used to facilitate an issuer distribution or in some other manner to subvert the objectives of Blue Sky laws. Transactions effected by an investment adviser/manager of a control person or affiliate of an issuer in securities of the issuer may not be eligible despite the adviser's discretionary authority to effect the transactions.

FOOTNOTES:

(n1)Footnote 1. 2002 Unif. Sec. Act § 202(3).

(n2)Footnote 2. 2002 Unif. Sec. Act § § 202(23).

(n3)Footnote 3. 2002 Unif. Sec. Act, Official Comments, § 202(3).

(n4)Footnote 4. *See* Ariz. Admin. Code Sec. R14-4-138.

(n5)Footnote 5. *See* N.M. Admin. Code Rule 12.11.12.19.

The reference to "world class" in connection with this non-issuer transaction exemption should not be confused with the World Class Foreign Issuer Exemption" adopted by NASAA in 1996 as a *securities* exemption. This exemption for qualifying foreign issuers is now a part of several Blue Sky laws, and is founded on the same premise as the non-issuer transaction exemptions discussed above, namely, that the manifest quality of and disclosure of information available in connection with such issuers and their securities eliminates the need for protections of state Blue Sky registration and qualification provisions.

(n6)Footnote 6. N.M. Admin. Code § 12.11.12.19(A)(1)(a).

(n7)Footnote 7. *See* 2002 Unif. Sec. Act, Official Comments, § 202(3).

(n8)Footnote 8. The 2002 NASSA amendment to section 402(b) of the Uniform Act, to create section 402(b)(13), is reproduced in CCH NASAA Reports P 4882, at 3597.

(n9)Footnote 9. The NASAA amendment adds a specific non-issuer transaction exemption. It should not be confused with the NASAA "World Class Foreign Issuer Exemption," adopted by NASAA in 1996 as a *securities* exemption, and which has also made its way into several Blue Sky laws.

(n10)Footnote 10. Id. Code § 30-14-202(23).

(n11)Footnote 11. Rev. Stat. Mo. § 2-202(23).

(n12)Footnote 12. *71 Okla. Stat. § 1-202(24)*.

(n13)Footnote 13. S.D. Cod. Laws § 47-31B-202(23).

(n14)Footnote 14. Utah Sec. Div. R. R164-14-22s.

(n15)Footnote 15. *23 V.I. Code § 612(23)*.

(n16)Footnote 16. As the drafters of the 2002 Uniform Securities Act note, this authority is established in conformity with the North American Free Trade Agreement (NAFTA) and the General Agreement on Trade in Services (GATS), *see* 2002 Unif. Sec. Act, *Official Comments* § 202(23).

(n17)Footnote 17. 2002 Unif. Sec. Act § 202(8).

(n18)Footnote 18. 2002 Unif. Sec. Act, *Official Comments*, § 202(8).



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CHAPTER 10 Regulation of Small Business Capital Formation

1-10 Blue Sky Regulation 10.syn

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§ 10.03 Federal and State Exemptions

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CHAPTER 10 Regulation of Small Business Capital Formation

1-10 Blue Sky Regulation § 10.01

§ 10.01 Regulatory Challenges

The United States enjoys the strongest capital markets in the world. In no small measure the strength of those markets lies in their depth and breadth. Backyard entrepreneurs and the largest "world class" companies alike share access to capital markets and the opportunities for success they make possible. To be sure, the scope and manner of capital formation may be drastically different as between the small businessperson and the world class company, but the object is the same, and the opportunities afforded to both are what drive the economy. The neighborhood capital market in which the individual entrepreneur is able to find and access the financial resources of family and friends to exploit a simple idea is no less significant than the ability of General Motors to access a consortium of money center banks and financial institutions in support of a billion dollar business expansion.

Financial market regulators do not desire to stand in the way of capital formation in either of the two extreme settings described above. Indeed, as to small business capital formation, since the passage of the federal Small Business Incentive Act of 1980,ⁿ¹ which is now contained in section 19 of the Federal Securities Act of 1933,ⁿ² federal and state securities regulators have worked together to find ways to help small business raise capital. The statutory mandate is clear, as section 19(d)(2) of the federal act prescribes as national policy:

It is the declared policy of this subsection that there should be greater Federal and State cooperation in securities matters, including--

- (A) maximum effectiveness of regulation,
- (B) maximum uniformity in Federal and State regulatory standards,
- (C) minimum interference with the business of capital formation, and

(D) a substantial reduction in costs and paperwork to diminish the burdens of raising investment capital (particularly by small business) and to diminish the costs of administration of the Government programs involved.ⁿ³

A further mandate of the 1980 legislation was for the development of a uniform exemption from securities law registration requirements for small issuers, which could be agreed upon among several states or between the states and the federal government.ⁿ⁴ Out of this mandate there later emerged Form U-7 and the Small Corporate Offering Registration (SCOR) process that is today widely in place among the states.ⁿ⁵ Although not a federal exemption, as such, the SCOR design has effectively been implemented through SEC Regulation D under the 1933 Act, which

provides for various limited offering exemptions from federal registration requirements, as well as Regulation A under the Act, and leaves to the states the ultimate authority to address requirements for small local and regional offerings that are eligible for SCOR and the use of Form U-7.

The focus of the 1980 federal legislation on elimination of barriers to small business capital formation reflected the challenges to small business and entrepreneurial capital formation that are presented not only by dual federal and state securities regulatory systems themselves, but by the costs and complexity of compliance within both systems. Just as important, both federal and state securities laws and regulations seriously limited access to sources of capital through restrictions on the extent to which small businesses could reach out to potential investors without running afoul of prohibitions on "offers" of securities, or the extent to which third-party networks or systems designed to match those in need of capital with providers could operate consistent with intermediary regulation by the states.

Efforts since 1980 to address such concerns have resulted in such progress as the widespread adoption of the NASAA Model Accredited Investor Exemption, and its interface with networks such as ACE-Net, a system sponsored by the U.S. Small Business Administration. Several states have followed the lead of NASAA to ease capital formation by small businesses by adopting "testing the waters" provisions. These states have made statutory or rule changes to permit offers, but not sales, of a security made by or on behalf of an issuer for the purpose of soliciting an indication of interest in receiving a prospectus for the security. Testing the waters permits an issuer to find out whether there is interest in investing in its business prior to expending resources in structuring and launching an offering.

States have also adopted varied forms of limited offering exemptions, most with the design of enabling greater access to capital and capital markets by those enterprises that create jobs and contribute to the state economy. The State Guides that are a part of this Treatise each present the array of limited offering exemptions or SCOR-related accommodations that are now an important element of state Blue Sky laws. The State Guides also disclose whether and to what extent "testing the waters" or other accommodations to small business capital formation are available in each state.

All of this is not to say that there remain no significant challenges in small business capital formation. To the contrary, state securities regulators continue to confront the need to balance investor protection against the need for easier access to capital. Capital formation for legitimate enterprises and entrepreneurial undertakings must be encouraged and accommodated; yet at the same time the potential for fraud and other prohibited practices in these settings must also remain a paramount concern. Promissory notes of highly risky or failing enterprises offered to elderly persons as a safe alternative for the investment of retirement assets may appear on the surface little different than a legitimate undertaking to obtain debt financing for a business enterprise through the issuance of promissory notes or other forms of debt instruments, and both sets of circumstances must be subject to scrutiny under registration and antifraud provisions of Blue Sky laws. The challenge in legitimate small business capital formation is to carefully plan and put in place a process for raising money that is consistent with the purpose and operation of Blue Sky laws, and which assures that either Blue Sky protections are not needed, or that one of the numerous opportunities to limit the burdens of compliance is properly utilized.

This chapter addresses the elements of planning and process that are necessary for efficient small business capital formation in the state regulatory environment. Whether debt or equity is the focus makes no difference; nor does the particular type of "security" or instrument that may be involved in the process. In small business capital formation the focus is on circumstances that either present the need for "investor" protection, in which some form of compliance with Blue Sky laws is necessary, or in which there is no purpose in applying those laws. In this analysis an *exemption* from compliance with registration provisions of a state Blue Sky law is in reality a form of compliance. The availability of an exemption, either for the security involved or for the particular transaction, may require some affirmative action on the part of the person relying on it, or it may be self-executing. In either case, however, reliance on an exemption from Blue Sky laws in capital formation is a process requiring planning and careful execution. Moreover, the antifraud provisions of Blue Sky laws will almost invariably apply in that process, regardless of any exemption from registration requirements.

It is thus essential to understand fully the fundamental point in small business capital formation that to be "exempt" under Blue Sky laws is not to be "excluded" from coverage of those laws. Small business capital formation may in fact be carried out in circumstances that are free from securities law concerns, and in § 10.2 below such threshold considerations are addressed. Meaningful opportunities to be excluded entirely from securities law coverage do exist, but they are wholly dependent upon the absence of a "security" in the relationship between the provider of capital and the small business user in need of it. Chapter 2 of this Treatise examines the fundamental notion of what is a "security" in great detail, and its importance cannot be overstated. In this chapter, however, only the threshold consideration for small business capital formation is considered, as it must be, as a challenge to those who seek "investors." Once past that threshold analysis the array of opportunities for compliance with Blue Sky laws in small business capital formation is examined, not as challenges or barriers to the process, but in fact as opportunities.

The *challenge* in small business capital formation presented by Blue Sky laws and regulations is only the challenge of the unknown and the fear of regulatory consequences when no attention is paid to planning and process at the outset. Great progress has been made in making Blue Sky laws into engines of small business capital formation rather than barriers. In the sections that follow, an amalgam of the mechanisms by which small business capital formation is favored in the application of Blue Sky laws is addressed. In their broader applications these mechanisms are addressed in great detail throughout the Treatise, and their particular availability in any state is a matter for the individual State Guides. What follows in this chapter, however, is a specialized focus on the practical role of Blue Sky regulation in small business capital formation.

FOOTNOTES:

(n1)Footnote 1. Omnibus Small Business Capital Formation Act of 1980, § 505, Pub. Law. 96-477.

(n2)Footnote 2. 15 U.S.C. § 77s.

(n3)Footnote 3. 15 U.S.C. § 77s(d)(2).

(n4)Footnote 4. 15 U.S.C. § 77s(d)(3)(C).

(n5)Footnote 5. Form U-7, the Small Corporate Offering Registration Form, was initially adopted by the North American Securities Administrators Association (NASAA) on April 29, 1989, and has since been amended on two occasions. Interstate use of the SCOR registration process and Form U-7 is coordinated through regions of the country.



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Blue Sky Regulation

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CHAPTER 10 Regulation of Small Business Capital Formation

1-10 Blue Sky Regulation § 10.02

§ 10.02 Threshold Regulatory Considerations

[1] The Creation of a "Security." For small businesses and entrepreneurs, capital formation is most commonly spoken about in terms of finding "investors." As a practical matter, all of those persons or entities that contribute capital in the formation or financing of a business enterprise are investors. Yet as thoroughly explored in Chapter 2, an "investor" within the intended protection of state and federal securities laws involves a much more refined notion than one who simply provides capital. Banks and other commercial lenders provide capital to start-up businesses, but in most circumstances are not viewed as investors for purposes of securities law protections despite the fact that a promissory "note" is identified as a security in all statutory definitions of the term. Likewise, true general partners and joint venturers who come together to pool financial resources and talents in the creation and operation of a business enterprise invest capital, but cannot claim the protection of securities laws when the nature of their relationship does not involve a separation between their capital contribution and the determinants of risk of the enterprise in which they are direct participants.

Small business capital formation may take place entirely outside the scope of state or federal securities laws. The single most important threshold consideration in the process is to determine whether there are securities law concerns at all. Blue Sky laws will have no impact on capital formation accomplished, initially and on a continuing basis, through these methods or mechanisms:

(1) Bona fide loans or financing. Debtor-creditor relationships that involve negotiated terms, adequate security, protective covenants and no equity conversion feature generally do not involve the critical element of investment risk that is essential to the creation of a security. The conclusion is not dependent on a "commercial" lender being involved. In small business capital formation a true debtor-creditor relationship may be established without regard to the characteristics of the lender. The focus is on the nature of the relationship between the debtor and creditor and the extent of protections afforded in the transaction that are the product of the creditor's ability to act directly for its own protection or to have information and secure protections in a negotiated transaction setting. Small businesses and entrepreneurs may raise capital by borrowing money, and unless the nature of the transaction and relationship between the parties is such as to make the lender a true "investor," Blue Sky laws have no role in the process.

To be sure, there is ample authority under Blue Sky laws for the examination of promissory notes and other debt instruments involved in ostensible debtor-creditor relationships to determine whether in fact a security is involved.ⁿ⁶ Indeed, first in the array of instruments and things defined as securities in the Blue Sky laws of all states is "any note."

As thoroughly discussed in Chapter 2, however, it is just as clear that not all notes or evidences of indebtedness are intended to be covered. In small business capital formation the legitimate use of private debt financing is a meaningful opportunity that remains available.

(2) True partnership and joint venture owner relationships. Consider the situation in which A, B, and C pool their funds to purchase an apartment building. By mutual agreement the three individuals delegate day-to-day management responsibilities to C, who will receive a somewhat larger share of net profits for her efforts. Otherwise the individuals intend to share equally in profits and losses of what they hope will be a successful enterprise.

In this scenario each of the participants has acquired an ownership interest in tangible property. It is not direct ownership, but rather an undivided, indirect interest to which the right to possess is curtailed and control is apportioned. Though something less than absolute, it is ownership nonetheless, and the dominant attribute among the three participants is the ultimate control each of them is presumed to possess and exercise. Despite the delegation of day-to-day management duties to one among them, the ultimate ability of each participant to exercise control over the enterprise is presumed. This empowerment, the opportunity to exercise control, creates a relationship of general partnership or as joint venturers.ⁿ⁷ They are in practical terms owners of the property and its value as an enterprise.

A security is not created in these relationships. A true general partnership or joint venture relationship does not create a security because it is premised upon the ability of participants to control the enterprise. Agreements negotiated one-on-one, creating enterprises in which "investors" are actively involved, have access to or have the power to obtain information, and are able to protect their own interests, are not within the protective reach of securities laws. Many things could be done to alter the relationship between participants in such a manner that the extent of risk they face in contributing to the capital of the enterprise is also altered. The existence of a true partnership or joint venture can be nullified or made impossible, and a different set of concerns arises in the capital formation process in which the protection of securities laws for "investors" is invited. The critical point, however, is that in planning for capital formation true partnership and joint venture relationships among participants will not trigger securities law compliance requirements.

(3) Certain "corporate" relationships. The nature of the relationship described above in terms of a true partnership or joint venture can also have application in certain relationships established through a corporate structure. As discussed in Chapter 2, some state courts have evidenced willingness to treat corporate relationships of "stockholders" that fairly approximate partnership or joint venture relationships as beyond the purview of Blue Sky laws.ⁿ⁸ An Illinois appellate court, for example, declined to extend coverage of that state's Blue Sky law remedies to the sale of corporate stock in a transaction that, according to the court, involved only the creation of a partnership in corporate form.ⁿ⁹ Forms of "corporate" relationships that are strictly defined by an agreement among the participants, for example, and which empower participants in the same manner as true partners may be seen as not requiring the application of securities laws.

From a planning perspective, however, any reliance on such a notion to support capital formation activities via the sale of "stock" would be a dangerous undertaking. Corporate stock possessing all the attributes and characteristics of traditional corporate stock will almost invariably be deemed to be a security for purposes of application of at least the antifraud provisions of Blue Sky and federal securities laws. It is only when the corporate "stock" in a business relationship is insignificant in relation to the direct contributions to the success of the enterprise by the holder that securities laws may not apply. Case law and administrative enforcement actions illustrate that those instances will be few. Nevertheless, in particular states it may be meaningful in the capital formation process.

[2] Federal Securities Law Implications The dual system of federal and state securities regulation in the United States means that planning for small business capital formation must take into account regulation at both levels. The creation of a "security" and its offer and sale through the use of any means of interstate commerce or communication must either be registered under the Federal Securities Act of 1933 or have an available exemption. For the most part the

exemptions available under the Federal Securities Act of 1933, in combination with SEC Regulations A and D, will easily encompass small business capital formation initiatives, and in most cases work in tandem with Blue Sky law exemptions or limited offering provisions. Nevertheless, in each instance of capital formation activity it must be clear that an available federal exemption applies in addition to any state exemption or mechanism that is relied upon.

[3] Intermediary Activities Small business capital formation initiatives and activities are most often undertaken directly by the person or business entity seeking financing. To the extent any security is created, that person or entity is the "issuer" of the security. An issuer may engage directly in the offer or sale of its securities or act through intermediaries, such as finders, brokers or other agents in those initiatives. However undertaken, an important threshold regulatory consideration is the extent to which Blue Sky *licensing* requirements apply to the activities of the issuer or any such intermediary.

Most states accommodate direct issuer capital formation activities by specifically excluding them from the definition of "broker" or "dealer" in their Blue Sky laws. The Revised Uniform Securities Act, for example, provides that the term "broker-dealer" means a person engaged in the business of effecting transactions in securities for the account of others or for its own account, but does not include: "[a]n issuer, except when effecting transactions other than with respect to its own securities."¹⁰ States without an express exclusion of issuers from the key definition incorporate one into an exemption or exclusion from the broker-dealer registration requirement itself. Some others, however, impose notice requirements on issuers who engage in the offer and sale of their own securities. The State Guides that are a part of this Treatise individually summarize all such exclusions or requirements. For planning in capital formation it is essential to be aware of any requirement relating to issuer activities in seeking out sources of capital as much as exemptions applicable to the transactions themselves.

The use of intermediaries in the process of capital formation is directly impacted by Blue Sky licensing requirements. "Issuer agents," for example, may be subject to special licensing or registration requirements.¹¹ Some "finders" may be covered by broker-dealer, agent or investment adviser licensing provisions,¹² and in any case planning in small business capital formation activities must include attention to the proper registration or licensing status of intermediaries engaged to assist in the process. The rescission remedies that are a part of nearly all Blue Sky laws are triggered in most instances by any violation associated with a transaction. Intermediary activities that produce a violation of registration or licensing requirements thus present a significant risk in capital formation initiatives that must be managed by thorough planning and careful attention to the involvement of unregistered intermediaries whose services may be essential, but for whom the potential for unlicensed broker-dealer, agent or investment adviser activity is an essential consideration.

FOOTNOTES:

(n1)Footnote 6. See Chapter 2 ("Definition of a Security"- 'Notes and Other Forms of Indebtedness')), *supra*.

(n2)Footnote 7. A "joint venture" is defined as a partnership for a single project. It is distinguished from a partnership only in scope and duration. The essential characteristics of a joint venture are: the community of interest among the participants; the agreement to share in gains and losses; and the mutual right of control, *see Sparks v. Baxter*, 854 F.2d 110 (5th Cir. 1988) .

(n3)Footnote 8. See Chapter 2, *supra*, and cases cited therein.

(n4)Footnote 9. *Doherty v. Kahn*, 289 Ill. App.3d 544, 224 Ill. Dec. 602, 682 N.E.2d 163 (Ill. App. 1997) .

(n5)Footnote 10. Rev. Unif. Sec. Act § 101(2).

(n6)Footnote 11. See, e.g., Massachusetts, Code Mass. Regs. §§ 12.203(6)-(9); Arizona, Ariz. Admin. Code Sec. R. 14-4-104.

(n7)Footnote 12. In Michigan, "finder" is specifically defined in the Blue Sky law as: "a person who, for consideration participates in the offer to sell, sale, or purchase of securities or commodities by locating, introducing, or referring potential purchasers or seller." *Mich. Comp. Laws § 451.801(i)*. The definition of "investment adviser" in Michigan specifically includes a "finder," *see Mich. Comp. Laws § 451.801(l)*.

The involvement of "finders" in small business capital formation has dramatically increased with the shrinkage in the number of broker-dealers and investment bankers serving the middle and small issuer market, and the increasing difficulty in finding alternatives. Although there are exceptions such as Michigan, "finder" activity takes place in a largely unregulated environment, in which there is generally little, if any information available regarding the finder.



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CHAPTER 10 Regulation of Small Business Capital Formation

1-10 Blue Sky Regulation § 10.03

§ 10.03 n13 Federal and State Exemptions

Exemptions from state Blue Sky laws are analyzed in depth in Chapters 7-9 of this Treatise. The array of securities and transactions that are exempt from registration requirements is considerable, and this Chapter will not repeat any of the prior analyses of exemptions. However, small business capital formation is typified by reliance on certain combinations of state and federal securities law exemptions, or limited offering provisions, for which a complete and practical understanding requires more focused attention on certain critical contextual points. The discussion below thus addresses three particular perspectives in which "exempt" or limited offerings are undertaken by small business issuers and entrepreneurs in a dual state and federal regulatory environment. Those perspectives involve: (1) Intrastate Offerings; (2) "Private" Offerings; and (3) Accredited Investor Offerings.

[1] Intrastate Offerings As a matter of federal securities regulation Congress recognized in the Federal Securities Act of 1933 that offerings that are entirely local in character should be left to regulation, if at all, only at the state level. Section 3(a)(11) of the Federal Securities Act of 1933 thus provides an exemption from federal registration provisions for:

Any security which is part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory.ⁿ¹⁴

In many instances small business capital formation initiatives are undertaken in an entirely local setting, and the federal intrastate offering exemption is an important consideration because it is a complete exemption from federal registration requirements, subject only to the "part of an issue," "person resident," and "doing business within" qualifications. SEC Rule 147 under the 1933 Actⁿ¹⁵ establishes a safe harbor in regard to each of these qualifications, but it does not establish exclusive standards for complying with the section 3(a)(11) exemption.ⁿ¹⁶ The exemption is also self-executing; no notice or other filing is required.

As seen throughout the State Guides that are a part of this Treatise, several state Blue Sky laws contain exemptions for offers and sales of securities in transaction circumstances that might only be described as "small," or *de minimis*, that is to say, offerings to a few people who are not required to satisfy any particular criteria or qualifications. In Maine, for example, any offer or sale of securities by a corporation, limited partnership or limited liability company organized under Maine law, or any issuer determined by the administrator to have its principal place of business in the state is permitted without registration if the number of non-institutional holders of securities of the entity does not at the time of

the sale (and will not as a consequence of the sale) exceed ten.ⁿ¹⁷ And in Missouri, which has adopted the 2002 Uniform Securities Act, a sale or offer to sell securities of an issuer is exempt from registration requirements if it is part of a single issue involving no more than 25 non-institutional purchasers in the state.ⁿ¹⁸

There is considerable flexibility in small business capital formation where such *de minimis* offering exemptions are available. This is so because there are no restrictions on offerees and purchasers other than the residential requirement. There is no federal *de minimis* exemption, as such, for an issuer.ⁿ¹⁹ It is only in reliance on the federal intrastate offering exemption that such an offering could be effected without meeting further federal requirements applicable to private offerings generally, or rules comprising Regulation D of the Federal Securities Act of 1933 specifically, if no other exemption is available. As noted above, there are key elements involved in the intrastate offering exemption, but in a great many small business and entrepreneurial financing situations, they will likely pose no challenge to accessing and obtaining needed capital from a close group of local investors or funding sources. The federal intrastate offering exemption may well be overlooked in planning for capital formation initiatives, as the more common focus is on "private" offering transactions that are discussed in section [2] below. Yet the efficient combination of federal and state exemptions in many cases of small business capital formation may well be the federal intrastate offering exemption and a *de minimis* exemption under state law.

Some states have also made provision for limited offerings of securities by an issuer incorporated or organized under the laws of the state and having its principal place of business and the majority of its employees there. Missouri, for example, exempts offers and sales of stock, limited partnership interests or debt securities of such an issuer in an aggregate amount up to \$500,000 during a 12 month period, without significant restrictions, provided at least 80% of the net proceeds of the offering are used in connection with operations of the issuer in the state.ⁿ²⁰ Where available, such issuer exemptions interact directly with the federal section 3(a)(11) intrastate offering exemption and may present a superior opportunity in small business capital formation when a state *de minimis* exemption is too restrictive.

[2] "Private" Offerings Section 4(2) of the Federal Securities Act of 1933ⁿ²¹ provides that the registration provisions of the federal Act do not apply to "transactions by an issuer not involving any public offering." This is the federal "private offering" exemption that has evolved historically as the primary exemption from registration under the federal securities laws relied upon by issuers for the offer and sale of securities to persons and in circumstances that satisfy limitations and criteria in case law and rules. Offers and sales pursuant to SEC Rule 506 of Regulation D under the federal Act are deemed to be transactions within the ambit of section 4(2), but the availability of the exemption is conditioned on meeting the specific requirements of the Rule and Regulation D limitations generally. Securities offered and sold pursuant to Rule 506 are federal "covered securities" under NSMIA,ⁿ²² and thus are not subject to state registration requirements, without regard to the availability of any state exemption.

Although Rule 506 of Regulation D is available for small business capital formation initiatives, the manner of offering limitations, nature of purchaser limitations and particular information requirements may present either cost or practical barriers in some circumstances. Rule 506 is a non-exclusive "safe harbor" provision.ⁿ²³ Issuers may also claim the section 4(2) private offering exemption in reliance upon case law and other principles that have guided its historic application.ⁿ²⁴ However, securities offered and sold directly in reliance on section 4(2) rather than Rule 506 are not federal covered securities. A corresponding state exemption must, therefore, be available. Moreover, the principles that have guided application of section 4(2) generally are not unlike the specific conditions or criteria of Rule 506, in that issuers have always been required to address the number of offerees, their qualifications to fend for themselves, and the extent and manner of access to information concerning the issuer and the offering.

Unlike the federal Act, the Uniform Securities Act does not, in any of its versions, contain a "private offering" exemption, although some states do include a provision matching the federal exemption. In Idaho, for example, there is a broad limited offering exemption for sales "not involving a public offering."ⁿ²⁵ Offers and sales may be made under this exemption if they satisfy all criteria set forth in Idaho court decisions interpreting exemptions in effect at the time the exemption is claimed.ⁿ²⁶

The 2002 Uniform Act (as with the Revised Uniform Act) reflects the evolution of exemptions for private transactions at the state level through a form of *de minimis* exemption, which provides in section 202(14) for an exemption from registration requirements for a sale or offer to sell securities by an issuer, if part of a single issue in which:

- (A) not more than 25 non-institutional purchasers are present in the State during any 12 consecutive months;
- (B) no general solicitation or advertising is made in connection with the offer to sell or the sale of the securities;
- (C) no commission or other remuneration is paid or given, directly or indirectly, to any person other than a registered broker-dealer or agent for soliciting a prospective purchaser in the state; and
- (D) the issuer reasonably believes that all non-institutional purchasers in the state are purchasing for investment.ⁿ²⁷

The 2002 Uniform Act exemption is realistic for small business capital formation in allowing up to 25 non-institutional purchasers. On the other hand, the *de minimis* exemption available in some states may be unattractive simply in terms of the permitted number of purchasers. Several, for example are limited to no more than 10 non-institutional purchasers, and impose other issuer requirements.ⁿ²⁸

For "private" offerings in states without a useful *de minimis* exemption from registration provisions, and for which Rule 506 under federal Regulation D is not a realistic undertaking, the NASAA Uniform Limited Offering Exemption (ULOE), or analog, as adopted in the state presents an alternative for offerings of securities in an amount up to \$5 million through its interaction with SEC Rule 505 under Regulation D.

The ULOE was designed to work in conjunction with the federal exemptions available in Rules 505 and 506 of Regulation D under the federal Act, and remains applicable for Rule 505 offerings, which do not involve federal covered securities. The key practical consideration in small business capital formation is minimizing compliance costs associated with the process, and Rule 505, as implemented through ULOE or its analog at the state level may present a desirable "private" offering alternative when another combination of exemptions is not available. Under Rule 505, for example, qualifying conditions as to "non-accredited" purchasers are more easily addressed.ⁿ²⁹

However approached, any "private" offering is subject to state and federal registration requirements in the absence of an exemption. While small business typically involves "private" undertakings and transactions, the characterization does not excuse compliance with state and federal securities laws, and the absolute need for capital formation activity to take place in accord with *coordinate* exemptions if a security is being offered and sold.

[3] Accredited Investor Offerings The discussions above relating to intrastate and "private" offerings in support of small business capital formation is oriented to minimizing transaction costs using an assumption that easy access to a small number of "non-accredited" investors is the goal. In each of the "private" settings discussed, however, the notion of "accredited" investors is mentioned, if only in terms of establishing numerical limitations on non-accredited investors that may be involved. Small business capital formation can just as meaningfully be focused on accessing only accredited investors.

"Accredited" investors are most often thought of in terms of institutions and high net worth individuals. However, in small business capital formation settings they also comprise venture capitalists, Small Business Investment Companies (SBIC) and participants in "Angel" networks that present opportunities for accessing capital and financing. Federal and many state securities laws deal specifically with accredited investors as part of their exemption structures, and in the coordination of exemptions that is so important to small business capital formation initiatives the flexibility offered

through attention to accredited investor provisions should not be overlooked.

Section 4(6) of the Federal Securities Act of 1933ⁿ³⁰ provides an exemption from federal registration requirements for:

[T]ransactions involving offers or sales by an issuer solely to one or more accredited investors, if the aggregate offering price of an issue of securities offered in reliance on this paragraph does not exceed the amount allowed under section 3(b) of this title, if there is no advertising or public solicitation in connection with the transaction by the issuer or anyone acting on the issuer's behalf, and if the issuer files such notice with the Commission as the Commission shall prescribe.

The federal exemption was adopted as part of the Small Business Incentive Act of 1980. For purposes of the section 4(6) exemption, accredited investor is defined in section 2(15) of the Federal Securities Act as:

(i) a bank, as defined in section 3(a)(2) whether acting in its individual or fiduciary capacity; an insurance company as defined in paragraph (13) of this subsection; an investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; a Small Business Investment Company licensed by the Small Business Administration; or an employee benefit plan, including an individual retirement account, which is subject to the provisions of [ERISA], if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such Act, which is either a bank, insurance company or registered investment adviser; or

(ii) any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulations which the Commission shall prescribe.ⁿ³¹

Accredited investor status is today also defined by the Commission in Rule 501 under Regulation D to include:

(a) As to natural persons,

(1) A director, executive officer or general partner (or its director, executive officer or general partner) of the issuer of the securities; or

(2) A person whose net worth (together with spouse) is at least \$1 million; or

(3) A person whose net income is greater than \$200,000 (\$300,000 with spouse) in each of the two most recent years, with a reasonable expectation of reaching the same income level in the current year.

(b) Certain financial institutions, institutional investors meeting prescribed asset requirements, or entities all of the owners of which are accredited investors.ⁿ³²

The amount limitation for the federal exemption under section 4(6) references section 3(b) of the Act,ⁿ³³ which empowers the SEC to act by rule to exempt securities from the federal registration requirements by reason of the small amount involved or the limited character of the offering. The maximum offering eligible for exemption under section 3(b), however, is \$5 million, which thus sets the maximum limit on offerings to accredited investors under section 4(6). There is no requirement that information be furnished by the issuer to accredited investors. However, section 4(6) itself prescribes, no advertising or "public solicitation" is permitted. Although this restriction might in some cases operate to impede access to potential accredited investors through the use of means such as the Internet, it is more likely that with care attention communications can be appropriately restricted through pre-qualification measures or by utilizing networks established for that purpose. A notice filing with the SEC utilizing Form D is also required.

At the state level, the NASAA Model Accredited Investor Exemption,ⁿ³⁴ has been adopted in several states,ⁿ³⁵ and

incorporates by reference the Regulation D Rule 501 federal definition of accredited investor. In numerous other states there is a functional equivalent of the Model exemption.ⁿ³⁶ State accredited investor exemptions, in most cases, do not place limitations on the manner or means of making a general announcement of the offering, although with the Model exemption there are limitations on the content of those announcements. Beyond the general announcement restrictions, there are no restrictions on dissemination of additional information provided it is delivered only to persons the issuer reasonably believes to be accredited investors. There is no maximum dollar limitation on an offering made to accredited investors, although there are procedural requirements and certain disqualifying criteria. States adopting the Model exemption also impose a notice filing and fee requirement.

In transactions carried out in reliance upon state accredited investor exemptions, resales of securities are typically limited to other accredited investors, or the securities must be registered. Sales of the securities may be made directly by the issuer, provided no commissions or other compensation is paid. When compensated intermediaries are involved, there is no limit on the amount of commissions that may be paid. However, commissions or other transaction-based remuneration may be paid only to licensed broker-dealers and agents.

Federal and state accredited investor exemptions can thus provide essential coordinate exemptions in small business capital formation, subject only to somewhat stricter limits in application of the federal exemption regarding the scope of permitted communications and the amount limitation. The objective of both Securities Act section 4(6) and the NASAA Model Accredited Investor Exemption is to enhance capital formation by small business and to ensure that qualified investors are not impeded from purchasing the securities of small businesses. The two exemptions work together well in providing the opportunity for issuers to seek out and directly access a broad spectrum of investors. As a caveat, however, these federal and state exemptions do not work in combination with other exemptions as part of a single plan of financing. Their application may be precluded by other activity carried out in intended reliance on another exemption. The concept of integration of offerings would, for example, prevent a small business issuer from attempting to undertake sales to non-accredited investors at the state level under a *de minimis* or other exemption when those transactions are deemed to be part of the same financing activity as sales of securities to accredited investors in reliance on the section 4(6) exemption under federal law and its state law analog. On the other hand, even in a state with no accredited investor exemption, an offer and sale of securities solely to accredited investors in conformity with the federal exemption would not preclude reliance on another available state exemption when there are no non-accredited investors involved and the maximum offering limitation is not exceeded. Integration is an extremely important consideration for small business capital formation activities, and is considered in more detail later in this Chapter.ⁿ³⁷ These kinds of circumstances also suggest advantages for small business issuer utilization of Rules 505 or 506 of Regulation D under the Securities Act of 1933, and other limited offering mechanisms, where both accredited and non-accredited investors are contemplated. That discussion follows below.

FOOTNOTES:

(n1)Footnote 13. The complete range of exempt transactions is presented in detail in Chapter 8 ("Exempt Issuer Transactions"), *infra*. Here, however, the focus is solely upon those exemptions that bear directly upon small business capital formation, and how they operate in that context.

(n2)Footnote 14. 15 U.S.C. § 77c(a)(11).

(n3)Footnote 15. 17 C.F.R. § 230.147.

(n4)Footnote 16. A Preliminary Note (3) to Rule 147 states in part:

Persons claiming the availability of the rule have the burden of proving that they have satisfied all of its provisions. However, the rule does not establish exclusive standards for complying with the Section 3(a)(11) exemption. The exemption would also be available if the issuer satisfied the standards set forth in relevant administrative and judicial interpretations at the time of the offering but the issuer would have the burden of proving the availability of the exemption.

(n5)Footnote 17. *32 Me. Rev. Stat. § 10502(P)*

(n6)Footnote 18. *Rev. Stat. Mo. § 2-202(14).*

(n7)Footnote 19. SEC Rule 504 of Regulation D under the Securities Act of 1933 offers an exemption from federal registration requirements for offerings under \$1 million, but imposes certain conditions and restrictions, including information requirements and a notice filing requirement. Rule 504 offerings in the small business capital formation setting are discussed further in § 10.05, *infra* .

(n8)Footnote 20. *Mo. Code. State Regs. § 30-54.240.*

(n9)Footnote 21. *15 U.S.C. § 77(d)(2).*

(n10)Footnote 22. *See 15 U.S.C. § 77r(b)(4)(D).*

(n11)Footnote 23. Rule 506 in the context of small business capital formation is discussed further in section 10.4[1], *infra*.

(n12)Footnote 24. In the seminal case addressing the application of section 4(2) of the federal Act the U.S. Supreme Court observed:

The natural way to interpret the private offering exemption is in light of the statutory purpose... .
[T]he applicability of the exemption turns on whether the particular class of persons affected needs the protection of the Act. An offering to those persons who are shown to be able to fend for themselves is a transaction not involving any public offering. *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125, 73 S. Ct. 981, 97 L. Ed. 1494 (1953) .

(n13)Footnote 25. *Dept. Fin. Rule 270.01.*

(n14)Footnote 26. *See also, Ohio Rev. Code § 1707.03(Q)*, which creates an exemption from registration requirements when "[t]he provisions of section 5 of the Federal Securities Act of 1933 do not apply to the sale by reason of an exemption under section 4(2) of that act." There are, however, certain other conditions, including a notice filing requirement.

(n15)Footnote 27. *2002 Unif. Sec. Act § 202(14); see also 71 Okla. Stat. § 401(b)(10).*

(n16)Footnote 28. *See, e.g., Alabama: Code. Ala. § 8-6-11(9).*

(n17)Footnote 29. Rule 505 and its interface with the ULOE and ULOE variations at the state level in small business capital formation are considered further in § 10.04[1], *infra* .

(n18)Footnote 30. *15 U.S.C. § 77d(6).*

(n19)Footnote 31. *15 U.S.C. § 77b (a)(15).*

By Rule 215 under the Act, *17 C.F.R. § 230.215*, the SEC defined accredited investors to include certain financial institutions, trusts meeting asset criteria, officers and directors of the issuer, and other persons who meet stated net worth and income criteria. The Rule 215 definition is now largely incorporated into Rule 501 of Regulation D.

(n20)Footnote 32. *17 C.F.R. § 240.501(a).*

(n21)Footnote 33. *15 U.S.C. § 77c(b)*.

(n22)Footnote 34. NASAA Reports (CCH) P 361 (Adopted Apr. 27, 1997)

(n23)Footnote 35. *See, e.g.,* Alaska: A.S. § 45.55.900(b)(18); Delaware, Del. Sec. Act Regs. § 503; Kansas: Kan. Admin. Regs. § 81-5-13.

The Model Accredited Investor Offering Exemption is not available to an issuer that is in the development stage that either has no specific business plan or purposes, or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies, or other entity or person.

(n24)Footnote 36. *See, e.g.,* California: *Cal. Corp. Code § 25102(N)*.

(n25)Footnote 37. Integration, or the "single issue" concept as particularly applied in the small business capital formation setting, is discussed in § 10.06, *infra*.



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Blue Sky Regulation

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CHAPTER 10 Regulation of Small Business Capital Formation

1-10 Blue Sky Regulation § 10.04

§ 10.04 Limited Offering Alternatives

Among the states there is a wide spectrum of offering alternatives that are aptly characterized as "limited" offerings. Some states provides several alternatives, while others focus only on implementation of federal Regulation D through the Uniform Limited Offering Exemption or its functional equivalent. Some make specific provision for small corporate offerings through adoption of SCOR and Form U-7 procedures, either as a limited offering exemption, a special form of registration,ⁿ³⁸ or simply as an accommodation for registrations by qualification.ⁿ³⁹ Various of these limited offering alternatives in the regulation of small business capital formation are considered further below.

[1] Federal Regulation D and the ULOE The distinction between "limited" and exempt offerings is generally though of in terms of whether the filing of some form of registration requirement either at the federal or state level is required. Thus, the available offerings under Regulation D of the federal Securities Act of 1933 are in practical terms exempt offerings because qualification results in an exemption from federal registration provisions, and at most a notice filing with the SEC on Form D is required. Nevertheless, for small business capital formation, utilization of federal Regulation D is most often undertaken in conjunction with the Uniform Limited Offering Exemption (ULOE), or its equivalent, in place at the state level. Thus, it is easiest to consider that combined, coordinate process in terms of a "limited" offering, particularly since one of the available "exempt" offerings under Regulation D is in fact generally subject to full registration procedures in the states.ⁿ⁴⁰

For small business capital formation, compliance with Regulation D under the Federal Securities Act of 1933, and thus the availability of an exemption from federal registration requirements, presents three alternatives:

(1) *Rule 504*, which provides an exemption for offerings not exceeding \$1 million, and which meet certain conditions.ⁿ⁴¹ There are, however, no purchaser limitations. As noted above, although Rule 504 offerings are exempt from federal registration requirements, they are not exempt under state Blue Sky laws, and there is no interface with the ULOE or its analog at the state level. Because utilization of SEC Rule 504 of Regulation D at the federal level generally requires compliance with registration procedures at the state level, its impact on small business capital formation is separately considered in § 10.05.

(2) *Rule 505*, which provides an exemption for limited offers and sales of securities not exceeding \$5 million, and which meet certain conditions, including information requirements.ⁿ⁴² Only 35 or fewer non-accredited investors are permitted; there is no limit on the number of accredited investors. Other than the numerical limit, there are no limitations or qualifications for non-accredited investors. There is

interface with ULOE at the state level.

(3) *Rule 506*, which provides an exemption for offers and sales, without any amount limitation, but which meet certain conditions, including "sophistication" qualifications placed on non-accredited investors, the permitted number of which is 35.ⁿ⁴³ After NSMIA, securities offered and sold pursuant to Rule 506 are federal "covered securities," and thus are not subject to state registration requirements, although antifraud provisions and notice filing requirements apply.

A fourth Regulation D alternative, *Rule 508*,ⁿ⁴⁴ derives entirely from Rule 504, 505 and 506, and provides that any one of those federal exemptions will not be lost if there is a good faith insignificant deviation or failure to comply with a particular requirement. Under Rule 508 the burden is on the issuer to show that the failure to comply did not pertain to a term, condition or requirement intended to protect a particular individual or entity, and that the failure to comply was insignificant in relation to the offering taken as a whole.

For small business capital formation in the context of Regulation D, only Rule 505 assures the availability of a state exemption through the ULOE or its equivalent and presents a practical alternative. Rule 504 offerings are subject to registration by qualification under state Blue Sky laws. Rule 506 offerings, although not subject to state registration requirements, present a meaningful challenge, and cost, associated with qualification of non-accredited investors who may purchase the securities. Indeed, Rule 506 includes this specific condition as to the nature of purchasers:

Each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believe immediately prior to making any sale that such purchaser comes within this description.ⁿ⁴⁵

In contrast, Rule 505 of Regulation D, while also limiting the number of non-accredited purchasers to no more than 35, does not impose any sophistication requirements on those non-accredited purchasers.ⁿ⁴⁶ And although the securities offered and sold under the rule are not federal covered securities, the ULOE and its individual state analogs are available to interface and provide the needed state exemption.

The ULOE, however, has its own set of conditions. For example, while non-accredited investors are not required to meet a sophistication standard, there is a *suitability* requirement on the part of the issuer if the non-accredited investor lacks sufficient knowledge and experience. Thus in Massachusetts, for example, in all sales to non-accredited investors made in reliance upon the Massachusetts Uniform Limited Offering Exemption,ⁿ⁴⁷ one of the following conditions must be satisfied, or the issuer and any person acting on behalf of the issuer shall have grounds to believe and after making reasonable inquiry shall believe that one of the conditions is satisfied:

a. The investment is suitable for the purchaser based on the other security holdings, financial situation and needs of the purchaser. It may be presumed that if the investment does not exceed 10% of the sum of the purchaser's net worth (excluding principal residence and its furnishings) and the net worth of the purchaser's spouse, if any, the investment is suitable; or

b. The purchaser either alone or with a purchaser representative as defined in § 501(h) of SEC Regulation D... has such knowledge and experience in financial and business matters as to be capable of evaluating the merits and risks of the prospective investment.ⁿ⁴⁸

The Massachusetts ULOE has the further provision:

5. In all sales made in the Commonwealth to investors who are not accredited investors, or accredited investors who are natural persons, the issuer and any person acting on its behalf shall have reasonable grounds to believe that the investment does not exceed 24% of the purchaser's net worth

(excluding principal residence and its furnishings. For purposes of this condition the purchaser's net worth shall include the net worth of his or her spouse.n49

The interface with Rule 505 of Regulation D also means that ULOE qualified offerings must meet the information requirements of SEC Rule 502(b) for sales to non-accredited investors. For small business issuers who are not subject to the reporting requirements of sections 13 or 15(d) of the Federal Securities Exchange Act of 1934, this means supplying to non-accredited investors the non-financial information equivalent to that which would be contained in Part II of Form 1-A under the Federal Securities Act of 1933 for those issuers that would qualify for use of Regulation A under the Act.n50 For issuers that would not qualify under Regulation A, the same kind of non-financial information that would be required in Part I of any other form of federal registration statement for which the issuer would be qualified is required.n51 Financial statement information is required as well. For offerings up to \$2 million, the information required by Item 310 of SEC Regulation S-B is required, except that only the issuer's balance sheet must be audited. For offerings in excess of \$2 million up to the \$5 million limit, the financial information contained in SEC Form SB-2 is required,n52 although the requirement is relaxed for issuers, other than limited partnerships, that cannot obtain audited financial statements without unreasonable effort or expense. In those situations only a balance sheet must be audited.

Compliance with the information requirements of Regulation D means that invariably, small business issuers will generate and utilize an offering memorandum or form of structured disclosure document. The Regulation D prohibition against general solicitation and advertising also applies.n53 The Regulation D prohibition extends to any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.n54

Under the ULOE, as with many variations of state limited offering provisions, there are "bad boy" disqualifications from eligibility to use the procedure. These procedures are not available for offerings in which issuers or key intermediaries have certain disciplinary or criminal histories, or are subject to other enforcement or administrative orders or judgments. The disqualifications may, however, be waived if the state administrator or agency of the state which created the basis for the disqualification determines that it is not necessary under the circumstances that the exemption be denied.

Finally, as with SEC Regulation D, ULOE procedures at the state level generally require a notice filing with the administrator on Form D or an equivalent form as may be designated. That is also the case for Rule 506 offerings.

As noted earlier, securities offered and sold in compliance with SEC Rule 506 of Regulation D are federal "covered securities," and thus are not subject to state registration requirements regardless of the availability of any exemption. For small business capital formation the barrier to effective use of Rule 506 is the qualification requirements applicable to non-accredited investors. Internet solicitations by issuers are also generally prohibited under Rule 506,n55 although password protected pages operated by intermediary networks that are accessible only to accredited or pre-qualified sophisticated investors may be permitted.n56 In small business capital formation the costs of seeking out and accessing sources of capital is lessened by the emergence of such networks, and the absence of any limitation on the amount of capital that may be raised. As a practical matter, however, these opportunities may not be available to smaller issuers in start-up and other early capital formation in local or regional settings. The fact that Rule 506 offerings involve NSMIA federal covered securities indicates the extent to which utilization has evolved on a substantial, national scale, and with the participation of large financial institutions. Rule 506 simply may not be a realistic undertaking in early stage small business capital formation. Indeed, even Rule 505, with its greater flexibility in regard to involvement of non-accredited investors may present no advantage in small business capital formation when compared to a coordinated undertaking utilizing an available state *de minimis* exemption in conjunction with the federal intrastate offering exemption discussed earlier in § 10.03[1].

[2] Small Corporate Offering Registration (SCOR) Each of the State Guides made a part of this Treatise includes a reference to how, if at all, the state incorporates or accommodates SCORn57 into its regulatory structure for capital formation. The great majority of states do make provision for SCOR procedures, which are based on the

NASAA Statement of Policy Regarding Small Company Offering Registrations adopted in April, 1996. In a preamble to the State of Washington SCOR registration proceduresⁿ⁵⁸ the objective is made clear:

[T]he administrator recognizes that small issuers raising small amounts of money face special problems not faced by issuers raising larger amounts, and that standards appropriate to registrations of larger offerings may become unduly burdensome when applied to registrations of small offerings. The optional [SCOR] registration method offered by these rules is intended to reduce the costs and burdens of raising capital for small business without sacrificing investor protection, and to maximize the amount of offering proceeds available to the issuer for investment in the business.ⁿ⁵⁹

The NASAA Policy, and SCOR, address offerings by qualifying small business issuers that are exempt from federal registration requirements under Rule 504 of Regulation D, or section 3(a)(11) of the Federal Securities Act of 1933-the intrastate offering exemption. Although there is no maximum limit on the amount of securities that may be sold pursuant to the federal intrastate offering exemption, the amount under Rule 504 of Regulation D is limited to \$1 million. That is also the maximum limit for SCOR, whether the federal exemption is Rule 504 or the intrastate offering exemption. In either case the assumption is that the offering would be subject to state registration in spite of the federal exemption. SCOR is meant to ease that burden.

SCOR is a form of limited registration based upon Form U-7, a uniform form of registration statement that also serves as the main disclosure document for use in the offering. However, the procedure is not available for use in connection with every type of securities offering, and is limited to companies that satisfy certain criteria. The issuer must:

1. Be a corporation or centrally managed limited liability company organized under U.S. or Canadian law, or any state, province or territory thereof, or the District of Columbia, and have its principal place of business in one of those jurisdictions;
2. Not be subject to the reporting requirements of Section 13 or 15(d) of the Federal Securities Exchange Act of 1934;
3. Not be an investment company registered or required to be registered under the Investment Company Act of 1940;
4. Not be engaged in or propose to engage in petroleum exploration and production, mining, or other extractive industries;
5. Not be a development stage company that either has no specific business plan or purpose, or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies or other entity or person; and
6. Not be disqualified by "bad boy" provisions.ⁿ⁶⁰

There are other conditions and limitations on SCOR, although they vary from state to state. Typically there is a minimum per share offering price, and the issuer must agree not to undertake stock splits or stock dividends within a prescribed period of time following effectiveness of the U-7 registration statement.ⁿ⁶¹ A SCOR registration in the Maryland, for example, is specifically conditioned on an undertaking by the issuer not to split its common stock, or declare a stock dividend, for two years following effectiveness of the registration.ⁿ⁶² SCOR issuers in Maryland are further required during the course of the offering to file quarterly reports with the administrator containing prescribed information, as well as annual financial reports for a period of three years following the effective date of the registration. Sales and advertising material must also be filed.

States that have not specifically adopted the SCOR procedure nevertheless make provision for small corporate offerings. Georgia, for example, makes specific provision for "Small Issue" registration by an issuer or an affiliate of an issuer when the following conditions are met:

- The aggregate amount of the total offering, within or outside the state, does not exceed \$500,000; or
- The aggregate number of persons in the state purchasing the securities registered under this provision from the issuer and all affiliates of the issuer during any 12 month period does not exceed 50 persons, including those person who acquire such securities in transactions that are otherwise exempt under a specific Georgia limited offering exemption. Securities issued in a Small Issuer registration in reliance on the numerical limitation on the number of investors may not be resold or transferred except pursuant to a registration statement or exemption for a period of one year from the date of issuance.ⁿ⁶³

The content of a Small Issuer registration statement in Georgia is prescribed by the Act, as well as the use of a prospectus that is a part of the registration statement. Although not prescribed as such, the form and content of the registration statement tracks Form U-7.ⁿ⁶⁴ Other requirements may be imposed. In Minnesota for example, the Commissioner is granted discretion in regard to SCOR registrations to issue stop orders for any of the following reasons in addition to those applicable to all registrations:

- The issuer's principal place of business is not in Minnesota, or in North Dakota, South Dakota, Iowa or Wisconsin;
- At least 50% of the issuer's full time employees are not located in Minnesota or in the contiguous states identified above; or
- At least 80% of the net proceeds of the offering are not going to be used in connection with the operations of the issuer in Minnesota or the contiguous states.

The Commissioner is also empowered to impose suitability requirements for investors in SCOR offerings.

The intent of the SCOR registration option for states is to offer a vehicle for development stage companies to raise capital, to provide investment opportunities to local investors, to streamline the regulatory process, and also to provide a tool for economic development. It is thus particularly compatible with the intrastate offering exemption under the Federal Securities Act of 1933. The main barrier to reliance on the SCOR offering process is the maximum \$1 million offering limitation. However, the advantages of SCOR lie in the minimization of compliance costs. There are, for example, no purchaser limitations, either as to number or sophistication. On the other hand, SCOR offerings are subjected to merit regulation in those states that continue to apply it. There is no special review treatment accorded SCOR offerings in these states, and the application of merit guidelines will determine whether the offering may proceed.

[3] Other Limited Offerings

[a] Regulation A Offerings Regulation A has long been a part of the federal securities laws, and creates a limited or "conditional" small issues exemption pursuant to section 3(b) of the Federal Securities Act of 1933 for offerings up to \$ 5 million, but subject to fairly rigorous procedures.ⁿ⁶⁵ Regulation A is comprised of SEC Rules 251 through 263 under the Federal Securities Act of 1933. Since the adoption of Regulation D, so-called "Reg A" offerings are less common. While promulgated pursuant to an exemption provision of the federal Act, Regulation A offerings involve a form of registration filed with the SEC, and the process is more akin to a conventional federal registration. For that reason, offerings made in reliance on Rule 505 of Regulation D, which is available to cover the same maximum amount as Regulation A, and which exempt the issuer from any federal filing other than a notice filing on Form D, more often

presents the cost-efficient approach to an offering up to \$5 million. However, advantages of Regulation A over Rule 505, and Regulation D generally, include:

- (1) There is no restriction on the resale of the securities;
- (2) Advertising and sales literature may be used in the offering;
- (3) "Testing the waters" is permitted in accordance with an applicable rule; and
- (4) There are no purchaser qualifications or limitations.

The main feature of Regulation A offerings impacting small business capital formation is the requirement for preparation, filing and use of an "offering circular" containing specified information. Yet, as seen earlier in regard to Rule 505 offerings, the information requirement for non-accredited investors incorporates Regulation A requirements in any event. Thus, essentially the same information would be required in either manner of offering, the only difference being that in Regulation A there is an SEC filing and review procedure.

Regulation A does not interface with state law exemptions under the ULOE or otherwise. Thus, in states making no provision for "testing the waters" by solicitations of interest, for example, use of that procedure under Regulation A may well violate the applicable Blue Sky law. A considerable number of states do not make provision for solicitations of interest, although others, such as Iowa,ⁿ⁶⁶ expressly permit solicitation of indications of interest for the purpose of indicating interest in receiving an offering circular or its equivalent. In states where solicitations of interest are permitted, there is normally a prescribed form and an advance filing requirement. Conditions also apply regarding issuers eligible to engage in the process.ⁿ⁶⁷

Use of Regulation A is made subject to issuer qualification criteria, which are essentially the same "bad boy" disqualifications that are now apart of Regulation D and ULOE analogs in the states. Besides the SEC filing, there are other procedures that add to the compliance burden. Sales and advertising literature must be filed with the SEC, and there are reporting requirements regarding sales and use of proceeds. Because there is no coordinate state law exemption for federal Regulation A offerings, they will in many cases be subject to state registration by qualification. The utility, however, may be the greater amount limitation than would be available under Rule 504 of Regulation D and the absence of any restrictions on purchasers, particularly in those states that do permit testing the waters.

[b] Other State Alternatives The universe of limited offering exemptions under state Blue Sky laws is considerable. Although substantial uniformity is achieved in regard to federal Regulation D offerings through the ULOE or equivalents among the states, and SCOR, there is a considerable array of other limited offering provisions. These include the various "private" offering exemptions or procedures that were in place prior to Regulation D and the ULOE. Other approaches to limited offerings include that illustrated by Michigan, which includes among its provision an exemption for sales of securities to promoters and other persons actively engaged in or reasonably expected to be engaged in the management of the issuer.ⁿ⁶⁸ The exemption extends to sales to persons who are related by blood or marriage to the promoter or person who is actively engaged in management, and who purchase with investment intent. Although the Michigan exemption is limited to sales to no more than ten persons in any twelve month period, the utility for small business capital formation is apparent. These issuer "relationship" exemptions are premised on the fact that the purchasers involved have access to all material facts with respect to the securities either by being actively involved or related to a person who is actively involved.ⁿ⁶⁹

Intrastate "issuer" exemptions have previously been discussed in regard to their utility in coordinating the federal intrastate offering exemption.ⁿ⁷⁰ These are useful alternatives in small business capital formation and impose only a minimal regulatory burden.ⁿ⁷¹ Several states simply exempt "small" offerings, usually up to \$500,000 when certain conditions are met.ⁿ⁷² These states may or may not also provide for a *de minimis* exemption in the manner discussed

earlier.ⁿ⁷³

As reflected in the 2002 Uniform Securities Act, all states make some meaningful provision for facilitation of small business capital formation through either outright exemptions or limited offering procedures. Thus, the 2002 Uniform Act itself provides an exemption for limited offering transactions to not more than 25 non-institutional purchasers during any twelve consecutive months, when certain conditions are satisfied.ⁿ⁷⁴ The drafters note that this provision would also apply to preorganization limited offerings as well as operating company limited offerings.ⁿ⁷⁵

Each of the State Guides summarizes the limited offering alternatives available in that state. The critical consideration in each instance remains, however, its coordination with an available federal exemption. The avenues available for small business capital formation under Blue Sky laws are numerous and varied. They do not operate independently of federal securities regulation, and for that reason the practical emphasis in small business capital formation militates to transactions which satisfy either the federal intrastate offering exemption or qualify under one of the provisions of Regulation D under the Federal Securities Act of 1933. One Regulation D alternative remains to be addressed, namely, reliance on Rule 504 which, although generally not exempt from registration at the state level, may provide needed flexibility. State level treatment of Rule 504 offerings is considered further in § 10.05 *below*.

FOOTNOTES:

(n1)Footnote 38. *See, e.g., Georgia: Ga. Code § 10-5-5(e)* (Small Issuer Registration).

(n2)Footnote 39. Hawaii, for example, has no provision specifically adopting the SCOR procedure for small corporate offerings. However, the state expressly permits the use of Form U-7 by qualifying issuers that register securities by qualification, *see Haw. Rev. Stat. § 485-24.5*.

(n3)Footnote 40. SEC Rule 504, an exemption for offerings of securities not exceeding \$1 million, provides no exemption from state registration requirements. Rule 504 offerings by small business issuers at the state level are considered further in § 10.05, *infra*.

(n4)Footnote 41. *17 C.F.R. § 230.504*.

(n5)Footnote 42. *17 C.F.R. § 230.505*.

(n6)Footnote 43. *17 C.F.R. § 230.506*.

(n7)Footnote 44. *17 C.F.R. § 230.508*.

(n8)Footnote 45. *17. C.F.R. § 230.506(b)(92)(ii)*.

(n9)Footnote 46. As with each of the alternative offerings under federal Regulation D, Rule 505 incorporates the counting methodology of Rule 501(e) in determining the 35 purchaser limitation. Under the rule, certain persons are excluded from the count, including any relative, spouse or relative of the spouse of a purchaser who has the same principal residence as the purchaser. *17 C.F.R. § 230.501(e)(1)(i)*.

(n10)Footnote 47. *950 Code Mass. Regs. § 14.402(B)(13)*.

(n11)Footnote 48. *950 Code Mass. Regs. § 14.402(B)(13)(3)*.

(n12)Footnote 49. *950 Code Mass. Regs. § 14.402(B)(13)(5)*.

(n13)Footnote 50. SEC Regulation A under the Federal Securities Act of 1933 in the context of small business capital formation is discussed further in § 10.04[3], *infra*.

(n14)Footnote 51. *17 C.F.R. § 230.502(b)(2)*.

(n15)Footnote 52. *17 C.F.R. § 230.502(b)(2)(B)*.

(n16)Footnote 53. *See 17 C.F.R. § 230.502(c)*.

(n17)Footnote 54. *17 C.F.R. § 230.502(c)(2)*.

(n18)Footnote 55. *See* Sec. Act Rel. No. 33-7233 (SEC July 31, 1995); Sec. Act Rel. No. 33-7856 (SEC May 4, 2000).

(n19)Footnote 56. *See* IPONET, SEC No-Action Letter, 1996 SEC No-Act LEXIS 642 (July 26, 1996).

(n20)Footnote 57. Florida, for example, has not adopted SCOR as such. Nevertheless, by rule, *see* Div. Sec. Rule 3E-700.028, the SCOR registration statement (Form U-7) may be used by qualifying issuers to register securities sold in offerings in which the aggregate offering price in any consecutive twelve month period does not exceed \$5 million.

(n21)Footnote 58. Wash. Admin Code Ch. 460-17A.

(n22)Footnote 59. Wash. Admin. Code § 460-17A-010 ("SCOR Registration")

(n23)Footnote 60. *NASAA Statement of Policy Regarding Small Company Offering Registrations*, CCH NASAA Reports P 413, at 409 (Apr. 28, 1996).

(n24)Footnote 61. *See, e.g.*, 14 Ill. Admin. Code § 130.525 (SCOR registration requires minimum \$1.00 per share offering price).

(n25)Footnote 62. *See* 03 Div. Sec. Rules 12(F).

(n26)Footnote 63. *Ga. Code § 10-5-5(e)*.

(n27)Footnote 64. In this regard, and specifically as to Small Issuer registrations, the Georgia Act provides:

The commissioner shall be authorized to participate in any program designed to promote and achieve compatibility with federal law and uniformity among the states and to promulgate such rules and regulations as may be necessary to achieve such compatibility and uniformity. *Ga. Code § 10-5-5(e)(10)*.

Hawaii also has no provision specifically adopting the SCOR procedure for small corporate offerings. However, Hawaii expressly permits the use of Form U-7, the Small Corporate Offering Registration form to satisfy prospectus requirements by issuers meeting requirements set out in the form, that register securities by qualification *see Haw. Rev. Stat. § 485-24.5*.

(n28)Footnote 65. The \$5 million maximum offering permitted under Regulation A is subject to a specific integration requirement. Thus, the maximum under Regulation A is \$5 million less the aggregate offering price for all securities sold within twelve months before the start of and during the offering of securities in reliance upon Regulation A, *see 17 C.F.R. § 230.251(b)*.

(n29)Footnote 66. *See* Iowa. Sec. Bur. Rule 191-50.91.

(n30)Footnote 67. *See, e.g.*, South Dakota: S.D. Dir. Sec. Regs. § 20:08:07:27 (Testing-the-waters exemption).

(n31)Footnote 68. *Mich. Comp. Laws § 451.802(b)(9)*.

(n32)Footnote 69. *See also Ind. Code § 23-2-1-2(b)(10)(G)(i).*

In Arizona the offer and sale of securities exclusively to bona fide employees or existing security holders of the issuer or a subsidiary of the issuer is permitted up to \$500,000 when certain conditions are satisfied, *see* Ariz. Admin. Code Sec. Rule 14-4-101.

(n33)Footnote 70. *See § 10.03[1], supra.*

(n34)Footnote 71. *See, e.g., Mont. Code Ann. § 30-10-105(8)(c).*

(n35)Footnote 72. *See, e.g., Kentucky: Ky. Rev. Stat. § 292.410(i).*

These exemptions may, however, be subject to a filing requirement or procedure, *see, e.g.,* Mo. Code State Reg. § 30-54.240.

(n36)Footnote 73. *See § 10.03[1], supra.*

(n37)Footnote 74. 2002 Unif. Sec. Act § 202(14).

(n38)Footnote 75. Official Comment 15, 2002 Unif. Sec. Act § 202.

This reference in the 2002 Uniform Act comments also serves as a reminder that many Blue Sky laws exempt offers (but not sales) of preorganization subscriptions when certain limiting conditions are satisfied. In Pennsylvania, for example, there is an exemption for offers *and sales* of preorganization subscriptions or securities of a newly formed entity to no more than five persons as part of its initial capitalization. *70 Pa. Stat. Ann. § 1-203.*

In most other states the availability of an exemption relating to preorganization subscriptions may be meaningful in the process of identifying sources of capital. However, the exemption does not extend to actual sales of the securities, and no funds may be collected in connection with the offers.



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CHAPTER 10 Regulation of Small Business Capital Formation

1-10 Blue Sky Regulation § 10.05

§ 10.05 SEC Rule 504 Offerings Under Blue Sky Laws.

Rule 504 of Regulation D under the Federal Securities Act of 1933ⁿ⁷⁶ creates an exemption from federal registration requirements for limited offers and sales of securities not exceeding \$ 1 million. There are issuer qualifications,ⁿ⁷⁷ and the conditions specified in Rule 501 and Rule 502(a),(c) and (d) applicable to all Regulation D offerings apply with equal force to Rule 504 offerings. However, the conditions contained in Rule 502(c) --limitations on the manner of offering-- and 502(d) --limitations on resale-- do not apply to Rule 504 offerings that are made:

(i) Exclusively in one or more states that provide for the registration of the securities, and require the public filing and delivery to investors of a substantive disclosure document before sale, and are made in accordance with those state provisions... [or]

(iii) Exclusively according to state law exemptions from registration that permit general solicitation and general advertising so long as sales are made only to "accredited investors" as defined in § 230.501(a).ⁿ⁷⁸

Securities offered and sold pursuant to Rule 504 are not federal covered securities, and in most states are not within the ambit of the ULOE or its equivalent.ⁿ⁷⁹ Thus, Rule 504 offerings generally must comply with registration requirements under Blue Sky laws, and indeed, in most cases are subject to registration by "qualification," although in some instances special provision is made to limit the scope of merit review or application of merit guidelines in those states that that engage in the process. The State of Washington, for example, applies only the following among its merit review standards to offerings that qualify for small corporate offering registration in that state:

- Promotional shares, but limiting the escrow requirement that would otherwise apply;
- Loans and material affiliated transactions;
- Options and warrants;
- Impoundment of proceeds;
- Specificity in use of proceeds;
- Unsound financial conditions;

- Preferred stock; and
- Unequal voting rights.ⁿ⁸⁰

To facilitate this process, and with a view to minimizing the burden and expense imposed on small business issuers, many states implemented the Uniform Limited Offering Registration (ULOR) protocol, designed specially for compliance by small business issuers seeking up to \$1 million in capital in conformity with SEC Rule 504.ⁿ⁸¹ ULOR and SCOR may be referenced interchangeably, and both are grounded in use of Form U-7-the SCOR registration form.

State registration of offerings made in reliance on SEC Rule 504 in some states involves a filing by the issuer on Form U-1-the Uniform Application to Register Securities-- accompanied by Form U-7, which serves as the disclosure document in the offering, along with various other documents and materials.ⁿ⁸² More often, however, only Form U-7 and designated attachments or included materials are required. While the filing procedure is not simple, the overarching intent among the states is that it be expedited. Thus, there may be a specific provision for automatic effectiveness or expedited review. In Iowa, for example:

Unless the administrator issues a stop order denying the effectiveness of the registration as provided in [the Act] the registration becomes effective on the fifth business day after the registration has been filed with the administrator, or earlier if the administrator permits a shorter time period between registration and effectiveness.ⁿ⁸³

On the other hand, New Mexico makes clear that the issuer should expect comments and questions concerning the answers set forth in Form U-7, and that changes may be required to be made before the registration is declared effective.ⁿ⁸⁴ Once effective, by whatever procedure, Form U-7, when used for registration of offerings exempt under Rule 504 of Regulation D may be used in lieu of the offering circular or other disclosure document or documents that would otherwise be required.ⁿ⁸⁵

In the wake of NSMIA, state authority to regulate capital formation activities through securities registration requirements is largely confined to offerings carried out in reliance upon the federal exemption accorded by Rule 504 of Regulation D, although in states without the ULOE or an equivalent, SEC Rule 505 and Regulation A offerings also remain subject to that authority. Much has been accomplished to ease the burden of small issuers who remain subject to state Blue Sky registration authority, and to support their ability to access capital efficiently. Nevertheless, if the only practical means of securing an exemption from federal registration requirements is Rule 504 of Regulation D, the small business issuer must, in most cases, face the burden of registration by qualification. The burden is ameliorated only to the extent that SCOR procedure is available, and the extent to which, if any, a state has made special provisions for small business capital formation beyond acceptance of Form U-7 as the required form of registration statement and offering document.

Rule 504, as with each of the exemptions available under Regulation D, is non-exclusive. A small business issuer may rely on any other applicable federal exemption, including section 4(2), outside of Regulation D, or more often, section 3(a)(11), the intrastate offering exemption. Many small offerings will qualify for more than one federal exemption. Nevertheless, an offering exempt under any of these provisions remains subject to state registration requirements unless a coordinate exemption is available. Even though Form U-7 will likely be available in the states for small issuers relying on these other federal exemptions, the flexibility afforded by Rule 504 in regard to the number and nature of purchasers will in many cases outweigh any other limitations in those situations in which the offering is subject to state registration in any event.

FOOTNOTES:

(n1)Footnote 76. 17 C.F.R. § 230.504.

(n2)Footnote 77. To be eligible to use Rule 504 the issuer may not be a reporting company under the Federal Securities Exchange Act of 1934, an investment company, or a development stage company with no specific business plan, or if it has a business plan to engage in an unidentified merger or acquisition.

(n3)Footnote 78. 17 C.F.R. § 230.504(b)(1)(i), (iii).

(n4)Footnote 79. *But see* Indiana: 710 Ind. Admin Code § 1-13-6(d) (The Indiana ULOE incorporates SEC Rule 504 offerings, subject to certain conditions).

(n5)Footnote 80. Wash. Admin. Code § 460-17A-070.

(n6)Footnote 81. *See, e.g.,* New Hampshire: N.H. Rev. Stat. § 421-B-15-a ("Uniform Limited Offering Registration").

The history and other aspects of ULOR are discussed in Chapter 8 ("Exempt Issuer Transactions"), *supra*.

(n7)Footnote 82. *See, e.g.,* Illinois: Ill. Admin. Code Sec. 130.525. Materials to be filed in addition to Forms U-1 and U-7 include:

- A copy of any selling agency agreement;
- The issuers articles of incorporation or charter documents
- The issuer's by-laws;
- Directors' resolutions relating to the offering;
- Advertising and sales materials;
- Opinion of counsel concerning legality of the securities being issued;
- Any subscription agreement;
- Financial statements, which in some cases must be audited;
- Various consents; and
- Certain worksheets and undertakings.

(n8)Footnote 83. Code Ia. § 507.207A ("Expedited Registration by Filing for Small Issuers").

(n9)Footnote 84. *See* N.M. Admin. Code, Sec. Div. Rule 12.11.10.14.

(n10)Footnote 85. *See, e.g.,* Ohio Admin. Code Rule 1301:6-3-09(D), which provides that notwithstanding requirements applicable to registered offerings generally:

[A]n issuer relying on Rule 504 of Regulation D of the Securities and Exchange Commission may use Form U-7 of the North American Securities Administrators Association in lieu of the offering circular or other disclosure document or documents required by [the Rules].



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CHAPTER 10 Regulation of Small Business Capital Formation

1-10 Blue Sky Regulation § 10.06

§ 10.06 Integration and Continuing Capital Formation

Integration of securities offerings occurs when separate sales of securities by an issuer are deemed to be part of "an issue." Integration operates to make separate sales of securities part of the same offering, and when it occurs the consequences are generally negative for issuer that have relied upon exemptions from federal or state registration that are based upon limitations that are exceeded or violated as a result of the integration of two or more offerings.

The process of small business capital formation is often carried out in stages, proceeding initially from "seed" capital to broader financing initiatives. While such stages may be quite separate and distinct undertakings, they may in some cases be seen as in fact part of a single plan of financing. In other situations an *abandoned* initiative, such as a registered offering in a state in reliance undertaken in reliance upon Rule 504 of Regulation D at the federal level that is abandoned and later followed by another form of limited or private offering in the state, may raise the prospect of integration. In such cases the abandoned registered offering might be considered a part of the later limited or private offering, so as to preclude availability of an exemption for the latter.

To determine whether ostensibly separate securities offerings should be integrated, several elements have been developed by which administrators assess whether there are compelling reasons to treat either a prior or subsequent sale or offering as part of another offering. The elements to be considered are:

- (a) Whether the sales are part of a single plan of financing;
- (b) Whether the sales involved issuance of the same class of security;
- (c) Whether the sales are made at or about the same time;
- (d) Whether the same type of consideration is received; and
- (e) Whether the sales are made for the same general purpose.ⁿ⁸⁶

For offerings made in reliance upon any of the provisions of Regulation D under the Federal Securities Act of 1933, integration is specifically addressed in SEC Rule 502(a),ⁿ⁸⁷ which provides:

All sales that are part of the same Regulation D offering must meet all of the terms and conditions of Regulation D. Offers and sales that are made more than six months before the start of a Regulation D

offering or are made more than six months after completion of a Regulation D offering will not be considered part of that Regulation offering, so long as during those six month periods there are no offers or sales of securities by or for the issuer that are of the same or a similar class as those offered or sold under Regulation, other than those offers or sales of securities under an employee benefit plan as defined in Rule 405 under the Act.

The question of integration for purposes of Regulation D offerings is otherwise a factual one, determined on the same elements identified above as are applied at the state level. However, consistent with the mission of Regulation D to provide for "safe harbors," the Rule 502(a) six month forward and backward looks makes possible a more objective assessment. State level assessments are more difficult.

In many instances of small business capital formation, initial or "seed" capital may be raised via an available state *de minimis* or other limited issuer exemption that affords maximum freedom in selling securities to a small number of people in circumstances that satisfy criteria for the intrastate offering exemption at the federal level. The operative notion is that initial capital formation is a discrete event, and not part of a continuing process. In practical terms, however, the process may actually proceed on a continuum, and the consequences of integration become apparent when subsequent sales of securities made ostensibly in reliance upon the same or another combination of federal and state exemptions are determined to be part of the same or "single" issue, for which the combined components do not qualify for an exemption.

Integration must, therefore, be carefully considered in any capital formation initiative. The exemptions from state and federal registration procedures are based upon specific sets of circumstances in which there is either no need for the protection afforded by the registration process, or in which the objective is accomplished by other means. However, as a cautionary note to Regulation D of the federal Securities Act makes clear:

In view of the objectives of these rules and the policies underlying the Act, Regulation D is not available to any issuer for any transaction or chain of transactions that, although in technical compliance with these rules, is part of a plan or scheme to evade the registration provisions of the Act. In such cases, registration under the Act is required.ⁿ⁸⁸

In the exercise of their enforcement authority state securities regulators will examine a series or chain of transactions in the same manner. Additionally, individual state exemptions themselves may contain an integration element in regard, for example, to the manner of counting purchasers in determining compliance with the numerical limitations on purchasers.ⁿ⁸⁹

Small business issuers must also be aware of special considerations for integration regarding an abandoned offering. As noted above, limitations on the number of offerees or purchasers in connection with various state level exemptions may provide for integration of *all* offers within a specified period, regardless of whether any sales actually took place. The decision to abandon a particular capital formation initiative does not mean that the small business issuer is free to pursue a subsequent effort without regard to the prior abandoned one. Each state exemption on which an issuer relies must be examined closely to determine whether any prior activity impacts the current availability of that exemption.

At the federal level the Securities and Exchange Commission has taken steps to lessen uncertainty regarding integration where abandoned registered or private offerings are either followed by or preceded another registered or private offering. In Rule 155ⁿ⁹⁰ under the Federal Securities Act of 1933 a "safe harbor" is established for issuers. Under Rule 155, an abandoned private offering followed by a registered offering, or conversely, and abandoned registered offering followed by a private offering will not be integrated when certain criteria are satisfied. Small business capital formation will not likely involve any registered offering under the federal Act, however, and the Rule 155 criteria afford no help to issuers in those circumstances in which only exempt transactions are involved. As an accommodation for multi-state offerings conducted pursuant to Rule 504, however, offers and sales may also be made in states that do not require

registration and use of an offering circular, provided purchasers in those states without such requirements also receive the offering circular prior to any sales being made to them, *see* 17 C.F.R. § 230.504(b)(1)(ii).

FOOTNOTES:

(n1)Footnote 86. *See, e.g.*, Ore. Admin. Rule 441-65-090(1); *see also* Securities Act Rel No. 33-4552 (Nov. 6, 1962).

(n2)Footnote 87. 17 C.F.R. § 230.502(a).

(n3)Footnote 88. Preliminary Note 6, Federal Securities Act of 1933, Regulation D.

(n4)Footnote 89. In Pennsylvania, for example, the "isolated transaction exemption" for an issuer requires that offers be made to no more than 90 in the state during a 12 month period, and that all prior offers made within the preceding 12 months in reliance upon another limited offering exemption must be included, *see* Pa. Code § 203.189(a),(c).

(n5)Footnote 90. 17 C.F.R. § 230.155.



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CHAPTER 11 Regulation of Intermediaries: Broker-Dealers, Investment Advisers and Associated Persons

2-11 Blue Sky Regulation 11.syn

§ 11.syn Synopsis to Chapter 11: Regulation of Intermediaries: Broker-Dealers, Investment Advisers and Associated Persons

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CHAPTER 11 Regulation of Intermediaries: Broker-Dealers, Investment Advisers and Associated Persons

2-11 Blue Sky Regulation § 11.01

§ 11.01 Intermediary Regulation Generally

In Chapters 5 and 6, registration and other elements of Blue Sky regulation in the distribution of securities were examined. Although the role of state securities regulation in the distribution of securities is significantly diminished in the wake of the National Securities Markets Improvement Act of 1996 ("NSMIA"),ⁿ¹ the mission of state Blue Sky laws to regulate the quality and conduct of market *intermediaries* who engage in business of selling securities or advising others in regard to their purchases has taken on greater importance. Indeed, as to investment advisers and their agents, NSMIA shifted registration and regulatory authority over large numbers of smaller investment advisers who no longer meet quantitative business requirements for registration with the U.S. Securities and Exchange Commission under the Investment Advisers Act of 1940.ⁿ² As for broker-dealers and securities salespersons, NSMIA addressed certain practical elements of individual state regulation in a nationally mobile society, and mandated uniformity in various operational and capital requirements.ⁿ³ However, the important licensing and qualification standards imposed by the states were left fully intact, along with all antifraud enforcement powers. It can be fairly said that in the post-NSMIA era, intermediary regulation has become the central feature of state securities law.

Here and throughout this chapter "intermediary" is the functional descriptor for brokers, dealers, broker-dealers, investment advisers, representatives, agents, salespersons, associated persons and any other functionary by which or through whom securities transactions are made or facilitated. On a larger scale, intermediaries range from entire markets themselves to clerical assistants in the office of an independent financial planner. Mutual funds (investment companies), insurance companies offering investment products and banks are all intermediaries, and to varying degrees they and other financial institutions are subject to regulation under federal and state securities laws. For state securities administrators, however, the focus day-to-day is on broker-dealers, investment advisers and their respective representatives or associated persons who interface with citizen investors, and who by their position may cheat, mislead or otherwise abuse a trust placed in them.

Consistent with the historic paternalistic mission of state Blue Sky laws, intermediary regulation by states has always been grounded in qualitative standards for *licensing* of those persons who, functionally, "engage in business" as such. The Uniform Act,ⁿ⁴ for example, simply defines "broker-dealer" as: "[A]ny person engaged in the business of effecting transactions in securities for the account of others or for his own account."ⁿ⁵ To be sure, there are several exclusions from the definition,ⁿ⁶ but, subject to application of the "engaged in the business" element, the functional definition is broad enough to reach a variety of non-traditional market intermediaries. Similarly, the definition of "investment adviser" that is widely adopted among the states brings within state regulatory authority any person who, for

compensation, engages in the business of advising others as to the value of securities, or the advisability of investing in or purchasing securities.ⁿ⁷ And an "agent" of either a broker-dealer or investment adviser is defined in terms of a "representative" effecting or attempting to effect purchases or sales of securities, or, where advisers are involved, a supervised person advising others as to purchases and sales or investments generally. State licensing requirements for individuals acting as agents are commonly phrased in terms of "salespersons" in the broker-dealer setting, and "investment adviser representatives" in that context.ⁿ⁸

The dual system of federal-state regulation of intermediaries involves both "registration" and licensing. Registration of intermediaries is a function of federal law, for broker-dealers under section 15(a) of the Securities Exchange Act of 1934,ⁿ⁹ and for investment advisers under section 203 of the Investment Advisers Act of 1940.ⁿ¹⁰ "Registration" of a broker-dealer with the SEC under the federal securities laws does not equate with licensing as a matter of state law. The SEC does not "license" broker-dealers or investment advisers. For broker-dealers, the Exchange Act and SEC rules adopted under it provide only for a registration application process but prescribe no qualitative standards or criteria upon which an application for registration is to be evaluated. Once an application on Form BD is filed, the SEC is empowered under section 15(b) of the Exchange Act formally to "institute proceedings" within a specified period of time in which to determine whether registration should be denied. Otherwise, if "requirements" are satisfied, registration must be granted.ⁿ¹¹ For investment advisers, the process is much the same under the Investment Advisers Act of 1940.

"Licensing" is the principal mechanism of state regulation of market intermediaries. Broker-dealers, investment advisers, salespersons and representatives must, absent an exemption, be licensed in each state in which the intermediary does business. Licensing of intermediaries has certain key components. For broker-dealers to become licensed, there are particular financial responsibility, organizational and operational requirements which they must meet. For individuals who are associated with broker-dealers or investment advisers in managerial or supervisory positions, there are examination requirements, as is also the case with salespersons and investment adviser representatives. Significant interpretive issues may arise in the assessment of what persons associated in some capacity with an intermediary are subject to licensing requirements. Investment advisers, for example, often enter into arrangements with "solicitors" who interact with potential advisory clients and make compensated referrals. In both broker-dealer and investment adviser settings, clerical and support staff may have meaningful interactions with investment or advisory clients that must be evaluated under "engaged in the business" definitions in Blue Sky laws. These particular issues are considered in more detail elsewhere.ⁿ¹²

Licensing under Blue Sky laws also involves an application process built around SEC Form BD and, for investment advisers, SEC Form ADV. The essential components of licensing are (1) demonstrated competency and (2) application of a qualitative standard. Competency is demonstrated by passing a National Association of Securities Dealers, Inc. (NASD) examination applicable to the position and nature of securities activities of the person involved or, alternatively, where investment adviser representatives are involved, by attaining certain professional designations or qualifications. Typical qualitative standards involve a determination of "good business repute" or some like assessment based upon a review of one's prior securities activities and the presence or absence of issues reflecting on character and conduct.ⁿ¹³ As part of the licensing process states also impose operational and financial responsibility requirements. However, the fundamental distinction between state and federal processes is the qualitative assessment made by state administrators whether to grant the privilege to engage in business as a securities intermediary within their borders.

Once licensed, broker-dealers, investment advisers and their respective representatives remain subject to continuing state regulatory authority, including continuing financial responsibility as applicable, financial reporting, periodic inspections, and the full range of administrative and antifraud enforcement powers provided under Blue Sky laws. As to the last of these, NSMIA made clear that state securities regulators retain antifraud enforcement authority over all broker-dealers, investment advisers and their respective representatives within their state without regard to federal preemption of other aspects of regulatory authority.ⁿ¹⁴ NSMIA also assured the ability of the states to require initial and renewal fee payments and "notice" filings for those intermediaries otherwise exempt from registration and licensing requirements in a particular state. Thus, SEC-registered investment advisers remain subject to notice filing, annual

renewal procedures, and payment of fees to states in which they engage in business.ⁿ¹⁵

Limitations on the scope of state regulation of intermediaries come by way of NSMIA preemption and by statutory exemptions. NSMIA imposed certain limitations with the goal of achieving uniformity in state and federal regulation, and also to eliminate unnecessary state intrusion in the dynamics of national markets in instances where there is no genuine need. Thus, NSMIA limits the ability of a state to regulate *de minimis* transactions by associated persons of a broker-dealer. The effect of the limitation is to permit representatives of licensed broker-dealers to effect transactions for existing customers in other states without being licensed in those states. There are meaningful requirements for this limitation on state authority to apply.ⁿ¹⁶ However, the objective of permitting continuity of service to a transient client population is clear enough, and legitimate state regulatory objectives are seen as being met through home state compliance.

State Blue Sky laws themselves expressly exempt several categories of persons from the key definitions. As noted earlier, for example, section 401(c) of the Uniform Act excludes several functional and institutional categories of persons from the definition of broker-dealer. Likewise, all state laws prescribe exclusions from the definition of "investment adviser" for certain institutions, professionals and others whose advisory activities are either secondary to other activities, or which are of a nature or scope as not to amount to being engaged in the business.ⁿ¹⁷ Even where not excluded from the definition of broker-dealer or investment adviser, intermediaries may be expressly exempt from licensing requirements based upon the scope of securities activities or the particular type of transactions in which the intermediary is involved. Some states, for example,ⁿ¹⁸ have adopted variants of section 202 of the Revised Uniform Act, which provides exemptions from the broker-dealer registration requirements for certain intermediaries who have no place of business in the state and meet other limiting criteria such as dealing exclusively with institutional investors.ⁿ¹⁹ And, after NSMIA, SEC-registered investment advisers are exempt from state registration and licensing (other than notice filing and fee payments) so long as they remain eligible for registration under the Investment Advisers Act of 1940. Other statutory exemptions operate to exclude certain investment adviser representatives whose business is limited to a small number of clients and is otherwise limited in scope.

The burden of compliance by intermediaries with registration and licensing requirements in and among states has been lessened considerably, and the efficiency of regulation significantly raised, by the degree of process uniformity that has been achieved. The universal adoption of SEC Form BD as a uniform application for registration as a broker-dealer; the use of SEC Form ADV for registration of investment advisers; and the use of Form U-4, as the universal base form for registration and licensing of representatives, all combine with the automated processes made possible by the Central Registration Depository (CRD) and the Investment Adviser Registration Depository (IARD) to streamline multiple state compliance in a national market setting.ⁿ²⁰ A central examining authority is responsible for the administration of all securities industry qualification tests, and the examination requirements themselves are today substantially uniform among the states.

For broker-dealers, uniformity in regulation of important financial responsibility and operational requirements has been achieved under NSMIA, which, among other things, established a national standard for net capital requirements. States may not impose net capital requirements on broker-dealers that are different from or that add to those applicable as a matter of federal law.ⁿ²¹ Uniformity is also mandated for broker-dealer and investment adviser books and records requirements, to the extent that no state may require an intermediary to maintain more than what is required in the state in which the intermediary is licensed and maintains its principal place of business.ⁿ²²

The dual federal-state system of intermediary regulation is thus today, more than ever before, a *coordinate* system of registration, licensing and enforcement authority.ⁿ²³ Before considering all aspects of Blue Sky law in this system in greater detail, however, it is also necessary to understand the important role of self-regulation in the process. As briefly discussed earlier, federal registration of broker-dealers includes the requirement of Exchange Act Rule 15b7-1 that all associated persons who effect or are involved in effecting securities transactions be registered or approved in accordance with the standards of training, experience, competence and other qualification standards established by the

rules of a self-regulatory organization or national securities exchange of which the broker-dealer is a member. Taken together, the effect of coordinate provisions in federal and state securities laws and their respective rules is a mandate that all broker-dealers licensed in a state be members of the National Association of Securities Dealers, Inc. (NASD). The NASD, as the only "registered securities association" in operation under provisions of section 15A of the Securities Exchange Act of 1934,ⁿ²⁴ is itself charged under the Act with establishing and enforcing rules which, among other things, are designed to prevent fraud, promote just and equitable principles of trade, and, in general, to protect investors and the public interest.ⁿ²⁵

Collectively, FINRA and the national securities exchanges are Self-Regulatory Organizations (SROs), which focus on business practices and conduct of members and associated persons, as well as supervision of associated persons. They are membership organizations, selective in accordance with their own constitutions, by-laws and established standards. Through FINRA-administered mechanisms, "registration" of various classes of securities industry functionaries is accomplished by a series of qualifying examinations. All SROs have conduct rules under which their members and associated persons are bound to act, and the rules are enforced through ongoing inspections along with structured administrative and adjudicative processes. In this the SROs are fully subject to SEC oversight powers established under the Exchange Act.ⁿ²⁶

As a matter of state regulation of intermediaries, self-regulation plays a particularly important role by encompassing within the membership and ongoing operational and business conduct requirements large numbers of small broker-dealers and their "registered representatives" operating on a local or regional basis, as well as representatives who may be resident and conducting business in the state but whose affiliation is with a broker-dealer having no other meaningful presence in the state. FINRA membership entails important supervisory responsibilities of members over the conduct of business by representatives, and state securities administrators rely on the system of self-regulation not only as a critical adjunct in the administration of their own laws and regulations, but also as adding a large measure of investor protection. As a practical matter, state administrators are dependent upon the strength and efficiency of self-regulation in the allocation of their limited resources. In the entire scheme of state regulation of intermediaries the role of self-regulation should be neither missed nor overestimated.

Against this backdrop, this chapter examines the mechanics of Blue Sky regulation of intermediaries. The licensing process for broker-dealers, investment advisers and their respective representatives or associated persons, in addition to the scope of state licensing authority in that process, is considered. Ongoing, or post-licensing, compliance requirements are also addressed. Although some aspects of administrative and enforcement authority regarding intermediaries are discussed here, fuller consideration of those areas appears elsewhere in the treatise.ⁿ²⁷

FOOTNOTES:

(n1)Footnote 1. "NSMIA" here and throughout this chapter and treatise refers to the National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996), which re-defined state and federal securities regulatory authority, and substantially preempted state authority over distributions of securities that are national in character. The scope of federal preemption in this area is fully considered in Chapters 5 and 6, *above*, which examine the extent of remaining state authority in securities registration and merit regulation processes. As discussed below, however, NSMIA left the role of the states in *intermediary* regulation, that is, regulation of broker-dealers, salespersons, investment advisers and their associated persons, largely untouched. Indeed, as to investment advisers and their agents, the role of state regulation was in fact substantially advanced.

(n2)Footnote 2. By adding new section 203A, NSMIA amended the Investment Advisers Act of 1940 to preempt state regulation of investment advisers with more than \$25 million in client assets under management, as well as all advisers to investment companies that are registered under the Investment Company Act of 1940, 15 U.S.C. § 80a-1, *et seq.* Conversely, investment advisers falling below the threshold assets under management test no longer qualify for SEC registration, and regulatory authority has been shifted to the states. Note, however, as discussed below, that all investment adviser *representatives* are subject to state regulatory authority regardless of federal preemption as to the

adviser itself.

(n3)Footnote 3. National standards in these areas, and the uniformity mandated by NSMIA generally, are *considered in more detail in § 11.02[1]*.

(n4)Footnote 4. As used throughout this chapter and treatise, the "Uniform Act" refers to the Uniform Securities Act, as promulgated by the National Conference of Commissioners on Uniform State Laws in 1956. The Uniform Act has been substantially adopted in a majority of states. The Uniform Act was revised in 1985, with that version thereafter referred to as the Revised Uniform Act. The Revised Uniform Act was incorporated piecemeal into a small number of state Blue Sky laws. The Uniform Act was again completely revised in 2002, and is now the Uniform Securities Act (2002), which has been adopted in several states, and is under consideration in a number of others. In this chapter and elsewhere in the Treatise, the Uniform Securities Act (2002) is referred to as the "2002 Uniform Act."

(n5)Footnote 5. Unif. Sec. Act § 401(c).

(n6)Footnote 6. Section 401(c) excludes from the definition of broker-dealer:

(1) an agent, (2) an issuer, (3) a bank, savings institution or trust company, or (4) a person who has no place of business in this state if (A) he effects transactions in this state exclusively with or through (i) the issuers of the securities involved in the transactions, (ii) other broker-dealers, or (iii) banks, savings institutions, trust companies, insurance companies, investment companies as defined in the Investment Company Act of 1940, pension or profit-sharing trusts, or other financial institutions or institutional buyers, whether acting for themselves or as trustee, or (B) during any period of twelve consecutive months he does not direct more than fifteen offers to sell or buy into this state in any manner to persons other than those specified in clause (A), whether or not the offeror or any of the offerees is then present in this state.

(n7)Footnote 7. Section 401(f) of the Uniform Act defines "investment adviser" as:

[A]ny 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. ...

This definition restates that contained in section 202(a)(11) of the Investment Advisers Act of 1940, *15 U.S.C. § 80b-2(a)(11)*, which is now the benchmark definition in all state laws as well. However, in several states, particularly those adopting the 2002 Uniform Act, the definition of investment adviser is broadened to include "financial planners" or other persons who "as an integral component of other financially related services, provides investment advice to others for compensation as part of a business that holds itself out as providing investment advice to others for compensation." 2002 Unif. Sec. Act § 102(15).

(n8)Footnote 8. Blue Sky law definitions of "investment adviser representative" are commonly grounded in the definition of "person associated with an investment adviser" set forth in section 202(a)(17) of the federal Investment Advisers Act of 1940, *15 U.S.C. § 80b-2(a)(17)*. Thus, for example, Section 102(16) of the 2002 Uniform Act defines investment adviser representative as:

[A]n individual employed by or associated with an investment adviser or federal covered adviser and who makes any recommendations or otherwise gives investment advice regarding securities, manages accounts or portfolios of clients, determines which recommendation or advice regarding securities should be given, provides investment advice or holds herself or himself out as providing investment advice,

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receives compensation to solicit, offer, or negotiate for the sale of or for selling investment advice, or supervises employees who perform any of the foregoing.

The "solicit" reference is not contained in the federal definition of investment adviser representative, and is a matter dealt with under federal law with specific rules governing solicitors. State securities laws approach the "solicitor" matter in different ways, in many cases adopting the federal rules governing solicitors rather than including them directly in the definition as in the 2002 Uniform Act.

Several states have adopted the definition of "investment adviser representative" contained in SEC Rule 203A-3 under the Investment Advisers Act of 1940, 17 C.F.R. § 275.203A-3(a). The variations among state definitions are *considered in more detail in § 11.03[3]*.

(n9)Footnote 9. 15 U.S.C. § 78o(a). Excluding a broker-dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange, section 15(a) makes it unlawful for any broker-dealer to make use of means or instrumentalities of interstate commerce to effect transactions in or to attempt to induce transactions in non-exempted securities without being registered with the SEC.

(n10)Footnote 10. 15 U.S.C. § 80b-3.

(n11)Footnote 11. Requirements necessarily include submission of all information and documents required by Form BD, which in turn incorporates operational requirements prescribed by the SEC in rules under section 15 of the Exchange Act, including Rule 15b7-1 regarding compliance with "qualification requirements of self-regulatory organizations." 17 C.F.R. § 240.15b7-1. The combined effect of statutory authority and SEC rules, among other things, is to require that associated persons of the broker-dealer seeking registration meet qualification standards established by national securities exchanges or FINRA. The interplay of self-regulatory organizations in federal and state intermediary regulation is discussed further below.

The SEC may also deny an application for registration as a broker-dealer if it appears that the applicant, if registered, would be subject to suspension or revocation under section 15(b)(4) of the Act. Disqualifying criteria under this section include false or misleading statements in the application, certain criminal convictions, other administrative proceedings, and violations of the securities laws generally.

(n12)Footnote 12. *See § 11.03[3]*.

(n13)Footnote 13. Particular state standards are *considered in more detail in § 11.04[3]*. The Uniform Act provides, among other criteria, that an administrator may deny an application for licensing as a broker-dealer or investment adviser on a determination that the applicant or any of its principals "has engaged in dishonest or unethical practices in the securities business," or "is not qualified on the basis of such factors as training, experience and knowledge of the securities business." Unif. Sec. Act § 201(a).

(n14)Footnote 14. Regarding broker-dealers, for example, section 18(c) of the Securities Act of 1933, which was added in NSMIA's complete revision of section 18, provides for the preservation of state authority as follows:

(1) Fraud authority--Consistent with this section, the securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions.

(n15)Footnote 15. Section 222(a) of the Investment Advisers Act, 15 U.S.C. § 80b-18a(a), provides:

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Nothing in this title shall affect the state of the securities commissioner (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this title or the rules and regulations thereunder.

Blue Sky laws and regulations today combine to require that investment advisers registered with the SEC must make annual notice filings with state administrators typically comprised of copies of all forms and papers filed by the adviser with the SEC, along with an annual fee and consent to service of process.

(n16)Footnote 16. The "*de minimis*" limitation on state licensing authority is considered further in §§ 11.02[1]-[2].

(n17)Footnote 17. Section 401(f) of the Uniform Act provides in pertinent part:

"Investment adviser" does not include (1) a bank, savings institution or trust company; (2) a lawyer, accountant, engineer or teacher whose performance of these services is solely incidental to the practice of his profession; (3) a broker-dealer whose performance of these services is solely incidental to the conduct of his business as a broker-dealer and who receives no special compensation for them; (4) a publisher of any bona fide newspaper, news magazine, or business or financial publication of general, regular and paid circulation; (5) a person whose advice, analyses, or reports relate only to securities exempted by section 402(a)(1); (6) a person who has no place of business in this state if (A) his only clients in this state are other investment advisers, broker-dealers, banks, savings institutions, trust companies, insurance companies, investment companies as defined in the Investment Company Act of 1940, pension or profit-sharing trusts, or other financial institutions or institutional buyers, whether acting for themselves or as trustees, or (B) during any period of twelve consecutive months he does not direct business communications into this state in any manner to more than five clients other than those specified in clause (A), whether or not he or any of the persons to whom the communications are directed is then present in this state; or (7) such other persons not within the intent of this paragraph as the [Administrator] may by rule or order designate.

(n18)Footnote 18. *See, e.g.:*

Colorado: Colo. Rev. Stat. § 11-51-402(1).

Nevada: Nev. Rev. Stat. § 90.320(1).

Rhode Island: R.I. Gen. Laws § 7-11-202(a).

(n19)Footnote 19. Rev. Unif. Sec. Act (1985) § 202(a)(1). Particular exemptions from broker-dealer licensing requirements are *considered in detail in § 11.02[2]*.

(n20)Footnote 20. The CRD, discussed further in § 11.02[3] (Broker-Dealer Licensing Procedures), is an electronic database and filing system for broker-dealers and registered persons. The system is operated by the Financial Industry Regulatory Authority (FINRA) under an agreement with the North American Securities Administrators Association (NASAA). For investment advisers, the IARD, permits investment advisers and investment adviser representatives to satisfy filing obligations under state and federal laws by making a single electronic filing. Information stored in the CRD and IARD is accessible by the general public through the Internet.

(n21)Footnote 21. Section 15(h)(1) of the Exchange Act, 15 U.S.C. § 78o(h)(1), added by NSMIA, prohibits states from imposing minimum capital and bonding requirements on broker-dealers that differ from or are in addition to the

requirements established under the Exchange Act. Section 222(c) of the Investment Advisers Act, *15 U.S.C. § 80b-18a(c)*, establishes the same limitation on state authority as to investment advisers, with the baseline being the requirements in place in the state in which the adviser is licensed and has its principal place of business. Net capital and other financial responsibility requirements applicable to broker-dealers, and intermediaries generally, are considered further in § 11.02[3][c].

(n22)Footnote 22. *See* Investment Advisers Act § 222(b), *15 U.S.C. § 80b-18a(b)*.

(n23)Footnote 23. Section 15(a)(1) of the Securities Exchange Act of 1934, *15 U.S.C. § 78o(a)(1)*, excludes any broker-dealer whose business is exclusively intrastate from registration requirements under federal law. A purely intrastate broker-dealer is increasingly a rarity. Nevertheless, in such cases regulation is entirely a matter of state law.

(n24)Footnote 24. *15 U.S.C. § 78o-3*.

(n25)Footnote 25. Under section 6 of the Exchange Act, *15 U.S.C. § 78f*, registered national securities exchanges have the same rulemaking and enforcement responsibility regarding the conduct of their members and associated persons.

(n26)Footnote 26. *See* Exchange Act section 19, *15 U.S.C. § 78s* (Registration, responsibilities and oversight of self-regulatory organizations).

Note, however, that under the federal regulatory structure there is presently no provision for any SRO for investment advisers, and none exists.

(n27)Footnote 27. *See* Chapter 14 (Administration and Enforcement).



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Blue Sky Regulation

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CHAPTER 11 Regulation of Intermediaries: Broker-Dealers, Investment Advisers and Associated Persons

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§ 11.02 Licensing of Broker-Dealers and Associated Persons

[1] Preliminary Licensing Considerations

Broker-dealer regulation generally, and state licensing requirements in particular, are conduct-driven. As defined in the Uniform Act, "broker-dealer" means "[a]ny person engaged in the business of effecting transactions in securities for the account of others or for his own account."¹ An "agent" under the Uniform Act is defined to be any individual "who represents a broker-dealer or issuer in effecting or attempting to effect purchases or sales of securities."² Other definitions in place among the states address securities "salesperson" or "representative" in like functional terms. In Illinois, for example, "salesperson" means:

[A]n individual, other than an issuer or a dealer, employed or appointed or authorized by a dealer, issuer or controlling person to offer, purchase or sell securities in this State.³

Administrative and criminal enforcement activities by state securities regulators focus heavily on conduct amounting to engaging in business as a broker-dealer without being licensed. In many instances persons who assist issuers of securities, or who play integral roles in the offer and sale of securities, provide information and assist investors, or who arrange transactions and receive fees, are subject to broker-dealer licensing requirements.⁴ The scope of conduct driving Blue Sky licensing and enforcement authority in this area is considered elsewhere in the Treatise.⁵ It is essential in any consideration of the specific licensing provisions and processes of Blue Sky laws, however, to appreciate their impact on any intermediary activity that falls within the ambit of extremely broad "engaging in the business" definitions.

Many states have requirements which potential registrants as intermediaries must meet before even filing applications. Some regulations, for example, specify minimum age requirements for persons engaging in the securities business,⁶ and while knowledge of the securities business is always a prerequisite, specific requirements indicating such knowledge may be imposed. For example, minimum experience in the securities business may be required before an application will even be considered. The requirements used to prove such experience differ. In some states, if the applicant is a nonresident individual, she must be registered or qualified to engage in the securities business in the state of her residence, or, if the applicant is an out-of-state corporation, in the state of its principal place of business.⁷ Other states require that applicants have securities experience for a given number of years,⁸ and, in most cases, FINRA membership is a prerequisite.

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A number of general rules are applicable to licensing of salespersons or representatives. First, in most states, not only is it unlawful for an unlicensed person to sell securities, but it is also unlawful for a broker-dealer or issuer to employ an agent who is unlicensed.ⁿ⁹ Further, states generally provide that an agent's registration is valid only while he or she is in the employ of a broker-dealer or issuer,ⁿ¹⁰ and that the appropriate authority must be notified upon the termination of a representative's employment or association by that broker-dealer.ⁿ¹¹

As a general rule, states discourage "dual" licensing, that is, the registration or employment of a representative by more than one broker-dealer,ⁿ¹² and in some states it is simply prohibited.ⁿ¹³ However, there are exceptions. Some states permit dual registration where the broker-dealers or issuers are under essentially the same management and control.ⁿ¹⁴ In some states, dual licensing is permitted with the consent of the principals for whom the agent will be working.ⁿ¹⁵ The concern in all of this is to ensure that responsibility of supervision over the representative or associated person will be assigned, and that supervisory procedures will be in place. Blue Sky laws and regulations generally mandate that broker-dealers must exercise reasonable supervision over the securities activities of their associated persons. Divided responsibility for supervision, though not unworkable in some settings, is undesirable. Thus, in several of the states in which multiple licensing is permitted, a specific request must be addressed to the administrator, and must contain not only the consent of each broker-dealer or employer involved, but also an undertaking that each will be jointly and severally liable for the acts of the dually licensed representative, and also a finding by the administrator that multiple licensing will not impair a determination of the supervisory responsibilities of each employer.ⁿ¹⁶

The Uniform Act provides that "[r]egistration of a broker-dealer automatically constitutes registration of any agent who is a partner, officer, or director, or a person occupying a similar status or performing similar functions,"ⁿ¹⁷ and while a number of states have enacted a comparable provision,ⁿ¹⁸ such provisions usually have no more effect than to relieve the registrants from separate filing, and sometimes separate registration fee, requirements. Notwithstanding whether a given state provides for automatic registration, the agents in that state who are in management positions in a broker-dealer firm may still have to meet other qualifications expected of agents, such as passing a securities examination.ⁿ¹⁹ One state provides for automatic registration of a salesman if the salesman in question is licensed by FINRA to a broker-dealer who is in good standing with FINRA, is employed by a broker-dealer who is licensed in the state, and is not otherwise disqualified by the Blue Sky regulations of that state.ⁿ²⁰

Preliminary licensing considerations most often involve close examination of definitions. For example, although the Uniform Act does not require issuers to be licensed, some states do require licensing of issuers or their associated persons selling their own securities and/or the securities of others.ⁿ²¹ Since registration is required in some situations, and because the Uniform Act excludes issuers from registration by specifying that they are not within the definition of "broker-dealer," identifying the issuer can be important. The Uniform Act provides:

"Issuer" means any person who issues or proposes to issue any security, except that (1) with respect to certificates of deposit, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors or persons performing similar functions or of the fixed, restricted management, or unit type, the term "issuer" means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which the security is issued; and (2) with respect to certificates of interest or participation in oil, gas, or mining titles or leases, or in payments out of production under such titles or leases, there is not considered to be any "issuer."ⁿ²²

The extent to which this definition has been adopted varies,ⁿ²³ and it should be kept in mind that although the Uniform Act does not require issuers to register, agents of issuers, with certain exceptions discussed below, are subject to registration requirements.

[a] Broker-Dealers

Every Blue Sky law provides for the licensing, or "registration," of broker-dealers.ⁿ²⁴ Although "broker-dealer" is broadly defined in terms of any person engaged in the business of effecting transactions for the account of others or her own account, typically several categories of institutions or persons are excluded from the definition. The Uniform Act is illustrative. Section 401(c) provides that broker-dealer does not include:

(1) an agent, (2) an issuer, (3) a bank, savings institution, or trust company, or (4) a person who has no place of business in this state if (A) he effects transactions in this state exclusively with or through (i) the issuers of the securities involved in the transactions, (ii) other broker-dealers, or (iii) banks, savings institutions, trust companies, insurance companies, investment companies as defined in the Investment Company Act of 1940, pension or profit-sharing trusts, or other financial institutions or institutional buyers, whether acting for themselves or as trustees, or (B) during any period of twelve consecutive months he does not direct more than fifteen offers to sell or buy into this state in any manner to persons other than those specified in clause (A), whether or not the offeror or any of the offerees is then present in this state.ⁿ²⁵

The Revised Uniform Act definition, adopted in a handful of states, simplifies the set of exclusions to:

- (i) a sales representative;
- (ii) an issuer, except when effecting transactions other than with respect to its own securities;
- (iii) a depository institution; or
- (iv) any other person the [Administrator], by rule or order, designates.ⁿ²⁶

In the 2002 Uniform Securities Act, which has now been adopted in several states and is under active consideration in others, the exclusions are:

- An agent;
- An issuer;
- A bank or savings institution if its activities as a broker-dealer are limited to those specified in subsections 3(a)(4), 3(a)(5)(B), and 3(a)(5) of the Securities Exchange Act of 1934, *15 U.S.C. Section 78c(a)(5)*, or a bank that satisfies the conditions described in subsection 3(a)(4)(E) of the Securities Exchange Act of 1934, *15 U.S.C. Section 78c(a)(4)*;
- An international banking institution; or
- A person excluded by rule or order.ⁿ²⁷

The exclusion of agents, issuers, and banks, savings institutions, or trust companies from the original definition of "broker-dealer" exists for very straightforward reasons. Agents are distinguished from broker-dealers under the Act just as they are distinguished from principals under common law. Moreover, agents, under the Uniform Act and every state's Blue Sky law, must be licensed in their own right and not as broker-dealers. They do not, however, exist independently. As discussed further below, every agent, whether characterized as a representative, salesperson or associated person, must be licensed in affiliation with at least one broker-dealer that is also licensed in the state.

As previously noted, the Uniform Act does not require the issuer of securities to be registered. Since, subject to exemption or exception, both the security involved and the issuer's agent selling the security must be registered, the requirement of issuer registration would cause a needless duplication of filings. The exclusion granted to banks, savings institutions, or trust companies is based on the extensive regulatory system each state has for such entities.ⁿ²⁸

The Uniform Act also excludes persons who have no place of business in the state and would otherwise be required to register as broker-dealers, except that they are involved in transactions with issuers, broker-dealers and institutional investors. The exclusion for transactions with the issuer of the securities is self-explanatory, since it is unlikely that the issuer would need the full protection of the Blue Sky law. The same is true for transactions with other broker-dealers or with the specified institutional investors. With regard to these latter two groups, the protective provisions of the Uniform Securities Act are limited to its antifraud provisions, since the securities that are the subject of transactions with such purchasers are exempt from registration under the Uniform Act. Thus, neither the out-of-state broker-dealer nor the security is subject to the Uniform Act's registration provisions, as such parties are deemed sophisticated investors who do not require the protection of those provisions.

The final exclusion is also available for persons having no place of business in the state, and who have a number of transactions over and above the number of sophisticated investors. Under the Uniform Act, an out-of-state broker-dealer is permitted to direct up to fifteen offers to buy or sell securities in the Uniform Act state in any twelve-month period without being required to register as a broker-dealer.ⁿ²⁹ However, in computing the number of offers, it does not matter whether or not the offeror or any of the offerees is then present in the state. This rule would allow a broker-dealer in one state to deal with a few out-of-state customers without the necessity of registration. This provision is especially significant for a broker-dealer who has up to fifteen clients in each of several states that have adopted this particular provision of the Uniform Act, since the filing and registration fees can be considerable.

[b] Representatives and Associated Persons

Blue Sky laws vary in the manner of labeling persons associated with a broker-dealer who are engaged in the securities business for purposes of licensing requirements. Whether such persons are identified as "agents," "representatives," or "salespersons," the individual licensing requirements are applicable to any person engaged in covered activities. Because individuals are not normally licensed in sales or representative capacities unless they are associated with a licensed broker-dealer, the common regulatory reference to "representative" or "associated person" is used here to encompass agents and any other label attached to those persons associated with a broker-dealer who are subject to individual licensing.

The Uniform Act and many state laws define "agent" simply as "any individual other than a broker-dealer who represents a broker-dealer or issuer in effecting or attempting to effect purchases or sales of securities."ⁿ³⁰ However, to better understand the scope of intended licensing requirements for individuals, the definition of "representative" adopted by the Financial Industry Regulatory Authority (FINRA) for purposes of its own registration requirements is more useful. Rule 1031 of the FINRA Membership and Registration Rules provides:

Persons associated with a member, including assistant officers other than principals, who are engaged in the investment banking or securities business for the member including the functions of supervision, solicitation or conduct of business in securities or who are engaged in the training of persons associated with a member for any of these functions are designated as representatives.ⁿ³¹

Broker-dealers often confront the issue of who within their organization is subject to individual licensing requirements, and a case-by-case functional assessment in terms of involvement in supervision, actual solicitation activities, or training is necessary. However, Blue Sky laws do in most instances make certain express exclusions from the basic definition. Under the Uniform Act, for example:

"Agent" does not include an individual who represents an issuer in (1) effecting transactions in a security exempted by clause (1), (2), (3), (10), or (11) of section 402(a), (2) effecting transactions exempted by section 402(b), or (3) effecting transactions with existing employees, partners, or directors of the issuer if no commission or other remuneration is paid or given directly or indirectly for soliciting any person in this state. A partner, officer, or director of a broker-dealer or issuer, or a person occupying a similar status or performing similar functions, is an agent only if he otherwise comes within this definition.ⁿ³²

The Uniform Act also excludes "agents of issuers," but not agents of broker-dealers, with respect to certain transactions.ⁿ³³ First among such transactions are those made on behalf of an issuer involving the following exempt securities:

(1) any security (including a revenue obligation) issued or guaranteed by the United States, any state, any political subdivision of a state, or any agency or corporate or other instrumentality of one or more of the foregoing; or any certificate of deposit for any of the foregoing;ⁿ³⁴

(2) any security issued or guaranteed by Canada, any Canadian province, any political subdivision of any such province, any agency or corporate or other instrumentality of one or more of the foregoing, or any other foreign government with which the United States currently maintains diplomatic relations, if the security is recognized as a valid obligation by the issuer or guarantor;ⁿ³⁵

(3) any security issued by and representing an interest in or a debt of, or guaranteed by, any bank organized under the laws of the United States, or any bank, savings institution, or trust company organized and supervised under the laws of any state;ⁿ³⁶

(4) any commercial paper which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which evidences an obligation to pay cash within nine months of the date of issuance, exclusive of days of grace, or any renewal of such paper which is likewise limited, or any guarantee of such paper or of any such renewal; andⁿ³⁷

(5) any investment contract issued in connection with an employees' stock purchase, savings, pension, profit-sharing, or similar benefit plan if the [Administrator] is notified in writing thirty days before the inception of the plan or, with respect to plans which are in effect on the effective date of this act, within sixty days thereafter (or within thirty days before they are reopened if they are closed on the effective date of this act).ⁿ³⁸

An exclusion is also provided for persons representing issuers who effect any transaction which would constitute a transaction exempt from securities registration.ⁿ³⁹ The nature of the exempt securities and exempt transactions is such that the protective purposes of Blue Sky laws are not served by requiring issuer representatives to be licensed in order to sell such securities.

The last exclusion of issuer representatives is for those who effect transactions with current employees, partners, or directors of the issuer on the condition that the agent receives no compensation for soliciting persons in the state. Protection to employees in such a case is provided by the Uniform Act, since offers of securities to employees are not exempt from registration. Consequently, licensing of the person representing the issuer would afford little additional protection.

The definition's final exclusion, of partners, officers, and directors of issuers and broker-dealers who are not otherwise acting as agents, is not surprising. Those who are partners, officers, or directors of a broker-dealer are automatically registered anyway, except in the case of *de minimis* transactions, and logic argues against a separate registration apparatus. Issuers, of course, are not required to be registered under the Uniform Act.

[c] "Finders"

As discussed further below, and as reflected in the 2002 Uniform Securities Act, many states deal with the scope of licensing requirements for agents or sales persons by way of exemptions from the registration requirement rather than exclusions from the basic definition. Whatever the particular statutory scheme, whether by certain activities a person falls within the basic definition of agent or salesperson is a common question. Often, the focus is on persons who act as "finders." The inquiry is well illustrated by the 2009 Colorado Court of Appeals analysis in *Black Diamond Fund, LLP v. Joseph*,ⁿ⁴⁰ in which individuals who facilitated investment transactions and received transaction-based compensation were held to be unlicensed sales representatives.

In *Black Diamond*, an individual located prospective investors, discussed the securities with prospective investors, obtained signed subscription documents and checks, and sent the agreements and checks on to the issuer. The Colorado Securities Commissioner concluded in an administrative proceeding that the individual had acted as unlicensed securities sales representatives, and issued a cease and desist order against them. On an appeal from that order, the Court of Appeals upheld the Commissioner's action, concluding, among other things:

Individuals who solicit investors by phone and in person, and who distribute documents and prepare and distribute sales circulars in the hope that potential investors will deposit money in the account, are seeking to effect securities transactions.ⁿ⁴¹

The fact that the individual did not actually accept subscription agreements was of no consequence. The Court of Appeals agreed with the Commissioner's conclusion that at a minimum, the individual was effecting or attempting to effect sales of securities, which is all that is necessary under the Colorado Blue Sky Law.

Black Diamond also involved the payment of transaction-based compensation--a hallmark of broker status. The administrative record showed that the individual had an oral agreement to receive a 5% fee upon completion of each subscription. He received compensation from the issuer based solely on the amount of securities sold to the parties he had located. The receipt of transaction-based compensation will invariably result in "broker," or as is the case here, agent or sales representative status. The conclusion is supported by a consistent line of SEC No-Action Letters under the parallel broker-dealer registration provisions of the federal securities laws. Compensation is indicative of whether one is a broker because such compensation is triggered by "effecting" a sale.ⁿ⁴² In *Black Diamond*, the court also pointed out that effecting transactions in securities is shown by actively soliciting clients, selling securities to the clients, and participating in securities transactions at key points in the chain of distribution.ⁿ⁴³

Solicitation of potential investors in *Black Diamond* involved "free meal" investment seminars conducted by the finder. So-called "free lunch" and "free dinner" marketing programs have proliferated and are the subject of regulatory scrutiny on various levels. In *Black Diamond*, the seminars were presented to people invited by mail, most of whom had no preexisting relationship with the issuer on whose behalf the finder presented the program. In these circumstances, advertising and general solicitation directly impact the availability of an exemption from registration for the securities themselves, as well as the intermediary licensing questions that inevitably arise when the programs involve an unlicensed presenter.

One state has addressed the "finder" issue directly by rule. Texas defines "finder" as an individual who receives compensation solely for introducing an accredited investor to a company issuing securities and/or introducing an issuer to accredited investors.ⁿ⁴⁴ Finder registration is limited to individuals. A Finder must submit an application on Form BD as a sole proprietor and pay a fee of \$275. The application must be filed in paper form with a cover letter stating that the application is for registration as a finder, and upon approval a certificate will be issued specifically limiting the individual to those activities.

[d] NSMIA De Minimis Limitation

NSMIA added a number of provisions to the Exchange Act which limit the authority of a state to regulate *de minimis* activities of associated persons of a broker-dealer.ⁿ⁴⁵ Persons associated with broker-dealers may effect *de minimis* transactions for existing customers in other states without being licensed in those states. For the limited exemption to apply, however, a person associated with a broker or dealer must not be ineligible to register in the state and must be registered with FINRA and at least one other state, and the broker-dealer must be registered in the state.ⁿ⁴⁶

The exemption applies for transactions on behalf of a customer who has had an account with the broker or dealer for at least thirty (30) days before the transaction, and for which one of two conditions is met. The first condition is that the customer must have been present in the state where the broker-dealer of the associated person is registered for at least thirty (30) consecutive days of the year prior to the transaction. The associated person must have been assigned to that customer for at least fourteen (14) days before the transaction, and must have been registered in the state in which the customer was resident or present for at least thirty (30) consecutive days during any time during the year preceding the transaction.ⁿ⁴⁷ However, this provision is contingent upon the associated person applying for registration in the new state within ten (10) days after the latter of the date of the transaction and the date of discovery of the presence of the customer in the other state for thirty (30) or more consecutive days or the change in the customer's residence.ⁿ⁴⁸

The second condition is that the associated person must have filed an application for registration in the state where the transaction is effected for an existing customer within the preceding sixty (60) days, unless the state has notified the associated person that the application has been denied or stayed for cause.ⁿ⁴⁹

The exemption for *de minimis* transactions by associated persons of a broker-dealer added by NSMIA allows for the movement of existing customers of a broker-dealer from one state to another without the necessity of the customer having to obtain the services of a new registered representative. Most states have amended their statutes and regulations to comply with NSMIA.ⁿ⁵⁰

[2] Exemptions From Licensing Requirements Generally

As introduced above, exemptions or exclusions from state licensing requirements for broker-dealers and representatives are based on either the nature of the broker-dealer's business or the limited extent of business within a particular state. There are variations among Blue Sky laws, as some establish exemptions as such while others make exclusions within key definitions.

The 2002 Uniform Act serves to illustrate the modern, post-NSMIA approach to the exemption of broker-dealers from licensing under Blue Sky laws. As adopted in Georgia, for example, the following broker-dealers are exempt from registration:

(1) A broker-dealer with no place of business in the state if its only transactions effected in the state are with:

(A) The issuer of the securities involved in the transactions;

(B) A person registered as a broker-dealer under this chapter or not required to be registered as a broker-dealer under this chapter;

(C) An institutional investor;

(D) A nonaffiliated federal covered investment adviser with investments under management in excess of \$100 million acting for the account of others pursuant to discretionary authority in a signed record;

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(E) A bona fide preexisting customer whose principal place of residence is not in the state and the person is registered as a broker-dealer under the Securities Exchange Act of 1934, *15 U.S.C. Section 78a, et seq.*, or not required to be registered under the Securities Exchange Act of 1934, *15 U.S.C. Section 78a, et seq.*, and is registered under the securities act of the state in which the customer maintains a principal place of residence;

(F) A bona fide preexisting customer whose principal place of residence is in the state but was not present in the state when the customer relationship was established, if:

(i) The broker-dealer is registered under the Securities Exchange Act of 1934, *15 U.S.C. Section 78a, et seq.*, or not required to be registered under the Securities Exchange Act of 1934, *15 U.S.C. Section 78a, et seq.*, and is registered under the securities laws of the state in which the customer relationship was established and where the customer had maintained a principal place of residence; and

(ii) Within 45 days after the customer's first transaction in this state, the person files an application for registration as a broker-dealer in this state and a further transaction is not effected more than 75 days after the date on which the application is filed, or, if earlier, the date on which the Commissioner notifies the person that the Commissioner has denied the application for registration or has stayed the pendency of the application for good cause;

(G) Not more than three customers in the state during the previous 12 months, in addition to those customers specified in subparagraphs (A) through (F) and subparagraph (H) of this paragraph, if the broker-dealer is registered under the Securities Exchange Act of 1934, *15 U.S.C. Section 78a, et seq.*, or not required to be registered under the Securities Exchange Act of 1934, *15 U.S.C. Section 78a, et seq.*, and is registered under the securities act of the state in which the broker-dealer has its principal place of business; and

(H) Any other person exempted by rule or order;⁵¹ and

(2) A person that deals solely in United States government securities and is supervised as a dealer in government securities by the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, or the Office of Thrift Supervision.⁵²

The 2002 Uniform Act also reflects the post-NSMIA approach to exemptions for agents and representatives from registration requirements. Here again, Georgia is illustrative in its exemption for:

(1) An individual who represents a broker-dealer in effecting transactions in the state limited to those described in Section 15(h)(2) of the Securities Exchange Act of 1934, *15 U.S.C. Section 78(h)(2)*;

(2) An individual who represents a broker-dealer that is exempt under subsection (b) or (d) of Code Section 10-5-30;

(3) An individual who represents an issuer with respect to an offer or sale of the issuer's own securities or those of the issuer's parent or any of the issuer's subsidiaries and who is not compensated in connection with the individual's participation by the payment of commissions or other remuneration based, directly or indirectly, on transactions in those securities;

(4) An individual who represents an issuer and who effects transactions in the issuer's securities exempted by Code Section 10-5-11, with the exception of paragraphs (11) and (14) of that Code section;

(5) An individual who represents an issuer that effects transactions solely in federal covered securities of the issuer, but an individual who effects transactions in a federal covered security under

Section 18(b)(3) or 18(b)(4)(D) of the Securities Act of 1933, 15 U.S.C. Section 77r(b)(3) or 77r(b)(4)(D), is not exempt if the individual is compensated in connection with the agent's participation by the payment of commissions or other remuneration based, directly or indirectly, on transactions in those securities;

(6) An individual who represents a broker-dealer registered in the state under subsection (a) of Code Section 10-5-30 or exempt from registration under subsection (b) of Code Section 10-5-30 in the offer and sale of securities for an account of a nonaffiliated federal covered investment adviser with investments under management in excess of \$100 million acting for the account of others pursuant to discretionary authority in a signed record;

(7) An individual who represents an issuer in connection with the purchase of the issuer's own securities;

(8) An individual who represents an issuer and who restricts participation to performing clerical or ministerial acts; or

(9) Any other individual exempted by rule or order.ⁿ⁵³

This provision reflects the existing pattern of exemptions among the states. Exemptions, or exclusions, for representatives from licensing requirements are based primarily upon activity involving only certain types of transactions or securities which are themselves exempt from Blue Sky registration, or circumstances in which the intermediary activity evokes less regulatory concern. While exempt securities and exempt transactions are not subject to Blue Sky registration, states are divided as to the extent to which statutory exemptions should apply to determine licensing obligations of broker-dealers and representatives. Some, such as Arizona, take the position that any broker-dealer or agent involved exclusively with exempt securities, or in exempt transactions, need not be licensed.ⁿ⁵⁴ Nevertheless, the Arizona Corporation Commission is empowered to require licensing of dealers and salespersons dealing with certain exempt securities or engaging in certain exempt transactions.ⁿ⁵⁵ Pursuant to this authority, the Commission adopted a regulation requiring the registration of dealers engaging in certain transactions involving private offerings, certain isolated transactions, transactions involving certain domestic and foreign governmental securities, transactions involving securities of certain non-profit organizations, and transactions involving securities which are listed on certain stock exchanges or concerning which information appears in a recognized securities manual.ⁿ⁵⁶ However, Arizona exempts from registration dealers or their agents who do not principally and primarily engage in making a "series" of private offerings, i.e., more than four private offerings in any consecutive 12-month period.ⁿ⁵⁷

Other states exempt broker-dealers and representatives from licensing only with respect to exempt transactions,ⁿ⁵⁸ while still others exempt only with respect to exempt securities.ⁿ⁵⁹ Still other states provide no exemption at all. This is the approach of the original Uniform Act.ⁿ⁶⁰ However, an amendment to the Uniform Act does provide exclusions under the Act for persons involved in specified securities transactions,ⁿ⁶¹ and to an extent, this approach has been adopted in several states.ⁿ⁶² These exclusions are generally accomplished by defining "persons"ⁿ⁶³ trading and dealing in securities in various capacities, and then excluding from the definitions persons involved in specified securities transactions.

The area of exemptions or exclusions from broker-dealer and representative licensing based upon exclusive involvement in exempt transactions is perilous for those intermediaries operating in multiple states. As noted earlier, many states provide some form of exemption from licensing requirements for dealers engaged exclusively in transactions with "institutional" investors. Yet, in Ohio, no person *other than an issuer* selling its own securities to institutional investors is exempt from licensing.ⁿ⁶⁴ Thus, variations in key definitions and licensing exemptions must be tracked closely. Blue Sky laws generally establish rights of rescission and other recovery for unlawful transactions, and extend liability to the key participants in the transaction. Intermediaries may be susceptible not only to regulatory action, but also to the full range of private remedies a state securities law may provide. When the unlawful element of a

transaction is a failure in licensing the consequences for an intermediary are multi-dimensional.

[3] Broker-Dealer Licensing Procedures

[a] Filing Requirements

The substantial uniformity in forms required to be filed in the various states for registration of broker-dealers,ⁿ⁶⁵ agents or representativesⁿ⁶⁶ and, where required, investment advisers,ⁿ⁶⁷ has been of great benefit to those who wish to be registered in a number of states. Transaction costs for these filings are relatively low. Moreover, the development of the Central Registration Depository (CRD)ⁿ⁶⁸ has made work in this area simpler. In addition to the principal form(s) required by each state, a number of supplemental forms and documentsⁿ⁶⁹ are also usually required, as are requirements for submission of photographs and/or fingerprints.

There are also filing fees. Initial applications for broker-dealer, agent, and investment adviser must be accompanied by the required filing or registration fee. Similarly, fees are required to be paid for renewal of broker-dealer, agent, and investment adviser registration, although the renewal fees in many states are lower than initial fees.ⁿ⁷⁰

States differ on the issue of whether fees are refundable when an application is withdrawn or denied.ⁿ⁷¹ Without stating a specific amount, the Uniform Act recommends that a portion of the fee be refunded in such cases.ⁿ⁷² However, a number of states, echoing the Revised Uniform Act,ⁿ⁷³ expressly provide that fees are not refundable under any conditions.ⁿ⁷⁴

[b] Examination Requirements

As a general rule, applicants wishing to engage in the securities business, whether in the capacity of broker-dealer, agent, investment adviser as a sole proprietor, or investment adviser representative, must first pass one or more examinations testing the applicant's knowledge of various aspects of the securities industry and of securities law. When the applicant is an agent, there is no trouble in determining who must take the exam, because agents are individuals by definition.

For agents or representatives of broker-dealers, NASAA developed a uniform securities agent examination (Series 63) designed to satisfy the license testing requirements of every state. A person seeking to be registered to do business as an employee of a broker-dealer (or in some cases, as a broker-dealer) may take the single test developed by NASAA, rather than a separate examination in every state requiring a test.ⁿ⁷⁵ However, states have adopted different requirements for broker-dealers organized in a business form other than a sole proprietorship.

In a few states, examination requirements do not apply to broker-dealers unless they are sole proprietorships.ⁿ⁷⁶ However, the definition of "agent" in each of these states includes partners, officers and directors of broker-dealers who are performing agent activities for their broker-dealer firms.ⁿ⁷⁷ An arguable conclusion is that all such "agents" would be required to pass all required examinations.

Other states have reached similar results through different methods. These states require all broker-dealer officers or partners,ⁿ⁷⁸ and in some states directors,ⁿ⁷⁹ to take exams. Examinations are sometimes required of those designated as principals,ⁿ⁸⁰ managers,ⁿ⁸¹ or supervisors.ⁿ⁸²

The purpose of these provisions is not to require every such member or every broker-dealer to meet the examination requirement. Regulations often exempt officers or partners not engaged in sales or solicitation of securities, or those performing only administrative functions,ⁿ⁸³ or persons not participating in managerial or sales activities or in supervising sales personnel.ⁿ⁸⁴

Broker-dealer examination requirements in some states are made applicable to "representatives" of the firm. These states specify that at least one person who occupies the position of officer, director, partner, etc. must take and pass all required examinations before registration of the broker-dealer will be approved.ⁿ⁸⁵ In a few states, the broker-dealer exam is required only of persons designated by the administrator. If no designation is made, registration may be granted without testing.

Similar rules are applicable to investment adviser examinations. Generally, the examination is required of any investment adviser's representative doing any acts which make the applicant an investment adviser.ⁿ⁸⁶ These rules often call particular attention to persons who are officers or partners of the investment adviser firm as being in a position of performing such services. The Uniform Act contains a provision to the effect that when tests are required of investment advisers, they may be required of "persons who represent or will represent an investment adviser in doing any of the acts which make him an investment adviser." Some states which require tests of investment advisers, and whose rules do not designate specific persons required to take the exam, have adopted this statutory provision.ⁿ⁸⁷ In all states where the statutes or regulations are unclear as to who must take the exam, administrators should be interrogated as to requirements.ⁿ⁸⁸ One state leaves it up to the administrator to choose one or more directors, officers, partners or employees to take the exam.ⁿ⁸⁹

Securities examinations involved here generally cover the applicant's familiarity with the overall nature of the securities industry and knowledge of the particular state's securities law. A few states have issued outlines indicating the type of material which will appear on the exams created by, and unique to, the respective state. As for those states who depend either partially or totally on uniform examinations both created and administered by FINRA, those topics likewise are set out in study outlines.ⁿ⁹⁰ FINRA, upon request, makes these outlines available to applicants.ⁿ⁹¹

[c] Net Capital and Bonding Requirements

All states have financial responsibility requirements for broker-dealers. These requirements are separate from requirements imposed as a matter of federal law or by FINRA as a condition of membership. Prior to NSMIA, broker-dealers could be subjected to multiple requirements as a condition to qualification and licensing in any state. To address this burden, NSMIA added new section 15(h)(1) to the Exchange Act, which prohibits states from imposing on broker-dealers minimum capital and bonding requirements that differ from or are in addition to the requirements established under the Exchange Act.ⁿ⁹² Previously, states had varied minimum capital requirements for broker-dealers which generally put a maximum limit on the aggregate indebtedness of broker-dealers and placed a floor on the amount of net capital which must be maintained. Some states had already adopted Rule 15c3-1 under the Exchange Act.ⁿ⁹³ Even after the passage of NSMIA, there are still a few states which have no net capital requirements for broker-dealers.ⁿ⁹⁴

Some states grant an exemption to broker-dealers who are in good standing and subject to the capital rules of FINRA or specified national securities exchanges.ⁿ⁹⁵ However, because FINRA membership itself involves net capital requirements scaled to the nature of a broker-dealer's business activities which fairly match the net capital requirements imposed in most states, the absence of a requirement, in any state, or the existence of an exemption based upon FINRA membership, does not in practice represent any lesser standard of regulation. Some states also permit an exemption where the administrator is satisfied that the broker-dealer has an established financial position and procedures in place for safeguarding the funds and securities of its customers.ⁿ⁹⁶

Bonding requirements may be imposed in addition to net capital requirements. However, in some states an overlap exists between minimum capital requirements and bonding requirements. These states allow the posting of a surety bond instead of maintaining an amount of minimum capital which would otherwise be required, and vice versa.ⁿ⁹⁷ Other states require surety bonds of broker-dealers in addition to minimum capital requirements.ⁿ⁹⁸ In lieu of posting a bond, an appropriate deposit in cash or securities with the administrator is acceptable in a number of states.ⁿ⁹⁹

Since agents or representatives of broker-dealers are individuals who are not in business for themselves, there are no minimum capital requirements imposed upon them. Nevertheless, it is not unusual for a state to require agents of broker-dealers and issuers to post surety bonds.ⁿ¹⁰⁰ Some states, however, require bonding only with respect to agents of issuers.ⁿ¹⁰¹ In certain cases, statutes have authorized administrators to promulgate rules requiring agents to be bonded.ⁿ¹⁰²

A few states have unique requirements in this area of agent regulation. Missouri, for example, prescribes that if the broker-dealer is exempt from bonding requirements because it maintains a prescribed minimum capital, then its agents are similarly exempt.ⁿ¹⁰³ In any event, not all similar-appearing bonding requirements are the same. There may be substantial differences in coverage, cost and ease of obtaining fidelity bonds, which principally deal with dishonesty, as opposed to surety or so-called "Blue Sky bonds," which principally provide coverage for violations of securities laws.

[d] Effective Dates and Duration of Licensing

In the main, applications for licensing as a broker-dealer, agent or securities salesperson become effective on an order of the administrator. Varying time periods and procedures among the states are discussed further below. However, a central element in all of this is the evaluative process carried out by administrators to determine whether an application should be granted. State authority to deny an application for licensing, together with the correlative power to revoke, suspend, or cancel a license, is considered in detail elsewhere.ⁿ¹⁰⁴ In considering the effectiveness and duration of licensing discussed below, it is essential to recognize that for an application to become effective is first dependent upon a determination that it should not be denied.

Although effective dates for initial registration vary from state to state, the effective dates within a single state are usually the same regardless of whether the applicant is a broker-dealer, an agent, or an investment adviser.ⁿ¹⁰⁵ The Uniform Act provides that initial registrations become effective at noon of the thirtieth day after the application is filed, unless a denial order has been issued or a proceeding which could result in registration denial is pending. This section also gives the administrator the power to accelerate registration, or, if an application amendment is filed, to delay it to noon of the thirtieth day after the filing of the amendment.ⁿ¹⁰⁶ The Revised Uniform Act, while eliminating the "clock" exactness of its earlier counterpart, retains the "calendar" exactness in the form of the 30-day effectiveness provision. The Administrator under this provision still has the power to accelerate the effective date, but the 30-day period is otherwise measured from the date of the filing of the last amendment to the application.ⁿ¹⁰⁷

A number of states have adopted one of these provisions both as to the effective date of registration and as to acceleration or delay of effectiveness.ⁿ¹⁰⁸ A few states have variations of these two provisions.ⁿ¹⁰⁹ In Alabama, for example, the effective date and time is five o'clock p.m. on the sixtieth day after filing, and effectiveness can be deferred until five o'clock p.m. of the sixtieth day after the filing of any amendment.ⁿ¹¹⁰

A few other states have effective dates which reasonably give applicants some idea of when they may begin to act in the securities business. Virginia, for example, requires affirmative approval or denial of the application within thirty days after filing, allowing up to three extensions of up to ninety days if written notice is given to the applicant.ⁿ¹¹¹ Texas requires a final decision on the application within fourteen days of the Dealer Registration Division's recommendation or receipt of complete responses to any remaining comments, whichever is later.ⁿ¹¹² But getting to these points is a complicated process, and there are several exceptions where exceeding this time period is allowed.ⁿ¹¹³

In all cases, registration as a broker, investment adviser, or associated person is subject to there being no order in effect, and no proceeding commenced or pending by which the registration could be denied, restricted, conditioned, or limited. The 2002 Uniform Act is illustrative:

If an order is not in effective and a proceeding is not pending under section 412, registration becomes effective at noon on the 45th day after a completed application is filed, unless the registration is

denied. A rule adopted or order issued under this [Act] may set an earlier effective date or may defer the effective date until noon on the 45th day after the filing of any amendment completing the application.ⁿ¹¹⁴

Unfortunately, the statutes in most states are not clear with regard to the details of any exceptions to the stated time period. Washington, for example, provides only that when an application "meets the requirements" for registration, as the director may by rule or otherwise determine, and no other denial order or proceeding is pending, the director shall make the application effective.ⁿ¹¹⁵ These states' statutes provide, or in some cases only suggest, that registration becomes effective on administrator approval, without any requirement that the application be acted upon within a specified time.ⁿ¹¹⁶

As for the term of licensing, under the original Uniform Act and virtually all state laws, registrations expire after one year from the effective date unless renewed. As reflected in section 406(d) of the 2002 Uniform Act, registrations for broker-dealers, investment advisers, and associated persons are effective until midnight on December 31 of the year in which the application for registration is filed. Thus, unless an order is in effect, a registration may be automatically renewed each year by filing whatever record may be required by rule or order, and by paying the requisite renewal fee, which in most cases is the same as the initial application fee for broker-dealers and investment advisers.ⁿ¹¹⁷ Some states follow this practice but vary the expiration date in accordance with the type of registration being sought, be it broker-dealer, agent or investment adviser.ⁿ¹¹⁸

[4] Reporting and Record Keeping Requirements

Most states have an affirmative requirement for the filing of broker-dealer financial statements subsequent to registrations. Some states provide that the financial statements be submitted with registration renewals,ⁿ¹¹⁹ while others require that the report reflect financial condition as of the close of the broker-dealer's fiscal year and be filed within a prescribed number of days after the close of such year.ⁿ¹²⁰ A few states allow the broker-dealer to select its own filing date,ⁿ¹²¹ but in such cases usually provide that reports filed in two consecutive years must be at least four months apart.ⁿ¹²² Where reports are required as of a fiscal year ending, and filed in accordance with such date, little danger exists of the information therein becoming outdated. To overcome the problem of a financial statement becoming outdated in a state requiring filings according to renewal or a self-selected date, states often require that the financial report be dated as of a maximum number of days prior or subsequent to the filing.ⁿ¹²³

A few states require additional financial reports throughout the year on a semi-annual basis.ⁿ¹²⁴ In fact, some states which do not have an annual report requirement require financial statements to be filed several times in any given year,ⁿ¹²⁵ and a number of states require monthly filings of financial information whenever the broker-dealer's minimum capital or aggregate indebtedness fails to meet specifications established by the state.ⁿ¹²⁶

For purposes of annual financial reporting, many states will accept copies of reports filed with the SECⁿ¹²⁷ or a recognized national securities exchange in satisfaction of or in lieu of financial reports required by that state. In a number of instances where filing deadlines cannot be met, reasonable extensions of time may be obtained.ⁿ¹²⁸

Not all broker-dealer post-registration filing requirements deal strictly with financial statements. Some requirements include filings whenever control of a broker-dealer firm changes handsⁿ¹²⁹ and immediate notification of the Administrator whenever a theft or mysterious disappearance of any significant amount of securities or funds has occurred.ⁿ¹³⁰

New York requires perhaps the most unusual post-registration filing. Basically, the state requires securities registration only in the case of real estate securitiesⁿ¹³¹ or intrastate offerings.ⁿ¹³² However, any time a dealer offers securities which were not previously offered, the dealer must file a "Further State Notice."ⁿ¹³³ These notices are no more than slips of paper calling for the name, business, or post office address and place of incorporation (if incorporated) of the

dealer or the names of the partners if a partnership, the name of the security or securities, the name of the issuer, the issuer's post office address and the state or country of organization.ⁿ¹³⁴ Two or more dealers may jointly file such notices.ⁿ¹³⁵

NSMIA established national standards for broker-dealer record keeping requirements. As a result, states are barred from imposing record keeping requirements on broker-dealers that differ from or are in addition to those established under the Exchange Act.ⁿ¹³⁶ Prior to NSMIA, post-registration record keeping requirements for broker-dealers in most states were based on the rules issued by the Securities and Exchange Commission pursuant to the Securities Exchange Act of 1934. These regulations require the keeping and maintaining of itemized blotters, ledgers and ledger accounts. Blotters, or other records of original entry, are required to contain the following:

- (a) itemized daily records of all purchases and sales of securities;
- (b) all receipts and deliveries of securities (including certificate numbers);
- (c) all receipts and disbursements of cash; and
- (d) all other debits and credits.

Such records shall show the account for which each such transaction was effected, the name and amount of securities, the unit and aggregate purchase or sale price (if any), the trade date, and the name or other designation of the person from whom purchased or received or to whom sold or delivered.ⁿ¹³⁷

Ledgers required to be kept are to reflect, among other information, all assets and liabilities, income and expenses, and capital accounts, in addition to securities in transfer, dividends and interest received, securities borrowed and loaned, money borrowed and loaned (including a record of collateral and substitutions in such collateral), and securities failed to receive and failed to deliver.ⁿ¹³⁸ Other separate records are generally required to include ledger accounts showing cash and margin accounts of each customer; ledgers giving long and short positions of the broker-dealer; memoranda reflecting customer transactions and separate memoranda showing details of sales and purchases made by the broker-dealer for his own account; copies of confirmations of each purchase and sale; records of cash and margin accounts; records of option transactions in which the broker-dealer has any interest or which have been granted or guaranteed by the broker-dealer; and a record of proof of balances of all ledger accounts in the form of trial balances. The Exchange Act requires broker-dealers to maintain their records for a period of not less than six years for some records, and not less than three years for other records.ⁿ¹³⁹ Records must be kept in such a manner as to be accessible for inspection by Administrators.ⁿ¹⁴⁰

[5] Securities Activities of Banks

On November 12, 1999, the Gramm-Leach-Bliley Act ("GLBA"), popularly referred to as the Financial Services Modernization Act, was signed into law.ⁿ¹⁴¹ GLBA made landmark changes to the laws governing the operation and regulation of the banking, securities and insurance industries, and was designed to permit financial service providers to affiliate with one another in providing a wide range of financial services under one roof. Among changes made by GLBA, the definition of "broker" contained in the Securities Exchange Act of 1934ⁿ¹⁴² was amended so as to permit banks to engage directly in certain securities activities without being deemed to be brokers, and thus without being subjected to federal registration and other requirements for broker-dealers generally discussed above.

In many instances, the exceptions added by GLBA to the definition of broker only codified pre-existing administrative orders and rules of federal banking regulators that had permitted banks to engage directly in a number securities transactions and activities. More significantly, however, GLBA also provides that banks may enter into "third party brokerage arrangements," that is, contractual or other written arrangements with SEC-registered broker-dealers to

engage in the offer and sale of securities on or off bank premises, without the bank itself being deemed to be a broker.ⁿ¹⁴³

Although GLBA operates to exclude banks from the definition of broker in the context of third party brokerage arrangements, many Blue Sky laws prohibit a licensed broker-dealer from sharing commissions or other transaction-based compensation with any unlicensed entity, such as a bank.ⁿ¹⁴⁴ Thus, while a bank may undertake such arrangements directly without federal broker-dealer registration under the Securities Exchange Act of 1934, state broker-dealer regulation may still be fully applicable. Some states have themselves dealt with the issue by providing limited relief, by rule, to bank and third party broker-dealer relationships under critical definitions.ⁿ¹⁴⁵ However, these provisions may not permit arrangements involving or amounting to commission-sharing between a bank and third party broker-dealer. After GLBA it is certain that greater attention will be focused on the utility of third party brokerage arrangements to expand services available to customers of smaller or community banks that have not previously pursued brokerage activities or services through the bank holding company affiliate structure mandated by previous laws and regulations. It is essential that in evaluating and establishing third party brokerage arrangements both the bank and the broker-dealer must closely assess the extent to which individual state securities laws will impact the desired relationship despite the GLBA changes at the federal level. Leases by third party broker-dealers, for example, providing for rent payable to the bank for space on premises based upon the level of revenues, gross commissions, or any other formula directly linked to securities transactions may run afoul of Blue Sky laws and regulations despite being a GLBA contractual or other written arrangement for the provision of third party brokerage services.ⁿ¹⁴⁶ GLBA does not preempt any state regulatory authority over broker-dealers and associated persons. And in all cases it is also certain that both federal and state antifraud rules and standards remain unaffected.

FOOTNOTES:

(n1)Footnote 1. Unif. Sec. Act § 401(c).

(n2)Footnote 2. Unif. Sec. Act § 401(b).

(n3)Footnote 3. Ill. Comp. Stat. ch. 815 § 5/2.9.

(n4)Footnote 4. In *Cowburn v. Leventis*, 366 S.C. 20, 619 S.E.2d 437 (Ct. App. 2005), for example, the court reversed a summary judgment that had been entered in favor of a lawyer who introduced investors and assisted them in setting up investment accounts that were used in a Ponzi scheme. The court found that there were genuine issues of material fact as to whether the lawyer's activities subjected him to broker-dealer licensing. The lawyer received referral fees for introducing investors to the other defendants. He provided the investors with written information and forms to assist in setting up investment accounts, and assisted some investors in completing the forms. The court viewed these activities as going far beyond merely recommending the investment to a friend. The court characterized the attorney's role as essential in marketing and referring investors.

(n5)Footnote 5. See Chapter 4.03, *above*, addressing state investor protection authority in the context of intermediaries "transacting business."

(n6)Footnote 6. See, e.g., Haw. Sec. Reg. § 16-38-5.1(a). 19 years of age.

(n7)Footnote 7. See, e.g.:

Arkansas: Ark. Sec. Rule 302.01(A)(1).

Kansas: Kan. Admin. Regs. 81-3-1(a)(2).

(n8)Footnote 8. See, e.g., D.C. Mun. Regs. tit. 17, § 1914.2(c). Sole proprietor broker-dealers or agents must have

a minimum of five years' experience in the securities business.

(n9)Footnote 9. *See, e.g.*, Wis. Stat. § 551.31(2).

(n10)Footnote 10. *See, e.g.*, Ark. Code Ann. § 23-42-301(b)(2).

(n11)Footnote 11. *See, e.g.*, Ark. Code Ann. § 23-42-301(b)(3)(A).

(n12)Footnote 12. *See, e.g.*, Tex. Admin. Code tit. 7, § 115.1(e).

(n13)Footnote 13. *See, e.g.*, Mass. Regs. Code tit. 950, § 12.201(2) (prohibition may be waived by the Director if multiple licensing would not interfere with effective supervision and is found to be in the public interest).

(n14)Footnote 14. *See, e.g.*:

Kansas: Kan. Admin. Regs. § 81-3-1(6) ("An agent shall not register with more than one broker-dealer or issuer at any one time, unless management and control of the broker-dealers or issuers are substantially identical.").

Michigan: Mich. Admin. Code r. 451.601.3(1) (management and control of the employing organizations are substantially identical and the administrator is convinced that no confusion or avoidance of responsibility will result).

In some states, this requirement is specifically included in the law, *see, e.g.*, Ga. Code § 10-5-31(e), which provides:

An individual may not act as an agent for more than one broker-dealer or one issuer at a time, unless the broker-dealers and the issuers for which the agent acts are affiliated by direct or indirect common control or are authorized by rule adopted or order issued under this chapter.

(n15)Footnote 15. *See, e.g.*:

California: Cal. Admin. Code tit. 10, § 260.216.16.

Indiana: Ind. Admin. Code tit. 710, r. 1-15-1(d) ("No person may register as an agent of more than one (1) broker-dealer unless the written consent of each such broker-dealer to the dual registration is filed with the commissioner").

(n16)Footnote 16. *See, e.g.*, 808 Ky. Admin. Regs. 10:030 § 5.

(n17)Footnote 17. Unif. Sec. Act § 202(a). The Revised Uniform Act contains no comparable provision. In the Uniform Act, the phrase "a person occupying a similar status or performing similar functions" is intended to apply to unincorporated, non-partnership organizations, such as Massachusetts trusts. *Id.*, comment. According to the comment, the details about partners, officers, directors and such similar persons, with respect to their qualifications and business history, will be revealed in the broker-dealer application, and requiring such persons to file separate agent applications would be an unnecessary duplication.

(n18)Footnote 18. *See, e.g.*, Mass. Regs. Code tit. 950, § 12.201(4).

Note that New York reaches approximately the same result by providing that any partner, officer, director or principal

of a registered broker or dealer who is acting as salesman is not required to be registered as a salesman. *N.Y. Gen. Bus. Law § 359-e(5)*.

(n19)Footnote 19. *See, e.g., Tex. Admin. Code tit. 7, § 115.3(c)(3)* (state securities law portion of exam only).

Securities examinations involved in broker-dealer and salesperson licensing are discussed in *further detail in § 11.02[3][b]*.

(n20)Footnote 20. *Or. Admin. R. 441-175-0130(1)*.

(n21)Footnote 21. Not all states requiring issuer licensing require it of all issuers. California, for example, requires licensing of only certain issuers. The usual method of requiring issuer registration is to include the term within the definition of "broker-dealer" and then to require the registration of the broker-dealer. *See, e.g., Cal. Corp. Code § 25004*, where persons issuing options with regard to securities not of their own issue are deemed issuers.

(n22)Footnote 22. Unif. Sec. Act § 401(g). This definition is nearly identical to that contained in section 2(a)(4) of the Securities Act of 1933, *15 U.S.C. § 77b(a)(4)*. In explaining the granting of non-issuer status to certificates of interest or participation in oil, gas or mining titles or leases, the Uniform Act drafters reasoned that since these interests are actually interests in real property, and therefore a type of artificial security, it is extremely difficult to ascertain the identity of the issuer. To avoid this obstacle, the drafters decided to make these interests non-issuer securities. *See* Unif. Sec. Act § 401(g) comment.

(n23)Footnote 23. For example, the definition of "issuer" in the Uniform Act has been substantially adopted in Maryland, while in Wyoming subsection two of the Uniform Act provision, dealing with oil, gas and mining interests, has not been adopted. *Compare Md. Corps. & Ass'ns Code Ann. § 11-101(i) with Wyo. Stat. § 17-4-113(a)(vi)*.

Other states have adopted a definition of "issuer" other than that contained in either the Uniform Act or the Revised Uniform Act. While the definition itself is basically the same, the difference occurs in the exceptions to the definition. Often, these exceptions are a mixture of the various incarnations of this provision. *See, e.g., Fla. Stat. § 517.021(13)*. The provision includes a promoter for a corporation, trust, partnership, or unincorporated association as an issuer. Also, the exceptions to the Uniform Act definition have not been adopted. *See also Tex. Rev. Civ. Stat. Ann. art. 581-4(G)*. The provision omits all exceptions to the Uniform Act definition.

In contrast, New York, which requires issuers to be registered, does not define the term either by regulation or by statute.

Reflecting variations that appear in Blue Sky laws, the 2002 Uniform Act defines "issuer" simply as "a person that issues or proposes to issue a security," but, in particular circumstances, subject to the following:

(A) The issuer of a voting trust certificate, collateral trust certificate, certificate of deposit for a security, or share in an investment company without a board of directors or individuals performing similar functions is the person performing the acts and assuming the duties of depositor or manager pursuant to the trust or other agreement of instrument under which the security is issued.

(B) The issuer of an equipment trust certificate or similar security serving the same purpose is the person by which the property is or will be used or to which the property or equipment is or will be leased or conditionally sold or that is otherwise contractually responsible for assuring payment of the certificate.

(C) The issuer of a fractional undivided interest in an oil, gas, or other mineral lease or in payments out of production under a lease, right, or royalty is the owner of an interest in the lease or in payments out of production under a lease, right, or royalty, whether whole or fractional, that creates fractional

interests for the purpose of sale.

2002 Unif. Sec. Act § 102(17).

(n24)Footnote 24. *See, e.g.:*

California: Cal. Corp. Code § 25210.

Illinois: Ill. Comp. Stat. ch. 815 § 5/8.

Wisconsin: Wis. Stat. § 551.31(1).

(n25)Footnote 25. Unif. Sec. Act § 401(c).

(n26)Footnote 26. Rev. Unif. Sec. Act § 101(2).

See, e.g., Colo. Rev. Stat. § 11-51-201(2).

Other states have adopted a definition of "broker-dealer" other than the Uniform Act and the Revised Uniform Act versions. Differences usually occur in the exclusions from the definition adopted, and are often hybrids of the two versions. *See, e.g., Cal. Corp. Code § 25004.* The exclusion for out-of-state persons who make limited offers into the state is omitted. The definition also excludes registered broker-dealers who are involved with certain exempted securities and transactions, as well as non-exempt securities and exchanges required to be registered with the Commissioner of Corporations when issuing or guaranteeing options.

A person who, on a commission basis, negotiates the sale of a corporation's entire stock on behalf of the purchaser is a broker-dealer within the meaning of the statutory provision. *See Nationwide Inv. Corp. v. California Funeral Serv., Inc., 40 Cal. App. 3d 494, 114 Cal. Rptr. 77 (1974) .*

(n27)Footnote 27. *See* 2002 Unif. Sec. Act § 102(4)(A)-(E).

(n28)Footnote 28. In North Dakota, banks are permitted to deal in securities for the purpose of buying securities from and selling them to individual and institutional customers without recourse and solely upon the order and for the account of the customers. *N.D. Cent. Code § 6-03-02(11).*

(n29)Footnote 29. *See, e.g., Ky. Rev. Stat. § 292.310(2)(c).*

(n30)Footnote 30. Unif. Sec. Act § 401(b).

(n31)Footnote 31. FINRA Membership and Registration Rule 1031(b), *FINRA Manual (CCH)* P 3201.

(n32)Footnote 32. Unif. Sec. Act § 401(b). As an example, California excludes individuals representing an issuer in effecting transactions in exempt securities, specifically including:

(1) Securities of the United States government, the Canadian government and those of certain other foreign governments.

(2) Securities consisting of interests in real estate subdivisions.

(3) Mutual capital certificates or savings accounts issued by savings and loan associations.

(4) Securities issued by specified non-profit organizations, chambers of commerce or trade or professional associations.

(5) Life income contracts issued by specified non-profit associations.

(6) Short term commercial paper.

A further exclusion is provided for out-of-state persons dealing exclusively with broker-dealers. An additional proviso is given that an issuer's officers and similar functionaries are agents only if they receive securities transaction-related income. In California, subdivision three of the Uniform Act provision is omitted.

The 2002 Uniform Securities Act does not provide specific exclusions from the definition. Rather:

"Agent" means an individual, other than a broker-dealer, who represents a broker-dealer in effecting or attempting to effect purchases or sales of securities or represents an issuer in effecting or attempting to effect purchases or sales of the issuer's securities, but a partner, officer, or director of a broker-dealer or issuer, or an individual having a similar status or performing similar functions, is an agent only if the individual otherwise comes within the term. The term does not include an individual excluded by rule or order under this [Act]. 2002 Unif. Sec. Act § 102(2).

(n33)Footnote 33. Unif. Sec. Act § 401(b)(1).

(n34)Footnote 34. Unif. Sec. Act § 402(a)(1).

(n35)Footnote 35. Unif. Sec. Act § 402(a)(2).

(n36)Footnote 36. Unif. Sec. Act § 402(a)(3).

(n37)Footnote 37. Unif. Sec. Act § 402(a)(10).

(n38)Footnote 38. Unif. Sec. Act § 402(a)(11).

(n39)Footnote 39. Unif. Sec. Act §§ 401(b)(3), 402(b). Exempt transactions under the Uniform Act are discussed in detail in Chapters 8 and 9.

(n40)Footnote 40. *211 P. 3d 727 (Colo. Ct. App. 2009)* .

(n41)Footnote 41. *211 P. 3d at 735* .

(n42)Footnote 42. Herbruck, Alder & Co., SEC No-Action Letter (June 4, 2002); Wirthlin, SEC No-Action Letter (Jan. 19, 1999).

(n43)Footnote 43. *Black Diamond Fund, LLLP v. Joseph*, *211 P.3d 727, 735 (Colo. Ct. App. 2009)* (citing federal authorities).

(n44)Footnote 44. *See* Tex. Admin. Code, Rule 115.1(a)(9).

(n45)Footnote 45. Section 3(a)(18) of the Exchange Act defines "person associated with a broker or dealer" or "associated person of a broker or dealer" as:

[A]ny partner, officer, director, or branch manager of such broker or dealer (or any person

occupying similar status or performing similar functions), any person directly or indirectly controlling, controlled by or under common control with such broker or dealer, or any employee of such broker or dealer, except that any person associated with a broker or dealer whose functions are solely clerical or ministerial shall not be included in the meaning of such term for purposes of Section 15(b) of this title.

15 U.S.C. § 78c(a)(18).

(n46)Footnote 46. Exchange Act § 15(h)(2), 15 U.S.C. § 78o(h)(2).

(n47)Footnote 47. Exchange Act § 15(h)(3)(A)(i), 15 U.S.C. § 78o(h)(3)(A)(i).

(n48)Footnote 48. Exchange Act § 15(h)(3)(B), 15 U.S.C. § 78o(h)(3)(B).

(n49)Footnote 49. Exchange Act § 15(h)(3)(A)(ii), 15 U.S.C. § 78o(h)(3)(A)(ii).

(n50)Footnote 50. *See, e.g., Tex. Admin. Code, tit. 7, § 115.1(j)(1).*

(n51)Footnote 51. By administrative order, entities that administer employee benefit plans that qualify for the employee benefit plan transactional exemption from registration (*Ga. Code § 10-5-11(21)*) are excluded from the definition of broker-dealer unless they fall within the definition in the Act by engaging in activities not strictly related to the administration of benefit plans.

(n52)Footnote 52. *Ga. Code § 10-5-30(b).*

(n53)Footnote 53. *Ga. Code § 10-5-31(b).*

(n54)Footnote 54. *See, e.g., Ariz. Rev. Stat. Ann. §§ 44-1843-44-1844.*

(n55)Footnote 55. *See, e.g., Ariz. Rev. Stat. Ann. § 44-1848.*

(n56)Footnote 56. *Ariz. Sec. Reg. § R14-4-104.*

(n57)Footnote 57. *Ariz. Sec. Reg. § R-14-4-104(7).*

(n58)Footnote 58. *See, e.g.:*

California: Cal. Corp. Code §§ 25200, 25203, 25206. The exempt transactions applicable to broker-dealer and agent registration are not necessarily the same transactions applicable for purposes of avoiding securities registration.

Illinois: Ill. Comp. Stat. ch. 815, § 5/8. This exemption applies only with respect to certain exempted transactions.

(n59)Footnote 59. *See, e.g., N.Y. Gen. Bus. Law § 359-f.* While the exemptions under subsection (1) are available to both broker-dealers and agents, those under subsection (2) are available only to broker-dealers, upon written application to the New York Attorney General.

(n60)Footnote 60. *See Unif. Sec. Act § 201.* The reasoning for this position was stated in an opinion of the Utah Attorney General:

The fact that a security may be quite sound and exempt under the law from registration does not

guarantee that any persons who may be engaged to sell such security would not by their sales methods and representations, present such security for sale in such a way as to damage the public. Perhaps it is for this reason that there is no provision in the code exempting agents or broker-dealers dealing in such a security from registration.

Sale of Exempt Securities by Unregistered Broker, Op. Att'y Gen., reprinted in [1961-1971 Transfer Binder] *Blue Sky L. Rep. (CCH)* P 70,648 (Aug. 21, 1964).

Other states embracing this approach include: Arkansas, Connecticut, Delaware, the District of Columbia, Maryland, Massachusetts, New Jersey, North Carolina, Puerto Rico, Tennessee, Utah, West Virginia and Wyoming.

(n61)Footnote 61. Unif. Sec. Act § 401(b)-(c) (1987 NASAA amendment).

(n62)Footnote 62. *See, e.g., Colo. Rev. Stat. § 11-51-402.*

(n63)Footnote 63. Under Section 401(i) of the Uniform Act, "person" is defined as follows:

"Person" means an individual, a corporation, a partnership, an association, a joint-stock company, a trust where the interests of the beneficiaries are evidenced by a security, an unincorporated organization, a government, or a political subdivision of a government.

Unif. Sec. Act § 401(i) (1986 NASAA amendment). The Blue Sky law of every state except Florida has such a definition of "person."

(n64)Footnote 64. *Ohio Rev. Code § 1707.14(A)(2).*

(n65)Footnote 65. Form BD. *See, e.g., Texas: 3A Blue Sky L. Rep. (CCH)* P 55,011 .

(n66)Footnote 66. Form U-4. *See, e.g., Cal. Admin. Code tit. 10, § 260.210(c).*

(n67)Footnote 67. Form ADV. *See, e.g., Ill. Admin. Code tit. 14, § 130.840(a)(1).*

(n68)Footnote 68. T The CRD system is a computer network which was initially designed to permit salespersons associated with broker-dealers to register with FINRA and in all the states in which they wish to conduct business by filing a single license application. The system is operated by FINRA under an agreement with NASAA. 1 *Blue Sky L. Rep. (CCH)* P 6531 (July 1993). The registration, transfer, termination, and renewal filings of agents are accomplished by filing the appropriate Form U-4 or Form U-5 (Uniform termination notice) with the CRD.

The CRD has been expanded to include the registration of broker-dealers, with most Form BD filings and amendments made through it.

An ancillary program for expediting the transfer of salespersons between participating firms via the CRD began in July 1984. Under the Temporary Agent Transfer Program ("TAT"), a salesperson may begin doing business as soon as the salesperson's new employer provides required information to the CRD Communications Center. FINRA member firms who execute and file a Broker-Dealer Undertaking may participate. Individuals who have a disciplinary history or are not qualified for the registration category requested in the transfer are not allowed to use the transfer program. To qualify for temporary registration under the program, an agent must have terminated registration from a member for other than disciplinary reasons within the preceding seven calendar days and have a clean disciplinary history. The agent must give the employing member a completed Form U-4 and must already be registered in each state where registration is being requested. The temporary registration will expire in twenty-one days unless the CRD receives a

Form U-4.

(n69)Footnote 69. As a result of joint regulatory initiatives by FINRA, NASAA (the North American Securities Administrators Association), the New York Stock Exchange and the U.S. Securities and Exchange Commission, nearly all of the basic forms involved in broker-dealer license filing today are uniform. These include Form BD, and other forms relating to consent to service of process, bonding and other particular requirements. Most recently, a joint regulatory initiative has produced uniform Form BR, for registration of broker-dealer branch offices, and to file notice of branch office openings and closings. Form BR was implemented on October 31, 2005, and provides for centralized branch office registration through the CRD System based upon a uniform definition of "branch office." Historically, states and the various regulatory bodies defined the term "branch office" differently. Disparate definitions resulted in conflicting requirements, and produced significant redundancies for broker-dealer firms.

Not all states require all uniform forms to be filed. Form BR, for example will be utilized only in those states that require branch office registration. The particular form filing requirements in every state is included as part of the individual State Guides in Volumes 3 and 4, of this Treatise.

(n70)Footnote 70. Fee requirements in individual states are addressed in the State Guides in Volumes 3 and 4.

(n71)Footnote 71. Note that refunds are granted only for withdrawal or denial. Refunds are not available in instances of revocation, suspension, and cancellation, which necessarily occur at a time subsequent to the registration process.

(n72)Footnote 72. Unif. Sec. Act § 202(b).

(n73)Footnote 73. Rev. Unif. Sec. Act § 206(d).

(n74)Footnote 74. *See, e.g.*, Ill. Comp. Stat. ch. 815, § 5/8(B)(9), (C)(7), (D)(10).

(n75)Footnote 75. The Series 63 Uniform Examination is mandatory in the following states: Alabama, Alaska, Arizona, Arkansas, California, Connecticut, Delaware, the District of Columbia, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, West Virginia, Wisconsin, and Wyoming.

(n76)Footnote 76. *See, e.g.*:

District of Columbia: D.C. Mun. Regs. tit. 17, § 1914.1.

Maryland: Md. Regs. Code tit. 02, § 2.02(A).

(n77)Footnote 77. *See, e.g.*:

District of Columbia: D.C. Sec. Act of 2000 § 101(3)(B).

Maryland: Md. Corps. & Ass'ns Code Ann. § 11-101(b).

(n78)Footnote 78. *See, e.g.*, Tex. Rev. Civ. Stat. Ann. art. 581-13(D).

(n79)Footnote 79. Tex. Rev. Civ. Stat. Ann. art. 581-13(D).

(n80)Footnote 80. *See, e.g.*, Ill. Comp. Stat. ch. 815, § 5/8(B)(8)(a).

(n81)Footnote 81. *See, e.g.*:

Connecticut: Conn. Agencies Regs. § 36b-31-15e.

New Jersey: N.J. Admin. Code tit. 13, § 47A-4.1.

(n82)Footnote 82. *See, e.g.*, Wis. Admin. Code § [SEC] 4.01(5).

(n83)Footnote 83. *See, e.g.*, Alaska Admin. Code tit. 3, § 08.012.

(n84)Footnote 84. *See, e.g.*:

Colorado: Colo. Rev. Stat. § 11-51-405(1).

Connecticut: Conn. Agencies Regs. § 36b-31-15e.

Minnesota: Minn. R. 2875.1910.

(n85)Footnote 85. *See, e.g.*, Wis. Admin. Code § [SEC] 4.01(5). At least one employee at the principal office must be designated as supervisor and fulfill the exam requirement.

(n86)Footnote 86. *See, e.g.*, Cal. Admin. Code tit. 10, § 260.236(a)(1), (c). Examination requirements applicable to investment advisers and investment adviser representatives are considered further in § 8.03[5] (Minimum Competency).

(n87)Footnote 87. *See, e.g.*:

Alaska: Alaska Stat. § 45.55.060(d)(6).

Missouri: Mo. Code Regs. tit. 15, § 30-51.030.

North Dakota: N.D. Sec. Reg. § 73-02-06-02(1).

(n88)Footnote 88. Utah Sec. Rule R164-4-2.

(n89)Footnote 89. S.C. Sec. Rule 113-5(1).

(n90)Footnote 90. Schedule to the By-laws of the Financial Industry Regulatory Authority, reprinted in FINRA Manual (CCH) P 1788.

(n91)Footnote 91. Schedule to the By-laws of the Financial Industry Regulatory Authority, reprinted in FINRA Manual (CCH) P 1788.

(n92)Footnote 92. 15 U.S.C. § 78o(h)(1); *see also* Exchange Act Rule 15c3-1, 17 C.F.R. § 240.15c3-1.

(n93)Footnote 93. *See, e.g.*, Cal. Admin. Code tit. 10, § 260.216.12(a). Net capital of at least \$25,000.

(n94)Footnote 94. These states are: Arizona, North Dakota, Oregon, and Texas.

(n95)Footnote 95. *See, e.g.*, Cal. Admin. Code tit. 10, § 260.216.12(d). *See also* 17 C.F.R. § 240.15c3-1(b)(1)-(2).

(n96)Footnote 96. *See, e.g.*, Cal. Admin. Code tit. 10, § 260.216.12(d).

(n97)Footnote 97. *See, e.g.*:

New Jersey: N.J. Admin. Code tit. 13, § 47A-1.6. Broker-dealers are required to maintain minimum capital or post a surety bond according to their activities.

(n98)Footnote 98. *See, e.g.*, Ark. Code Ann. § 23-42-305(a).

(n99)Footnote 99. *See, e.g.*, Ark. Code Ann. § 23-42-305(b)(4). If securities are substituted, they must be issued by the United States, the State of Arkansas, or a political subdivision thereof.

(n100)Footnote 100. *See, e.g.*:

North Dakota: N.D. Cent. Code § 10-04-10(2). In such amounts as the Administrator may require. Only self-employed salespersons need post bonds.

Puerto Rico: P.R. R. & Regs. tit. 10, § 892-7.

(n101)Footnote 101. *See, e.g.*, Cal. Admin. Code tit. 10, § 260.216.15(a). \$10,000.

(n102)Footnote 102. *See, e.g.*:

Delaware: Del. Code Ann. tit. 6, § 7314(f); Del. Sec. Rule 605.

North Carolina: N.C. Gen. Stat. § 78A-37(d). The bond may be up to \$10,000.

Utah: Utah Code Ann. § 61-1-4(6)(a).

West Virginia: W. Va. Code § 32-2-202(f).

Wyoming: Wyo. Stat. § 17-4-104(e).

(n103)Footnote 103. Mo. Rev. Stat. § 409.202(f).

(n104)Footnote 104. *See* § 8.04 (Denial, Suspension and Revocation of Licensing), *above*.

(n105)Footnote 105. Only California, Louisiana, and New York appear to have separate effective dates.

(n106)Footnote 106. Unif. Sec. Act § 202(a).

(n107)Footnote 107. Rev. Unif. Sec. Act § 208(a).

(n108)Footnote 108. *See, e.g.*:

Massachusetts: Mass. Gen. L. ch. 110A, § 202(a).

Wisconsin: Wis. Stat. § 551.32(c).

(n109)Footnote 109. *See, e.g., Cal. Corp. Code § 25211(c).* The agent or broker-dealer application becomes effective on the third business day after the application is filed or upon the day the certificate is issued, whichever first occurs. The Commissioner may delay effectiveness for up to 15 business days (or longer with the applicant's permission).

(n110)Footnote 110. *Ala. Code § 8-6-3(f).*

(n111)Footnote 111. *Va. Code Ann. § 13.1-505(I).*

(n112)Footnote 112. *Tex. Admin. Code tit. 7, § 104.5(f).*

(n113)Footnote 113. *Tex. Admin. Code tit. 7, § 104.6.*

(n114)Footnote 114. 2002 Unif. Sec. Act § 406(c).

Section 412 of the 2002 Uniform Act reflects a common provision in state securities laws empowering the administrator to issue an order not only denying an application for registration, but also one that conditions or limits registration.

(n115)Footnote 115. *Wash. Rev. Code § 21.20.070.*

In fact, when the Uniform Act was written, the drafters commented that "[t]he typical statute says nothing about when registration becomes effective." *See* Unif. Sec. Act § 202(a) (drafter's comment).

(n116)Footnote 116. *See, e.g., Fla. Stat. § 517.12(11).*

(n117)Footnote 117. 2002 Unif. Sec. Act § 406(d).

(n118)Footnote 118. *See, e.g., Wis. Admin. Code § 4.07:*

(a) Broker-dealers and their agents: December 31 at midnight.

(b) Issuer agents: July 31 or at the termination of the offering for which the agent was licensed, whichever occurs first.

(n119)Footnote 119. *See, e.g., Ga. Code Ann. § 10-5-3(i).*

(n120)Footnote 120. *See, e.g., Wis. Admin. Code § 4.04(1).* Within 60 days after the close of the fiscal year. Broker-dealers registered under the Securities Exchange Act of 1934 are excluded from the filing requirement provided they are not delinquent in their financial statement filing with the SEC.

(n121)Footnote 121. *See, e.g.:*

California: Cal. Admin. Code tit. 10, § 260-241.2(a)(4).

Illinois: Ill. Admin. Code tit. 14, § 130.824.

(n122)Footnote 122. *See, e.g.:*

California: Cal. Admin. Code tit. 10, § 260-241.2(a)(4).

Illinois: Ill. Admin. Code tit. 14, § 130.824.

While Illinois specifically requires that such reports be dated at least four months apart, California insists that once a filing date is chosen, the broker-dealer must keep the same filing date in each subsequent year unless a change is approved by the Commissioner. Illinois also requires the broker-dealer wishing to change this filing date to file a written request with the Securities Department.

(n123)Footnote 123. *See, e.g.,* Cal. Admin. Code tit. 10, § 260.241.2(a)(5). Sixty days.

(n124)Footnote 124. *Mich. Admin. Code R 451.603.4(1)*. Reports are due within six months, or about six months after the date of the last report. One of the reports must be audited, and no report shall be more than 45 days old as of the date of filing.

(n125)Footnote 125. *Or. Admin. Rule 441-195-0050(b)*.

(n126)Footnote 126. *See, e.g.,* Cal. Admin. Code tit. 10, § 260.241.2(d). Whenever net capital is reduced to 120% of its required minimum, or aggregate indebtedness is in excess of 1,200% of its net capital, or if net capital is reduced to less than 5% of the aggregate debit items, a report furnished or approved by the Commissioner is required within 15 days of such occurrences.

(n127)Footnote 127. *See, e.g.,* Cal. Admin. Code tit. 10, § 260.241.2(c).

(n128)Footnote 128. *See, e.g.,* Wis. Admin. Code § 4.04(1)(c).

(n129)Footnote 129. *See, e.g.:*

Massachusetts: Mass. Regs. Code tit. 950, § 12.203(4)(b).

New Mexico: N.M. Admin. Code tit. 12, § 11.2.8.4.

Wisconsin: Wis. Admin. Code § [SEC] 4.04(4).

(n130)Footnote 130. *See, e.g.:*

New Mexico: N.M. Admin. Code tit. 12, § 11.2.8.7.

Wisconsin: Wis. Admin. Code § [SEC] 4.04(6).

(n131)Footnote 131. *N.Y. Gen. Bus. Law § 352-e*.

(n132)Footnote 132. *N.Y. Gen. Bus. Law § 359-ff*.

(n133)Footnote 133. *N.Y. Gen. Bus. Law § 359-e(8)*.

(n134)Footnote 134. *N.Y. Gen. Bus. Law § 359-e(8)*.

(n135)Footnote 135. *N.Y. Gen. Bus. Law* § 359-e(8).

(n136)Footnote 136. Exchange Act § 15(h)(1), *15 U.S.C. § 78o(h)(1)*.

(n137)Footnote 137. Exchange Act Rule 17a-3(a)(1), *17 C.F.R. § 240.17a-3(a)(1)*.

(n138)Footnote 138. Exchange Act Rule 17a-3(a)(2) and (4), *17 C.F.R. § 240.17a-3(a)(2), (4)*.

(n139)Footnote 139. Exchange Act Rule 17a-4(a), *17 C.F.R. § 240.17a-4(a)*.

(n140)Footnote 140. Wisconsin, for example, requires the records to be kept at a broker-dealer's principal office or a place under the direct control of the principal office. Wis. Admin. Code § [SEC] 4.03(2).

(n141)Footnote 141. Pub. L. No. 106-102, 113 Stat. 1338.

(n142)Footnote 142. Securities Exchange Act § 3(a)(4), *15 U.S.C. § 78c(a)(4)*.

(n143)Footnote 143. Securities Exchange Act § 3(a)(4), *15 U.S.C. § 78c(a)(4)*. GLBA changes to the federal securities laws that allow banks to engage in certain securities activities are effective May 12, 2001.

(n144)Footnote 144. In Ohio, for example:

No dealer or salesperson shall ... [s]hare any commission, discount, or other remuneration from the purchase or sale of a security with any person not licensed as a dealer or salesperson in Ohio or in the jurisdiction where the purchase or sale of the security took place.

Ohio Admin. Code § 1301:6-3-19(A)(7).

See also S.C. Sec. Comm'r Rules, Order 97006(A)(22) (prohibiting knowingly paying or splitting fees or commissions with unlicensed persons except as otherwise allowed by law).

(n145)Footnote 145. See, e.g., *Ohio Admin. Code* § 1301:6-3-15(M).

In Kansas, a Blue Sky Policy Statement provides that banks and savings and loan associations that enter into arrangements for providing brokerage services need not be licensed as broker-dealers if specific conditions are met. Conditions include requiring that all broker-dealers involved in the sale of securities through a bank must be licensed in the state; advertising must be approved in advance; no bank employee may provide investment advice; the broker-dealer maintains suitability responsibility; and all antifraud provisions apply to both the broker-dealer and the bank. *Quarterly Bulletin May-June 1983, 2 Blue Sky L. Rep. (CCH) P 26,503*.

See also Me. Sec. Div. Rules, ch. 506 (Rule Governing Broker-Dealers Transacting Business on the Premises of Financial Institutions).

(n146)Footnote 146. Blue Sky laws may just as significantly impact in a bank's undertaking of other securities activities now expressly permitted by GLBA. A bank that engages directly in securities activities may, for example, be deemed to be a securities dealer unless the securities transactions are consummated by or through a licensed person, see, e.g., *Ohio Rev. Code* § 1707.01(E)(1)(e).



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Blue Sky Regulation

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CHAPTER 11 Regulation of Intermediaries: Broker-Dealers, Investment Advisers and Associated Persons

2-11 Blue Sky Regulation § 11.03

§ 11.03 Licensing of Investment Advisers and Investment Adviser Representatives

[1] State Investment Adviser Regulation Generally

Prior to 1996 and the enactment of NSMIA, a large majority of states provided in their Blue Sky laws for regulation of investment advisers and investment adviser "representatives" or agents. Nevertheless, principal regulatory focus on these securities market intermediaries was a matter of federal law, and the authority of the U.S. Securities and Exchange Commission under the Investment Advisers Act of 1940. The federal act establishes a regulatory scheme based upon registration (but not licensing) of investment advisers, utilizing SEC Form ADV not only as a registration form but also as a structured disclosure document, and providing broad antifraud enforcement authority. The federal act imposes no minimum competency or qualification standards for either investment advisers or investment adviser representatives, and involves no licensing as such. Rather, federally registered investment advisers are subject to various rule requirements for disclosure; for the keeping of certain prescribed categories of books and records; and to SEC periodic examinations and ultimate enforcement authority.

"Investment Adviser," as defined in the federal act, 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 part of a regular business, issues or promulgates analyses or reports concerning securities; n1

The Uniform Act definition of investment adviser is taken almost verbatim from the federal act, modified only to the extent of adding a limited exclusion from the definition for certain persons having no place of business in the state.n2

The basic definition of investment adviser thus involves three distinct elements: (1) providing advice or analyses concerning securities; (2) being engaged "in the business;" and (3) receiving compensation. In SEC Release IA-1092 under the Investment Advisers Act of 1940,n3 the SEC offered guidance on each of these elements for determining whether a person is an investment adviser, and also sought to clarify the application of the Act to persons who provide investment advice in conjunction with other financial services. According to the SEC, such persons include financial planners who advise individuals or families based on individualized assessments of needs and objectives; pension consultants in certain circumstances; and sports or entertainment representatives who are involved in planning and money management services.n4 Providing advice or analyses concerning securities is interpreted broadly enough to

encompass persons who advise concerning general categories of investments without making specific recommendations. Being engaged in the business is determined by the degree of advisory activities, and generally connotes holding oneself out as an adviser for which specific compensation is received. Receiving compensation means deriving any economic benefit as a result of providing advice.ⁿ⁵ The SEC cautioned, however, that whether a person providing financially related services of the type addressed in its interpretive release is an investment adviser within the meaning of the Act always depends on the particular facts and circumstances.

Every state has, for the most part, adopted the federal definition of investment adviser, and several have expanded it specifically to encompass the activities of financial planners. Washington, for example, adds to the core federal definition the following:

"Investment adviser" also includes financial planners and other persons who, as an integral component of other financially related services, (a) provide the foregoing investment advisory services to others for compensation as part of a business or (b) hold themselves out as providing the foregoing investment advisory services to others for compensation. Investment adviser shall also include any person who holds himself out as a financial planner.ⁿ⁶

Specific exclusions from the definition of investment adviser include: "[A]" lawyer, accountant, engineer, or teacher whose performance of investment advice is solely incidental to the practice of the person's profession."ⁿ⁷ Although some regulatory uncertainty may arise in the determination of what is "solely incidental" to the practice of one of these professions, identifying a qualifying profession is facially a straightforward task based on common usage of the terms. However, consideration of the "teacher" exclusion from investment adviser registration requirements under the Texas Securities Actⁿ⁸ by the United States Court of Appeals for the Fifth Circuit illustrates that the qualifying status is not so easily determined. In *S & D Trading Academy, LLC v. AAFIS Inc.*,ⁿ⁹ the "trading academy" defendant relied on the teacher exclusion from the definition of investment adviser under the Texas Act in providing training on "day trading" of stocks to Chinese citizens working as traders for a U.S. based investment company. The arrangement for training terminated, and the training academy sued for payment for its services on breach of contract and other grounds. The District Court granted summary judgment against the training academy because it was not registered as an investment adviser under the Texas Securities Act, and could not base a suit on an alleged agreement the performance of which violated the Act.ⁿ¹⁰ The U.S. Court of Appeals for the Fifth Circuit affirmed summary judgment, rejecting the contention that the investment advisory services involved were performed solely incidental to the primary purpose of teaching.

In its defense, the training academy asserted that the court should have simply given the term "teacher" its common meaning. It argued that a teacher need not be a professor or lecturer at an accredited or certified institution, and that the teacher exclusion should apply broadly to any person whose occupation is instructing. Embracing SEC no-action letters interpreting the teacher exception to the federal Investment Advisers Act definition,ⁿ¹¹ the Fifth Circuit concluded that the teacher exception to the definition of investment adviser is narrow. A teacher in this context is not, said the Court, anyone who teaches. As to the *S & D Training Academy*, the Court observed:

Neither Cleary nor Comper [its principals] were professional teachers. They were not associated with an accredited school or course, and their training was not part of a program regularly offered by an educational institution. Moreover, their training was not academic in nature. They provided the traders with market research, stock recommendations, and trading strategies for a particular day or particular stock. The goal of the training was to influence the investment decision making of the Chinese traders and to enable them to maximize their profits.ⁿ¹²

To interpret the exception otherwise would undermine the investor protection purpose of the Texas Securities Act. *S & D Training Academy* well illustrates the point that any statutory exclusion from regulatory coverage under securities laws must be examined in relation to the investor protection goal, of securities laws in general, and state Blue Sky laws

in particular. If an exclusion or exception from a key definition applies, it is because there is no need for the special protection registration that would afford in a particular context or setting. The further exclusion from the definition of investment adviser under federal and state securities laws for "a broker-dealer or its agents whose performance of investment advice is solely incidental to the conduct of business as a broker-dealer and that does not receive special compensation for the investment advice,"ⁿ¹³ for example, presumes not only that the broker-dealer intermediary is otherwise regulated, but also that the common agency function involving transaction-based compensation does not trigger the need for additional protection that would be afforded by registration and regulation under investment adviser laws. However, the business of a broker-dealer and the nature of compensation associated with it have evolved significantly, and presumptions of the 1940s have been severely tested, with resulting regulatory controversy that remains unsettled. The steady functional convergence of investment advisers and broker-dealers, and the need for harmonizing the regulation of each will bring the point well illustrated by *S & D Training Academy* into continuously sharper focus.

As for investment adviser representatives, many states have likewise adopted the federal definition of "investment adviser representative" in their statutes and regulations. The federal definition provides that "investment adviser representative" of an investment adviser means a supervised person of the investment adviser who has more than five clients who are natural persons (other than excepted persons) and more than 10% of whose clients are natural persons. However, a supervised person is excepted from the definition if that supervised person:

- (a) Does not on a regular basis solicit, meet with, or otherwise communicate with clients of the investment adviser; or
- (b) Provides only impersonal investment advice.ⁿ¹⁴

Although the federal Investment Advisers Act includes a definition "investment adviser representative," there are no specific registration or regulatory provisions aimed at representatives in the federal act or SEC regulations promulgated under it. That is not the case, however, in state laws, which, as will be seen, impose licensing requirements based upon minimum competency standards much in the same manner as with state-licensed salespersons or representatives of securities broker-dealers. State laws likewise impose licensing, and concomitant qualification standards, on investment advisers themselves. In these important respects federal and state regulatory approaches to investment adviser regulation differ markedly, though in a manner quite consistent with the historic distinction between state and federal securities regulation generally.

With the enactment of NSMIA, and the realignment of state and federal securities regulatory roles that it brought about, state regulation of investment advisers is of vastly greater significance, as large numbers of smaller investment advisers previously registered with the SEC under the federal act have been rendered solely subject to state regulation. An important aspect of NSMIA was the literal divestiture from SEC regulation of investment advisers whose scope of operations, defined in terms of "assets under management" or the national character of business activity, is such as to no longer meet a threshold for SEC registration and regulation under the Investment Advisers Act of 1940. These investment advisers, together with their "investment adviser representatives," must comply with state investment adviser laws in each state in which their activities are such that no exemption or exception is available. In some states, hundreds of formerly SEC-registered investment advisers are subject to state licensing and regulatory requirements where none existed before NSMIA.

The realignment of federal and state roles in securities regulation means that state securities commissioners and agencies will devote greater resources to the activities of smaller investment advisers not only in licensing, but also in active ongoing oversight through examination and enforcement authority. Investment advisers and their representatives are critical market intermediaries who enjoy direct interaction with and involvement in the investment decision-making of vast numbers of individuals and small institutions. They are positioned such that the potential for fraud and the abuse of trust relationships is constantly present. State securities regulators, mindful of their historic protective mission, will

increasingly police investment adviser activities armed with broad qualitative standards and a considerable arsenal of enforcement weapons in the post-NSMIA era.

This section examines the common aspects of state regulation of investment advisers and investment adviser representatives in the wake of NSMIA. Unlike other aspects of state securities regulation, commonality among the states in this area is not a function of the Uniform Securities Act, but rather the large-scale adoption at the individual state level of the statutory and administrative scheme of the federal Investment Advisers Act of 1940, modified today to accomplish particular regulatory objectives, and also to satisfy the NSMIA-prescribed limitations on the scope of state authority where activities in a national market setting are involved. The discussion below examines the common elements of investment adviser regulation now in place among the states, along with a thorough consideration of the limitations on the scope of state authority that are necessary in practical assessments and applications of these newly important elements of Blue Sky regulation.

[2] Investment Adviser Licensing

In the wake of NSMIA all states except Wyoming have licensing provisions governing investment advisersⁿ¹⁵ and their representatives.ⁿ¹⁶ NSMIA divided the regulatory authority between the SEC and the states based on the level of assets under management. Investment advisers with assets under management of \$25 million or more and advisers to registered investment companies are exclusively regulated by the SEC.ⁿ¹⁷ Additionally, advisers without a principal office or place of business in a state in which they are regulated or required to be regulated are subject to SEC registration without regard to the level of assets under management. Currently, only investment advisers in Wyoming and the U.S. Virgin Islands are thus left subject to SEC regulation. All other investment advisers fall under the exclusive jurisdiction of the states, although the SEC has preemptive authority to permit other investment advisers to register federally if it determines that state registration would be unfair, a burden on interstate commerce, or otherwise inconsistent with the objectives of NSMIA.ⁿ¹⁸

NSMIA impacted state authority in the licensing of investment advisers in two ways. First, Congress established a national *de minimis* standard, by which states are precluded from requiring registration, licensing or qualification of any investment adviser if the investment adviser does not have a place of business within the state, and if during the preceding twelve-month period the investment adviser had fewer than six clients who are residents of the state.ⁿ¹⁹ States typically provide *de minimis* exceptions from licensing requirements for investment advisers who have no place of business within the state, and who meet certain criteria not only in terms of the number of clients who are residents, but also in situations in which an adviser services particular types of clients. Ohio, for example, excepts all investment advisers who have no place of business in the state and who have during the preceding twelve-month period had no more than five clients, and also those advisers who have as clients only certain "institutional" clients.ⁿ²⁰ However characterized, the types of advisory clients commonly included by states as the basis for a licensing exception are: (a) other investment advisers; (b) broker-dealers; (c) banks; (d) trust companies; (e) savings and loan associations; (f) insurance companies; (g) employee benefit plans of a certain size; and (h) governmental agencies or instrumentalities.ⁿ²¹ These exceptions are self-executing, meaning that no filing with the administrator is required, thus eliminating even "notice" filings.

NSMIA further preempted state regulatory authority over investment advisers having more than \$25 million in client "assets under management," as well as advisers to investment companies (mutual funds) that are registered under the Investment Company Act of 1940. As noted above, "assets under management" means the aggregate value of securities portfolios with respect to which an investment adviser provides "continuous and regular supervisory or management services."ⁿ²² The \$25 million asset divider for purposes of federal preemption is made subject to SEC authority to prescribe a higher amount that the Commission may deem appropriate. Pursuant to that authority, the SEC has, by Rule 203A-1 under the Act, established a threshold for SEC registration of \$30 million in assets under management for an investment adviser who is subject to licensing in the state in which it maintains its principal place of business. For advisers having between \$25 million and \$30 million in assets under management, and who are licensed under an

investment adviser statute of the state in which they maintain their principal place of business, registration with the SEC is optional.ⁿ²³ As investment advisers with \$25 million or less under management are now exclusively regulated by the states, these smaller advisers are subject to the full range of state licensing and enforcement powers. Licensing of investment advisers under state Blue Sky laws mirrors the process applicable to licensing broker-dealers. Licensing involves initial competency and fitness determinations by state administrators, as well as ongoing inspections, significant record keeping requirements, and a considerable array of enforcement powers. It is important, therefore, at the outset to identify the scope of state authority as determined by critical definitions and associated exemptions or exclusions.

As with broker-dealers, licensing of investment advisers is commonly addressed in Blue Sky laws in terms of "registration." The Uniform Act provides:

It is unlawful for any person to transact business in this state as an investment adviser unless (1) he is so registered under this act, (2) he is registered as a broker-dealer without the imposition of a condition under section 204(b)(5), or (3) his only clients in this state are investment companies as defined in the Investment Company Act of 1940 or insurance companies.ⁿ²⁴

The registration requirement today is straightforward. Any person other than a federal covered adviser who transacts business as an investment adviser must be registered. "Investment adviser" generally means a person that, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or the advisability of investing in, purchasing, or selling securities or that, for compensation and as a part of a regular business, issues or promulgates analysis or reports concerning securities. In several states, the term includes a financial planner or other person that, as an integral component of other financially related services, provides investment advice to others for compensation as part of a business or that holds itself out as providing investment advice to others for compensation. This is the definition contained in the 2002 Uniform Act.ⁿ²⁵ As with the definitions of each intermediary and associated person, post-NSMIA, there are certain exclusions from the definition. For investment advisers, these are:

- (A) An investment adviser representative;
- (B) A lawyer, accountant, engineer, or teacher whose performance of investment advice is solely incidental to the practice of the person's profession;
- (C) A broker-dealer or its agents whose performance of investment advice is solely incidental to the conduct of business as a broker-dealer and that does not receive special compensation for the investment advice;
- (D) A publisher of a bona fide newspaper, news magazine, or business or financial publication of general and regular circulation;
- (E) A federal covered investment adviser;
- (F) A bank or savings institution;
- (G) A credit union; or
- (H) Any other person excluded by rule or order.

All states have necessarily adopted the substance of the 2002 Uniform Act provisions to accommodate federal covered advisers under NSMIA and, as discussed below, the NSMIA *de minimis* requirements.ⁿ²⁶

Although there are variations, state investment adviser laws today provide exemptions from the registration requirement

for those investment advisers whose scope of business activity is limited. This is driven not only by the need to accommodate NSMIA as to federal covered advisers, but also to implement the national *de minimis* standard mandated by NSMIA. Thus, with certain variations, there are exemptions from registration, as reflected in the 2002 Uniform Act, for:

(1) A person with no place of business in the state that is registered under the securities act of the state in which the person has its principal place of business if its only clients in the state are:

(A) Federal covered investment advisers, investment advisers registered under the Act, or broker-dealers registered under the Act;

(B) Institutional investors;

(C) Bona fide preexisting clients whose principal places of residence are not in this state if the investment adviser is registered under the securities act of the state in which the clients maintain principal places of residence; or

(D) Any other client exempted by rule adopted or order issued under the Act;

(2) A person without a place of business in the state if the person has had, during the preceding 12 months, not more than five clients that are resident in the state in addition to those specified under paragraph (1) above; or

(3) Any other person exempted by rule or order.ⁿ²⁷

[3] Representative Licensing

Although NSMIA preempted state licensing authority over those larger investment advisers that remain eligible for registration with the SEC under the federal Investment Advisers Act of 1940, it preserved state authority with respect to all investment adviser representatives, including those of SEC-registered advisers, by providing that a "State may license, register or otherwise qualify an investment adviser representative who has a place of business located within that State."ⁿ²⁸ Thus, unless specifically exempt from registration, all investment adviser *representatives* are subject to state licensing regardless of association with or employment by an SEC-registered investment adviser that is not itself subject to state authority. As discussed earlier, SEC-registered investment advisers are subject to "notice" filing in those states in which they engage in business. Their identified representatives in those states, however, must be licensed individually.

States adopting the 2002 Uniform Act provide the exemption from registration for investment adviser representatives that contained in section 404(b) of the Act, such that the following individuals are exempt from registration:

(1) An individual who is employed by or associated with an investment adviser that is exempt from registration under section 403(b) or a federal covered adviser that is excluded from the notice filing requirements of section 405; and

(2) Any other individual exempted by rule or order issued under this [Act].ⁿ²⁹

The effect of this provision is to provide a limited exemption for representatives of investment advisers which themselves meet the criteria for exemption in a particular state in which it has no place of business discussed above. That is to say that one who is an investment adviser representative of an investment adviser having no place of business in the state, and who meets the requirements for exemption as to the clients serviced, or the *de minimis* criteria, is also exempt. Importantly, this is not to say that representatives of a federal covered adviser generally are exempt from registration. The exemptions from registration for investment adviser representatives in each state necessarily assume

that a representative will in fact be registered under the law of the state in which the federal covered adviser has a place of business and does not transact *de minimis* business or limit its business to institutional or other permitted clients.

In states that have not adopted the 2002 Uniform Act, the requirement is in many cases clearly stated. In Maryland, for example:

An investment adviser representative who has a place of business located in this state may not transact business on behalf of a federal covered adviser, unless the investment adviser representative is registered or exempt from registration under this subtitle.ⁿ³⁰

NSMIA did not define "investment adviser representative," nor did it supply guidance as what constitutes a "place of business." The definition of investment adviser representative varies from state to state. As noted earlier, however, the starting point in the post-NSMIA era is the definition of investment adviser representative set out in Rule 203A-3 under the federal Investment Advisers Act of 1940, which provides:

"Investment adviser representative" of an investment adviser means a supervised person of the investment adviser:

- (i) Who has more than five clients who are natural persons (other than excepted persons ...); and
- (ii) More than ten percent of whose clients are natural persons (other than excepted persons ...).ⁿ³¹

Newer investment adviser provisions in Blue Sky laws adopt definitions of investment adviser representative that are virtually identical to the federal definition, and focus on the role of a "supervised person."ⁿ³² Others have adopted a more functional definition that is inclusive of any partner, officer, or director, or a person occupying similar status or performing similar functions, or anyone else employed by or associated with an investment adviser who:

- (a) Makes any recommendation or otherwise renders advice regarding securities;
- (b) Manages accounts or portfolios of clients;
- (c) Determines which recommendation or advice regarding securities should be given;
- (d) Solicits, offers, negotiates for the sale of or sells investment advisory services; or
- (e) Supervises employees who perform any of the above functions.ⁿ³³

In general, an investment adviser representative is a natural person who gives advice on behalf of an investment adviser to a certain minimum number of natural person clients through regular meetings or communications.

Because several state definitions, like the federal definition, broadly define investment adviser representative in terms of a "supervised person," all supervised persons would be subject to state licensing registration or qualification requirements under those definitions. However, NSMIA preempted state regulation of "supervised persons" of SEC-registered advisers, except those persons who are in fact investment adviser representatives. Supervised persons who do not, on a regular basis, solicit, meet with, or otherwise communicate with clients of the investment adviser, or who provide only impersonal investment advice, are thus excluded from the definition of investment adviser representative,ⁿ³⁴ as are supervised persons who provide only "impersonal" investment advice.ⁿ³⁵ The exception for "impersonal" investment advice operates to exclude persons who provide advisory services only by means of written materials or oral statements that do not purport to meet the objectives and needs of specific individuals or accounts.ⁿ³⁶

[4] Filing Requirements

Compliance with state Blue Sky laws entails either a "notice" filing in the case of SEC-registered advisers operating within a state, or full licensing procedures in the case of all others. As discussed above, investment adviser representatives must qualify for licensing regardless of the filing status of the advisers with which they are associated.

The Uniform Act provides that an applicant for licensing as an investment adviser "shall file with the [Administrator] an application for licensing and a consent to service of process The application for licensing must contain the information that the [Administrator], by rule, requires."³⁷ In practice, licensing of investment advisers and investment adviser representatives is accomplished through completion and submission of SEC Form ADV--"Uniform Application for Investment Adviser Registration"--prescribed under the Investment Advisers Act of 1940. Form ADV is formatted both for a paper version and for electronic filing through the Investment Advisor Registration Depository (IARD). SEC-registered investment advisers must submit their initial registration through the IARD. Participation in the IARD requires establishing account access to the system through FINRA. IARD also accepts filings by state-registered investment advisers, who must pay the same fees as SEC-registered advisers. Nearly all states now mandate electronic filing through the IARD.

Form ADV consists of two parts. Part 1 collects information concerning the adviser and associated persons. It is comprised of various questions and schedules addressing business practices, ownership and control of the adviser, persons who provide investment advice on behalf of the adviser, and detailed disciplinary histories. Part 2 is itself divided in two parts. Part 1A includes information to be provided by all investment advisers. Part 1B, prepared by the North American Securities Administrators Association (NASAA) on behalf of state securities regulators, contains additional items to which state-registered advisers must respond. Part 1B includes bonding and capital information, and information concerning financial planning services, custody of client funds or securities, compliance personnel, and arbitration claims. Part 2 contains information required to be disclosed to prospective advisory clients, and doubles as a disclosure document for compliance with the "brochure" rule under the Investment Advisers Act of 1940, governing dissemination of information.³⁸ Part II functions as the current brochure of an adviser, to be continuously amended as necessary, delivered to prospective clients, and annually offered to current clients. States have substantially adopted the SEC brochure rule into their own investment adviser statutes and regulations.³⁹

For SEC-registered investment advisers required only to make "notice" filings under Blue Sky laws, Form ADV is combined with a form of consent to service of process and a fee to complete the filing. Notice filings in states are annual, and must be renewed prior to expiration. Form ADV amendments are made electronically through the IARD.

Filing requirements for investment advisers subject to licensing under state laws involve an application generally consisting of not only a complete Form ADV filed electronically, but also certain other items including the identification of a designated "principal" of an adviser that is not itself a natural person, a schedule of all persons who will act as investment adviser representatives in the state, certain background and qualifying information on those identified representatives, and standard fingerprint cards to the extent a representative is not already on file in the Central Registration Depository (CRD). Most states also provide for direct submission of other materials or information as may be required by the administrator, such as prescribed financial statements, the extent of the requirements for which differs according to whether the adviser expects to have custody or possession of client funds or securities, or requires prepayment of advisory fees. In Florida, for example:

Investment adviser applicants shall file financial statements as of a date within ninety (90) days prior to the date of filing for registration, which statements may be unaudited financial statements defined in paragraph (2)(d) of this Rule. However, each investment adviser who has custody or possession of clients' funds or securities; requires prepayment of advisory fees six months or more in advance and in excess of \$500 per client; or computes net capital pursuant to SEC Rule 15c3-1 for purposes of compliance with Rule 3E-600.016(3), shall file [audited] financial statements.⁴⁰

In Hawaii, the requirement also illustrates incorporation of the NSMIA mandate that intermediaries not be made subject to multiple, varying burdens for advisers whose principal place of business is in a different state. Having prescribed the financial statement similar to Florida set out above, Hawaii goes on to provide:

If the investment adviser maintains its principal place of business in a state other than this state and the investment adviser is registered in that state and in compliance with its financial reporting requirements, this requirement [for financial statements] shall be deemed satisfied by the investment adviser filing with the commissioner a copy of those financial statements, if any, that are required to be filed by the adviser in the state where it maintains its principal place of business.ⁿ⁴¹

Investment adviser representative licensing is accomplished through filing an application consisting of prescribed items including a complete Form U-4--"Uniform Application for Securities Industry Registration or Transfer." Form U-4 collects personal, employment and disciplinary history information and, coupled with such other evidence required by states concerning attainment of a minimum competency standard, serves as the basic means by which administrators determine the fitness of a representative for licensing under the applicable qualitative standard. Representatives must also submit standard fingerprint cards if they have not already been submitted through the CRD in connection with a prior securities registration or license. States may also require additional items specifically dealing with satisfaction of the minimum competency standard discussed below and, where applicable, certain notification evidence in the event a representative will act for more than one investment adviser. There is a separate fee for investment adviser representative license applications, and licensing and fees for representatives are annual, as they are in the process applicable to the advisers themselves.

The filing requirements supply the sources of information used by administrators in measuring an applicant for licensing as an investment adviser or investment adviser representative against the particular standard for granting licenses. Forms ADV and U-4 in particular present considerable securities industry background information, and allow for a determination of the worthiness of an applicant to engage in business in the state. Regulations under Blue Sky laws typically list particular factors taken into consideration, which in all cases encompass the same factors applied to licensing of broker-dealers and their associated persons. In some states specific factors applicable to investment advisers and representatives are included. In Hawaii, for example, specific issues bearing on an applicant's worthiness include a series of adviser-specific factors such as charging unreasonable advisory fees, failing to disclose material conflicts of interest, guaranteeing results and advertising violations.ⁿ⁴²

In general, administrators rely on this information to assess whether an applicant has engaged in fraudulent conduct or has been found liable for conduct constituting incompetence in financial activities. The information also discloses whether the applicant has been subject to administrative, civil or other disciplinary action by regulatory authorities or has failed to satisfy any judgment or ward. Administrators may also learn whether an applicant has been found guilty of a felony, or of any misdemeanor involving theft, deception or moral turpitude; and, in general, whether the applicant has engaged in any conduct which would reflect on the applicant's reputation for honesty, integrity, and competence in business and personal dealings.

As illustrated by the Uniform Act,ⁿ⁴³ states utilize the filing requirements as the basis for summary orders denying an application (or in some cases notices of intent to issue such orders), which trigger the right of an applicant to initiate a hearing.ⁿ⁴⁴ The hearing procedure effectively places the burden on the applicant to demonstrate that the indicated basis for denying the license is insubstantial, or that the public interest would not be served by denial.

[5] Minimum Competency

Applicants for state licensing as investment advisers or investment adviser representatives must demonstrate that they are qualified by training and experience to engage in the advisory business. There are generally three ways in which an applicant may satisfy the minimum competency standards for investment advisers and representatives under Blue Sky

laws: (1) by being continuously registered for a prescribed period of time as an investment adviser with the SEC under the Investment Advisers Act of 1940; (2) by achieving a passing score on one of the designated "series" of examinations administered by FINRA; or (3) by achieving and maintaining a certain professional designation such as that of Certified Financial Planner, Chartered Financial Analyst, Chartered Investment Counselor, Chartered Financial Consultant, or Certified Public Accountant/Personal Financial Specialist.

In the wake of NSMIA, prior continuous SEC registration as an investment adviser makes for a relatively simple transition from federal to state regulation for those advisers no longer eligible for SEC registration. However, because SEC registration does not extend to investment adviser representatives, satisfaction of the minimum competency requirements in many, if not most, instances involves passing one of the Series 6, 7, 8, 22, 24, 26, 39, 62, 63, 65 or 66 examinations administered through FINRA. For individuals previously employed in the securities industry, the requirement does not mean new or additional testing. An individual who has at some time passed one of the designated examinations may not be required to take it or another again in connection with an application for licensing as an investment adviser representative, or as the designated principal of an investment advisory firm. Thus, individuals previously qualified under securities industry standards, whether or not current in that qualification, may meet state minimum competency requirements.ⁿ⁴⁵

To facilitate the examination requirement for individuals having no prior securities industry registration, the North American Securities Administrators Association (NASAA), in conjunction with FINRA, created the Series 65 Investment Advisers Examination specifically for this purpose. Series 65 is a limited purpose examination focusing on the basic ethical responsibilities of investment advisers, the Uniform Securities Act, and the federal securities laws, especially the Investment Advisers Act of 1940. It is a two-hour, 75-question computer-based exam. A passing score is 70%. The exam is available for individual investment advisers and designated principals of advisory firms, and it is also used for the qualification of investment adviser representatives.ⁿ⁴⁶

Minimum competency for advisers and representatives may also be satisfied, and examination requirements waived, for individuals holding certain professional designations. There are minor variations in specific accrediting requirements attached to some of these provisions, but the Oregon list of qualifying professional designations is representative:

(A) Chartered Financial Analyst (CFA) granted by the Association for Investment Management and Research;

(B) Certified Financial Planner (CFP) issued by the Certified Financial Planner Board of Standards, Inc.;

(C) Chartered Financial Consultant (ChFC) awarded by the American College, Bryn Mawr, Pennsylvania;

(D) Chartered Investment Counselor (CIC) granted by the Investment Counsel Association of America; or

(E) Personal Financial Specialist (PFS) administered by the American Institute of Certified Public Accountants.ⁿ⁴⁷

[6] Post-Registration Requirements

Subject to section 222 of the Investment Advisers Act of 1940,ⁿ⁴⁸ which was added by NSMIA and mandated a national standard, states may establish minimum financial requirements, requirements for reports and recordkeeping and other requirements for investment advisers on an on-going basis.ⁿ⁴⁹

[a] Reporting and Record Keeping Requirements

Once licensed, investment advisers are subject to current information reporting requirements,ⁿ⁵⁰ and such further annual or periodic financial reports as an administrator may prescribe. States also impose specific record keeping requirements. With few exceptions, state books and records requirements for investment advisers track--indeed in many cases, incorporate by reference--those contained in the federal Investment Advisers Act of 1940. Records generally required of all investment advisers include: (1) general journals (including at least a cash receipts and cash disbursement journal); (2) general ledger; (3) order memoranda (for brokerage orders); (4) bank records; (5) bills and statements; (6) trial balances and financial records; (7) written communications (business correspondence sent and received); (8) a list of any discretionary accounts; (9) trading authority or powers of attorney; (10) written agreements pertaining to the business of the adviser; (11) advertising materials; (12) representatives' personal transaction records; (13) principals' personal transaction records; (14) solicitor agreements and client acknowledgments; (15) record of providing disclosure statements; and (16) backup data for performance reports or claims.ⁿ⁵¹ Additional items or categories of records may be required depending upon the particular nature or scope of an adviser's business. Advisers with custody of client funds or securities generally must keep additional records such as a separate ledger for each client showing all purchases, sales proceeds, and deliveries of securities for the account of the client, with dates and prices, copies of transaction confirmations, and securities records showing the names of clients who have positions in those securities.ⁿ⁵² And advisers who provide supervisory or management services must keep separate records for each client showing securities purchased and sold, including date, amount and price, as well as a listing of client names by security positions.ⁿ⁵³

As a general matter, ongoing financial reporting requirements for investment advisers are similar to, if not the same as, those required of broker-dealers in the same state, especially with respect to reporting and filing dates.ⁿ⁵⁴ However, in one state the investment adviser must file reports only when the investment adviser has discretionary authority with respect to transactions in a client's securities or has custody of a client's funds or securities.ⁿ⁵⁵ Some states mandate financial reporting if the investment adviser either has custody or possession of clients' funds or securities or requires advisory fees in excess of \$500 per client to be paid six months or more in advance.ⁿ⁵⁶ In other states, investment adviser reporting and filing requirements differ in other ways from those applicable to broker-dealers.ⁿ⁵⁷

Akin to reporting requirements, the State Corporation Commission in Virginia has authority to require the dissemination of information about an investment adviser when doing so is in the public interest.ⁿ⁵⁸ Information given to clients or prospective clients under the federal Investment Advisers Act of 1940 and rules promulgated thereunder may be used for this purpose to the extent allowed by the Commissioner.ⁿ⁵⁹

Pursuant to the NSMIA amendments to the Investment Advisers Act, states are prohibited from imposing record keeping requirements on a state-registered adviser whose principal place of business is not in that state if those requirements are in addition to those required under the laws of the state in which the investment adviser maintains its principal place of business and with whose applicable books and records requirements the adviser already complies.ⁿ⁶⁰ Generally, these records include journals containing receipt and disbursement records; general and auxiliary ledgers reflecting asset, liability, reserve, capital, income and expense accounts; memoranda of orders given by the investment adviser to buy or sell customers' securities, together with any instructions given by the customer; checkbooks, bank statements, canceled checks and cash reconciliations; records of bills and statements, paid or unpaid, relating to the business of the investment adviser; trial balances, financial statements and internal audit working papers; communications received or dispatched relating to any investment advice, the receipt, disbursement, or delivery of funds or securities, or the placing or execution of orders to buy or sell securities; a list of all discretionary accounts; copies of all powers of attorney; copies of all written agreements with customers; copies of advertising material; and records of transactions in which the investment adviser obtains any beneficial ownership.ⁿ⁶¹

The rules requiring record keeping for investment advisers generally prescribe that records be kept for a stated minimum period of time, although the period not only varies from state to state, but often varies within a single state depending on the type of record.ⁿ⁶²

[b] Minimum Financial Requirements

Unlike broker-dealers, there are no blanket minimum financial requirements among the states for investment advisers. Minimum net capital, net worth, or bonding requirements, if imposed at all, are generally keyed to whether the adviser maintains custody of client funds or securities, or exercises discretionary authority. In Iowa, for example, an investment adviser who has custody of client funds or securities must maintain a minimum net worth (as defined in the statute) of \$35,000. Every investment adviser who has discretionary authority over client funds or securities, but who does not have custody, must maintain a minimum net worth of \$10,000.ⁿ⁶³ In all cases where such requirements are imposed, however, NSMIA forbids any state from requiring an adviser to maintain a higher bond or net capital amount than would be required by the state in which it maintains its principal place of business and with whose bonding and capital requirements it complies.ⁿ⁶⁴

Only a handful of states have investment adviser minimum capital requirements applicable under all circumstances.ⁿ⁶⁵ Others, like Iowa noted above, impose minimum requirements only when the investment adviser is in possession of clients' funds or securities, or has discretionary authority over client funds.ⁿ⁶⁶ And some of these states prescribe a minimum ratio between minimum net capital and aggregate indebtedness which must be maintained.ⁿ⁶⁷

Some states provide for a surety bond in lieu of a minimum capital requirement.ⁿ⁶⁸ And many states have general requirements that investment advisers post surety bonds.ⁿ⁶⁹ However, as with net capital or net worth requirements, a number of these provide that the bond is needed only when the investment adviser has custody of funds or securities of one or more clients.ⁿ⁷⁰ Additionally, in several instances the surety bond requirement is not applicable to investment advisers who continuously maintain net capital of at least \$100,000.ⁿ⁷¹

FOOTNOTES:

(n1)Footnote 1. Investment Advisers Act § 202(a)(11), 15 U.S.C. § 80b-2(a)(11).

(n2)Footnote 2. See Unif. Sec. Act § 401(f).

(n3)Footnote 3. Investment Advisers Act Rel. No. 1092 (Oct. 8, 1987).

(n4)Footnote 4. Investment Advisers Act Rel. No. 1092 (Oct. 8, 1987).

(n5)Footnote 5. Investment Advisers Act Rel. No. 1092 (Oct. 8, 1987).

(n6)Footnote 6. *Wash. Rev. Code. § 21.20.005(6); see also Va. Code Ann. § 13.1-501(A).*

The 2002 Uniform Securities Act provides, subject to the same exclusions that are contained in the federal definition, and encompassing financial planners:

"Investment adviser" means a person that, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or the advisability of investing in, purchasing, or selling securities or that, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities. The term includes a financial planner or other person that, as an integral component of other financially related services, provides investment advice to others for compensation as part of a business or that holds itself out as providing investment advice to others for compensation... ." 2002 Unif. Sec. Act § 102(15).

(n7)Footnote 7. See 2002 Unif. Sec. Act § 102(15)(B).

(n8)Footnote 8. *Tex. Rev. Civ. Stat. Ann. art. 581-33K.*

(n9)Footnote 9. No. 08-40711, 3A *CCH Blue Sky L. Rep.* P74,776 (5th Cir. 2009).

(n10)Footnote 10. The Texas Securities Act, as with nearly all Blue Sky laws, includes a provision that:

No person who has made or engaged in the performance of any contract in violation of any provision of this Act or any rule or order or requirement hereunder, or who has acquired any purported right under any such contract with knowledge of the facts by reason of which its making or performance was in violation, may base any suit on the contract. Tex. Rev. Civ. Stat. Ann. art. 581-33K.

(n11)Footnote 11. See Joseph P. Canouse Esquire, SEC No-Action Letter (July 15, 1977); J.H. Rodgas, Jr., SEC No-Action Letter (Sept. 7, 1974); Frank T. Hines, SEC No-Action Letter (Aug. 21, 1972).

(n12)Footnote 12. 3A *CCH Blue Sky L.Rep.* P74,776, at 80,135 (5th Cir. 2009).

(n13)Footnote 13. See 2002 Unif. Sec. Act § 102(15)(C).

(n14)Footnote 14. Investment Advisers Act Rule 203A-3(a)(1), 17 *C.F.R.* § 275.203A-3(a)(1).

"Impersonal investment advice" is defined under the rule as investment advisory services provided by means of written material or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts. Investment Advisers Act Rule 203A-3(a)(3)(ii), 17 *C.F.R.* § 275.203A-3(a)(3)(ii).

(n15)Footnote 15. See, e.g.:

California: Cal. Corp. Code § 25230.

Texas: Tex. Rev. Civ. Stat. Ann. arts. 581-4(C), 581-12 (Texas includes investment advisers within the definition of "dealer").

(n16)Footnote 16. See, e.g., *Ala. Code* § 8-6-3(c).

(n17)Footnote 17. "Assets under management" is determined by the aggregate value of securities portfolios for which an investment adviser provides continuous and regular supervisory or management services. Investment Advisers Act § 203A(a)(2), 15 *U.S.C.* § 80b-3a(a)(2).

(n18)Footnote 18. To address eligibility for SEC registration and switching from SEC registration, for investment advisers operating in states having an investment adviser statute the SEC issued Rule 203A-1 under the Investment Advisers Act, 17 *C.F.R.* § 275.203A-1. By the rule, the SEC established a threshold of \$30 million of assets under management for requiring SEC registration if the adviser maintains its principal office and place of business in a state otherwise requiring licensing. The rule exempts advisers having between \$25 million and \$30 million of assets under management from SEC registration if the adviser elects to be licensed in the applicable state.

(n19)Footnote 19. Investment Advisers Act § 222(d), 15 *U.S.C.* § 80b-18a(d).

(n20)Footnote 20. *Ohio Rev. Code* § 1707.141(B)(3).

(n21)Footnote 21. See, e.g., *Utah Code Ann.* § 61-1-3(3)(b).

(n22)Footnote 22. Investment Advisers Act § 203A(a)(2), 15 *U.S.C.* § 80b-3a(1).

(n23)Footnote 23. Investment Advisers Act Rule 203A-1(a)(2), 17 *C.F.R.* § 275.203A-1(a)(2).

(n24)Footnote 24. Unif. Sec. Act § 201(c).

(n25)Footnote 25. *See* 2002 Unif. Sec. Act § 102(15).

(n26)Footnote 26. *See, e.g., Cal. Corp. Code §§ 25202, 25230.* California, for example, now exempts those persons already registered in another state if (1) they have no place of business in California and (2) during the preceding 12-month period they have had fewer than six clients who are residents of California.

(n27)Footnote 27. *See* 2002 Unif Sec. Act § 403(b); *see also* Indiana: *Ind. Code § 23-19-4-3(b).*

(n28)Footnote 28. Investment Advisers Act § 203A(b)(1)(A), *15 U.S.C. § 80b-3a(b)(1)(A).*

(n29)Footnote 29. 2002 Unif. Sec. Act § 404(b).

(n30)Footnote 30. Md. Ann. Code § 11-402(b)(3).

(n31)Footnote 31. *17 C.F.R. § 275.203A-3(a)(1).*

"Excepted persons" for purposes of making these determinations are those described as "qualified" clients in Rule 205-3(d)(1) under the Act, *17 C.F.R. § 275.205-3(d)(1).* These are natural persons who have at least \$750,000 under management of the investment adviser; or have a net worth in excess of \$1,500,000; or are otherwise qualified under certain provisions of the Investment Company Act of 1940; or are associated with the investment adviser itself in a managerial capacity; or who have been employed by the investment adviser for at least 12 months in the performance of certain types of duties.

(n32)Footnote 32. *See, e.g.:*

Ohio: Ohio Rev. Code § 1707.01(II).

(n33)Footnote 33. *See, e.g., Wash. Rev. Code § 21.20.005(14).*

(n34)Footnote 34. *17 C.F.R. § 275.203A-3(a)(2)(i).*

(n35)Footnote 35. *17 C.F.R. § 275.203A-3(a)(2)(ii).*

(n36)Footnote 36. The SEC has issued rules clarifying whether a "solicitor" for an SEC-registered adviser is subject to state qualification requirements as well. The SEC determined that if a solicitor is an employee of the adviser for which he or she solicits, NSMIA preempts state law unless the solicitor is also an investment adviser representative under Rule 203A-3(a). *See 17 C.F.R. § 275.203A-3(b).*

Particular issues and procedures involved in the use of solicitors by investment advisers are discussed in more detail in § 11.05[d], *below*.

(n37)Footnote 37. Unif. Sec. Act. § 205.

(n38)Footnote 38. *See* Rule 204-3 under the Investment Advisers Act, *17 C.F.R. § 275.204-3.* Advisers must provide either the current Part II of Form ADV or a "brochure" containing at least the same required information.

(n39)Footnote 39. *See, e.g., Pa. Code tit. 64, § 404.011(b):*

An investment adviser registered under section 301 of the act shall offer and deliver to each client and prospective client a current firm brochure and one or more supplements as required by this section.

The brochure and supplements shall contain the information required by Part 2 of Form ADV.

The brochure rule is discussed further in § 11.06[2][d].

(n40)Footnote 40. *Fla. Admin. Code Ann. r. 3E-300.002(4)(a)*.

(n41)Footnote 41. *Haw. Rev. Stat. § 485-14(e)(4)*.

(n42)Footnote 42. *Haw. Admin. Rules 16-38-7(c)(1)-(27)*.

(n43)Footnote 43. *Unif. Sec. Act § 204(c)*.

(n44)Footnote 44. *See, e.g., Ark. Code Ann. § 23-42-308(c)(2)*, which provides:

Upon entry of the order, the commissioner shall promptly notify the applicant or registrant, as well as the employer or prospective employer, if the applicant or registrant is an agent or representative, that the order has been entered, and of the reasons therefor, and that within fifteen (15) days after the receipt of a written request the matter will be set down for hearing.

Both the process and the grounds involved for denial of all intermediary license applications are considered further in § 11.04, below .

(n45)Footnote 45. *See, e.g., Conn. Agencies Regs. § 36b-31-15e(e)* ("[E]ach applicant for registration as an investment adviser agent shall supply evidence to the commissioner that such applicant has taken and successfully passed the Uniform Investment Adviser Law Examination or such other examination determined by the commissioner to be acceptable in lieu thereof.").

States may impose a time limit on the effectiveness of a prior passing score. In Pennsylvania, for example, persons registering as investment advisers or investment adviser representatives must have passed a designated examination within two years of filing an application. However, Pennsylvania also expressly provides for "grandfathering," i.e., waiver of the examination requirement, for applicants who received a passing score on designated examinations sometime prior to January 1, 2000. *Pa. Code § 303.032(a)-(b)*.

(n46)Footnote 46. A "Uniform Combined State Law Examination," designated as Series 66, was created to fulfill examination requirements for securities salespersons and investment advisers/representatives. A passing score on the Series 66 examination satisfies state requirements for the Series 63 examination (Uniform Securities Agent State Law Examination) and the investment adviser qualification at the same time, and is particularly useful to financial planners whose combined advisory and securities sales activities involve qualification both as a registered representative of a broker-dealer as well as either an investment adviser or an investment adviser representative.

(n47)Footnote 47. *Or. Admin. Rule 441-175-0120(5)(b)*. Oregon, like most other states, provides for waiver of examination requirements for "such other professional designation as the Director may by order recognize." *Or. Admin. Rule 441-175-0120(5)(b)*. However, state administrators have not recognized any other professional designations.

(n48)Footnote 48. 15 U.S.C. § 80b-22 (2000).

(n49)Footnote 49. *See* 2002 *Unif. Sec. Act* § 411.

(n50)Footnote 50. *See, e.g., Idaho Rule 061, Idaho APA 12, tit. 01, ch. 08*:

All broker-dealers and investment advisers must assure that current and accurate information is on

file with the Department at all times. If information in an application for registration becomes inaccurate or incomplete, additional information must be submitted through updates on the appropriate Form BD, on the CRD system, or Form ADV or by direct notice to the Department.

(n51)Footnote 51. *See, e.g.,* Ohio Admin. Code § 1301:6-3-151(C)(1).

(n52)Footnote 52. *See, e.g.,* Haw. Sec. Reg. § 16-38-41(b).

(n53)Footnote 53. *See, e.g.,* Haw. Sec. Reg. § 16-38-41(c).

(n54)Footnote 54. *See, e.g.,* Cal. Admin. Code tit. 10, § 260.241.2(a)(4). Reports are required following initial registration on a date chosen by the investment adviser, and annually thereafter on or before such date.

(n55)Footnote 55. *Or. Admin. Rule 441-195-0050(1).*

(n56)Footnote 56. *See, e.g.:*

North Carolina: N.C. Admin. Code tit. 18, § 6.1708(a), (c). Within 90 days following the end of the fiscal year.

Oklahoma: Okla. Sec. Rule 660:10-7-44. The financial report must be filed by the last day of the fourth month following the close of the fiscal year.

Utah: Utah Sec. Rule R164-5-3(D)(1). As of the end of the investment adviser's fiscal year.

(n57)Footnote 57. *See, e.g.:*

Mississippi: Miss. Sec. Rule 609 (copies of a balance sheet and net capital statement required to be filed within 90 days after the end of the fiscal year).

Tennessee: Tenn. Sec. Rule 0780-4-3-.02(4)(a). (reports required to be filed within 90 days after the close of the fiscal year).

Washington: Wash. Admin. Code § 460-24A-060. (reports required to be made as of the close of the fiscal year and filed within 90 days thereafter).

West Virginia: W. Va. Sec. Reg. § 13.04(1). (reports required to be made as of the close of the fiscal year and filed within 60 days thereafter).

(n58)Footnote 58. *Va. Code Ann. § 13.1-505.1.*

(n59)Footnote 59. *Va. Code Ann. § 13.1-505.1.*

(n60)Footnote 60. Investment Advisers Act § 222(b), 15 U.S.C. § 80b-18a(b).

(n61)Footnote 61. The rule of each state should be carefully consulted, since some variance exists among them regarding the nature of the records to be kept. Some examples are as follows:

California: Cal. Admin. Code tit. 10, § 260.241.3.

Illinois: Ill. Admin. Code tit. 14, § 130.845.

Texas: Tex. Admin. Code tit. 7, § 115.5(b).

Wisconsin: Wis. Admin. Code § [SEC] 5.03.

(n62)Footnote 62. *See, e.g., Cal. Admin. Code tit. 10, §§ 260.241.1, 260.241.3(e).*

(n63)Footnote 63. Iowa Admin. Code r. 191-50.106(1). "Net worth" is defined as an excess of assets over liabilities, as determined in accordance with generally accepted accounting principles, but excluding a considerable variety of assets from the calculation. Iowa Admin. Code r. 191-50.106(1), § 191-50.106(4).

(n64)Footnote 64. Investment Advisers Act § 222(c), 15 U.S.C. § 80b-18a(c).

(n65)Footnote 65. *See, e.g., W. Va. Sec. Reg. § 13.02(1)* (every investment adviser shall maintain net capital of not less than \$25,000, in the form of cash, securities, or other liquid assets as may be prescribed by the commissioner).

Often, the option to post a surety bond is provided as an alternative to the net capital or, more commonly, minimum net worth requirements. In Utah, for example, unless an investment adviser posts a surety bond, it must maintain a minimum net worth of \$35,000. *See Utah Sec. Rule R164-4-4(D).*

(n66)Footnote 66. *See also:*

California: Cal. Admin. Code tit. 10, § 260.237.1(a)(1). \$25,000 minimum net capital.

Wisconsin: Wis. Admin. Code § [SEC] 5.02.

In most states, the statutes give Administrators the authority to impose minimum capital and/or bonding requirements. *See, e.g.:*

Delaware: Del. Code Ann. tit. 6, § 7314(e). Del. Sec. Rule 704.

Kansas: Kan. Stat. Ann. § 17-1254(i).

(n67)Footnote 67. *See, e.g.:*

Kentucky: The Kentucky Blue Sky law, for example, empowers the Commissioner to require the existence and maintenance of a minimum liquid net capital for advisers, and a minimum ratio between net capital and aggregate indebtedness. Ky. Rev. Stat. § 292.330(6).

See also Cal. Admin. Code tit. 10, § 260.237.1(a). Aggregate indebtedness must not exceed 500% of net capital.

(n68)Footnote 68. *See, e.g.:*

Alabama: Sec. Rule 830-X-3.06(6). A \$50,000 bond is acceptable in lieu of the net capital requirements.

Idaho: Idaho Rule 031, Idaho APA 12, tit. 01, ch. 08. Investment advisers not required to post a surety

bond must maintain tangible net assets in excess of \$5,000.

New Jersey: N.J. Admin. Code tit. 13, § 47A-2.2. A \$25,000 surety bond is acceptable in lieu of \$25,000 minimum capital.

(n69)Footnote 69. *See, e.g.:*

Delaware: Del. Code Ann. tit. 6, § 7314(e); Del. Sec. Rule 705. The Commissioner has the discretion to require the adviser to post a surety bond.

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:7(IV).

(n70)Footnote 70. *See, e.g.:*

District of Columbia: D.C. Sec. Act of 2000 § 203(g)(1)(A).

Maryland: Md. Regs. Code tit. 02, § 05.14(B)(2). \$10,000.

Minnesota: Minn. R. 2875.1930(1). \$25,000.

Mississippi: Miss. Sec. Rule 605. \$30,000.

New Mexico: N.M. Admin. Code tit. 12, § 11.3.4.2. The bond amount may be set by the Director at a minimum of \$100,000 and a maximum of \$1,000,000.

Utah: Sec. Rule R164-4-5(F). \$10,000.

(n71)Footnote 71. *See, e.g., Minn. R. 2875.1930.*



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Blue Sky Regulation

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CHAPTER 11 Regulation of Intermediaries: Broker-Dealers, Investment Advisers and Associated Persons

2-11 Blue Sky Regulation § 11.04

§ 11.04 Denial, Suspension, and Revocation of Intermediary Licensing

State authority to deny, suspend or revoke the license of an intermediary extends uniformly to broker-dealers, investment advisers and their respective associated persons or representatives. Blue Sky laws identify several grounds upon which state administrators may deny licenses to firms and persons engaged in the securities business. Under the Uniform Act, the Revised Uniform Act, and the Blue Sky laws of most states, an order denying or late depriving a person of a license may be entered if it is in the public interest, and if either the applicant has demonstrated certain disqualifying criteria or the administrator makes certain findings. The bases upon which an application for licensing may be denied are the same as those controlling authority to suspend or revoke a license once granted. A denial, suspension or revocation judged to be in the public interest is, *a fortiori*, necessary to protect the investing public.ⁿ¹

All of the common criteria for denying, suspending or revoking the license of an intermediary are discussed in more detail below. As a practical matter, in the initial application or periodic renewal or transfer processes, the principal criteria fall under the heading of character and fitness, or good "business repute." Although ultimate judgments are subjective, they are based upon an assessment of an applicant's regulatory history, satisfaction of applicable examination requirements and complete submission of required application documentation. The denial of a license involves an order of the administrator that is the product of an administrative procedure and findings. Although administrative procedures vary among the states, the denial of a license is typically preceded by a notice of intent identifying grounds, and affording the applicant an opportunity to be heard and to present evidence in support of the application.ⁿ² The procedure is the same where a suspension or revocation is involved.

The ability of state administrators to respond to applications with institution of appropriate proceedings to deny, or later to suspend or revoke, has been rendered far more efficient through the mechanism of the Central Registration Depository (CRD) for electronic filing of basic and continuously updated information for broker-dealers and their registered persons. The CRD represents a one-stop electronic filing system readily accessible to state regulators, as well as the investing public. All state licensing procedures for broker-dealers require filing with the CRD of Form U-4 for those persons who are to be registered representatives of a broker-dealer, and thus licensed as salespersons, agents or associated persons, and of Form BD for the broker-dealer itself. Forms U-4 and BD are "evergreen," that is, subject to continuous amendment and updating.ⁿ³ The creation of the Investment Adviser Registration Depository (IARD) system will eventually accomplish the same result with regard to investment advisers and their representatives. These databases permit the more or less continuous monitoring of licensed intermediaries by state regulators, and represent the main resource for assessing continuing fitness for licensing. For that reason, an essential aspect of initial licensing of an

intermediary in any state is entry by the applicant into the CRD or, eventually, by investment advisers and representatives into the IARD.ⁿ⁴

The overall "public interest" requirement attached to licensing determinations is intended to assure that minor or technical issues will not mandate denial of an application or institution of a suspension or revocation.ⁿ⁵ However, it is also clear that the fact that no member of the investing public suffers injury does not mean that adverse action on an application or a license is unwarranted.ⁿ⁶ The crucial distinction is substantially technical or inadvertent violations versus willful ones.

The statutes, as noted, apply to denial, suspension and revocation of registrations. Suspensions constitute temporary remedies applicable where there is a need for a drastic change in the methods of conducting business before a level of unfitness is reached. Two states put outside limits on the period of suspension, usually one year.ⁿ⁷ But in one case, where no maximum time period was indicated by statute, a five-year suspension was deemed proper.ⁿ⁸ A few states provide for the less harsh penalty of censure.ⁿ⁹ However, it has been held that even where the statute does not specifically provide for such a remedy, it is implicit that the administrator who has authority to suspend or revoke registrations has the implicit power to impose lesser sanctions such as censure or reprimand.ⁿ¹⁰

The Uniform Act and the Revised Uniform Act specify numerous grounds for denial, suspension or revocation of registrations.ⁿ¹¹ In the discussion below, particular criteria identified in the Uniform Act and the Revised Uniform Act as the bases upon which to deny, suspend or revoke licenses are addressed. Not all states, of course, adopt each or all of these categories. Nevertheless, an attempt has been made to broaden each concept so that as many state provisions as possible may be included. Other non-Uniform Act criteria are similarly included. An important caveat is that administrators may take action against persons in the securities business even where the prohibition is not expressly set forth in the statutes or regulations. The rationale for this is simply that general statutory language, when read in the light of interpretive cases, is sufficient to set forth disciplinary grounds not spelled out in statutes or regulations.ⁿ¹²

[1] Incomplete, False, or Misleading Application

The Uniform Act and many states provide for disciplinary measures against, broker-dealers, agents and investment advisers making false or misleading statements and omissions in their respective licensing applications. As illustrated by the 2002 Uniform Act, specifically, these statutes give Administrators the power to deny, suspend, or revoke registration whenever the applicant (in the case of denial) or registrant (in the case of suspension or revocation):

[h]as filed an application for registration in this State under this [Act] or the predecessor act within the previous 10 years, which, as of its effective date or any date after filing in the case of an order denying effectiveness, was incomplete in a material respect or contained a statement that, in light of the circumstances under which it was made, was false or misleading with respect to a material fact;ⁿ¹³

In a suspension or revocation proceeding the application must have been false or misleading as of the effective date of licensing. The fact that events occur subsequent to this date which change the nature or accuracy of application information is not grounds for administrative action under this provision.ⁿ¹⁴ If, however, the registrant is required to file corrections to information contained in the original applicationⁿ¹⁵ and fails to do so, the registrant may be subject to suspension or revocation, not under this section, but under provisions which punish noncompliance with the statute.ⁿ¹⁶

In a denial proceeding, the effective date cannot, of course, apply. Consequently, the date of filing is used in such cases.ⁿ¹⁷ In one state, the provision has been altered to allow denial, revocation or suspension if the application is materially inaccurate as of the effective date or as of the date an order of denial, suspension or revocation is issued.ⁿ¹⁸ This provision seems automatically to pick up the requirement that application amendments be filed to correct outdated information.ⁿ¹⁹

A few Blue Sky laws contain a provision comparable to the provision in the Uniform Act and the Revised Uniform Act, minus the chronological benchmarks. These statutes simply provide for denial, suspension or revocation if the applicant or registrant has made a materially false statement in the application for registration.ⁿ²⁰ Some states carry their provisions beyond the registration application. These statutes apply also to any material information contained in any report filed with the Administratorⁿ²¹ or to any information supplied in any proceedings. Again, the lack of a specific provision in other statutes does not mean that such actions would not be punishable. To the contrary, they would likely fall under disciplinary measures permitted for non-compliance with any provision of the Blue Sky law.

The willingness of state administrators to revoke registration for material misstatements or omissions contained in an application was demonstrated in a New Jersey caseⁿ²² where an agent responded in the negative to application questions dealing with arrests or convictions for crimes, disciplinary proceedings by administrative, governmental or regulatory bodies, or charges of violations of statutes or rules of any such body. The agent had been convicted pursuant to a military court martial for desertion, grand larceny and resisting arrest. In explaining why he omitted these details from the application, the agent argued that the questions constituted an illegal invasion of his privacy and that since he was seeking admission to a civilian occupation, he was under the reasonable belief that only matters bearing on his civilian record were being questioned. The court answered these points by stating first that admission into a licensed profession requires that the state look "into those portions of the applicant's private life which affect the public interest."ⁿ²³ Second, the court pointed out that the application clearly called for a record of "convictions" and "disciplinary action, past or pending, by any administrative, governmental or regulatory body." The court asserted that "[t]he questions are sufficiently clear to convey to anyone intelligent enough to act as a securities agent the nature of the information sought to be elicited."ⁿ²⁴

[2] Non-Compliance with Statutes or Rules

Perhaps the provisions giving the broadest grounds for revocation, suspension or denial of registrations of persons in the securities business are those which permit such actions for non-compliance with any statutory provision of the Blue Sky law or any rule or regulation promulgated under it. The Uniform Act and Revised Uniform Act provide that the administrator may take action whenever an applicant or registrant "has willfully violated or willfully failed to comply with any provision of this [A]ct[,], or a predecessor act[,], or any rule or order under this act or a predecessor act."ⁿ²⁵ Apart from those portions of the provision referring to predecessor acts, a majority of states have adopted this provision substantially intact.ⁿ²⁶ Differences generally occur because a state has dropped the requirement that the violation or failure to comply be willful,ⁿ²⁷ or because the statute is silent with respect to violations of administrative rules.ⁿ²⁸ Delaware takes a unique approach in retaining the Uniform Act language for violations of the statute, but providing in a separate section for violations of the Commission's regulations or failure to comply with an order of the Commissioner.ⁿ²⁹ Among the states that have adopted the Revised Uniform Act,ⁿ³⁰ not only is willful violation of the statutes or rules grounds for revocation, denial or suspension, but so are breaches of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, the Investment Company Act of 1940, and the Commodity Exchange Act of 1974.

The requirement that violations be "willful" is closely tied to the public interest factor, which is generally indispensable to a denial, suspension or revocation. The drafters of the Uniform Act intended the concept of willfulness to restrain administrators from pouncing on every technical or inadvertent violation of the statute or rules. However, in order for a failure to comply or a violation to be considered willful, the complainant need not prove that the registrant had knowledge of the violation or the intent to commit a violation. All that is needed is a showing that "the person acted intentionally in the sense that he was aware of what he was doing."ⁿ³¹ Cases examining administrative proceedings support this view.ⁿ³²

Several states emphasize that certain acts constitute non-compliance by specifically listing them as grounds for denial, revocation or suspension, even though such actions are also warranted under the broad provision on non-compliance.

These statutes stress such infractions as failing to file required financial statementsⁿ³³ or other reports,ⁿ³⁴ failing to keep required books and records,ⁿ³⁵ not permitting administrative examination of such books and records,ⁿ³⁶ and failing to maintain minimum capitalⁿ³⁷ and/or bonding requirements.ⁿ³⁸ A few states provide for broker-dealer discipline where the registrant is dealing in securities through an unregistered agent.ⁿ³⁹ The use by a broker-dealer of an unlicensed agent is an unlawful act in most statesⁿ⁴⁰ and would therefore fall under the general non-compliance provisions.

Specific acts of non-compliance have been the subject of disciplinary proceedings. In *Mayflower Securities Co. v. Bureau of Securities*,ⁿ⁴¹ for example, the Securities Administrator had ordered a twenty-day suspension of a broker-dealer for trading in securities through an unregistered agent and failing to keep required records. The charge of using an unregistered agent arose from practices of both the broker-dealer and the Administrator, which the court described as "loose at both ends."ⁿ⁴² The Administrator's practice was to send agent renewal applications to broker-dealers, who would complete one portion of an agent's form and then turn the form over to the agent to complete the balance. In this particular instance, the agent returned his completed form to his manager for filing, but for some reason it was never filed. Unknown was whether the form was ever submitted to the Administrator or was lost in the Administrator's office. The situation came to light when the agent, believing he was registered, applied to have his registration transferred to another broker-dealer employer. The Administrator then sent a representative to the broker-dealer's office to examine the latter's files to see if the agent had engaged in securities transactions in the state. Unfortunately, the broker-dealer was in the process of moving and could not locate the records, and this gave rise to the second charge. The records, however, were in existence and were subsequently offered to the court. In view of the circumstances, the court reversed the suspension,ⁿ⁴³ noting that the violations, at most, were technical and not willful, and that a reprimand of the broker-dealer by the administrator might be more fitting under the facts.ⁿ⁴⁴

The facts of this case are rather unusual in that the administrator may have been at fault for not licensing the agent, and that the records could not be located due to the unhappy coincidence that the offices were being moved. But not all administrative proceedings arise due to happenstance. Most, in fact, involve serious charges that the exercise of proper care would have prevented. In another proceeding,ⁿ⁴⁵ an agent was also in charge of keeping various records for his broker-dealer employer. Unfortunately, because he was too concerned with the commissions he could earn as an agent, he slipped badly in his record keeping duties, particularly in keeping track of margin accounts. This lapse not only cost his customers many thousands of dollars, but forced his employer out of business. The agent received a rather light punishment. The administrator took into consideration his youth and lack of maturity, the fact that his actions were neither intended to defraud nor in intentional disregard of appropriate standards, and the fact that his service as agent was otherwise generally satisfactory. Accordingly, instead of outright revocation, the administrator suspended the agent's registration for five years.ⁿ⁴⁶

The registrations of broker-dealers have also been revoked as a result of such conduct as failing to maintain minimum capital as required by statute and regulations,ⁿ⁴⁷ selling unregistered securities,ⁿ⁴⁸ and trading in securities through unlicensed agents.ⁿ⁴⁹ In one instance, the license of an investment adviser was revoked for, among other things, acting as an agent of an issuer and selling its unregistered securities.ⁿ⁵⁰

[3] Character and Conduct Determinations

[a] Dishonest or Unethical Practices and Fraud

Securities administrators are broadly empowered to deny, revoke or suspend a license under provisions such as that contained in the Uniform Act triggered on a finding that the applicant or registrant "has engaged in dishonest or unethical practices in the securities business."ⁿ⁵¹ While many states have adopted the Uniform Act provision,ⁿ⁵² some have refined or supplemented it in various ways. The District of Columbia, for example, empowers the Commissioner to act in circumstances in which a registrant has shown himself or herself to be "incompetent, untrustworthy, or financially irresponsible."ⁿ⁵³ Two states focus on conduct involving one taking "unfair advantage of a customer."ⁿ⁵⁴

Three others apply their provisions to all "dishonest or unethical" practices without the proviso that they occur in the securities business.ⁿ⁵⁵

In other states, the basis of administrative action is often fraudulent conduct, or at least "fraud" is often the pivotal word in these provisions even where the statutory language is embellished to include other comparable standards.ⁿ⁵⁶ The criteria in some states are even more ambiguous, where persons in the securities business are required to possess "integrity"ⁿ⁵⁷ or are not permitted to be of "bad business repute"ⁿ⁵⁸ or to have demonstrated "unworthiness" to engage in business.ⁿ⁵⁹

Fortunately, one can read most of these terms in the light of more specific statutory provisions and regulations that give examples of the types of behavior which, if not fraudulent, are certainly dishonest or unethical.ⁿ⁶⁰ Such acts include market manipulations,ⁿ⁶¹ sales of securities at unconscionable variations from current market prices,ⁿ⁶² the charging of excessive or unreasonable commissions or markups,ⁿ⁶³ the making of fictitious or pretended sales or purchases of securities,ⁿ⁶⁴ and unreasonable delays in turning over securities to those persons entitled to them.ⁿ⁶⁵ Regulations in a number of states set out considerable lists of acts and practices that are specifically labeled dishonest, unethical, or fraudulent, or which establish at least a presumption that an applicant is not of good business repute.ⁿ⁶⁶ Administrators may use such acts and practices as the basis for denying, suspending, or revoking registrations.

Administrators have, in fact, acted in disciplinary proceedings on such grounds as charging unfair prices,ⁿ⁶⁷ making misleading statements or material misrepresentations with respect to securities being sold,ⁿ⁶⁸ treating a customer's account as a discretionary account without written authorization,ⁿ⁶⁹ and inducing customers to purchase securities that are unsuitable to the customer's financial resources.ⁿ⁷⁰ On the matter of suitability, the Maryland Securities Commissioner adopted the pertinent NASD rule to find that an agent who gave an unsuitable recommendation had committed a dishonest or unethical practice, and the Commissioner's decision was upheld on appeal.ⁿ⁷¹ One state administrator deemed unethical a combination of an agent's inducing excess trading, making unauthorized use of a customer's funds, and borrowing money from a customer.ⁿ⁷²

In addition, the North Dakota Securities Commissioner has issued an advisory that industry professionals participating in media talk shows and giving recommendations concerning specific securities may be deemed to be engaged in unethical solicitations of business.ⁿ⁷³

[b] Criminal Convictions

In *Higgins v. New Jersey Bureau of Securities*,ⁿ⁷⁴ the court addressed the scope of securities administrators' consideration of criminal history in licensing determinations:

Convictions have a bearing on a determination as to the applicant's character. We see no justification for the argument ... that the Bureau must confine its inquiry to an applicant's conduct directly relating to the security business in searching for indicia of character and may not inquire concerning the applicant's life in general.ⁿ⁷⁵

Although the quoted language indicates that the states have broad authority in looking into criminal convictions of securities business applicants and registrants, the Uniform Act and Revised Uniform Actⁿ⁷⁶ place limits on the convictions to be considered for purposes of denial, suspension or revocation of a license. The Uniform Act authorizes Administrators to act whenever the person or firm involved "has been convicted, within the past ten years, of any misdemeanor involving a security or any aspect of the securities business, or any felony."ⁿ⁷⁷

The Revised Uniform Act, much more descriptive than its predecessor, allows Administrators to proceed if the registrant:

within the last ten years, has been convicted of an offense that the [Administrator] finds:

(i) involves the purchase or sale of a security, taking a false oath, making a false report, bribery, perjury, burglary, robbery, or attempt or conspiracy to commit any of these offenses;

(ii) arises out of the conduct of business as a broker-dealer, investment adviser, depository institution, insurance company, or fiduciary; or

(iii) involves the larceny, theft, robbery, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds or securities or an attempt or conspiracy to commit any of those offenses[.]ⁿ⁷⁸

Some states have added additional factors. One, for example, requires the Administrator to consider rehabilitation of the applicant or registrant before licensing can be denied.ⁿ⁷⁹ Since criminal convictions serve only as a basis, not as a mandate, for disciplinary proceedings, administrators arguably could and would consider rehabilitation before acting negatively on an application or registration, with or without a specific statutory command. Only two other states, which have a provision differing from the Uniform Act, direct the administrator to consider rehabilitation of offenders.ⁿ⁸⁰ Two states, which otherwise have adopted the original Uniform Act provision, authorize disciplinary action if a charge is pending involving unlawful conduct in connection with securities or an aspect of the securities business.ⁿ⁸¹

A few states alter the Uniform Act provision by eliminating the time period during which misdemeanor convictions involving securities or the securities business are applicable.ⁿ⁸² In other aspects, these statutes are substantially the same as the Uniform Act.ⁿ⁸³ Elimination of the ten-year period would, of course, act to the detriment of the applicant or the registrant, for the administrator would then be entitled to review an open-ended record. One jurisdiction expands the Uniform Act provision by allowing the administrator additionally to consider any offense, felony or otherwise, within the past ten years if it arises out of a fiduciary or financial services position.ⁿ⁸⁴

Other states with provisions dealing with criminal convictions vary in their approaches. Most prescribe administrative action for any felony conviction committed at any time.ⁿ⁸⁵ A few, however, are interested in only certain felony convictions. The named felonies are those involving securities or an aspect of the securities business,ⁿ⁸⁶ those involving fraud as an essential element,ⁿ⁸⁷ or those involving moral turpitude.ⁿ⁸⁸ One state requires only that the Commissioner find that the conviction has a "direct bearing" on the registrant's ability to serve the public,ⁿ⁸⁹ while another mandates that the crime "indicat[e] a lack of fitness to engage in the securities business."ⁿ⁹⁰ New Jersey authorizes the Bureau Chief, after a hearing, to bar from acting as a broker-dealer, agent or investment adviser any person convicted of designated crimes under federal, state or foreign securities, banking, insurance, commodities trading or antifraud laws.ⁿ⁹¹ Three states allow consideration of only those felony convictions which occurred in the past ten years,ⁿ⁹² and two consider only those occurring within the last five years.ⁿ⁹³

More often than not, the states having criminal conviction sanctions other than those contained in the Uniform Act or the Revised Uniform Act will follow the Uniform Act's example and authorize licensing discipline only for certain misdemeanor convictions. The most common ground is the one contained in the Uniform Act: a misdemeanor conviction involving a security or an aspect of the securities business.ⁿ⁹⁴ Some, however, include broader categories of misdemeanors, specifically those involving moral turpitude,ⁿ⁹⁵ breach of fiduciary duty,ⁿ⁹⁶ fraud,ⁿ⁹⁷ or those labeled "infamous crimes."ⁿ⁹⁸

Two states have provisions governing administrative consideration of both felonies and misdemeanors which differ from the statutes in all other states.ⁿ⁹⁹ In these states, denial, suspension or revocation of registration is permissible if a criminal conviction (1) involved the purchase or sale of a security, (2) arose out of the conduct of the business of a broker-dealer or investment adviser, (3) involved theft, or (4) involved mail fraud under federal statutes.ⁿ¹⁰⁰ These states further provide that a finding by a court of civil liability for any of those grounds may also serve as the basis of a

disciplinary action, although in one of them any such finding, civil or criminal, must have been made during the preceding ten years.ⁿ¹⁰¹ A similar provision with respect to time exists, as mentioned, in most states.

Although only a few states have taken the position that Administrators may treat a plea of *nolo contendere* as the equivalent of conviction for disciplinary purposes,ⁿ¹⁰² others would likely reach the same conclusion.

Some statutes contain no provision mentioning criminal convictions, but do contain authorization for the denial, suspension or revocation of registration if the applicant or registrant "has been guilty of any fraudulent act in connection with the sale of any securities."ⁿ¹⁰³ This provision deserves special mention because although a conviction is certainly equivalent to guilt, statutes of this kind do not make it plain as to whether or not conviction is a necessary element. Although there may be no precedent for such action, an administrator may conceivably make a finding of "guilt" for purposes of this provision without having to look for a criminal conviction.

[c] Injunctions and Previously Issued Orders

Judicially-imposed injunctions are a common ground that may be used by state administrators to deny, suspend or revoke licenses. The authority to so act under the Uniform Act arises whenever the applicant or registrant:

is permanently or temporarily enjoined by any court of competent jurisdiction from engaging in or continuing any conduct or practice involving any aspect of the securities businessⁿ¹⁰⁴

and under the 2002 Uniform Act when the applicant or registrant:

is enjoined or restrained by a court of competent jurisdiction in an action instituted by the administrator under this [Act] or the predecessor act, a State, the Securities and Exchange Commission, or the United States from engaging in or continuing and act, practice, or course of business involving an aspect of a business involving securities, commodities, investments, franchises, insurance, banking, or finance.ⁿ¹⁰⁵

Although some differences in language exist, mostly as a result of the Uniform Act version selected, most states have enacted a provision which permits similar administrative enforcement. These provisions are fairly straightforward and warrant few comments. Note, however, that these provisions refer to injunctions issued by "any court." Thus, administrators may look beyond the courts of their own respective states. Injunctions issued in other states, or even other countries, arguably are sufficient for the taking of administrative action.

The fact that these statutes are written in the present tense is also pertinent. If the administrator is going to act, such action must be on the basis of an injunction that is currently in effect. The basis for administrative disciplinary proceedings vanishes if the injunction expires or is vacated.ⁿ¹⁰⁶ Nevertheless, a prior injunction would clearly bear upon assessments of good business repute or other character and fitness standards applied in the licensing process.

Once an administrator has denied, revoked or suspended a registration, the possibility exists, albeit not a very serious one, that the subject of the order will reapply for registration either in the same capacity or in some other aspect of the securities field. The drafters of the Uniform Act acknowledged that even in the absence of a statutory provision authorizing the denial of the new application, the administrator would probably have the power to act on grounds such as *res judicata*.ⁿ¹⁰⁷ However, both the Uniform Act and the 2002 Uniform Act make the power clear with a provision that most states have substantially adopted, authorizing the administrator to deny an application submitted by any person who "is the subject of an order of the [Administrator] denying, suspending, or revoking registration as a broker-dealer, agent, or investment adviser [or investment adviser representative]."ⁿ¹⁰⁸ The drafters explained the provision as follows:

Its inclusion here is designed to make it clear that, when a person who has had his registration

revoked applies for a new registration after an interval, the Administrator does not have to establish again the ground which led to the earlier denial or revocation order. The only question in such a case would be whether it is in the public interest to enter a denial order in view of the period which has expired since the earlier order and any interim circumstances; and presumably the Administrator could deny a new application summarily without even going into the public interest question if the interval since the earlier order was quite short.ⁿ¹⁰⁹

Both Pennsylvania and California have a slightly different provision. Pennsylvania specifies that a person who has had a registration denied, revoked or suspended may have a new application denied if the person seeks registration in another capacity.ⁿ¹¹⁰ However, one should not assume that a reapplication to resume business in the same capacity will not be denied. Similarly, the California provision applies only to agents who are applying to become broker-dealers. If the agent is under a currently effective order of denial, suspension or revocation, an application to be a broker-dealer is subject to denial.ⁿ¹¹¹ In Tennessee, the Commissioner may also deny, suspend or revoke an application or registration if the applicant or registrant is the subject of a Commissioner's order to cease and desist from violating any provision of the state's securities laws.ⁿ¹¹²

Under the Uniform Act and the 2002 Uniform Act, administrators may consider denial or revocation orders entered by the SEC or securities administrators of other states as the basis of denial, suspension or revocation orders in their own states.ⁿ¹¹³ Similarly, an administrator may base a disciplinary proceeding on an SEC order of suspension or expulsion of an applicant or registrant from a national securities exchange or a national securities association, or on a fraud order of the United States Post Office. The administrator, however, is subject to certain limits. First, any such order relied on must be currently in effectⁿ¹¹⁴ and must have been entered within the past five years.ⁿ¹¹⁵ Second, under the Uniform Act provision, if any such order is to be the basis of a revocation or suspension proceeding, such proceeding must be instituted within one year of the date of termination of the order being relied upon.ⁿ¹¹⁶ Finally, under the Uniform Act provision, if the order serving as the basis of the proceedings is of another state, the grounds for that order must also be grounds under the statute of the state where the Administrator is now acting.ⁿ¹¹⁷

The vast majority of states have enacted the Uniform Act provision in one of its various incarnations,ⁿ¹¹⁸ but some have made alterations. However, the general pattern of the Act's provision has been followed. The sole exception to this is Arizona, whose provisions defy cabining into one of the Uniform Act versions. Arizona provides that the registrant or applicant will be subject to administrative penalization if it is subject to an order of the SEC denying or revoking registration under the Exchange Act; or is subject to an order denying or revoking membership in a national securities association registered under the Exchange Act; or has been suspended for a period exceeding six months or expelled from membership in a national securities exchange registered under the Exchange Act.ⁿ¹¹⁹

[4] Lack of Training, Experience, or Knowledge

Most Blue Sky lawsⁿ¹²⁰ provide that licenses of persons in the securities business may be denied, revoked or suspended whenever the applicant or registrant "is not qualified on the basis of such factors as training, experience, and knowledge of the securities business."ⁿ¹²¹

The risk of ever licensing such persons is, of course, addressed to a great extent by requiring applicants to pass one or more securities examinations. This is true even in states not having a statutory provision comparable to that of the Uniform Act. Nevertheless, there are certain constraints on administrators in the exercise of authority to deny a license on this basis. The Uniform Act provides:

The [Administrator] may not enter an order against a broker-dealer on the basis of the lack of qualification of any person other than (A) the broker-dealer himself if he is an individual or (B) an agent of the broker-dealer.ⁿ¹²²

Similarly, action based on lack of qualification of an investment adviser must be due to such lack in the investment adviser himself, if an individual, or employees performing investment advisory services.ⁿ¹²³ These provisions take into consideration the fact that broker-dealer or investment adviser firms may have directors or limited partners who are inactive in the business, and that such persons need not have the otherwise necessary qualifications.ⁿ¹²⁴

Although some states have specific qualification requirements with emphasis on experience in the securities business, the dictate of most Blue Sky lawsⁿ¹²⁵ is to force administrators to give the same consideration to an applicant's or registrant's training in the securities field as they would give to prior experience.ⁿ¹²⁶ These provisions do not allow the denial, suspension or revocation of a registration "solely on the basis of lack of experience if the applicant or registrant is qualified by training or knowledge or both."ⁿ¹²⁷

Representatives, agents or associated persons, of course, must generally be in the employ of a broker-dealer or issuer in order to be licensed. Administrators generally assume that broker-dealers will provide training for these persons.ⁿ¹²⁸ Consequently, Blue Sky laws often provide,ⁿ¹²⁹ as do the Uniform Act and the Revised Uniform Act,ⁿ¹³⁰ that an agent's qualifications to engage in the securities business need not be as great as the broker-dealer's. Specifically, the Uniform Act provides:

The Administrator shall consider that an agent [a sales representative] who will work under the supervision of a registered [licensed] broker-dealer need not have the same qualifications as a broker-dealer.ⁿ¹³¹

In 1986, NASAA amended the provision to give the same treatment to investment advisers and their representatives.ⁿ¹³² Under most circumstances, a registered broker-dealer is presumed to be able to act as an investment adviser in some capacity and does not have to have additional registration as such.ⁿ¹³³ However, administrators may find that a broker-dealer is not qualified to act as an investment adviser in such activities. Therefore, the Uniform Act and a number of Blue Sky lawsⁿ¹³⁴ provide that:

The [Administrator] shall consider that an investment adviser is not necessarily qualified solely on the basis of experience as a broker-dealer or agent. When he finds that an applicant for initial or renewal registration as a broker-dealer is not qualified as an investment adviser, he may by order condition the applicant's registration as a broker-dealer upon his not transacting business in this state as an investment adviser.ⁿ¹³⁵

The National Conference of Commissioners on Uniform State Laws amended the provision in 1988 by omitting the second sentence,ⁿ¹³⁶ and a number of states have adopted the provision as thus modified.ⁿ¹³⁷

[5] Failure to Supervise

The failure of a broker-dealer to reasonably supervise agents,ⁿ¹³⁸ or of an investment adviser to reasonably supervise representatives,ⁿ¹³⁹ constitutes grounds for the denial, suspension or revocation of the registration of the broker-dealer or investment adviser. Responsibility of securities industry principals for the acts, practices and conduct of agents in connection with securities activities may be the subject of a specific mandate, as, for example, in Virginia.ⁿ¹⁴⁰ However stated, it is certain that a finding that a broker-dealer or investment adviser applicant or registrant that has agents or representatives has failed reasonably to supervise will, coupled with a public interest finding, be sufficient to deny a license.ⁿ¹⁴¹ This is particularly meaningful for applicants licensed in one or more states who seek additional licensing in other states. Even when the application is a new one, such an intermediary has some history of business and operations elsewhere, and historic supervisory issues may be explored in each new state in which a license is sought. Information leading to supervisory inquiries in the licensing process is readily available through the Central Registration Depository (CRD), which discloses all reportable complaints and proceedings involving a broker-dealer or registered person. The Investment Advisor Registration Depository (IARD) provides the same information for advisers

and representatives.

A few Blue Sky laws set standards for supervision, providing, for example, that no person shall be deemed to have failed in supervisory responsibility if established procedures and a system for applying them are in force.ⁿ¹⁴² Any such procedure must be of a nature that would prevent and detect, as far as is practicable, violations of Blue Sky laws and regulations. The person responsible for supervision must reasonably enforce the procedures and have no reasonable cause to believe that they are not being complied with by persons for whom the supervisor is responsible.

A number of states have promulgated regulations requiring broker-dealers, and in some cases investment advisers,ⁿ¹⁴³ to establish written procedures for supervising agents and employees. For broker-dealers, these procedures must provide for such actions as the review and written approval of the supervisor of the opening of each new customer account; the periodic examination of all customer accounts; review and written approval of all securities transactions; the review of the currency and accuracy of required books and records; the review of all correspondence pertaining to securities transactions; the review and written approval of any authority given by a customer delegating discretionary authority; and the review and written approval of the handling of any customer complaint.ⁿ¹⁴⁴ For investment advisers the requirements may be more generally stated.ⁿ¹⁴⁵ In all cases, however, the requirement that there be no demonstrated failure to supervise (or likelihood of failure) as a basis for granting a license is clear.

[6] Insolvency

Insolvency of an applicant or registrant is almost a universal ground for the denial, suspension or revocation of registrations. Many statesⁿ¹⁴⁶ have adopted the Uniform Act provision, which permits Administrators to refuse or terminate registration when the applicant or registrant:

[I]s insolvent, either in the sense that [the applicant's or registrant's] liabilities exceed [the applicant's or registrant's] assets or in the sense that he cannot meet his obligations [cannot be met] as they mature; but the [Administrator] may not enter an order against a broker-dealer or investment adviser under this clause [subsection] without a finding of insolvency as to the broker-dealer or investment adviser.ⁿ¹⁴⁷

Under this provision, if insolvency is to be used as grounds for an administrative proceeding, the applicant or registrant itself must be insolvent. In other words, the fact that a partner or director of a broker-dealer or investment adviser firm is insolvent is not sufficient in and of itself to make a finding of insolvency against the firm.ⁿ¹⁴⁸

A certain amount of uniformity exists also among states that have not adopted the Uniform Act provision in that in several of them, a finding of insolvency may not be used as a ground for denying, suspending or revoking an agent's registration. These statutes specifically refer to the insolvency of broker-dealersⁿ¹⁴⁹ and, where appropriate, investment advisers.ⁿ¹⁵⁰

Other states have provisions that are basically comparable to the provision in the Uniform Act, but these statutes do not include the Uniform Act provision that a specific finding of insolvency must be made against a firm itself.ⁿ¹⁵¹ Other states provide for insolvency by referring to the registrant's failure to comply with net capital or aggregate indebtedness requirements.ⁿ¹⁵²

[7] Non-Payment of Fees

As a technical ground for denying licensing, the Uniform Act provides for administrative action when the applicant:

[H]as failed to pay the proper filing fee; but the Administrator may enter only a denial order under this clause, and he shall vacate any such order when the deficiency has been corrected.ⁿ¹⁵³

About half the states have substantially adopted this provision,ⁿ¹⁵⁴ but even where not enacted it would seem clear that

as a practical matter, licenses would be denied when prescribed fees are not paid.ⁿ¹⁵⁵ Other states have adopted the Revised Uniform Act version, which requires the applicant to pay the fee within 30 days of notification by the Administrator of the deficiency and drops the denial order proviso.ⁿ¹⁵⁶

FOOTNOTES:

(n1)Footnote 1. *Mayflower Sec. Co., Inc. v. Bureau of Sec.*, 64 N.J. 85, 312 A.2d 497, 500 (1973) .

See also Charles M. Blair & Co. v. Sec. Div., 401 Mass. 660, 518 N.E.2d 1157 (Mass. 1988) (the burden of proving that denial of registration would be in the public interest is on the Division); *In the Matter of E.F. Hutton & Co.*, [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,363, 1986 Mass. Sec. LEXIS 9 (Mass. Sec. Div. 1986) (a guilty plea to criminal information relating to a cash management program did not warrant revocation, suspension or restriction of a broker-dealer's license in the public interest where investors' funds were not endangered and the broker-dealer entered into undertakings with the Division to have an independent consultant examine the broker-dealer's policies and practices).

(n2)Footnote 2. In Washington, for example:

No order may be entered ... denying or revoking registration without appropriate prior notice to the applicant or registrant (as well as the employer or prospective employer if the applicant or registrant is a salesperson or an investment adviser representative), opportunity for hearing, and written findings of fact and conclusions of law.

Wash. Rev. Code § 21.20.120.

(n3)Footnote 3. The roles (and requirements) of Form BD, Form U-4, and also Form U-5--"Uniform Notice of Termination"--are discussed in more detail above, at § 11.02[3][a], above.

(n4)Footnote 4. The IARD is discussed in more detail above, at § 11.03[4], above. The authority of states to require participation of investment advisers and representatives in the IARD, thus imposing the costs associated with it, is unclear.

(n5)Footnote 5. Unif. Sec. Act § 204(a) (Comment).

(n6)Footnote 6. *In re Ridgway, McLeod & Assocs.*, 116 N.J. Super. 172, 281 A.2d 390, 392 (App. Div. 1971) ; *In the Matter of Daniel S. Brier & Co., Inc.*, New Jersey Bureau of Sec., [1961-1971 Transfer Binder] Blue Sky L. Rep. (CCH) P 70,917 (N.J. Bureau of Sec. 1970).

(n7)Footnote 7. *See, e.g.:*

Arizona: Ariz. Rev. Stat. Ann. §§ 44-1961(A), 44-1962.

California: Cal. Corp. Code §§ 25212-25213.3, 25232.

(n8)Footnote 8. *In the Matter of Diaz*, [1961-1971 Transfer Binder] Blue Sky L. Rep. (CCH) P 70,724 (D.C. Pub. Service Comm'n 1966).

(n9)Footnote 9. *See, e.g., Cal. Corp. Code §§ 25212-25213, 25232.*

(n10)Footnote 10. *Mayflower Sec. Co., Inc. v. Bureau of Sec.*, 64 N.J. 85, 312 A.2d 497, 497 (1973) .

(n11)Footnote 11. Rev. Unif. Sec. Act § 212(a) (12 grounds); Unif. Sec. Act § 204(a) (1986 NASAA amendment) (11 grounds).

(n12)Footnote 12. *See Selig v. Novak*, 256 Ark. 278, 285, 506 S.W.2d 825, 830 (1974) , in which the court counseled that the specific grounds set forth in the statute for denial, suspension or revocation:

[s]hall not be exclusive and the division may deny an application or suspend or revoke any license or censure any licensee for any cause whether similar to or different from these causes when necessary or appropriate in the public interest or for the protection of investors.

(n13)Footnote 13. 2002 Unif. Sec. Act § 412(d).

(n14)Footnote 14. Unif. Sec. Act § 204(a) (Comment).

(n15)Footnote 15. *See, e.g.*, Rev. Unif. Sec. Act § 209(g); Unif. Sec. Act § 203(c).

(n16)Footnote 16. *See § 11.04[2], below.*

Note also that the Uniform Application Forms BD, U-4 and ADV all require updating whenever any information contained in them is no longer accurate.

(n17)Footnote 17. *See* note 14, *above*, and accompanying text.

(n18)Footnote 18. *Or. Rev. Stat. § 59.205(6).*

(n19)Footnote 19. *Or. Rev. Stat. § 59.195(2).*

(n20)Footnote 20. *See, e.g.:*

Florida: Fla. Stat. § 517.161(1)(b).

Louisiana: La. Rev. Stat. Ann. § 51:704(A)(1).

Vermont: Vt. Stat. Ann. tit. 9, § 4221a(a)(1).

(n21)Footnote 21. *See, e.g., Cal. Corp. Code §§ 25212(a), 25213, 25232(a).*

(n22)Footnote 22. *Higgins v. New Jersey Bureau of Sec.*, 100 N.J. Super. 266, 241 A.2d 660 (App. Div. 1968) .

(n23)Footnote 23. 241 A.2d at 663-664 .

(n24)Footnote 24. 241 A.2d at 664 .

(n25)Footnote 25. Rev. Unif. Sec. Act § 212(a)(2); Unif. Sec. Act § 204(a)(2)(B) (1986 NASAA amendment).

(n26)Footnote 26. *See, e.g.:*

Colorado: Colo. Rev. Stat. § 11-51-410(1)(b).

Washington: Wash. Rev. Code § 21.20.110(1)(b).

(n27)Footnote 27. *See, e.g., Tex. Rev. Civ. Stat. Ann. art. 581-14(A)(5).*

(n28)Footnote 28. *Ill. Comp. Stat. ch. 815, § 5/8(E).*

(n29)Footnote 29. *Del. Code Ann. tit. 6 § 7316(a)(2) and (12).*

(n30)Footnote 30. *See, e.g., N.H. Rev. Stat. Ann. § 421-B:10(I).*

(n31)Footnote 31. *Unif. Sec. Act § 204 (Comment).*

(n32)Footnote 32. *See, e.g.:*

Colorado: Collins Sec. Corp. v. State Dep't of Regulatory Agencies, 501 P.2d 127, 129 (Colo. Ct. App. 1972) .

New Jersey: See also Mayflower Sec. Co. v. Bureau of Sec. in Div. of Consumer Affairs of Dep't of Law & Public Safety,, 64 N.J. 85, 312 A.2d 497 (1973) ; Kenneth Marshall & Co. v. State, 119 N.J. Super. 588, 293 A.2d 200, 203 (App. Div. 1972) .

(n33)Footnote 33. *See, e.g.:*

Arizona: Ariz. Rev. Stat. Ann. § 44-1961(A)(5).

North Dakota: N.D. Cent. Code § 10-04-11(1)(e).

For a general discussion of required financial reports, *see §§ 11.02[4] (Broker-dealers) and 11.03[6] (Investment advisers).*

(n34)Footnote 34. *See, e.g.:*

Arizona: Ariz. Rev. Stat. Ann. §§ 44-1961(A)(5), 44-1962(A)(3).

Texas: Tex. Rev. Civ. Stat. Ann. art. 581-14(A)(7).

(n35)Footnote 35. *See, e.g., Wash. Rev. Code §§ 21.20.100(1), 21.20.110(1).*

(n36)Footnote 36. *See, e.g.:*

Arizona: Ariz. Rev. Stat. Ann. §§ 44-1961(A)(5), 44-1962(A)(3).

Washington: Wash. Rev. Code §§ 21.20.100(4), 21.20.110(1).

(n37)Footnote 37. *See, e.g., Ind. Code §§ 23-2-1-11(a)(8).*

(n38)Footnote 38. *See, e.g., Ind. Code §§ 23-2-1-11(a)(8).* For a discussion of capital and bonding requirements, *see §§ 11.02[3][c] (Broker-dealers) and 11.03[7] (Investment advisers) supra.*

(n39)Footnote 39. No such discipline is appropriate if an agent is not required to be registered in the state, as, for

example, representatives who qualify under the NSMIA *de minimis* exemption from licensing. For a discussion of agent licensing requirements generally, *see* § 11.02[1][b], *above*.

(n40)Footnote 40. *See* § 11.02[1][b], *above*.

(n41)Footnote 41. 64 N.J. 85, 312 A.2d 497 (1973) .

(n42)Footnote 42. 312 A.2d at 501 (1973) .

(n43)Footnote 43. 312 A.2d at 504 (1973) .

(n44)Footnote 44. 312 A.2d at 500-501 , 504 (1973).

(n45)Footnote 45. In the Matter of Diaz, [1961-1971 Transfer Binder] Blue Sky L. Rep. (CCH) P 70,724 (D.C. Pub. Service Comm'n 1966).

(n46)Footnote 46. In the Matter of Diaz, [1961-1971 Transfer Binder] Blue Sky L. Rep. (CCH) P 70,724 (D.C. Pub. Service Comm'n 1966).

(n47)Footnote 47. *See In re Ridgway, McLeod & Assocs.*, 116 N.J. Super. 172, 281 A.2d 390, 392 (1971) .

(n48)Footnote 48. *See, e.g.:*

Colorado: Collins Sec. Corp. v. State Dep't of Regulatory Agencies, 501 P.2d 127, 129 (Colo. Ct. App. 1972) (fifteen-day suspension).

New Jersey: In the Matter of Daniel S. Brier & Co., Inc., note 6, *above*, [1961-1971 Transfer Binder] Blue Sky L. Rep. (CCH) at P 70,917.

Wisconsin: In the Matter of Shaughnessy & Co., Inc., [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,237 (Wis. Office of Comm'r of Sec. 1975), *aff'd*, P 71,348 (1977). This proceeding involved a number of violations which resulted in a one-year suspension. Permanent revocation was not ordered due to the firm's previous 37-year unblemished record.

(n49)Footnote 49. *See, e.g.:*

Oklahoma: In the Matter of Hunt & Fitzgerald, Inc., [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,004 (Dep't of Sec. 1971) (four-month suspension).

Wisconsin: In the Matter of Shaughnessy & Co., Inc., [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) at P 71,237, *aff'd*, P 71,348 (1977).

(n50)Footnote 50. In the Matter of John R. Brick & Co., [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,211 (Wis. Sec. Comm'r 1971).

(n51)Footnote 51. Unif. Sec. Act § 204(a)(2)(G).

(n52)Footnote 52. *See, e.g.:*

Arizona: Ariz. Rev. Stat. Ann. §§ 44-1961(A)(13), 44-1962(10).

Wisconsin: Wis. Stat. § 551.34(1)(g).

(n53)Footnote 53. D.C. Sec. Act of 2000 § 207(a)(14).

(n54)Footnote 54. *See, e.g.:*

Pennsylvania: 70 Pa. Cons. Stat. § 1-305(a)(ix).

Wisconsin: Wis. Stat. § 551.34(1)(g).

(n55)Footnote 55. *See, e.g.:*

Delaware: Del. Code Ann. tit. 6, § 7316(a)(7).

Michigan: Mich. Comp. Laws § 451.604(a)(1)(G).

Oregon: Or. Rev. Stat. § 59.205(2).

(n56)Footnote 56. *See, e.g.:*

Arizona: Ariz. Rev. Stat. Ann. §§ 44-1961(A)(11), 44-1962(9) ("fraudulent act or practice in connection with the purchase or sale of securities").

Texas: Tex. Rev. Civ. Stat. Ann. art. 581-14(A)(3) ("any inequitable practice in the sale of securities or ... any fraudulent business practice").

(n57)Footnote 57. *See, e.g.:*

Arizona: Ariz. Rev. Stat. Ann. §§ 44-1961(A)(6), 44-1962(4).

Indiana: Ind. Code § 23-2-1-11(a)(9).

(n58)Footnote 58. *See, e.g., Fla. Stat. § 517.161(1)(l).*

(n59)Footnote 59. *See, e.g.:*

Florida: Fla. Stat. § 517.161(1)(h). *See Fla. Admin. Code Ann. r. 3E-600.013* (regarding "demonstrations" of "unworthiness").

Hawaii: Haw. Rev. Stat. § 485-15(11).

(n60)Footnote 60. Many acts labeled dishonest or unethical are, in fact, fraudulent. *See Chapter 6, above.*

(n61)Footnote 61. *See, e.g., Kan. Admin. Regs. 81-3-1(i); NASAA Statements of Policy/Dishonest or Unethical Business Practices* (1983), § 1(n)(2)-(3), reprinted in Vol. 4, *below* at p. 4-143 *et seq.*

(n62)Footnote 62. *See, e.g., Ga. Comp. R. & Regs. r. 590-4-2-.14(1)(a)(7).*

(n63)Footnote 63. *See, e.g., Wis. Admin. Code § [SEC] 4.06(1)(k)-(l).*

(n64)Footnote 64. *See, e.g., Kan. Admin. Regs. 81-3-1(i); NASAA Statements of Policy/Dishonest or Unethical Business Practices (1983), § 1(n)(1), reprinted in Vol. 4 below at p. 4-143 et seq.*

(n65)Footnote 65. *See, e.g., Wis. Admin. Code § [SEC] 4.06(1)(a).*

(n66)Footnote 66. *See, e.g.:*

California: Cal. Admin. Code tit. 10, §§ 260.218-260.218.6.

Ohio: Ohio Admin. Code § 1301:6-3-19.

Wisconsin: Wis. Admin. Code § [SEC] 4.06.

(n67)Footnote 67. *See, e.g.:*

Oklahoma: In the Matter of Hunt & Fitzgerald, Inc., note 51 *above*, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) at P 71,004.

(n68)Footnote 68. *See, e.g.:*

Wisconsin: In the Matter of John R. Brick & Co., note 52 *above*, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) at P 71,211. *See also* In the Matter of Shaughnessy & Co., [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,237, *aff'd*, P 71,348 (1977).

(n69)Footnote 69. *Collins Sec. Corp. v. State Dep't of Regulatory Agencies*, 501 P.2d 127, 129-30 (Colo. Ct. App. 1972) .

(n70)Footnote 70. *Collins Sec. Corp. v. State Dep't of Regulatory Agencies*, 501 P.2d 127, 129-30 (Colo. Ct. App. 1972) . *See also:* In the Matter of Roy C. Cordell, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,210 (Wis. Sec. Comm'r 1972).

(n71)Footnote 71. *Brewster v. Securities Commissioner*, [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,683 (Md. Cir. Ct. 1987).

See also FINRA Conduct Rule 2310, reprinted in FINRA Manual (CCH) P 4261.

(n72)Footnote 72. In the Matter of Gerald P. Ireland, [1986-1987 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,361 (Mich. Corp. and Sec. Bureau 1986).

(n73)Footnote 73. Public communications by dealers and salesmen, *N.D. Sec. Bulletin*, 2 *Blue Sky L. Rep. (CCH)* P 44,519 (Feb. 1987).

(n74)Footnote 74. 100 N.J. Super. 266, 241 A.2d 660 (App. Div. 1968) .

(n75)Footnote 75. 241 A.2d at 663 .

(n76)Footnote 76. Rev. Unif. Sec. Act § 212(a)(4); Unif. Sec. Act § 204(a)(2)(C).

(n77)Footnote 77. Unif. Sec. Act § 204(a)(2)(C).

(n78)Footnote 78. Rev. Unif. Sec. Act § 212(a)(4).

(n79)Footnote 79. *Kan. Stat. Ann. § 17-1254(m)(3)*.

(n80)Footnote 80. *See, e.g.:*

New Jersey: N.J. Rev. Stat. § 49:3-58(a)(2)(iii).

North Dakota: N.D. Cent. Code §§ 10-04-10.2, 10-04-11(1)(g).

(n81)Footnote 81. *See, e.g.:*

Arkansas: Ark. Code Ann. § 23-42-308(a)(2)(C).

Kentucky: Ky. Rev. Stat. Ann. § 292.330(13)(a)(3).

(n82)Footnote 82. *See, e.g.,*

Montana: Mont. Rev. Code Ann. § 30-10-201(13)(c).

Virginia: Va. Code Ann. § 13.1-506(4).

(n83)Footnote 83. Virginia specifies that the convictions to be considered may be from within or without the state. *See* note 84, *above*. The fact that no state having a provision making criminal convictions the basis of disciplinary action refers to crimes within the state warrants the assumption that the place of conviction is irrelevant.

(n84)Footnote 84. D.C. Sec. Act of 2000 § 207(a)(3)(B).

(n85)Footnote 85. *See, e.g., Tex. Rev. Civ. Stat. Ann. art. 581-14(A)(1)*.

(n86)Footnote 86. *See, e.g.:*

Arizona: Ariz. Rev. Stat. Ann. §§ 44-1961(A)(8), 44-1962(6).

Maine: Me. Rev. Stat. Ann. tit. 32, § 10313(1)(C).

(n87)Footnote 87. *See, e.g.:*

Arizona: Ariz. Rev. Stat. Ann. §§ 44-1961(A)(8), 44-1962(6).

Indiana: Ind. Code § 23-2-1-11(a)(15).

(n88)Footnote 88. *See, e.g.:*

New Jersey: N.J. Rev. Stat. § 49:3-58(a)(2)(iii).

Washington: Wash. Rev. Code § 21.20.110(1)(c).

(n89)Footnote 89. *N.D. Cent. Code § 10-04-11(1)(g).*

(n90)Footnote 90. *Me. Rev. Stat. Ann. tit. 32, § 10313(1)(C).*

(n91)Footnote 91. *N.J. Rev. Stat. § 49:3-56(k).*

(n92)Footnote 92. *See, e.g.:*

Arizona: Ariz. Rev. Stat. Ann. §§ 44-1961(A)(8), 44-1962(6).

Colorado: Colo. Rev. Stat. § 11-51-410(1)(c).

(n93)Footnote 93. *See, e.g.:*

Indiana: Ind. Code § 23-2-1-11(a)(15).

Washington: Wash. Rev. Code § 21.20.110(1).

(n94)Footnote 94. *See, e.g.:*

Arizona: Ariz. Rev. Stat. Ann. §§ 44-1961(A)(8), 44-1962(6).

Colorado: Colo. Rev. Stat. § 11-51-410(1)(c).

(n95)Footnote 95. *See, e.g., Fla. Stat. § 517.161(1)(j).*

(n96)Footnote 96. *Colo. Rev. Stat. § 11-51-410(1)(c).*

(n97)Footnote 97. *See, e.g., Tex. Rev. Civ. Stat. Ann. art. 581-14(A)(3).*

(n98)Footnote 98. *Del. Code Ann. tit. 6, § 7316(a)(3).*

(n99)Footnote 99. *See, e.g.:*

California: Cal. Corp. Code §§ 25212(b)(1), 25213, 25232(b)(1). However, a change in the California statute requires the Commissioner to suspend for not more than 12 months or bar from employment with or management or control of a broker-dealer any individual who has been convicted of specified fraud offenses. *Cal. Corp. Code §§ 25212(b)(1), 25213, 25232(b)(1), § 25213.3.*

Pennsylvania: 70 Pa. Cons. Stat. § 1-305(a)(ii)(A).

(n100)Footnote 100. *See 18 U.S.C. §§ 1341, 1342-1343.*

(n101)Footnote 101. *See, e.g.:*

Pennsylvania: 70 Pa. Cons. Stat. § 1-305.

(n102)Footnote 102. *See, e.g., Cal. Corp. Code §§ 25212(b)(1), 25213, 25232(b).*

(n103)Footnote 103. *Ohio Rev. Code Ann. § 1707.19(1)(7).*

(n104)Footnote 104. Unif. Sec. Act § 204(a)(2)(D).

(n105)Footnote 105. 2002 Unif. Sec. Act § 412(d)(4).

(n106)Footnote 106. *See* Unif. Sec. Act § 204(a) (Comment).

(n107)Footnote 107. Unif. Sec. Act § 204(a) (Comment).

(n108)Footnote 108. Unif. Sec. Act § 204(a)(2)(E).

(n109)Footnote 109. Unif. Sec. Act § 204(a)(2)(E) (Comment).

(n110)Footnote 110. *70 Pa. Cons. Stat. § 1-305(a)(viii).*

(n111)Footnote 111. *Cal. Corp. Code § 25212(h).*

(n112)Footnote 112. *Tenn. Code Ann. § 48-2-112(a)(2)(E).*

(n113)Footnote 113. Section 204(a)(2)(F) of the Uniform Act provides:

The Administrator may by order deny, suspend, or revoke any registration if he finds ... that the applicant or registrant ... is the subject of an order entered within the past five years by the securities administrator of any other state or by the Securities and Exchange Commission denying or revoking registration as a broker-dealer, agent, or investment adviser, or the substantial equivalent of those terms as defined in this act, or is the subject of an order of the Securities and Exchange Commission suspending or expelling him from a national securities exchange or national securities association registered under the Securities Exchange Act of 1934, or is the subject of a United States Post Office fraud order; but (i) the [Administrator] may not institute a revocation or suspension proceeding under [this clause] more than one year from the date of the order relied on, and (ii) [he] may not enter an order under [this clause] on the basis of an order under another state act unless that order was based on facts which would currently constitute a ground for an order under this section.

In 1986, NASAA amended the provision to provide for administrative action against any applicant or registrant who:

[I]s the subject of an adjudication or determination within the past five years by a securities or commodities agency or administrator of another state or a court of competent state that the person has violated the Securities Act, the Exchange Act, the Investment Advisers Act, the Investment Company Act or the Commodity Exchange Act, or the securities or commodities law of any other state.

Section 204(a)(2)(F) of the Uniform Act (1986 NASAA amendment). In 1987 NASAA again amended the provision to provide for administrative action against any applicant or registrant who:

[I]s the subject of an adjudication or determination, after notice and opportunity for hearing, within the past 10 years by a securities or commodities agency or administrator of another state or a court of competent state that the person has willfully violated the Securities Act, the Exchange Act, the Investment Advisers Act, the Investment Company Act or the Commodity Exchange Act, or the securities or commodities laws of any other state.

(n114)Footnote 114. Unif. Sec. Act § 204(a) (Comment).

(n115)Footnote 115. Unif. Sec. Act § 204(a) (Comment).

(n116)Footnote 116. Unif. Sec. Act § 204(a) (Comment).

(n117)Footnote 117. Unif. Sec. Act § 204(a) (Comment). NASAA modifications of this provision eliminated the facet dealing with pre-existing administrative actions by private organizations and other states. The main thrust of these versions of the provision is the violation of the law of fellow states or of federal securities law, namely the Securities Act, the Securities Exchange Act, the Investment Advisers Act, the Investment Company Act or the Commodity Exchange Act.

(n118)Footnote 118. *See, e.g.:*

Delaware: Del. Code Ann. tit. 6, § 7316(a)(6). The statute increases the five-year proviso to ten years, but eliminates the last two provisos.

(n119)Footnote 119. *Ariz. Rev. Stat. Ann. §§ 44-1961(A)(10), 44-1962(8).*

(n120)Footnote 120. *See, e.g.:*

Wyoming: Wyo. Stat. § 17-4-106(a)(ii)(J).

(n121)Footnote 121. Unif. Sec. Act § 204(a)(2)(I).

(n122)Footnote 122. Unif. Sec. Act § 204(b)(1). A number of states have adopted this provision. *See, e.g., Del. Code Ann. tit. 6, § 7316(b)(1).*

(n123)Footnote 123. Unif. Sec. Act § 204(b)(2). A number of states have adopted this provision. *See, e.g., Del. Code Ann. tit. 6, § 7316(b)(1).*

(n124)Footnote 124. Unif. Sec. Act § 204(b) (Comment).

(n125)Footnote 125. *See, e.g., Del. Code Ann. tit. 6, § 7316(b)(2).*

(n126)Footnote 126. Unif. Sec. Act § 204(b) (Comment).

(n127)Footnote 127. *See, e.g., Vt. Stat. Ann. tit. 9, § 4221a(10).*

(n128)Footnote 128. Unif. Sec. Act § 204(b) (Comment).

(n129)Footnote 129. *See, e.g., Wyo. Stat. § 17-4-106(d)(iii).*

(n130)Footnote 130. Rev. Unif. Sec. Act § 213(4); Unif. Sec. Act § 204(b)(4).

(n131)Footnote 131. *See* Unif. Sec. Act § 204(b)(4); Rev. Unif. Sec. Act § 213(4).

(n132)Footnote 132. Unif. Sec. Act § 204(b)(4) (1986 NASAA amendment). A number of states have adopted this provision. *See, e.g., Utah Code Ann. § 61-1-6(4)(d).*

(n133)Footnote 133. *See, e.g.,* the exemption from the definition of "investment adviser" in Rev. Unif. Sec. Act § 101(7)(iv).

(n134)Footnote 134. *See, e.g., Utah Code Ann. § 61-1-6(4)(e).*

(n135)Footnote 135. Unif. Sec. Act § 204(b)(5).

(n136)Footnote 136. Rev. Unif. Sec. Act § 213(5).

(n137)Footnote 137. *See, e.g.,* Me. Rev. Stat. Ann. tit. 32, § 10313(2)(E).

(n138)Footnote 138. Rev. Unif. Sec. Act § 212(a)(11); Unif. Sec. Act § 204(a)(2)(J).

(n139)Footnote 139. *See, e.g.,* Wis. Stat. § 551.34(1)(j).

(n140)Footnote 140. *21 Va. Admin. Code § 5-20-260* (Supervision of Agents).

(n141)Footnote 141. *See* Unif. Sec. Act § 204(a)(2)(J) (Comment).

(n142)Footnote 142. *See, e.g., Cal. Corp. Code § 25212(g).*

(n143)Footnote 143. *See, e.g.:*

Alabama: Sec. Rule 830-X-3-.13(3).

Pennsylvania: 64 Pa. Code § 305.011(a)(2).

Wisconsin: Wis. Admin. Code § [SEC] 5.05(1).

(n144)Footnote 144. *See, e.g.:*

Oregon: Or. Admin. Rule 441-205-0210(3).

Virginia: 21 Va. Admin. Code § 5-20-260.

Administrators may well take formal or informal positions on particular areas of supervision. In North Dakota, for example, the Securities Commissioner has advised that the participation of an agent in a media talk show in which the agent makes recommendations concerning specific securities could serve as the basis of a "failure to supervise" charge against the agent's principals. Public communications by dealers and salesmen, *N.D. Sec. Bulletin*, 2 *Blue Sky L. Rep. (CCH)* P 44,519 (Feb. 1987).

(n145)Footnote 145. In Wisconsin, for example:

Each investment adviser shall establish written supervisory procedures and a system for applying the procedures, which may reasonably be expected to prevent and detect any violations of [the Blue Sky law], and rules and orders thereunder. The procedures shall include the designation and licensure of a

number of supervisory employees reasonable in relation to the number of its licensed investment adviser representatives, offices and investment activities in this state.

Wis. Admin. Code § [SEC] 5.05(1).

(n146)Footnote 146. *See, e.g., Ark. Code Ann. § 23-42-308(a)(2)(H).*

(n147)Footnote 147. Unif. Sec. Act § 204(a)(2)(H); Rev. Unif. Sec. Act § 212(a)(9).

(n148)Footnote 148. Unif. Sec. Act § 204(a) (Comment).

(n149)Footnote 149. *See, e.g., Tex. Rev. Civ. Stat. Ann. art. 581-14(4).*

(n150)Footnote 150. *See, e.g., Fla. Stat. § 517.161(i).*

(n151)Footnote 151. *See, e.g., Wis. Stat. § 551.34(1)(h).*

(n152)Footnote 152. *See, e.g., N.H. Rev. Stat. Ann. § 421-B:10(I)(b)(8).*

(n153)Footnote 153. Unif. Sec. Act § 204(a)(2)(K).

(n154)Footnote 154. *See, e.g., Wis. Stat. § 551.34(1)(k).* The denial order provision is omitted.

(n155)Footnote 155. Unif. Sec. Act § 204(a) (Comment).

(n156)Footnote 156. Rev. Unif. Sec. Act § 212(a)(12); *see, e.g., Ga. Code Ann. § 10-5-4(a)(12).*



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Blue Sky Regulation

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CHAPTER 11 Regulation of Intermediaries: Broker-Dealers, Investment Advisers and Associated Persons

2-11 Blue Sky Regulation § 11.05

§ 11.05 Cancellation or Withdrawal of Licensing or Application

The end result of a cancellation of a registration or applicationⁿ¹ to engage in the securities business, at least under the Uniform Act and the Revised Uniform Act, is the same as a revocation or denial. However, in the case of cancellation, no taint of wrongdoing exists on the part of the applicant or registrant. The grounds for cancellation arise when the applicant or registrant:

- (1) is no longer in existence;
- (2) has ceased to do business;
- (3) is subject to an adjudication of mental incompetence;
- (4) is subject to the control of a committee, conservator or guardian; or
- (5) cannot be located after a reasonable search by the Administrator.ⁿ²

A number of states have adopted these grounds for cancellation,ⁿ³ although a few, which otherwise have the same provision, consider such action by the administrator a revocation or denial.ⁿ⁴

Both the Uniform Act and the 2002 Uniform Act also allow registrants voluntarily to withdraw their registrations upon application. Under ordinary circumstances, the withdrawal of an application becomes effective thirty days after it is received by the administrator, or within a shorter time if so permitted. However, a registrant may not use a withdrawal to escape administrative proceedings. In Florida, for example:

The department may deny any request to terminate or withdraw any application or registration if the department believes that an act which would be ground for denial, suspension, restriction, or revocation under this chapter has been committed.ⁿ⁵

If a proceeding is pending when the application is filed, the application may be denied or conditions may be imposed upon its effectiveness. Similarly, denial or imposition of conditions may come into play if a revocation or suspension proceeding is instituted within thirty days after the withdrawal application is filed. Even if withdrawal becomes

effective, the Administrator may still start a disciplinary proceeding within one year of the effective date.ⁿ⁶ But in such a case the grounds for action must be the registrant's willful violation of or willful failure to comply with the state's Blue Sky law or regulations.ⁿ⁷

While some statesⁿ⁸ have substantially adopted the Uniform Act withdrawal provision, others have made variations. The most common change is to allow administrators to institute disciplinary proceedings in the one-year period following effectiveness of withdrawal for any ground indicated under that state's Blue Sky law.ⁿ⁹ A few states add some additional grounds in such cases. Others have created their own unique or not so unique (statutes that borrow selectively from the Uniform Act) provisions for withdrawals.ⁿ¹⁰ At least one state places no condition on withdrawal or "cancellation."ⁿ¹¹

Withdrawal of an application for licensing often occurs in response to an administrator's notice of intent to deny the license. As discussed earlier, Blue Sky laws provide for notice and the right to a hearing prior to issuance of a final order of denial, and upon receipt of the notice of intent to deny an applicant may choose to withdraw rather than proceed with a hearing. However, because administrators may at that stage of the process deny the request for withdrawal based upon the particular grounds involved in the intended denial of the license, an applicant faces the risk that an adverse determination will issue, and the further consequences of such a determination on a pending or intended application in another state. It is essential to assess potential grounds for denial well before making application for licensing in a state rather than attempting to avoid the undesired result of a denied request to withdraw followed by a denial of the license itself. State administrators are generally available informally to assist in these pre-filing assessments.

FOOTNOTES:

(n1)Footnote 1. Under the Revised Uniform Act, "[a]n application for a license may be withdrawn by the applicant without prejudice before the license becomes effective." Rev. Unif. Sec. Act § 214(a).

(n2)Footnote 2. Unif. Sec. Act § 204(d).

(n3)Footnote 3. *See, e.g., Ala. Code § 8-6-3(k).*

(n4)Footnote 4. *See, e.g., Cal. Corp. Code § 25242(b).*

Two states have left off some of the aforementioned elements given in the Uniform Act provision, but consider such elements causes for revocation or denial. These states are:

Colorado: Colo. Rev. Stat. § 11-51-411 (elements two and four).

Virginia: Va. Code Ann. § 13.1-506(3) (elements one, two, three and five).

(n5)Footnote 5. *Fla. Stat. § 517.161(5).*

(n6)Footnote 6. Rev. Unif. Sec. Act § 214(b)-(c); Unif. Sec. Act § 204(e).

(n7)Footnote 7. Unif. Sec. Act § 204(e) (Comment).

(n8)Footnote 8. *See, e.g., Wis. Stat. § 551.32(9)(a).*

(n9)Footnote 9. *See, e.g., Utah Code Ann. § 61-1-6(6).*

(n10)Footnote 10. *See, e.g., Cal. Corp. Code § 25242(a).* The statute refers to "surrender," not withdrawal, of registration. This provision is similar to its Uniform Act counterpart except that nothing in the statute authorizes the

Administrator to institute proceedings after the withdrawal or surrender has become effective.

(n11)Footnote 11. Haw. Sec. Reg. § 16-38-5.6(c).



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Blue Sky Regulation

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CHAPTER 11 Regulation of Intermediaries: Broker-Dealers, Investment Advisers and Associated Persons

2-11 Blue Sky Regulation § 11.06

§ 11.06 Post-Licensing Intermediary Regulation and Enforcement

Once licensed and operating in a state, intermediaries are subject to the full administrative and enforcement authority of the designated state regulatory agency. Rulemaking, interpretive processes, investigative authority and the available arsenal of enforcement weapons are reviewed in detail in Chapter 14 of this treatise.ⁿ¹ The ongoing reporting and financial responsibility (net capital) requirements for broker-dealers, plus annual license renewal procedures, books-and-records requirements and periodic on-site inspections of both broker-dealers and investment advisers (all of which have been covered earlier in this chapter) are augmented by substantial authority regarding administrative enforcement proceedings, judicial enforcement actions and criminal prosecutions. There are certain aspects of intermediary post-licensing operations that may form the basis for such actions and that merit particular consideration here. Each is discussed in more detail below.

[1] Broker-Dealers and Associated Persons

[a] Supervision Requirements

The responsibility of broker-dealer management to establish and maintain an effective supervisory system to safeguard against possible violations of the Blue Sky law, federal securities laws, and various rules and regulations of the Securities and Exchange Commission and the self-regulatory organizations is a cornerstone of intermediary compliance responsibility in many states.ⁿ² The responsibility is typically imposed via rules or regulations under the Blue Sky law. In these states, a broker-dealer is required to subject every agent or employee to the oversight of a supervisor. A broker-dealer who is a member of a self-regulatory organization such as FINRA would, of course, also have to comply with rules of the organization as well as the rules of the states in which it is licensed.

As seen earlier, some states require that each broker-dealer establish, maintain, and enforce written procedures that will enable it to supervise the activities of its associated persons.ⁿ³ A FINRA Conduct Ruleⁿ⁴ serves as the model for these provisions, but no state has specifically adopted it. Many, however, have incorporated the following essential features of the rule: (1) that a copy of the procedures be kept at each business office,ⁿ⁵ and (2) that a partner, officer, manager or some qualified person or employee be designated to discharge the supervisory function.ⁿ⁶

[b] New Accounts

Closely related to basic supervisory responsibility, several states require the review and written approval by the

designated supervisor of the opening of each new customer account.ⁿ⁷ At this time the supervisor can ensure that adequate information has been obtained regarding a customer's objectives, needs and finances. The review of new accounts will assist the broker-dealer in complying with the suitability rules of any self-regulatory organization of which the broker-dealer is a member.ⁿ⁸

[c] Accounts and Transactions Generally

The frequent review of customer accounts and the prompt review and written approval by the designated supervisor of all securities transactions are part of a broker-dealer's supervisory responsibility in some states.ⁿ⁹ These regulations also include a provision for the review and written approval of all correspondence pertaining to the solicitation or execution of securities transactions.ⁿ¹⁰

The review of accounts would necessarily involve a check for churning and switching of securities in customers' accounts. Churning or switching occurs when a broker-dealer or agent, acting in his or her own interests and against those of his customer, induces transactions in the customer's account which are excessive in size and frequency in light of the character of the account. Many states have adopted regulations prohibiting such a pattern of trading.ⁿ¹¹

[d] Discretionary Accounts

A discretionary account vests authority in a broker-dealer or salesperson to effect securities transactions without first obtaining an order or the approval of a customer. Because such authority is so vulnerable to abuse, the SEC and the self-regulatory organizations have imposed specific and stringent requirements for the handling of discretionary accounts.ⁿ¹² Only a few states, however, have adopted their own regulations providing for the review and approval of such accounts.ⁿ¹³ The provisions in those states generally require review and written approval by a designated supervisor of a customer's delegation of discretionary authority, and the prompt written approval of each discretionary order entered in the account.

A larger number of states have adopted provisions prohibiting merely the exercise of discretionary power without written authority.ⁿ¹⁴

[e] Sales Practices

Some states have adopted provisions either prohibiting certain sales techniques and methods of salespersons, or, in the case of their correspondence with customers, providing for supervisory review. The following subsections deal with those sales practices that have been specifically addressed by regulations.

Boiler Rooms. A boiler room operation is a high-pressure selling campaign for the promotion of generally speculative or low-priced securities that is usually carried out by telephone. The prospective purchaser, normally not known by, and not having an account with, the broker-dealer or salesman, is encouraged to buy the security regardless of investment needs and objectives. Several states specifically prohibit "boiler room" operations.ⁿ¹⁵

Suitability. The self-regulatory organizations have requirements regarding the suitability of recommendations made to customers, and a majority of the states have followed suit.ⁿ¹⁶ FINRA rule, for instance, requires that the broker-dealer, in recommending to a customer the purchase, sale, or exchange of a security, must have "reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."ⁿ¹⁷ Three states have adopted FINRA rule.ⁿ¹⁸ A NASAA pronouncement goes farther, and imposes a duty of inquiry in order to determine the suitability of recommendations. The provision prohibits:

Recommending to a customer the purchase, sale or exchange of any security without reasonable grounds to believe that such transaction or recommendation is suitable for the customer based upon

reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other relevant information known by the broker-dealer.ⁿ¹⁹

A large number of statesⁿ²⁰ have adopted this rule.

Several states prohibit the making of false, misleading, deceptive, exaggerated or flamboyant representations in the solicitation or sale of a security.ⁿ²¹ The following representations serve as examples:

- (1) representations that the security will be resold or repurchased;
- (2) representations that the security will be listed or traded on an exchange or established market;
- (3) representations that an immediate or extensive increase in value, market price or investment return will result;
- (4) representations that there is a guarantee against risk or loss; and
- (5) statements with respect to the issuer's financial condition, anticipated earnings, potential growth or success.

[f] Operations Generally

Supervision over sales practices in some states specifically includes the review of all correspondence sent to customers relating to the purchase, sale, or solicitation for the purchase or sale of securities.ⁿ²² Some also have specific requirements relating to record keeping and handling of customer complaints. FINRA defines a complaint as "any written statement of a customer or any person acting on behalf of a customer alleging a grievance involving the activities of those persons under the control of the member in connection with the solicitation or execution of any transaction or the disposition of securities or funds of that customer."ⁿ²³ FINRA requires each member to maintain a separate file of all written complaints of customers and the action taken by the member, if any.ⁿ²⁴ Several states have substantially adopted this requirement,ⁿ²⁵ or at least require that a record or file of complaints be kept.ⁿ²⁶ Others provide for the prompt review and written approval of the handling of customer complaints.ⁿ²⁷ Some also include the failure or refusal to furnish to a customer information to which the customer is entitled or to respond to a formal written demand or complaint as a ground for the denial, suspension or revocation of registration.ⁿ²⁸

"Back office" operations of a broker-dealer revolve around the currency and accuracy of the transactional books and records that the broker-dealer is required to maintain.ⁿ²⁹ Few states, however, have specific provisions for the review of back office operations as part of their supervisory procedures.ⁿ³⁰ These provisions include the currency and accuracy of books and records and the status and causes of "Fails to Receive" and "Fails to Deliver," net capital, credit extensions, and financial reports.

FINRA requires its members to review the activities of each office and to conduct at least an annual inspection of each "office of supervisory jurisdiction" (OSJ).ⁿ³¹ FINRA mandates that an office of supervisory jurisdiction be directly responsible for the review of the activities in that office, in other offices, or both.ⁿ³² Three states have incorporated FINRA requirement into their regulations.ⁿ³³ Six others require broker-dealers periodically to inspect each business office to insure that the written supervisory procedures are being enforced.ⁿ³⁴ Indiana requires that every branch office located in the state be open for inspection and examination by the Division.ⁿ³⁵

[g] Compensation-Related Issues

Licensing under Blue Sky laws entitles both broker-dealers and agents to be paid transaction-based compensation,

whether in the form of commissions or fees. However, only licensed persons may receive such compensation. A licensed broker-dealer or agent may not pay or share any portion of fees or commissions from the sale of securities to or with an unlicensed person or entity. Rules under Blue Sky laws prohibit dividing or otherwise splitting commissions, profits, or any other compensation from the purchase or sale of securities with any person who is not also licensed, or registered, as an agent of the same broker-dealer, or another broker-dealer with which the agent is licensed or registered in accordance with a dual licensing provision, if permitted under the state's Blue Sky law.ⁿ³⁶ Thus, broker-dealers may not pay referral, finder, or solicitation fees to unlicensed persons.

[h] Recruiting

The SEC, the self-regulatory organizations, and a few state securities commissioners have emphasized the review of methods of recruiting and training of salespersons as part of an overall broker-dealer supervisory system.ⁿ³⁷ Apart from the procedures incident to registration itself, however, the states have not incorporated such a review process as part of their regulations.

A number of states do require, as part of the books and records to be kept by broker-dealers, that a questionnaire or application for employment be executed by each salesperson and that the document be approved in writing by an authorized representative of the broker-dealer.ⁿ³⁸ In addition to the usual statistical information, the document generally must include a complete listing of business connections for at least ten years, a record of any denial, suspension, or revocation of registration or any disciplinary action taken, and a record of any injunctions, arrests, indictments, or convictions. At least one state requires a broker-dealer to investigate potential representatives.ⁿ³⁹

[2] Investment Advisers and Representatives

[a] Advisory Agreements

States have established minimal restrictions on advisory agreements by largely adopting the restrictions imposed on SEC-registered investment advisers under the Investment Advisers Act of 1940. Thus, an investment advisory agreement must provide that the contract may not be assigned without the client's consent.ⁿ⁴⁰ Regulations define "assignment" generally to include any direct or indirect transfer of an advisory contract by an investment adviser, or any transfer of control or management of an investment adviser.ⁿ⁴¹ However, regulations also make clear that a transaction that does not result in a change in actual control or management of the investment adviser will not be deemed to be an assignment requiring consent of the client.ⁿ⁴² Thus, reorganization or other corporate transactions that do not effect continuing responsibility for investment advisory or management functions will not normally be considered an assignment. It is essential nevertheless that every advisory contract include the provision.

States also impose restrictions on advisory contracts by requiring disclosure of fee arrangements and the precise nature of services the adviser will render; restrictions on the manner of providing compensation to an adviser; and requirements mandating notification of changes in the membership of an investment adviser that is a partnership.ⁿ⁴³ Particular compensation-related issues in advisory relationships are discussed further below. All of these contract requirements are framed as prohibitions, so as to provide that an adviser may not enter into, extend or renew any advisory agreement, or in any manner perform an agreement which either includes or fails to include a covered provision. A review of advisory agreements is a standard element of field examinations of investment advisers.

[b] Compensation

Advisory fees and compensation of investment advisers generally are addressed under Blue Sky laws in two ways. First, under the general heading of dishonest or unethical practices,ⁿ⁴⁴ states prohibit charging an advisory client a fee that is unreasonable in light of the type of services to be provided, the experience and expertise of the adviser, and the sophistication and bargaining power of the client. These prohibitions may be augmented by a specific disclosure requirement relating to charging fees for advisory services that will involve additional compensation to the adviser

through commissions on executed transactions. Financial planners licensed as investment advisers who are also independent contractor registered representatives of broker-dealers through which recommended transactions are effected, or who would be entitled to receive other transaction-based fees or compensation in connection with a client's securities purchase must be particularly cognizant of these restrictions under state and federal securities laws. The fact that a fee will be charged for rendering investment advice when a commission for executing transactions pursuant to such advice will also be paid is considered to be a material conflict of interest which could reasonably be expected to impair the rendering of unbiased and objective advice.ⁿ⁴⁵

States also address compensation specifically in terms of prohibiting "performance" fees. Tracking prohibitions under the Investment Advisers Act of 1940,ⁿ⁴⁶ state Blue Sky laws and regulations generally prohibit advisers from receiving any type of advisory fee calculated as a percentage of capital gains or appreciation in a client account. Several states address the point as an advisory contract prohibition. In California, for example, no investment adviser may enter into a contract which:

Provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client, except as may be permitted by rule or order of the commissioner.ⁿ⁴⁷

There are exceptions to the prohibition against performance fees. Rules and regulations allow contracts for performance fees with (1) certain "qualified" clients, if specific conditions are met; (2) an investment company registered under the Investment Company Act of 1940; and (3) clients that are not U.S. residents. These are exceptions also made in the Investment Advisers Act of 1940.ⁿ⁴⁸ They are expanded in several states to include clients meeting certain other qualifying criteria. In Ohio, for example, clients with at least \$750,000 assets under management with the adviser, or more than \$1.5 million net worth, may enter into performance-based arrangements, as well as clients who are "qualified purchasers" under section 2(a)(51)(A) of the Investment Company Act of 1940, and certain knowledgeable employees of the investment adviser.ⁿ⁴⁹

The general prohibition against performance-based fees does not mean that investment advisers may not determine advisory fees based upon the value of assets under management. Here again, the states have generally adopted provisions of the federal Investment Advisers Act,ⁿ⁵⁰ in which a set-percentage advisory fee periodically calculated and charged on the value of assets under management, which necessarily reflects both gains and losses during the period of calculation, is permitted. As provided in the federal act, the general prohibition against compensation based on a share of capital gains or capital appreciation shall not be construed to prohibit an advisory contract "which provides for compensation based on the total value of a fund averaged over a definite period, or as of definite dates, or taken as of a definite date."ⁿ⁵¹

State-licensed investment advisers and representatives who service employee benefit plans must also consider broader requirements relating to fees applicable to their activities under the federal Employment Retirement Income Security Act (ERISA).ⁿ⁵² ERISA imposes certain fiduciary obligations on investment advisers involved in the management of benefit plan assets and, in general, obligates advisers to act solely in the interests of plan participants and beneficiaries, to exercise prudence, to maintain adequate diversification of plan investments, and to act consistently with controlling plan provisions. ERISA fiduciary principles impact advisory fees by addressing certain "prohibited transactions" between plans and persons who are defined as "parties in interest," or involving self-dealing by fiduciaries. For broker-dealers and affiliated investment advisers involved with ERISA-covered plans it is essential that services fall within an exemption to prohibited transaction provisions. ERISA itself includes a "necessary services" exemptionⁿ⁵³ from prohibited transactions for parties in interest who provide services to plans if: (a) the services are necessary for the establishment or operation of the plan; (b) the services are furnished under a contract that is reasonable; and (c) no more than reasonable compensation is paid. Additionally, subject to certain conditions, a Department of Labor Prohibited Transaction Class Exemptionⁿ⁵⁴ further permits the receipt of commissions by a broker-dealer affiliated with a plan fiduciary for effecting or executing transactions on behalf of the plan.

Investment advisers dealing with benefit plans are thus not only subject to Blue Sky laws and regulations addressing the reasonableness of fees in relation to services provided, but also face the prospect of federal scrutiny under ERISA. Under ERISA the Department of Labor has enforcement authority, and private rights of action are created for plans and plan participants.

[c] Advertising

Investment advisers and investment adviser representatives are prohibited under all state Blue Sky laws from making untrue statements or misleading statements of material facts in the solicitation of advisory clients. As the District of Columbia Blue Sky law declares:

In the solicitation of, or dealings with, advisory clients, a person shall not knowingly make an untrue statement of a material fact, or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading.ⁿ⁵⁵

Advertising by investment advisers and representatives receives special attention, and several states have adopted SEC Rule 206(4)-1 under the Investment Advisers Act of 1940,ⁿ⁵⁶ which provides that an advertisement may not:

- (1) use or refer to any testimonial (which includes any statement of a client's experience or endorsement);
- (2) refer to past, specific recommendations made by the adviser that were profitable, unless the advertisement sets out a list of all recommendations made by the adviser within the preceding period of not less than one year, and complies with other, specified, conditions;
- (3) represent that any graph, chart formula or other device can, in and of itself, be used to determine which securities to buy or sell, or when to buy or sell such securities, or can assist persons in making those decisions, unless the advertisement prominently discloses its limitations and the difficulties regarding its use; and
- (4) represent that any report, analysis, or other service will be provided without charge unless the report, analysis or other service will be provided without any obligation whatsoever.

"Advertisement" is broadly defined in the federal rule to include any notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, that offers any investment advisory service.ⁿ⁵⁷ In order to narrow the definition sufficiently to take into account the nature and scope of cyberspace communications, Arizona provides that a communication over a computer on-line service, including an electronic bulletin board, will not be deemed to be an advertisement when an investment adviser or investment adviser representative either is engaged in a "discussion" regarding securities and does not receive any compensation from any person for the discussion, or simply responds to unsolicited inquiries regarding the provision of investment advisory services.ⁿ⁵⁸ Other states, such as Alaska, make specific provision for advertising on the Internet by investment advisers, subject to requirements,ⁿ⁵⁹ or, as in Rhode Island, create an exemption for the use of the Internet for general dissemination of information on products and services by investment advisers.ⁿ⁶⁰ A critical element in these flexible approaches is that the Internet communication may not involve rendering personalized investment advice.

Investment adviser advertising often includes information concerning past performance. Advertising past performance, whether actual performance or hypothetical or model results, is generally permitted so long as the advertisement also discloses all material facts necessary to avoid any unwarranted inference that past performance implies future success. Such advertising must also disclose the effect of material market or economic conditions on the results presented. It

must also state whether and to what extent the advertised results reflect the reinvestment of dividends, and it may not make or suggest claims about the potential for profit without also disclosing the potential for losses. Additionally, examiners regularly challenge advertising based on gross performance data, that is, data that does not reflect the deduction of advisory or other fees and expenses that a client would pay.ⁿ⁶¹

To permit review of all advertising material utilized by investment advisers, regulations under Blue Sky laws typically provide that advertisements be retained either as part of required books and records, or under specific requirements, for set periods of time. In Connecticut, for example, every investment adviser must maintain "[a] separate file containing copies of all advertising published, circulated or broadcast in or from Connecticut by the investment adviser in the conduct of its investment advisory business."ⁿ⁶² Retention periods vary from three to five years. However, in all cases, after NSMIA retention requirements are subject to the limitations prescribed by section 222 of the federal Investment Advisers Act.

[d] Disclosure Requirements

For investment advisers and representatives the principal disclosure requirement is most often identified as the "brochure" rule or requirement.ⁿ⁶³ By it, investment advisers must furnish each advisory client and prospective advisory client with a written disclosure statement, or "brochure," containing prescribed types of information about the adviser and its business practices. The brochure rule is typically satisfied by dissemination of Part II of Form ADV, or another written document containing at least that information. An adviser must deliver the brochure either: (1) at least forty-eight hours before entering into any written or oral contract with a client or prospective client; or (2) at the time of entering into the contract so long as the contract permits the client to terminate the contract without penalty within five business days after entering into it. Advisers are also typically required either to deliver or to offer to deliver a brochure to existing clients on an annual basis, without charge.ⁿ⁶⁴

There are exceptions to the brochure rule. In many states advisers are not required to deliver a brochure to clients for whom they provide advisory services under a contract for impersonal investment advice for a fee of less than \$200. An adviser entering into a contract for impersonal investment advice for a fee of \$200 or more is required only offer to deliver a brochure at the time of entering into the contract.ⁿ⁶⁵

There are other disclosure requirements in the adviser/client relationship. Ohio, for example, imposes additional disclosure requirements on investment advisers and representatives who have custody of or discretionary trading authority over client funds or securities; or who require prepayment of more than \$500 of an advisory fee.ⁿ⁶⁶ Custody of client funds or securities triggers specific regulatory notification and disclosure requirements in many states, as well as specific account segregation requirements. Notification to state administrators is normally accomplished through the appropriate response on Form ADV. Requirements for particular notification and disclosure to clients in these circumstances vary. However, North Carolina is representative in requiring notice to clients of the place where and the manner in which the client's funds or securities will be maintained. Any changes in the place or manner of custody must also be reported, and at least once every three months the adviser must send an itemized statement showing the funds and securities in custody, and all debits, credits and transactions in the account during the period.ⁿ⁶⁷

States address other particular information to be disclosed, as, for example, specifically requiring disclosure of all material facts regarding the financial and disciplinary history of an adviser, as required by Rule 206(4)-4 under the Investment Advisers Act of 1940.ⁿ⁶⁸ Under such targeted standards of conduct or general antifraud provisions, investment advisers and representatives may also specifically be required to disclose information regarding compensation, as, for example, whether the adviser's fee is higher than that typically charged by other advisers for similar services; or whether the potential exists for any conflict of interest between the adviser and the client. These kinds of disclosures are encompassed in Part II of Form ADV, and advisers electing to supply clients and prospective clients with a copy of the form in satisfaction of the brochure rule will normally satisfy such other specific disclosure requirements in that manner.

[e] Referral Arrangements and Solicitors

Payments to unlicensed third parties of referral fees or fees for solicitation of advisory clients may be prohibited under state investment adviser laws or regulations. North Carolina, for example, declares by rule that it is a dishonest or unethical practice for an investment adviser to "utilize" any unlicensed agent or subagent who meets the definition of investment adviser representative.ⁿ⁶⁹ The latter is defined by the Blue Sky law specifically to include any person associated with an investment adviser who solicits, offers or negotiates for the sale of or sells investment advisory services.ⁿ⁷⁰ Other states address the issue in terms of Rule 206(4)-3 under the federal Investment Advisers Act,ⁿ⁷¹ limiting the payment of referral fees or payments generally for client solicitations. Under this approach investment advisers or investment adviser representatives are prohibited from paying a cash fee, directly or indirectly, to an unlicensed third party for referring clients to the adviser unless the arrangement complies with a number of conditions.ⁿ⁷² Requirements under these provisions include a written agreement with any solicitor detailing the referral fee arrangement, a written disclosure statement by the solicitor to persons solicited, and a written acknowledgement by the solicited client that the disclosure statement and a copy of the adviser's brochure have been provided.

SEC Rule 206(4)-3 under the Investment Advisers Act is explicit in prescribing the content of the written agreements required between advisers and solicitors, as well as the requisite disclosure statement of the solicitor. Every adviser is obligated to make a bona fide effort to ascertain, and to have a reasonable basis for believing, that a solicitor has complied with the agreement. Retention of these documents, including the client's written acknowledgment, is specifically added to the array of books and records that the adviser must maintain.

The 2002 Uniform Act specifically addresses "referral fees" by investment advisers. Section 404(f) of the 2002 Act provides:

An investment adviser registered under this [Act], a federal covered adviser that has filed a notice under Section 405, or a broker-dealer registered under this [Act] is not required to employ or associate with an individual as an investment adviser representative if the only compensation paid to the individual for a referral of investment advisory clients is paid to an investment adviser registered under this [Act], a federal covered investment adviser who has filed notice under Section 405, or a broker-dealer registered under this [Act] with which the individual is employed or associated as an investment adviser representative.ⁿ⁷³

This provision, which is new in the 2002 Act, adds a degree of flexibility in the payment of referral fees by investment advisers by clarifying that it is not necessary for the paying adviser to employ or associate with the individual who is to be paid for referrals, so long as the referral fees are paid to a registered investment adviser with which the individual is in fact associated. This, however, does not address the more common situation in which an adviser pays referral fees to an unregistered person, who is not affiliated with any other investment adviser. In those situations, the solicitor provisions or rules, which in most cases mirror SEC rules under the Investment Advisers Act of 1940, will control.

[f] General Antifraud and Ethical Considerations

Often under the general heading of "dishonest or unethical practices," rules and regulations under Blue Sky laws address a variety of conduct requirements for investment advisers and investment adviser representatives. Prominent in many states is an express *suitability* responsibility. As fiduciaries, investment advisers are charged with the duty to provide only suitable investment advice. This duty generally requires that the adviser or representative determine that the investment advice given is suitable for the client on the basis of information furnished by the client, and after reasonable inquiry concerning the client's investment objectives, financial situation and needs, and any other information known or acquired by the adviser after examination of financial records.ⁿ⁷⁴ By these provisions suitability is made into an active obligation or duty, that is, advisers must undertake a reasonable inquiry and information-gathering process on which to formulate and dispense investment advice.

Other specific matters commonly addressed under the heading of unlawful, unethical or dishonest business practices include:

- (1) Exercising discretionary authority in the purchase or sale of securities for a client account without obtaining written authority, or permitting the exercise of authority by a third party without written trading authority;
- (2) Inducing trading in a client account that is excessive in size or frequency in view of the financial resources, investment objectives and character of the account;
- (3) Borrowing money from or loaning money to a client except under certain conditions;
- (4) Charging unreasonable fees;
- (5) Failing to disclose any conflict of interest;
- (6) Guaranteeing specific results which will be achieved on the basis of advice rendered;
- (7) Disclosing information about a client to others without the consent of the client, unless required by law;
- (8) Providing a report or recommendation to any client prepared by someone other than the adviser without disclosing that fact;
- (9) Misrepresenting qualifications of financial condition of the investment adviser; and
- (10) Failing to obtain "best execution" of clients' transactions.ⁿ⁷⁵

Overarching general antifraud provisions found in all versions of the Uniform Actⁿ⁷⁶ are also common. In Indiana, for example, the Blue Sky law spells out investment adviser responsibility first and foremost in terms common to all general antifraud provisions, namely, employing any "device, scheme or artifice to defraud" another person, or engaging in any act, practice or course of business that would "operate as a fraud or deceit" upon the other person.ⁿ⁷⁷ State rules and regulations may also include express adoption of section 206(4) of the federal Investment Advisers Act of 1940, which declares that it shall be unlawful for an investment adviser to engage in any act, practice or course of business which is fraudulent, deceptive or manipulative.ⁿ⁷⁸ In Montana, for example, advisers are prohibited from:

[E]ngaging in any act, practice or course of business which is fraudulent, deceptive, or manipulative, or contrary to the provisions of Section 206(4) of the Investment Advisers Act of 1940, which is hereby adopted and incorporated herein, notwithstanding the fact that such investment adviser is not registered or required to be registered under Section 203 of the Investment Advisers Act of 1940. ...ⁿ⁷⁹

Whether addressed under the heading of fraudulent, unethical or deceptive business practices, or separately considered, two further specific aspects of business and operations of investment advisers are commonly referenced. The first is a prohibition dealing with principal transactions and "agency cross" transactions. State regulations addressing these matters flow directly from SEC Rule 206(3)-2 under the Investment Advisers Act of 1940,ⁿ⁸⁰ which prohibits an investment adviser, acting as a principal for its own account, from selling any security to or purchasing any security from an advisory client unless the client is notified in writing and has given consent to the transaction prior to its completion. An adviser who is also a broker may under these rules act as broker for both its advisory client and the party on the other side of the transactions (an "agency cross transaction") without obtaining the client's prior consent to

each such transaction if the adviser obtains prior consent for these types of transactions and complies with certain other conditions.ⁿ⁸¹

Drawing again on the federal Act,ⁿ⁸² state rules and regulations also specifically mandate that investment advisers establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material non-public information by the adviser and any of its representatives. Written "insider trading" policies are thus adopted by investment advisers, and prominently included among books and records for inspection by examiners.

Investment advisers are also charged in most states with specific supervisory responsibility regarding all activities performed on the advisers' behalf. Approaches vary from requiring designated (and examination-qualified) supervisors on site at principal and branch officesⁿ⁸³ to more general provisions imposing a more general duty of supervision.ⁿ⁸⁴ Indiana not only prescribes an overarching responsibility for investment advisers to diligently supervise the advisory activities of representatives and employees, but goes further to require a designated supervisor for each investment adviser representative and office employee, and written procedures. Required procedures specifically include administrative review and written approval of all new client accounts; periodic examination of client accounts "to detect and prevent irregularities or abuse;" prompt review of all complaints; review of correspondence; and frequent review and specific written approval for the delegation by any client of discretionary authority.ⁿ⁸⁵ Advisers must periodically inspect each office location to assure that written procedures are being enforced, and are further charged with the duty to ensure that all employees are properly trained regarding disclosure requirements and the administrative, civil and criminal liability provisions of the Blue Sky law.ⁿ⁸⁶

FOOTNOTES:

(n1)Footnote 1. *See* §§ 14.01-14.09 ("Administration and Enforcement"), *below*; Section 14.09 in particular presents "Principal Considerations for Regulatory Actions" against broker-dealers and other intermediaries that were identified by the North American Securities Administrators Association (NASAA) in 2005 as available guidelines for its members. Although the Principal Considerations are available for application by state administrators in their sole discretion, they represent an outstanding resource for intermediaries in assessing their own compliance structure and commitment to a establishing and maintaining a compliance culture.

(n2)Footnote 2. *See, e.g.,* Cal. Admin. Code tit. 10, § 260.218.4(a)-(b).

(n3)Footnote 3. *See, e.g.,* Cal. Admin. Code tit. 10, § 260.218.4(c).

(n4)Footnote 4. FINRA Conduct Rule 3010 (Supervision), NASD Manual (CCH) PP 4831-4836.

(n5)Footnote 5. *See, e.g.,* Wis. Admin. Code § [SEC] 4.05(2).

(n6)Footnote 6. *See, e.g.,* Cal. Admin. Code tit. 10, § 260.218.4(b).

(n7)Footnote 7. *See, e.g.,* Cal. Admin. Code tit. 10, § 260.218.4(c)(1).

(n8)Footnote 8. *See, e.g.,* New York Stock Exchange Rule 405, N.Y.S.E. Guide (CCH) P 2405 (the "know your customer" rule).

(n9)Footnote 9. *See, e.g., California:* Cal. Admin. Code tit. 10, § 260.218.4(c)(2)-(3).

See also Wisconsin: Wisconsin Bulletin, 3 Blue Sky L. Rep. (CCH) P 64,941 (June 1986).

(n10)Footnote 10. *See, e.g.,* Cal. Admin. Code tit. 10, § 260.218.4(c).

(n11)Footnote 11. *See, e.g.,*

California: Cal. Admin. Code tit. 10, § 260.216.5.

Wisconsin: Wis. Admin. Code § [SEC] 4.06(1)(b), (2)(i).

In states that do not expressly prohibit churning, a broker-dealer could still be penalized for having violated the general antifraud rules, *see Selig v. Novak*, 256 Ark. 278, 506 S.W.2d 825 (1974), or for having engaged in a dishonest or unethical practice. *See In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 575 Sec. Reg. & L. Rep. (BNA) F-2 (Okla. Sec. Dep't 1980).

In Florida, a broker-dealer was held liable for punitive damages for failure to supervise a salesperson who had churned a client's account by making volatile purchases and sales that were unsuitable for the client's investment objectives. *Petrites v. J.C. Bradford & Co.*, 646 F.2d 1033 (5th Cir. 1981).

See also Taylor v. First Jersey Secur., Inc., 533 So. 2d 1383 (La. App. 1988) (allegations that a broker made false statements to induce excessive trading in a customer's account were sufficient to establish a cause of action for "churning" under the Louisiana Blue Sky law).

(n12)Footnote 12. *See, e.g.*, Exchange Act Rule 15c1-7, 17 C.F.R. § 240.15c1-7.

(n13)Footnote 13. *See, e.g.*:

California: Cal. Admin. Code tit. 10, § 260.218.4(c)(4).

Georgia: Ga. Comp. R. & Regs. r. 590-4-2-.08(1)(b)(5).

(n14)Footnote 14. *See, e.g.*:

California: Cal. Admin. Code tit. 10, § 260.218.6.

Missouri: Mo. Code Regs. tit. 15, § 30-51.170(1)(C).

(n15)Footnote 15. *See, e.g.*, Ind. Admin. Code tit. 710, r. 1-17-1(j).

(n16)Footnote 16. *See, e.g.*, Ala. Sec. Rule 830-X-3-.12.

(n17)Footnote 17. NASD Conduct Rule 2310(a), NASD Manual (CCH) P 4261.

(n18)Footnote 18. *See, e.g.*:

Arkansas: Ark. Sec. Rule 308.01(D).

Connecticut: Conn. Agencies Regs. § 36b-31-15a(a)(2).

Minnesota: Minn. R. 2875.0910(2).

(n19)Footnote 19. NASAA Statements of Policy/Dishonest or Unethical Policies, § 1(c), reprinted in Vol. 3, *below*, at p. 4-143 *et seq.*

(n20)Footnote 20. *See, e.g.*, Wis. Admin. Code § [SEC] 4.06(1)(c)1.

(n21)Footnote 21. *See, e.g.*:

Arkansas: Ark. Sec. Rule 308.01(B).

Hawaii: Haw. Sec. Reg. § 16-38-7(b)(8).

(n22)Footnote 22. *See, e.g.*, Cal. Admin. Code tit. 10, § 260.218.4(c)(3).

(n23)Footnote 23. NASD Conduct Rule IM-3310(e).

(n24)Footnote 24. NASD Conduct Rule IM-3310(d).

(n25)Footnote 25. *See, e.g.*, Cal. Admin. Code tit. 10, § 260.218.5(d)(2).

(n26)Footnote 26. *See, e.g.*, Tex. Admin. Code tit. 7, § 115.5(a)(4)(C)(vii), (b)(2)(B)(vii).

(n27)Footnote 27. *See, e.g.*, Cal. Admin. Code tit. 10, § 260.218.4(c)(5).

(n28)Footnote 28. *See, e.g.*, Ga. Comp. R. & Regs. r. 590-4-2-.14(a)(11).

(n29)Footnote 29. *See* § 11.02[4], *above*, for a discussion of record keeping requirements.

(n30)Footnote 30. *See, e.g.*, Or. Admin. Rule 441-205-0210(3)(d).

(n31)Footnote 31. NASD Conduct Rule 3010, NASD Manual (CCH) P 4831.

(n32)Footnote 32. NASD Conduct Rule 3010, NASD Manual (CCH) P 4831.

(n33)Footnote 33. *See, e.g.*:

Indiana: Ind. Admin. Code tit. 710, r. 1-14-6(b).

Minnesota: Minn. R. 2875.0910(3), (5)-(6).

Nevada: Nev. Admin. Code ch. 90, § 3925.

(n34)Footnote 34. *See, e.g.*:

Alabama: Sec. Rule 830-X-3-.13(4)(b).

California: Cal. Admin. Code tit. 10, § 260.218.4(d)(2).

Georgia: Ga. Comp. R. & Regs. r. 590-4-2-.08(c).

Oregon: Or. Admin. Rule 441-205-0210(4).

Pennsylvania: 64 Pa. Code § 305.011(a)(3).

Virginia: 21 Va. Admin. Code § 5-20-260(E)(2).

(n35)Footnote 35. *Ind. Admin. Code tit. 710, r. 1-14-6(e).*

(n36)Footnote 36. *See, e.g.:*

Massachusetts: See, e.g., 950 Code. Mass. Reg. § 12.204.

See also Trade Stock Am., Inc. v. Millette, 19 Mass. L. Rep. 437, 2005 Mas. Super. LEXIS 261 (Super. Ct. 2005) (Unregistered broker-dealer could not enforce a direct claim to securities commissions received by an agent from another broker-dealer).

(n37)Footnote 37. *See Supervisory Responsibilities of Broker-Dealer Management, Joint Release of Maryland Division of Securities, NASD District 10 and 11, Pennsylvania Securities Commission, Philadelphia-Baltimore-Washington Stock Exchange, District of Columbia Public Service Commission, Virginia Division of Securities, and Securities and Exchange Commission, Exchange Act Rel. No. 8404 (Sept. 11, 1968). See also Rule 17a-3(a)(12) of the Securities Exchange Act of 1934, 17 C.F.R. § 240.17a-3(a)(12) (requiring a registered broker-dealer to keep and maintain an employment application for each associated person approved in writing by an authorized representative of the broker-dealer).*

(n38)Footnote 38. *See, e.g., Cal. Admin. Code tit. 10, § 260.241(a)(12).*

(n39)Footnote 39. *Minn. R. 2875.0910(5).*

(n40)Footnote 40. *See, e.g., Cal. Corp. Code § 25234(a)(2) (no contract permitted which "[f]ails to provide, in substance, that no assignment of the contract shall be made by the investment adviser without the consent of the other party to the contract").*

See also:

Connecticut: Conn. Gen. Stat. § 36b-5b(1)(B).

Ohio: Ohio Admin. Code § 1301:6-3-151(I)(a)(ii).

(n41)Footnote 41. *Ohio Admin. Code § 1301:6-3-151(I)(4)(a).*

(n42)Footnote 42. *See, e.g.:*

Connecticut: Conn. Agencies Regs. § 36b-31-5e (" 'assignment' shall not include a transaction not resulting in a change of actual control or management of an investment adviser").

Ohio: Ohio Admin. Code § 1301:6-3-151(I)(4)(b).

(n43)Footnote 43. *Cal. Corp. Code § 25234 (Contract Requirements).*

(n44)Footnote 44. *See, e.g., Colo. Sec. Act § 51-4.8(IA)(J). See also Colo. Rev. Stat. § 11-51-410(1)(I)(II).*

(n45)Footnote 45. *See Ga. Comp. R. & Regs. r. 590-4-8-.17(i).*

(n46)Footnote 46. Investment Advisers Act § 205(a)(1), 15 U.S.C. § 80b-5(a)(1).

(n47)Footnote 47. *Cal. Corp. Code* § 25234(a)(1).

(n48)Footnote 48. See Investment Advisers Act Rule 205-3, 17 C.F.R. § 275.205-3.

(n49)Footnote 49. See, e.g.:

Nebraska: Neb. Admin. Code ch. 11, §§ 002, 005.01 ("qualified client").

Ohio: Ohio Admin. Code § 1301:6-3-151(I)(5)(d)(i).

California: See also Cal. Admin. Code tit. 10, § 260.234 (Compensation based on capital gains). California permits compensation based on capital gains provided all conditions under the federal Investment Advisers Act are met. In addition, California provides for such agreements with qualified "institutional investors," but excludes certain smaller pension or profit-sharing plans.

(n50)Footnote 50. Investment Advisers Act § 205(b), 15 U.S.C. § 80b-5(b); see, e.g., *Fla. Admin. Code Ann. r. 3E-600.0131(1)(a)*1.

(n51)Footnote 51. Investment Advisers Act § 205(b), 15 U.S.C. § 80b-5(b).

Missouri adopts the federal provision, but with certain significant qualifications. In its regulations, Missouri permits performance-based compensation as provided in the federal Act, but with the additional important restrictions: (1) The investment adviser may in no way have solicited or advertised the performance-based compensation; (2) The client must have requested the performance-based fee arrangement; and (3) The contract must include express acknowledgment of the client and the adviser of the general prohibition and contain an agreement that neither the adviser nor the client "retains any civil liability for having engaged in the payment or receipt of performance-based compensation." Mo. Code Regs. § 30-51.145(2)(A)-(C).

(n52)Footnote 52. 29 U.S.C § 1001 et seq. ("ERISA").

(n53)Footnote 53. *ERISA* § 406(a).

(n54)Footnote 54. Prohibited Transaction Class Exemption No. 86-128, 4 *CCH Pension Plan Guide* P 16,631 (Nov. 18, 1986).

(n55)Footnote 55. D.C. Sec. Act of 2000 § 502(d).

(n56)Footnote 56. 17 C.F.R. § 275.206(4)-1.

See, e.g.:

California: Cal. Admin. Code tit. 10, § 260.235(a).

Ohio: Ohio Admin. Code § 1301:6-3-44(A).

Pennsylvania: 64 Pa. Code § 404.010(a).

Tennessee: Tenn. Sec. Rule 0780-4-3-.09.

(n57)Footnote 57. Investment Advisers Act Rule 206(4)-1(b), *17 C.F.R. § 275.206(4)-1(b)*.

(n58)Footnote 58. Ariz. Sec. Reg. § R14-6-101(B)(2)(d).

(n59)Footnote 59. *Alaska Admin. Code tit. 3, § 08.055*.

(n60)Footnote 60. R.I. Sec. Div. Regs., Rule 202(a)(2)(c)(v); *see also* Del. Sec. Rule 707.

(n61)Footnote 61. In connection with invariable requests to review data underlying performance or rate of return advertising, many states specifically include the retention of accounts, books and internal work papers which have been used or which form the basis of such representations. In New Mexico, for example, books and records requirements specifically include:

All accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations in any notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser circulates or distributes, directly or indirectly, to 10 or more persons (other than persons connected with such investment adviser); provided, however, that, with respect to the performance of managed accounts, the retention of all account statements, if they reflect all debits, credits, and other transactions in a client's account for the period of the statement, and all worksheets necessary to demonstrate the calculation of the performance or rate of return of all managed accounts shall be deemed to satisfy the requirement of this paragraph.

N.M. Admin. Code tit. 12, § 11.3.6.1(Y).

(n62)Footnote 62. *Conn. Agencies Regs. § 36b-31-14b(b)(4)*.

(n63)Footnote 63. *See, e.g.,* Ark. Sec. Rule 302.02(I) ("Brochure requirement").

(n64)Footnote 64. *See, e.g.:*

Arkansas: Ark. Sec. Rule 302.02(I)(2). These rules track SEC Rule 204-3 under the Investment Advisers Act of 1940, *17 C.F.R. § 275.204-3*.

New York: *See also* N.Y. Comp. Codes R. & Regs. tit. 13, § 11.4. New York regulations require annual distribution of an "investment adviser statement" to clients, indicating that a copy of the adviser's Form ADV and all exhibits or the equivalent brochure as filed with the state may be requested in writing from the adviser, and further that such requests must be satisfied within seven days of receipt.

(n65)Footnote 65. These exceptions are consistent with federal law. Rule 204-3 under the Investment Advisers Act states that a "contract for impersonal advisory services" means:

[A]ny contract relating solely to the provision of investment advisory services (i) by means of written material or oral statements which do not purport to meet the objectives or needs of specific individuals or accounts; (ii) through the issuance of statistical information containing no expression of opinion as to the investment merits of a particular security; or (iii) any combination of the foregoing services.

17 C.F.R. § 275.204-3(g)(1).

(n66)Footnote 66. *See Ohio Admin. Code § 1301:6-3-44(D)(1)(a).*

(n67)Footnote 67. N.C. Admin. Code tit. 18, § 6.1802(a)(4)-(5).

(n68)Footnote 68. *See, e.g., Miss. Sec. Rule 623(R).*

(n69)Footnote 69. N.C. Admin. Code tit. 18, § 6.1801(a)(18).

(n70)Footnote 70. *N.C. Gen. Stat. § 78C-2(3)(d).* The definition, however, excludes a licensed dealer or salesperson.

(n71)Footnote 71. 17 C.F.R. § 275.206(4)-3.

(n72)Footnote 72. *See, e.g.:*

Mississippi: Miss. Sec. Rule 623(Q).

Missouri: Mo. Code State Regs. tit. 15, § 30-51.145.

Ohio: Ohio Admin. Code § 1301:6-3-44(C).

(n73)Footnote 73. 2002 Unif. Sec. Act § 404(f).

(n74)Footnote 74. New Mexico is typical in declaring the following to be unlawful, unethical or dishonest conduct or practice by an investment adviser:

Recommending to a client to whom investment supervisory, management or consulting services are provided the purchase, sale or exchange of any security without reasonable grounds to believe that the recommendation is suitable for the client on the basis of information furnished by the client after reasonable inquiry concerning the client's investment objectives, financial situation and needs, and any other information known by the investment adviser.

N.M. Admin. Code, tit. 12, § 11.3.10.2(A).

(n75)Footnote 75. Under general fiduciary principles applicable to investment advisers, an adviser must not cause the client to enter into any transaction at an unreasonable price, or one that is not reasonably related to the current market price of the security. In meeting this obligation, an adviser must secure execution of client transactions in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances then existing. This requires that an adviser investigate the range and quality of brokerage services available when placing orders, taking into account factors such as execution capability, commission rate, responsiveness, financial responsibility and the value of any research services provided.

In practice, it is common for investment advisers to establish relationships with a particular broker-dealer, to which advisory clients are referred for establishing advised accounts. These practices must be fully addressed in Part II of Form ADV, or whatever brochure is utilized, and it is further expected that the adviser will set out the basis upon which it has determined that the costs associated with the selected broker-dealer are competitive and justified in terms of services provided for the benefit of the client.

(n76)Footnote 76. Unif. Sec. Act § 102(a); Rev. Unif. Sec. Act § 503; 2002 Unif. Sec. Act § 501.

(n77)Footnote 77. *Ind. Code § 23-2-1-12.1(a)*.

(n78)Footnote 78. *15 U.S.C. § 80b-6(4)*.

(n79)Footnote 79. *Mont. Admin. R. 6.10.127(1)(u)*.

See also:

Iowa: Iowa Admin. Code r. 191-50.104(1)(t).

Kentucky: 808 Ky. Admin. Regs. 10:040, § 6(a)-(c).

Massachusetts: Mass. Regs. Code tit. 950, § 12.205(9)(b)(1).

(n80)Footnote 80. *17 C.F.R. § 275.206(3)-2*.

(n81)Footnote 81. *See, e.g., N.C. Admin. Code tit. 18, § 6.1803(b)(6)* ("No agency cross transaction may be effected in which the same investment adviser recommended the transaction to both any seller and any purchaser.").

Rules permitting agency cross transactions also prescribe particular procedures and content of written confirmation of each such transaction, to include, for example, information concerning the source and amount of any remuneration received by the adviser in connection with the transaction.

(n82)Footnote 82. Investment Advisers Act § 204A, *15 U.S.C. § 80b-4a*, provides in pertinent part:

Every investment adviser subject to section 204 of this title shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such investment adviser's business, to prevent the misuse in violation of this Act or the Securities Exchange Act of 1934, or the rules or regulations thereunder, of material, nonpublic information by such investment adviser or any person associated with such investment adviser. ...

(n83)Footnote 83. *See, e.g., N.M. Admin. Code, tit. 12 § 11.3.9.5*.

(n84)Footnote 84. *See, e.g.:*

New Hampshire: N.H. Admin. Rules Atg-Se § 502.04 (requiring notice of any branch office of an adviser and identification of the person responsible for daily supervision of the office).

Ohio: Ohio Admin. Code § 1301:6-3-19(B)(9).

(n85)Footnote 85. *Ind. Admin. Code tit. 710, r. 1-16-15*.

(n86)Footnote 86. *Ind. Admin. Code tit. 710, r. 1-16-15*.

See also Mass. Regs. Code tit. 950, § 12.205(10)(b). Massachusetts imposes the further responsibility and duty on investment advisers to ascertain, by investigation, "the good character, business repute, qualifications and experience" of any person prior to making a certification in the application of any such person for licensing. Mass. Regs. Code tit.

950, § 12.205(10)(b), § 12.205(10)(e).



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CHAPTER 11 Regulation of Intermediaries: Broker-Dealers, Investment Advisers and Associated Persons

2-11 Blue Sky Regulation § 11.07

§ 11.07 Financial Privacy Standards for Broker-Dealers and Investment Advisers

Certain provisions of The Gramm-Leach-Bliley Act ("GLBA"), enacted November 12, 1999,ⁿ¹ have been considered earlier in regard to exceptions from the critical Securities Exchange Act definition of "broker" for certain securities activities of banks.ⁿ² With GLBA Congress also established as national policy that each financial institution has an affirmative and continuing obligation to respect and protect the privacy of its customers, and to protect the security and confidentiality of those customers' nonpublic personal information.ⁿ³ "Financial institution" is defined in GLBA as any institution the business of which is engaging in certain financial activities, including banking, securities underwriting, investment advisory and insurance services.ⁿ⁴ "Nonpublic personal financial information" means personally identifiable financial information either provided by a consumer to a financial institution; resulting from a transaction with the consumer or any service performed for the consumer; or otherwise obtained by the financial institution.ⁿ⁵

The Act directed regulatory agencies to establish standards: (a) to insure the security and confidentiality of consumer records and information; (b) to protect against any anticipated threats or hazards to the security and integrity of such records; and (c) to protect against unauthorized access to or use of such records or information which could result in substantial harm or inconvenience to a customer.ⁿ⁶ For broker-dealers and SEC-registered investment advisers, the SEC was charged under GLBA with rulemaking and enforcement authority. For state-licensed investment advisers, by virtue of a catchall provision, the Federal Trade Commission (FTC) was given such rulemaking and enforcement authority.ⁿ⁷ As for all designated agencies, GLBA mandated consultation and coordination for the purpose of ensuring, to the greatest extent possible, consistent and comparable regulations. As a result, the operative provisions of privacy rules issued by the SEC and the FTC are virtually identical.ⁿ⁸

Rules applicable to broker-dealers and investment advisers provide as follows:

- (1) Broker-dealers and investment advisers must develop a privacy policy, and disclose it initially to consumers and annually to customers.ⁿ⁹
- (2) Consumers must be given the right to opt out of the transmission of their nonpublic information to non-affiliated third parties.
- (3) There are no limits on sharing information with affiliates. Also, information may be shared with agents and service providers for purposes of marketing the broker-dealer's or investment adviser's own

products and services (as long as the agent or service provider is not authorized to initiate changes to the account directly).

(4) Broker-dealers and investment advisers must adopt procedures that are reasonably designed to protect customer records and information.

Subject to limited exceptions permitting delayed delivery, the notice provisions direct that a clear and conspicuous notice accurately reflecting a broker-dealer's or investment adviser's privacy policy and practice must be provided to customers at the time a customer relationship is established. As for consumers, notice must be given before any nonpublic personal information is disclosed to a nonaffiliated third party, although initial notice is not required if the broker-dealer or investment adviser does not share nonpublic personal financial information with nonaffiliated third parties, and does not have a customer relationship with the consumer. Annual notices to customers must also contain clear and conspicuous statements of privacy policies and practices. All notices must contain specific information including the categories of nonpublic personal information that are collected and disclosed, as well as the categories of affiliated and nonaffiliated third parties to whom nonpublic personal information is disclosed.

The "opt out" notice to be provided by broker-dealers and investment advisers must state that the broker-dealer or investment adviser discloses or reserves the right to disclose nonpublic personal financial information to nonaffiliated third parties. It must also provide that the consumer has the right to opt out of that disclosure, and provide a reasonable means by which the consumer may exercise that right. There are limited exceptions to the notice and opt-out provisions that permit disclosure of information in connection with joint-marketing, processing or servicing arrangements, and also for compliance with legal requirements.

The SEC rules include various examples and sample privacy policy disclosures for use in privacy and opt-out notices.ⁿ¹⁰ Commentary accompanying the FTC rules applicable to state-licensed investment advisers states that compliance by a state-licensed investment adviser with applicable examples contained in the SEC rules will constitute compliance with the FTC rules.

FOOTNOTES:

(n1)Footnote 1. Pub. L. No. 106-102, 113 Stat. 1338.

(n2)Footnote 2. *See § 11.02[5], above.*

(n3)Footnote 3. GLBA § 501, 15 U.S.C. § 6801.

(n4)Footnote 4. GLBA § 509(3), 15 U.S.C. § 6809(3).

(n5)Footnote 5. GLBA § 509(4), 15 U.S.C. § 6809(4).

(n6)Footnote 6. GLBA § 501(b), 15 U.S.C. § 6801(b).

(n7)Footnote 7. GLBA §§ 504-505, 15 U.S.C. §§ 6804-6805.

(n8)Footnote 8. *See* Regulation S-P, 17 C.F.R. part 248 (SEC); and 16 C.F.R. part 313 (FTC).

GLBA and the agency rules were structured with an effective date of November 13, 2000, but a *compliance* date of July 1, 2001.

(n9)Footnote 9. "Consumer" means an individual who obtains or has obtained a financial product or service primarily for personal, family or household purposes, or that person's legal representative. "Customer" means a consumer who has a customer relationship with a broker-dealer or investment adviser. A "customer relationship" is a

continuing relationship between a consumer and the broker-dealer or investment adviser under which the broker-dealer or adviser provides one or more financial products or services to the consumer that are to be used primarily for personal, family or household purposes.

(n10)Footnote 10. Exchange Act Rel. No. 42974 (June 23, 2000).



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CHAPTER 12 Blue Sky Laws and the Internet

2-12 Blue Sky Regulation 12.syn

§ 12.syn Synopsis to Chapter 12: Blue Sky Laws and the Internet

§ 12.01 Introduction

§ 12.02 Blue Sky Regulatory Authority in Cyberspace

[1] "Offers" in Cyberspace

[2] Intermediary Licensing Issues

§ 12.03 Securities Fraud on the Internet

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CHAPTER 12 Blue Sky Laws and the Internet

2-12 Blue Sky Regulation § 12.01

§ 12.01 Introduction

The role of state securities regulation in cyberspace was first introduced in Chapter 4, where the issue of the scope of state administrators' jurisdiction under Blue Sky laws over offers and sales of securities undertaken via the Internet, and related intermediary activities, was considered.ⁿ¹ Defining individual state regulatory jurisdiction in an age of worldwide indiscriminate electronic communications instantly disseminated to tens of millions of people presents a significant challenge. On one hand, state securities administrators regularly confront violations of Blue Sky laws on the Internet including the offer and sale of unqualified securities, unlicensed broker-dealer and investment adviser activities, and, above all, fraudulent offers and sales of securities. As a vehicle for committing securities fraud, the Internet is cheap and easy to use. Websites, news groups, chat rooms and e-mail messages are effectively utilized to tout investment schemes and offers of speculative "microcap" stocks. Given the historic mission of Blue Sky laws, state securities regulators have understandably focused great attention on policing the Internet for such investment scams, and on defining the scope of their jurisdiction in a manner that gives the greatest protection. On the other hand, the Internet represents a powerful tool in legitimate capital formation, particularly by small businesses. The Internet dramatically lowers the cost of reaching prospective investors. It is a particularly effective means of linking entrepreneurs needing capital to investors. A prime example is the Angel Capital Electronic Network (ACE-Net), sponsored by the U.S. Small Business Administration. ACE-Net is an Internet-based system designed to match entrepreneurs with "accredited investors" who subscribe to the system.

Today there are direct offerings of securities through issuer websites. There is electronic delivery of required disclosure materials, electronic proxy voting, and a proliferation of online intermediary services. Investors enjoy instant access to a wealth of research data and financial news that was previously available only to Wall Street professionals. The access is reciprocal, and investors are alarmingly vulnerable to Internet-based fraud. Blue Sky regulation in cyberspace is principally challenged because technology has outpaced laws. The Uniform Securities Act, the Revised Uniform Act and the Blue Sky statutes in non-Uniform Act states are products of a different age, in which the evolution of the Internet and its special regulatory challenges could not have been foreseen. Yet the concerns for investor protection are the same.

This chapter examines the major challenges posed by the Internet both for state regulators and for the market participants operating under the scrutiny of such regulators. The manner in which states have sought to balance competing policy concerns is considered in each of the three main areas of Blue Sky regulation, namely, offerings, intermediary licensing, and fraud. From the baseline issue of the scope of state securities regulation in the world of e-commerce, the perspectives of issuers, intermediaries and investors are considered. Structural changes in markets that test the limits of state regulation, and the evolution of electronic global securities markets generally, round out a

cyberspace assessment of the impact of Blue Sky laws today and into the future. Because the Internet is fundamentally changing the relationship between investors and intermediaries, special attention is also paid to the role of Blue Sky regulation in policing online trading, and to state investor protection initiatives. Finally, the particular impact on Blue Sky regulation of the Electronic Signatures in Global and National Commerce Act,ⁿ² enacted in June 2000, is examined.

FOOTNOTES:

(n1)Footnote 1. *See* ch. 4, *supra*.

(n2)Footnote 2. Pub. L. No. 106-229, 114 Stat. 464 (2000), codified at 15 U.S.C. §§ 7001-7031 (Supp. 2001).



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CHAPTER 12 Blue Sky Laws and the Internet

2-12 Blue Sky Regulation § 12.02

§ 12.02 Blue Sky Regulatory Authority in Cyberspace

At the baseline, the exercise of Blue Sky regulatory authority is grounded either in an act amounting to an offer or sale of securities, or in conduct amounting to engaging in the securities business. Critical definitions control, and section 414(c) of the Uniform Act thus sets the scope of Blue Sky regulatory authority broadly:

[A]n offer to sell or to buy is made in this state, whether or not either party is then present in this state, when the offer (1) originates from this state, or (2) is directed by the offeror to this state and received at the place to which it is directed (or at any post office in this state in the case of a mailed offer).n1

Drafters of the Uniform Act addressed electronic offers and sales of securities only in terms of excluding from the key definition of "offer" such radio and television programming which is received within a state but which originates from a different state.n2 Although the Revised Uniform Act expanded the exclusion in 1985 to cover offers by "other electronic communication" originating outside the state as well as radio and television broadcasts,n3 and may thus be said at least to contemplate something akin to Internet communications, it is certain that neither the drafters of the original Uniform Act nor those of the Revised Uniform Act could have envisioned the extent to which the Internet has emerged as a dominant means of electronic commerce and communication, and the extent to which it today allows access to investors. It is certain, however, that Blue Sky administrators have historically acted on the basis of purposeful activity and communications directed into their states. In setting the scope of regulatory authority, the Uniform Act expressly defines authority in terms of "any act instrumental in effecting prohibited conduct" being done in the state, whether or not either party is present in the state at that time.n4

The vast potential of the Internet in the establishment and support of eventually seamless worldwide securities markets carries an equally vast potential for the fraud and abuse that drive Blue Sky regulation. State regulators have therefore set out to respond effectively and efficiently to meet the dangers while fully recognizing that there are practical and proper limits on the scope of their authority in cyberspace.

In the simplest sense, the Internet is a medium of communication.n5 Any communication amounting to an offer to sell a security that is directed into a state, by any medium, triggers application of Blue Sky laws and regulations as to issuers and all intermediaries involved in it. Unless preempted by the National Securities Markets Improvement Act of 1996 (NSMIA),n6 or eligible for an exemption, an offer triggers state registration and qualification requirements for issuers,

2-12 Blue Sky Regulation § 12.02

and licensing requirements for intermediaries; offers are also subject to scrutiny under antifraud provisions in all cases. A major challenge posed to state regulation by the Internet is the extent to which an electronic communication available generally to anyone having access to the Internet is in fact *directed* to recipients within a particular state, who may act on it, and thus fall within the ambit of protection under that state's Blue Sky law.

Long ago the so-called "red herring" legend, or disclaimer of an offer, was embraced by states in the context of the dissemination of certain preliminary offering documents or announcements relating to distributions of securities pursuant to registration under the federal Securities Act of 1933, or otherwise in "tombstone" announcements in multi-state print media. Such a disclaimer of an offer is, of course, a fiction, as a printed advertisement, or even a "red herring" prospectus, that is widely circulated is available, if not disseminated, in states in which there is no Blue Sky law qualification. As will be seen below, state Internet rules or regulations, with some common grounding in published guidance of the North American Securities Administrators Association (NASAA), have applied the same fiction to Internet communications that plainly "offer" securities to all persons who have Internet access, but which disclaim the offer to any person in a particular non-qualifying state. Offers of securities are allowed on the Internet providing that a disclosure is made stating that it is not specifically directed to any person in a particular state. An indirect offer, however, is in fact made where information on a website may be accessed by anyone interested. The key consideration, of course, is that notwithstanding the offer disclaimer, no *sales* of the securities may be made unless the securities are properly registered.ⁿ⁷

Outside the offering context, state securities regulatory concerns also arise in the use of the Internet by broker-dealers and other market intermediaries for general dissemination of information on products and services. Here too, communications made on the Internet through postings on bulletin boards, displays on home pages and websites, or similar methods involve communications made generally to anyone having access to the Internet. By distributing information on available products and services through Internet communications that are available to persons in any state, broker-dealers, investment advisers, and their agents or representatives may be deemed to be transacting business within the ambit of Blue Sky licensing provisions. With further NASAA guidance, many states have promulgated policy statements or interpretive rules prescribing parameters that will allow such intermediaries to make Internet communications without being deemed to be "transacting business" in the state. Compliance with these requirements, coupled with other screening methods, is being employed successfully by intermediaries in the establishment and management of websites so as to limit access to individuals residing only in those states in which the intermediary and its associated persons are licensed.

Internet-based referral services that link customers to financial service providers through a website "portal" involving general advertising of those services and their availability are now common, and raise a separate set of regulatory issues relating to both advertising and broker-dealer licensing requirements. Referral services typically include general advertising of services and no direct solicitation of customers or special compensation for referrals. As discussed further in section 12.02 below, such website portals will not generally be deemed to be transacting, or engaging in, securities business in circumstances involving no direct or active solicitation in an effort to effect or attempt to effect sales of securities.ⁿ⁸

Electronic publications can also implicate Blue Sky *investment adviser* regulatory requirements. Daily publication of financial information and stock predictions on a website, for example, may constitute advising others as to the value of securities, or amount to issuing or promulgating analyses or reports concerning securities, activities that meet the definition of investment adviser if the requisite compensation element is present.ⁿ⁹ Whether an exemption or exclusion from the definition of investment adviser based on a bona fide "newspaper, news magazine, or business or financial publication of general, regular and paid circulation" as used in Blue Sky laws is available for an Internet communication is also a matter for further consideration. As a practical matter, such information presented on the Internet can be downloaded and printed in hard copy by the user if desired in such a format. Internet users would most often simply read the information from their computer screens without printing it, but the option is always available. As such, there is no real conceptual difference for purposes of Blue Sky regulation between a message sent via the Internet and one

printed on paper and mailed. The "bona fide publications" exemption or exclusion that is a part of state and federal investment adviser laws may thus operate to keep Internet postings outside the scope of regulation when requisite criteria are met.ⁿ¹⁰

Internet-spawned developments in e-commerce impact state Blue Sky laws in other ways. Notably, the Electronic Signatures in Global and National Commerce Act ("E-Sign"),ⁿ¹¹ enacted in June 2000, directly impacts state securities laws and requirements relating to the use of offering circulars and prospectuses, and record-keeping requirements for intermediaries. E-Sign opens the door to new state provisions for maintenance of electronic records, and addresses standards for accuracy, integrity and accessibility of such electronic records. There is also continuing development and implementation of the Securities Registration Depository (SRD) system for electronic registration of securities offerings in multiple states. The SRD is based on current Internet technology.ⁿ¹² And state regulators are themselves reaching out to enhance regulatory and enforcement effectiveness through Internet websites and in the implementation of Internet-based filing and retrieval systems.

In defining the scope of regulatory authority, however, the challenge in the application of Blue Sky laws and regulations in cyberspace lies in dealing with basic definitions that have set the threshold from the beginning. In the discussion below the two most common and critical issues regarding Blue Sky authority and use of the Internet are considered. Subsection [1] examines how states have grappled with the baseline notion of an "offer" of securities effectively broadcast across all boundaries. Then, subsection [2] focuses on the extent to which regulatory objectives of the states in licensing securities market intermediaries are balanced with the realities of the online environment.

[1] "Offers" in Cyberspace All of state securities regulation is a function of definitions. The scope of state regulatory authority under Blue Sky laws has been shown throughout the previous chapters to be set by the literal and contextual application of statutory definitions, constrained to the extent of the federal-state regulatory duopoly that is today prescribed by NSMIA. Blue Sky regulation in cyberspace is no different. An "offer" or "offer to sell" communicated via the Internet is no less an "attempt or offer to dispose of, or solicitation of an offer to buy, a security"ⁿ¹³ than one made via a telephone solicitation, newspaper advertisement or mailing into the state, if it is purposely directed there. As the California Corporations Commissioner has opined:

As a general rule, every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security for value made by communication on a proprietary or electronic delivery system such as the World Wide Web, otherwise known as the Internet, is an "offer" or are "offers to sell" securities "in this state."ⁿ¹⁴

Although Blue Sky law definitions of "offer" are all qualified by the "for value" element, use of the Internet to distribute "free" unregistered securities will not escape regulatory scrutiny. In a series of no-action letters, the U.S. Securities and Exchange Commission has considered several proposed Internet-based programs by which issuers wished to give away unregistered securities over the Internet to persons who visited their websites. The SEC staff has made clear that the issuance of unregistered securities in consideration of a person's registration on or visit to the issuer's website would amount to an offer or sale under the like definitions of offer and sale contained in the federal securities laws.ⁿ¹⁵ State administrators would likely come to the same conclusion. Issuance of "free" securities over the Internet, where tied to some action associated with an issuer's website, or where shown to involve some element of value to the issuer, would thus violate state registration provisions in the absence of an available exemption.

Use of Internet websites to advertise investment opportunities, or in any manner to solicit investors or the referral of investors, represents an offer subject to Blue Sky registration requirements.ⁿ¹⁶ As regulatory actions taken at the federal level illustrate, use of the Internet amounts to general solicitation or advertising for the sale of securities. The Securities and Exchange Commission has, for example, addressed postings of offerings to sell securities by individuals on an independently operated Internet auction site. In two 1999 administrative proceedings,ⁿ¹⁷ the SEC found violations of the registration provisions of the federal securities laws where individuals offered securities for sale over

the Internet auction site run by eBay, Inc. Although no sales of the securities were ultimately made, the postings attracted several bids that were communicated through the auction website. Both offerors consented to the imposition of a cease-and-desist order. In other administrative proceedings the SEC has addressed "free" stock promotions on the Internet as amounting to offers within the ambit of the registration provisions where it is evident that the donor succeeds by the giveaway in advancing some economic objective.ⁿ¹⁸ Clearly, the broadest notion of an "offer" broadcast through the Internet will be applied by regulators, and the critical issue becomes whether an Internet offer, solicitation or communication is targeted to persons in a particular jurisdiction.

Internet postings are not, by themselves, targeted communications if measures are taken that are reasonably designed to prevent them from being acted upon in a jurisdiction. The SEC has, for example, focused on the global character of Internet communications to deal with offshore offers of securities or investment services that by their terms are not made to U.S. persons. In that context the Commission has opined:

[A]pplication of the registration provisions of the U.S. securities laws depends upon whether Internet offers, solicitations or other communications are targeted to the United States. We would not view issuers, broker-dealers, exchanges, and investment advisers that implement measures that are reasonably designed to guard against sales or the provision of services to U.S. persons to have targeted persons in the United States with their Internet offers.ⁿ¹⁹

For state securities regulation, the key is understanding whether a communication is in fact purposefully directed into a state. While a communication made on an Internet website is directed generally to anyone who has access to the Internet,ⁿ²⁰ it need not be construed as constituting an offer of securities, or an activity making the sender subject to licensing, if it is not *specifically* directed to any person in the state and the need for investor protection accorded by Blue Sky laws is not present.ⁿ²¹ Thus, in Indiana, the Commissioner determined as early as 1995 that it is not necessary or appropriate for the protection of investors in that state to require registration of securities offered by an issuer on the Internet, but not directed and sold to persons in Indiana.ⁿ²²

Recognizing that the goals of investor protection and access to capital markets can and should be reconciled with the use of the Internet, in 1996 the North American Securities Administrators Association (NASAA) adopted a resolution calling for the exemption from registration for offers and sales of securities made over the Internet if certain conditions are met. Starting from the premise that an Internet offer may be construed as an offer to any person having access to the Internet, the NASAA Resolution encourages states to take appropriate steps to exempt Internet offers from the registration provisions of their securities laws when the following conditions are met:

A. The Internet offer indicates, directly or indirectly, that the securities are not being offered to the residents of a particular state; and

B. An offer is not otherwise specifically directed to any person in a state by or on behalf of an issuer of the securities.

Following on, the NASAA Resolution encourages appropriate steps to permit sales of securities that are the subject of Internet offers under these further conditions:

A. No sales of the securities shall be made in any state until the offering has been registered and declared effective, and [a final disclosure document] has been delivered to the investor prior to such sale;
or

B. The sales are exempt from registration.ⁿ²³

The NASAA Internet Resolution has been adopted in thirty-one states,ⁿ²⁴ with most others signaling an intention either to adopt or to apply it.ⁿ²⁵

The impetus for the NASAA Internet Resolution was a 1995 order of the Pennsylvania Securities Commission addressing Internet communications regarding securities that do not result in sales in the state. Pennsylvania was the first state to provide an exemption for Internet communications if: (1) offering documents indicate that securities are not being offered to persons in the state; (2) the securities are not in fact being offered to persons in the state by any other means; and (3) no sales of the securities are made in the state as a result of the offering. If these conditions are not satisfied, Pennsylvania takes the position that an offer made on the Internet constitutes a mass mailing, publicmedia advertisement, and general solicitation that is subject to registration requirements under the Blue Sky law.ⁿ²⁶

Some states have followed the Pennsylvania lead by crafting a specific Internet exemption from registration and advertising requirements. In Alaska, for example, an offer on the Internet by an issuer is exempt from that state's registration requirements and advertising regulations if:

(1) the offer directly discloses, in a format and at a prominent place in the offer and in an advertisement of the offer on the Internet, that the securities are not being offered to persons in this state;

(2) the offer is not otherwise specifically directed to a person in this state by or on behalf of the issuer; and

(3) a sale of the issuer's securities is not made in this state as a result of the offer.ⁿ²⁷

Wyoming likewise enacted a specific Internet exemption in its Blue Sky law, such that any offer (but not a sale) of a security made on or through the Internet is exempt from registration and literature filing requirements if it satisfies the Pennsylvania criteria.ⁿ²⁸

There are subtle variations in language among the states in regulations or exemptions, the impact of which is largely unnoticed, but which affect the construction and scope of an Internet offering disclaimer. The Pennsylvania approach, for example, not only requires the disclaimer of any direct or indirect offer to persons in the state and stipulates that neither the issuer nor any person acting on its behalf may otherwise specifically direct the offer to anyone in the state, but also blocks any sales in the state as a result of an Internet offer. Thus, unlike the NASAA Internet Policy, which clearly contemplates sales being made at such time as the offering has been registered and declared effective in the state, Pennsylvania clearly prohibits any sales "as a result of the offering."ⁿ²⁹

Regardless of subtle differences, to qualify under any available exemption or policy statement in a particular state, an Internet website offering must indicate that the securities are not being offered to residents of that state. The Ohio Division of Securities determined that a website home page available to all residents that included an investment introduction, and permitted access to an online prospectus or subscription materials at another website location that was not restricted, constituted an illegal offer under Blue Sky laws despite an express, general disclaimer that the prospectus was not a solicitation to "Residents of the United States of America or the citizens of individual states of the United States of America."ⁿ³⁰ The "solicitation" disclaimer was plainly offset by the fact that the investment introduction on the website was entirely unrestricted, the introduction included a company representation that "you will be able to purchase shares of common stock directly from us," and the link to the website prospectus and subscription agreement permitted state residents access without any restriction.

Internet home pages and websites which provide interested parties the ability to electronically access information related to the business activities of an issuer and which describe or reference an offering of securities constitute offers or solicitations to the general public. Providing such access will usually run afoul of Blue Sky laws if the home page or website is simply a conduit for a general solicitation and these securities are not registered or express restrictions are not included.ⁿ³¹ However, where Blue Sky laws or regulations allow for some form of notice referring or relating to a securities offering, or the website or home page acts as a link between it and some permissible general announcement

regarding an offering,ⁿ³² so long as an issuer's website does not contain information that is inconsistent with that allowable pursuant to the notice or general announcement provision, the posting itself should not be a concern.ⁿ³³ "Gateway" technology used to direct interested persons to a website where a permissible notice or general announcement appears, and further screening mechanisms then operate to restrict access to further information in accordance with state laws and regulations, is entirely consistent with the approach taken with outright Internet offers.

Screening mechanisms must be meaningful, and effective. In *CGI Capital, Inc.*,ⁿ³⁴ a broker-dealer sent e-mail communications containing preliminary information about two private placement securities offerings to thousands of individuals for whom the firm had obtained e-mail addresses through various Internet promotions. The securities offerings were restricted by federal exemption criteria to sophisticated or accredited investors. The e-mail messages contained a link to CGI Capital's website, which required users to enter a password to access the offering presentation. However, the password had been supplied to every recipient of the e-mail solicitation, and there was no warning or restriction that prevented recipients from forwarding the password to other potential investors. On the website, CGI provided a sales presentation and a subscription form. Accepting an Offer of Settlement in this administrative proceeding, the SEC found that CGI had engaged in a general solicitation to thousands of individuals, some of whom had no pre-existing substantive relationship with the firm, and had failed to verify whether those persons met criteria for availability of an exemption from registration. The password-protected website, said the SEC, allowed potential investors to access the offering materials before any determination was made concerning their eligibility.

The access issue in *CGI Capital* was more complex than would normally be involved at the state level because the screening related to particular criteria needed to establish a federal exemption from registration. Nevertheless, the case underscores the point also made by the Ohio Division of Securities in *Kevin G. Duffy*, discussed above,ⁿ³⁵ that restrictions must be meaningful. A preliminary or general disclaimer appearing on a page that links to an entirely unrestricted offering site may easily run afoul of Blue Sky laws if an individual is in fact able to view offering documents that have not been qualified for offering in his or her state.

One effective approach to restricting access is shown through an Illinois Securities Bureau Statement of Position. In *Investment Management & Research, Inc.*,ⁿ³⁶ a gateway designed to be exclusive means of access to a website containing offering information included the following message:

Due to various state registration requirements concerning the solicitation of securities, we are required to limit access to the following pages to individuals residing in states in which these securities are currently properly registered. In order for us to meet this requirement, please enter the state in which you are currently residing: _____

Further access is not permitted until the user's state of residence is entered. If the user resides in a state in which the security is registered, access is permitted, with the following message appearing on the first page:

This information is only intended for use by individuals residing in the following states: _____, _____, _____, ... [the states in which the representative and security are registered]. This security may not be offered by us to individuals accessing this information from any state not listed above.

If the user resides in a state in which the representative or the security is not registered, further access is denied, and the following message appears:

Unfortunately, the securities about which we are providing information are not currently registered in your state, and therefore we will be unable to distribute this information to you at this time. Please press _____ to return to the previous menu. n37

As a further consideration, for an Internet offering properly qualified by restriction to be made only in a particular state, the website offering must indicate that the securities are being offered only to residents of that state, and that it is not directed specifically to any person outside the state except pursuant to an applicable qualification.ⁿ³⁸

The operation of issuer-sponsored Internet "bulletin board" services or platforms to provide information to prospective buyers and sellers of stock, and thereby facilitate trading, presents hybrid issues under federal and state securities laws. In *Real Goods Trading Corp.*,ⁿ³⁹ the SEC staff considered the proposed establishment of a passive bulletin board by an issuer of thinly-traded common stock under registration provisions of the Securities Act of 1933. The company's Internet platform allowed for listing names, addresses and telephone numbers (or other contact information such as e-mail addresses) of interested buyers and sellers; the number of shares offered for sale or desired to be purchased; the price; and the date on which the information was entered into the system. Participants could enter this information directly through the company's website, or by otherwise sending it to the company to be entered for the participant. The bulletin board displayed only information, and neither it nor the company played any role in effecting transactions. Any and all transactions would be effected only through direct contact between participants.

The establishment and maintenance of such a bulletin board or platform specifically designed to facilitate securities transactions triggers concern whether the posted offers and resulting sales made through the system would violate registration provisions. Additionally, the platform itself could be deemed functionally to be an exchange, or the company operating it a broker-dealer or investment adviser. On the matter of registration, the SEC staff concluded that the operation of the bulletin board would not require registration of the offers and sales effected through it. The staff was satisfied that the entirely passive character of the system, coupled with several notices and procedures built into it (including a restriction that neither the issuer nor any of its affiliates could use the system to buy or sell securities except in compliance with the securities laws) sufficed to take it outside the ambit of the registration provisions. The staff also concluded that the system would not be subject to registration under federal law as an exchange or as a broker-dealer.ⁿ⁴⁰

The SEC no-action letters stand for the proposition that there is no general solicitation or attempt to dispose of securities in the operation of a website that merely allows potential buyers and sellers to become more easily known to each other. Every resulting transaction must, as with any securities transaction, be exempt from federal and state registration requirements. However, the establishment and operation of a passive Internet platform that facilitates those transactions will not, even where operated by the issuer of the securities, themselves amount to an offering subject to registration requirements. The principle is equally well applied under state Blue Sky laws, and the fact that such websites are generally accessible should not be seen as an offer subject to registration requirements.

Use of the Internet by investment professionals to transmit or distribute general information about available products and services is most often considered by state securities regulators under the aegis of broker-dealer, investment adviser and representative licensing requirements. The common issue is whether such Internet postings amount to engaging in or transacting securities business in a state, so as to trigger licensing requirements. Such activities by representatives or dealers are also scrutinized under offer definitions and, unless properly restricted and limited as to content, may be held to be violations of registration requirements. By regulation, Illinois thus provides that salespersons or dealers who use the Internet to distribute information on available products and services will not be deemed to be engaging in the offer of securities provided that:

- (1) The communication contains a legend clearly stating that the salesperson or dealer may only transact business in those states where he, she or it is registered or otherwise excluded or exempted from State registration;
- (2) The sender of the communication has taken reasonable measures to insure that any subsequent interaction between prospective customers or clients residing in states where the salesperson or dealer is not registered is limited so as to not otherwise require State salesperson, dealer or securities registration;

(3) The communication does not involve the actual effecting of securities transactions or trades for compensation over the Internet but is limited to the dissemination of information on products or services; and

(4) In the case of a salesperson, the affiliation with a dealer is prominently disclosed within the communication; the dealer retains the responsibility of reviewing and approving the content of the Internet communication; the dealer has authorized the distribution or dissemination of information on products and services via the Internet communication; and the salesperson is acting within the scope of his or her authority in distributing or disseminating the Internet communication.ⁿ⁴¹

As noted above, to consider whether Internet posting of information constitutes an offer or attempt to dispose of a security under Blue Sky laws often involves the tandem issue of whether the persons doing so become subject to broker-dealer, salesperson or other intermediary licensing requirements. As discussed in section 12.02[2] below, states have taken a practical approach designed to avoid unnecessary extension of those requirements. Nevertheless, use of the Internet in such a manner that an offer results in a particular state will almost invariably lead to the conclusion that the persons directly associated with that offer are subject to licensing.

[2] Intermediary Licensing Issues Blue Sky licensing requirements for broker-dealers, salespersons, investment advisers and intermediaries generally are triggered by activity amounting to "transacting business" or "engaging in business" as such.ⁿ⁴² The Internet has spawned creation of websites, "platforms," and "portals" that are designed to facilitate communication and/or dealing between issuers and investors, particularly in those markets dominated by institutional investors. At the same time, "Alternative Trading Systems" (ATSs) or, as more popularly known, "Electronic Communications Networks" (ECNs), have effectively become electronic exchanges, providing for order routing, order matching or "crossing," and price discovery. Trading systems vary from single-price auction systems such as the "Arizona Stock Exchange," to those that collect and disseminate continuous quotations, and provide for automatic execution of orders to buy or sell. The development of such systems has progressed to the point that several have undertaken to register under the federal Securities Exchange Act of 1934 as national securities exchanges in their own right.ⁿ⁴³

Alternative trading systems and ECNs will be regulated as a matter of federal and state law either as exchanges or broker-dealers. However, from a Blue Sky law perspective there is a different level of Internet platforms which are designed to facilitate securities transactions, but which involve no trading systems or other clearly market-oriented functions such as matching. These types of facilities serve an informational or listing function, by which buyers and sellers, or issuers and investors, may find each other and deal, independent from the Internet facility that brought them together. In *Prescient Markets, Inc.*,ⁿ⁴⁴ the Colorado Securities Commissioner considered whether such an Internet platform met the definition of broker-dealer under that state's Blue Sky law, such that licensing would be required. The sponsoring corporation sought to operate a password-protected Internet website designed to allow direct issuers of commercial paper to interact with institutional purchasers. The Internet platform allowed issuers to post their rates for commercial paper, and afforded the opportunity for institutional investors to browse the rates and issuer information, and communicate offers online. Acceptance, confirmation or rejection of the proposed transaction was entirely between the issuer and the investor, with the Internet platform sponsor having no role in effecting transactions.

The *Prescient* Internet platform operated effectively on a subscription basis. The sponsor entered into separate service agreements with each direct issuer of commercial paper desiring to post rates on the site. For designing the Internet platform, providing the software, and operating the platform by electronically transmitting all communications between issuers and investors, the sponsor received compensation from each issuer in an amount equal to a fixed percentage of the dollar amount of the issuer's commercial paper processed through the Internet platform and outstanding on each day during the relevant billing period. Institutional investors were permitted access to the website and, by online registration, were entitled to designate specific issuers to whom they would like to submit offers. Investors were also required to enter into an offline access agreement with the sponsor of the Internet platform, acknowledging, among

other things, that the sponsor provides only access to the program and has no role in any ultimate transaction.

Beyond the initial execution of agreements with issuer and investor participants, Prescient had no contact with either. It did not provide advice or make any recommendations. It did not accept orders or carry accounts. It did not receive, transfer or hold any investor funds or securities, and it played no role in clearance and settlement. Based upon its limited intermediary role between commercial paper issuers and institutional investors, Prescient requested an order excluding it from the definition of broker-dealer, and likewise excluding its officers, directors and employees from the definition of "sales representative" under the Colorado Blue Sky law. The Commissioner agreed, concluding that the platform for Internet postings regarding commercial paper in these circumstances did not trigger investor protection concerns, and that an order excluding the sponsor and its executives would be consistent with the public interest.ⁿ⁴⁵

Prescient illustrates the role of an Internet platform as an information provider, to facilitate transactions that may not have otherwise occurred by efficiently establishing direct interaction between issuers and investors. Prescient performed a facilitative role, not the intermediating role that is the hallmark of a broker-dealer. The Colorado order excluding the sponsor of the Internet platform from the key licensing definition instructs that simply providing an information resource, even where compensation is ultimately a function of resulting transactions, will not amount to "transacting business" as a broker-dealer in circumstances where the sponsor of the Internet platform has provided only a medium through which issuers and investors may enjoy direct access to one another.

States have also responded favorably to the operation of Internet platforms that involve expanded functions. In *Internet Stock & Securities Exchange*,ⁿ⁴⁶ the Utah Division of Securities granted no-action advice in regard to a business plan for creation of an Internet-based stock listing service and brokerage. Under the multi-phased business plan, an Internet platform was proposed to allow issuers whose securities were registered under state and federal securities laws, but not exchange-listed, to gain greater exposure and liquidity for their stock. In the first phase of the undertaking a listing service was to be implemented, to operate as an electronic bulletin board. Thereafter, it was proposed to add a brokerage or trading function, by which "crossing" of buys and sells of participants would be effected. In this phase of operation the sponsor of the platform intended to become licensed under Utah law as a broker-dealer, and eventually introduce an underwriting capability, by which it would assist Utah companies in preparing for and making Internet offerings of securities.

Responding favorably to the business plan, the Utah Securities Division emphasized the sponsor's intention to comply with state and federal regulatory requirements as each phase of its plan is implemented. The Division staff premised its view on the assumption that regulatory requirements, including any requirements of the U.S. Securities and Exchange Commission regarding the licensing of securities exchanges, would be followed. It is clear, however, that the first, bulletin board, phase of operation of the Internet platform (which was to be referred to only as "Internet Stock & Securities Listings") could be undertaken without licensing under the Utah Blue Sky law.

As a general matter, the major consideration in assessing Internet-based intermediary activities in light of broker-dealer registration requirements is the extent of one's participation in securities transactions at the key points in the chain of distribution. The U.S. Securities and Exchange Commission has addressed several situations in which a company, as part of its business, assists issuers in structuring proposed securities transactions; helps issuers identify potential investors; or advertises, or otherwise helps issuers in order-taking or order routing processes. The SEC has taken the position that companies engaged in these activities are effecting transactions in securities for the account of others, and are subject to broker-dealer registration requirements under the federal securities laws.

In *MuniAuction, Inc.*,ⁿ⁴⁷ the SEC staff concluded that an auction company bringing together buyers and sellers of securities through its website for a fee would be engaged in the business of effecting transactions for the account of others, and would be required to become registered as a broker-dealer under the federal securities laws. The company was not involved in active solicitation of investors, did not advise investors, and received only "hosting" fees rather than any transaction-based compensation. Nevertheless, the Staff determined that in bringing together buyers and sellers for

a fee, MuniAuction was in fact engaged in business as a broker-dealer through its website auction. The company conducted extensive participant solicitation and advertising efforts, and participated in the order-taking process through purchasers' submission of their bids on securities through the website. In declining to grant no-action advice, the SEC staff offered the following guidance in applying the key definition, whatever the setting:

A person effects transactions in securities if he or she participates in such transactions "at key points in the chain of distribution". Such participation includes, among other activities, assisting an issuer to structure prospective securities transactions, helping an issuer to identify potential purchasers of securities, soliciting securities transactions (including advertising), and participating in the order-taking or order-routing process (for example, by taking transaction orders from customers). Factors indicating that a person is "engaged in the business" include, among others: receiving transaction-related compensation; holding one's self out as a broker, as executing trades, or as assisting others in settling securities transactions; and participating in the securities business with some degree of regularity. In addition to indicating that a person is "effecting transactions," soliciting securities transactions is also evidence of being "engaged in the business."⁴⁸

The operation of Internet platforms designed to facilitate direct interaction between issuers and investors is subject to the same analysis. State securities administrators (as well as the SEC) can be expected carefully to assess whether a non-intermediating, information resource role in a transactional setting is in fact a designed step in the chain of distribution.

Intermediary licensing requirements in Blue Sky laws focus on the competency, quality and financial responsibility of persons and firms that actually deal with the investing public. The regulatory construct is based upon agency relationships and intermediary filters in which there are inherent conflicts of interest and overall concerns for fairness in dealing. Broker-dealers and their representatives enable investors to access markets, but in so doing occupy a position that involves more than passive facilitation. The operation of fair and orderly markets is dependent to a significant degree upon the integrity of the essential intermediaries who make them work. Even more the concern at the state level is the intermediary role in capital formation, and the responsibility of those persons and firms who interact directly with the investing public on behalf of issuers in the distribution of securities. *Prescient*, discussed above,⁴⁹ illustrates the potential of the Internet in providing the means of direct access between issuers and investors in the capital formation process. To be sure, the Internet platform there involved controlled access by institutional investors, and securities that were exempt from registration under the Colorado Blue Sky law in any case. Nevertheless, the concern for investor protection so central to the notion of "transacting business" that is the heart of Blue Sky licensing definitions was missing where the sponsor was a passive facilitator of direct, non-intermediated interaction between issuers and investors. Likewise, considering the proposed *Internet Stock & Securities Exchange*,⁵⁰ the Utah Securities Division responded favorably to the staged implementation of a facility that would progressively meet regulatory concerns as functions expanded significantly.

The Internet will increasingly serve as a medium for direct interaction in capital formation, by-passing traditional market intermediaries. Use of the Internet for direct access to potential investors, however, produces no less concern over content and quality of communication. In *In re James H. Penfield*,⁵¹ a foreign corporation advertised on its Internet website seeking "joint venture" and "equity financing" partners, which the Texas Securities Commissioner determined to be securities. The securities were not registered under the Texas Blue Sky law, and the individual respondent was not registered to offer and sell them. Principal focus, however, was placed on the Internet advertisement itself, which the Commissioner found to be materially misleading or likely to deceive the public because it failed to disclose facts concerning the individual respondent, and deceptively portrayed a prototype facility.⁵² An order to cease publication, dissemination and use of the Internet advertisement in the State of Texas issued. The order to cease publication, issued under the Commissioner's authority to regulate advertising and sales materials, was the simplest approach in these circumstances. Because it was expressly made broad enough to encompass any "substantially similar" advertisements or sales materials of the issuer, the order effectively interdicted the Internet offer and sale of

unregistered securities, and the role of the individual respondent as an unlicensed salesperson.

Penfield involved the direct offer of securities via the Internet. There was no question regarding the objective or intent of the respondents in their website posting, and if a broker-dealer had been involved in the process there would have been no question that the intermediary had in fact been transacting business in the state by virtue of the unrestricted Internet offering. The issue for intermediaries becomes more clouded, however, in circumstances involving use of the Internet only to distribute information concerning available products and services.

The NASAA Internet Resolutionⁿ⁵³ does not address intermediary licensing issues that may arise by reason of Internet communications. NASAA has, however, issued a Model Interpretative Order concerning intermediaries utilizing the Internet to distribute information about their products and services. Use of the Internet for this purpose will not be deemed to be "transacting business" in a state for purposes of licensing requirements if certain conditions are met.ⁿ⁵⁴ The Model Interpretive Order is once again premised on the fact that under Blue Sky laws the distribution of information on available products and services via Internet communications available to persons in a state could be construed as an intermediary "transacting business" in the state *regardless of the intent of the person originating the communication*. The goal is thus to avoid application of the critical definition in circumstances where it is clear that no actual activity is being undertaken. The methodology established relies principally on a legend, along with "firewall" technology to assure that no purposeful activity is in fact directed into the state. Thus, as the NASAA Model Order has been adopted as a Policy Statement in Alabama, for example, Internet communications by intermediaries must contain a legend in which it is clearly stated that:

- (1) The intermediary may only transact business in the state if it has first been licensed, or has been excluded from licensing requirements; and
- (2) No follow-up, individualized responses by the intermediary that involve either the effecting or the attempt to effect transactions in securities, or to render personalized investment advice for compensation, will be made absent compliance with applicable intermediary licensing provisions, or an available exemption or exclusion.

To the legend requirement are added the following requirements:

- (1) The Internet communication must contain a mechanism, including and without limitation, technical "firewalls" or other implemented policies and procedures designed reasonably to ensure that prior to any subsequent, direct communication with prospective customers or clients in the state, the intermediary is first licensed or qualifies for an exemption from licensing; and
- (2) The Internet Communication does not involve either effecting or attempting to effect transactions in securities or the rendering of personalized investment advice for compensation in the state.ⁿ⁵⁵

The NASAA Model Interpretive Order imposes certain further requirements on broker-dealer agents/representatives and investment adviser representatives who may originate Internet communications. The individual's affiliation with a broker-dealer or investment adviser must be prominently disclosed; that affiliated broker-dealer or investment adviser must authorize the particular distribution of information and retain responsibility for reviewing and approving its content; and, finally, the agent or representative must act within the scope of the authority granted by the broker-dealer or investment adviser.ⁿ⁵⁶

An example of a "gateway" or "firewall" mechanism designed to permit access to websites only by individuals residing in states in which a broker-dealer and representative are licensed is presented in section 12.02[1] above with regard to limiting offers. The series of access steps discussed there is augmented by another, which appears if the user resides in a state in which the representative is not licensed, as follows:

Unfortunately, we are not currently registered in your state, and therefore will be unable to distribute our investment information to you at this time. Should you desire further information on the ways in which our firm may be able to meet your investment needs, please feel free to write us at [Branch Address] (or e-mail us at [E-Mail Address]) briefly explaining the information you desire. We may be able to refer you to a representative in your area, or we may become registered in your state, at which time we would be able to further discuss how our services might meet your needs. n57

In *Communications Over the Internet*,ⁿ⁵⁸ the South Dakota Division of Securities responded favorably to a broker-dealer registered representative's proposal to establish a website without being licensed in that state. In doing so, the Division observed that the following procedures, which supply a succinct amalgam of requirements in the conduct of Internet activities by an intermediary, constitute all of the procedures in place necessary to meet that state's rule:

- (1) The registered representative would not be located in, or have an office location in, the state. In addition, the registered representative would in no way hold out to the public any location in the state as providing securities products or services.
- (2) The registered representative would establish a website from another state, which would be accessible from all states, which would be used to distribute general information on the products and services offered by the registered representative.
- (3) The website would contain a legend clearly stating that: (a) the registered representative may only transact business in the state after first complying with the state's applicable licensing requirements; and (b) individualized follow-up responses to persons in the state by the registered representative will not be made without first complying with applicable licensing requirements.
- (4) The website would contain a mechanism or other implemented policies and procedures designed reasonably to ensure that prior to any subsequent direct communication with prospective customers or clients in the state, the registered representative is first licensed or qualifies for an exemption from licensing.
- (5) The website would be limited to the dissemination of general information on products and services offered by the registered representative, and it would not involve either effecting or attempting to effect transactions in securities, or the rendering of personalized investment advice.
- (6) The registered representative's affiliation with a broker-dealer would be prominently disclosed within the website.
- (7) The broker-dealer would review and approve the content and layout of the website for compliance with all NASD, SEC, and state rules pertaining to communication with the public, and would authorize the distribution of the information on the registered representative's securities products and services through the website.
- (8) The registered representative is properly registered with the NASD and other states, and would not transact any business or provide any individualized, direct communications regarding securities products or services with any prospective customers or clients in the state without first complying with applicable licensing requirements.ⁿ⁵⁹

These procedures combine to satisfy all state rules and requirements addressing Internet activities by intermediaries, whether formulated in terms of the NASAA Model Interpretive Order or otherwise. The procedures enumerated have general application to Internet activities of any intermediary. Where investment advisers are involved, however, there is

an added dimension for consideration in regard to the Internet dissemination of information.

The NASAA Model Interpretive Order is made applicable not only to broker-dealers and their representatives who use the Internet to distribute information, but also to investment advisers and investment adviser representatives. State investment adviser licensing provisions, like the federal Investment Advisers Act of 1940, exclude from the definition of investment adviser the following persons:

A publisher of any bona fide newspaper, news magazine, or business or financial publication of general, regular, and paid circulation.ⁿ⁶⁰

Some states make clear that the publication exclusion applies to communications whether in hard copy form or by electronic means.ⁿ⁶¹

In *SEC v. Lowe*,ⁿ⁶² the U.S. Supreme Court interpreted the "bona fide publications" exclusion from the definition of investment adviser as establishing three criteria to be met in order to qualify. First, the publication must be "bona fide," in the sense that it contains disinterested commentary and analysis rather than promotional material. Second, it must be of "general and regular circulation," meaning that there be no indication that the publication is timed to affect a particular industry or specific market activity. Finally, the communications between the publisher and subscribers must remain "entirely impersonal" and cannot develop into personalized advice attuned to a client's personal investment concerns.ⁿ⁶³

Even those states which have not expressly incorporated electronic delivery of information have opined that publication of information in electronic form rather than print media presents no conceptual difference in determining the availability of the exclusion. As the Kentucky Division of Securities has observed:

The information presented on the Internet could be downloaded and printed in hard copy by the user if the user desired such a format. Although most Internet users simply would read the information from their computer screens without ever downloading or printing it on a hard copy, the option is certainly always available. As such, we can see no real conceptual difference for purposes of securities regulation between a message sent on the Internet and a message printed on paper and mailed. The operative facts are that the message or communication was sent and that it was received.ⁿ⁶⁴

Those who publish investment information electronically on the Internet normally do so seeking paid subscribers. Nevertheless, the information is disseminated to the general public, and is the same for all who access it. Such information is not tailored to any particular investor's wants or needs, and no information is gathered with respect to any user's specific investment needs, risk tolerances or financial position. Just as importantly, there are no "touted" stocks. That being the case, such electronic publications will normally qualify for exclusion from the definition of investment adviser, and thus not be subject to any state licensing requirement.ⁿ⁶⁵

All of the foregoing discussion suggests that state regulators focus principally upon whether a person or entity has undertaken some purposeful or targeted Internet securities activity in their states. The scope of state jurisdiction over some market intermediaries may nevertheless turn on more esoteric notions than purposeful activity versus passive posting of information on a website accessible to users in any state. In *Rollin v. William V. Frankel & Co.*,ⁿ⁶⁶ an Arizona appellate court held that Arizona courts could not assert personal jurisdiction over defendants who were market-makers in the Nasdaq Stock Market simply because those market-makers post electronic quotations that are available nationwide. The case did not involve claims under the Arizona Blue Sky law or any issue concerning the scope of regulatory authority. Rather, the case was a class action that derived from the plaintiffs' purchase of stock of an issuer in bankruptcy that continued to trade in the Nasdaq Stock Market for a period after the bankruptcy court extinguished all of the shares. The Arizona plaintiffs sued the two New Jersey-based market-makers in the stock, who they alleged were negligent in executing the transactions for the plaintiffs' brokers. The trades between the plaintiffs'

brokers and the market-makers all took place outside of Arizona, and neither of the market-maker firms engaged in business in Arizona.

Market-makers maintain continuous two-sided markets in securities by entering "bid" and "ask" quotations that are displayed in an electronic network operated by the Nasdaq Stock Market. The display of quotations represents a willingness either to buy or to sell a particular quantity of the shares at the displayed quote. Market-maker quotes are broadcast through the system to the investment community, but are not accessible by the general public. In *Rollin* the court of appeals affirmed the trial court dismissal of the case against the market-makers for lack of personal jurisdiction. The court concluded that although the market-makers' quotes were electronically accessible to broker-dealers throughout the country who could effect transactions for their customers, the posting of quotes did not amount to a purposeful posting directed to customers in Arizona. The plaintiffs claimed that the market-makers had conducted a continuous and systematic business in Arizona through participation in the electronic Nasdaq Stock Market. The court, however, declined to accept the broad proposition that when an entity intentionally uses an electronic medium to reach beyond its boundaries to conduct business, the exercise of specific jurisdiction is appropriate. The market-makers, said the court, did not purposefully avail themselves of Arizona based on specific contacts or intentional, directed, solicitation there.

Rollin injects a degree of uncertainty into the assessment of the extent to which participation in an Internet-based electronic market will constitute engaging in business sufficient to trigger regulatory authority under Blue Sky laws. The issue is perhaps most significant in projecting what role states may play in policing Internet trading platforms, matching services, and their operators as electronic markets continue to evolve. If *Rollin* is widely embraced, critical Internet activity for purposes of Blue Sky regulation may be only that which can be identified as specifically targeted into the state, or which amounts to actual solicitation. As the court observed:

As best we can determine from the record, Frankel's and HTM's connection with Arizona was limited to the chance that a broker-dealer located anywhere in the country *might* have accessed their quote for a particular stock on NASDAQ's computer system and, finding the quote satisfactory, *might* have purchased some of that stock from them for an Arizona customer. As that scenario reflects, Frankel and HTM had no way of controlling to whom they sold stock or of knowing what customer base their stock purchasers represented.ⁿ⁶⁷

The court was satisfied that Nasdaq market-makers' automated listing of bid and ask quotations was more akin to passive Internet activity than to interactive conduct, open solicitation, or "doing business" on the Internet.ⁿ⁶⁸ As applied in the particular setting, in which the market-maker function of the de-centralized, dealer-based Nasdaq Stock Market clearly does not involve investor solicitation and agency activities, the conclusion may be sound. Still, the evolution of electronic communications networks that perform both passive and interactive functions will test the notion, and state securities regulators may be inappropriately impeded if *Rollin* is fully embraced. There are significant challenges ahead for state securities regulators in dealing with the dramatically changing market landscape and the extent to which direct access to electronic trading facilities becomes the norm, and the competition for investor orders increases. The role of Blue Sky laws and regulations in the evolving electronic marketplace must yet be defined.

FOOTNOTES:

(n1)Footnote 1. Unif. Sec. Act § 414(c).

(n2)Footnote 2. Section 414(e) of the Uniform Act provides in pertinent part: "An offer to sell or to buy is not made in this state when ... a radio or television program originating outside this state is received in this state."

(n3)Footnote 3. Section 801 of the Revised Uniform Act provides in pertinent part that "[a]n offer to sell or to purchase made in a radio or television program or other electronic communication received in this State which originates outside this State is not made in this State." Rev. Unif. Sec. Act § 801(g) (emphasis added).

For purposes of determining whether an electronic communication *shall* be considered as originating within the state, the Revised Uniform Act includes among four categories a communication supplied by an electronic network with the signal originating from outside the state for redistribution to the general public in the state. *Id.*, § 801(h)(2).

(n4)Footnote 4. Unif. Sec. Act. § 414(f).

But see Rollin v. William V. Frankel & Co., 996 P.2d 1254 (Ariz. App. 2000), in which the court held that Arizona state courts could not exercise personal jurisdiction over Nasdaq market-makers where it could not be shown that the market-makers had purposefully directed their activities toward Arizona. *Rollin* did not involve a challenge to the scope of regulatory authority under the Arizona Blue Sky law; however, the focus in the case on the role of electronic networks in connection with offers, purchases and sales of securities raises questions concerning the scope of that authority, particularly in regard to intermediary regulation and the emergence of electronic exchanges and Internet-based securities trading platforms. These issues, and *Rollin*, are discussed further in section 12.02[2], *infra*.

(n5)Footnote 5. Under the Florida Blue Sky law, for example, the "Internet" is defined as:

[T]he global information system comprised of independent computer networks which are interconnected and share information without the use of a central processing center by use of the Transmission Control Protocol (TCP/IP) suite, to include without limitation, the World Wide Web, proprietary or "common carrier" electronic delivery systems, or similar medium.

Fla. Div. Sec., Rule 3E-100.010(3).

(n6)Footnote 6. The National Securities Markets Improvement Act of 1996 (NSMIA), Pub. L. No. 104-290, 110 Stat. 3416 (1996), replaced, in its entirety, section 18 of the Securities Act of 1933, 15 U.S.C. § 77r. NSMIA preempted much of state regulatory authority over securities offerings that are national in character.

The impact of NSMIA on Blue Sky laws in the offering context is discussed in detail in Chapters 5 (Registration) and 6 (Merit Regulation), *supra*. Where applicable, NSMIA preempts state authority to impose registration requirements, and the enforcement of related qualification standards. It does not, however, affect the enforcement of antifraud provisions and regulations, nor does it in any manner limit state authority under Blue Sky laws in regard to licensing of intermediaries.

(n7)Footnote 7. *See In re* Internet Advertising and Broker-Dealer Compliance, Wy. Sec. Div. No-Action Letter, 1997 Wy. No-Act. LEXIS 5 (Apr. 8, 1997). Wyoming exempts issuers from registration who advertise their securities through the Internet and make offers, but not sales. Sales may be made only after proper registration occurs.

As to sales, and the activities of intermediaries in regard to Internet postings that would trigger licensing requirements, "gateway" restrictions and electronic screening generally in order to avoid particular licensing requirements are discussed in section 12.02[2], *infra*.

(n8)Footnote 8. *See, e.g.*, Kan. Sec. Comm'r, Request for Opinion No. 2001-003, 2000 Kan. Sec. No-Act. LEXIS 13 (Dec. 8, 2000) (broker-dealer and agent registration not required when a bank referred customers, through a website, to a broker-dealer for brokerage services).

(n9)Footnote 9. Regulation of investment advisers under state Blue Sky laws is presented in detail in Chapter 11, *supra*. Particular investment adviser considerations associated with Internet publication of financial information, *see, e.g.*, Neural Applications Corp., Del. Div. Sec., No-Action Letter, 1996 Del. Sec. No-Act. LEXIS 39 (May 22, 1996), are addressed in section 12.02[2] below.

(n10)Footnote 10. In *SEC v. Lowe*, 472 U.S. 181 (1985), the leading case interpreting the "bona fide publications" exclusion from the federal Investment Advisers Act of 1940, the U.S. Supreme Court established three criteria to be met in order to qualify for the publication exclusion. First, the publication must be "bona fide" in the sense that it contains "disinterested commentary and analysis as opposed to promotional material." *Id.*, 472 U.S. at 203. Second, the publication must be "of general and regular circulation," meaning that there must be no indication that the publication is timed to affect specific market activity. *Id.*, 472 U.S. at 204. Finally, the communications between the publisher and recipients must be "entirely impersonal," and cannot develop into personalized advice attuned to clients' personal investment concerns. *Id.*, 472 U.S. at 210.

(n11)Footnote 11. Pub. L. No. 106-229, 114 Stat. 464 (2000), codified at 15 U.S.C. §§ 7001-7031.

(n12)Footnote 12. SRD is a recently redesigned electronic filing system that enables filers and the states to access a central database through its website. The goal of the SRD is to establish a low-cost, secure and easy-to-use complete state securities filing system, although at present the system is focused on mutual fund filings through the Internet-utilizing Form NF, the Uniform Investment Company Notice Filing. SRD allows for instant access by state reviewers to record filings, and reduces file status uncertainty.

Some states have set out to develop their own electronic filing systems. Pennsylvania, for example, has implemented an electronic Uniform Investment Company Notice Filing system, and in Ohio the Ohio Automated Securities Information Submission system (OASIS) is designed, like the SRD, eventually to be a complete filing system.

(n13)Footnote 13. Unif. Sec. Act § 401(j)(2).

(n14)Footnote 14. Comm'r Op. 96/2C, Cal. Dep't Corp. File No. OP 6600, 1996 Cal. Sec. LEXIS 3 (Oct. 17, 1996).

The California Commissioner concluded that under the Blue Sky law, making information available via the Internet also constitutes "publishing" the information for purposes of requirements relating to general announcements regarding securities offerings and "written document" issues. Textual, "readable"-only information on a website generally accessible to the public was determined to be information "published by written document only" for purposes of a California exemption. More importantly, a "general announcement" communicated over the Internet was determined to be an "advertisement" under the Blue Sky law. Internet posting of general announcements and information and advertising issues generally are considered in more detail in section 12.02[2], *infra*.

(n15)Footnote 15. See American Brewing Co., SEC No-Action Letter, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,521, 1999 SEC No-Act. LEXIS 87 (Jan. 27, 1999); Vanderkam & Sanders, SEC No-Action Letter, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,520, 1999 SEC No-Act. LEXIS 96 (Jan. 27, 1999); Simplystocks.com, SEC No-Action Letter, 1999 SEC No-Act. LEXIS 131 (Feb. 4, 1999).

(n16)Footnote 16. Tri-West Investment Club, Pa. Sec. Comm'n Cease and Desist Order, Dkt. No. 0101-13, 2001 Pa. Sec. LEXIS 14 (Feb. 6, 2001).

See also P.A.E. Properties, Pa. Sec. Comm'n Cease and Desist Order, Dkt. No. 9801-07, 1998 Pa. Sec. LEXIS 43 (May 12, 1998) (information posted on an Internet website relating to an offer of investments constituted a solicitation and advertisement in violation of registration requirements).

(n17)Footnote 17. John R. Hoff, Admin. Proc. File No. 3-10081, Sec. Act Rel. No. 7757, 1999 SEC LEXIS 2220 (Oct. 20, 1999); Louis Sitaras, Admin. Proc. File No. 3-10082, Sec. Act Rel. No. 7758, 1999 SEC LEXIS 2219 (Oct. 20, 1999).

(n18)Footnote 18. See Universalscience.com, Inc., Admin. Proc. File No. 3-10266, Sec. Act Rel. No. 7879, 2000

SEC LEXIS 1632 (Aug. 8, 2000).

(n19)Footnote 19. See "Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore," Sec. Act Rel. No. 7516, 1998 SEC LEXIS 488 (Mar. 23, 1998).

(n20)Footnote 20. See, e.g., *In re* Agency for Interamerican Finance, Consent Order of Prohibition, File No. 9500492, 1996 Ill. Sec. LEXIS 44 (Ill. Sec. Dep't Feb. 22, 1996) (Consent Order based on allegation that offering information had been "made available on the Internet for electronic access by others, including Illinois investors").

(n21)Footnote 21. The Internet allows a variety of forms of communication. Although the principal focus in this chapter is on website postings, the Internet also allows for e-mail communications specifically directed to particular persons, groups or entities. These targeted communications are comparable to traditional mail or direct solicitation, and do not alter basic regulatory analysis simply because of the communication medium. E-mailed offers or solicitations, even those that are sent in a mass transmission ("spamming"), are on their face targeted to a specific recipient or recipient set.

(n22)Footnote 22. Ind. Admin. Order, 2 Blue Sky L. Rep. (CCH) P 24,687 (Nov. 15, 1995).

(n23)Footnote 23. NASAA Reports (CCH) P 7040 (Jan. 7, 1996).

(n24)Footnote 24. See, e.g.:

Connecticut: Order Exempting Certain Offers of Securities Made on the Internet From Securities Registration, 1A Blue Sky L. Rep. (CCH) P 14,567 (Mar. 28, 1996).

Idaho: Idaho Dep't Fin. Rule 300.07 (Interpretations/definitions).

Illinois: Ill. Admin. Code tit. 14, § 130.211(a) (Definition of acts not constituting an "offer" of securities).

Iowa: Iowa Admin. Code r. 191-50.13 (Offers on the Internet).

Maine: Code Me. R. § 02-029-532 (Securities Offerings on the Internet).

Maryland: Order, In the Matter of Offers of Securities Through the Internet, 2 Blue Sky L. Rep. (CCH) P 30,595, 1996 Md. Sec. No-Act. LEXIS 4 (Apr. 22, 1996).

Michigan: Exemption Order, Offerings Made Through the Internet, 2 Blue Sky L. Rep. (CCH) P 32,637 (May 23, 1996).

Nebraska: Interpretive Opinion No. 23, Applicability of the Securities Act of Nebraska to Offers Effected Through the Internet That Do Not Result in Sales to Nebraska Residents, 1996 Neb. Sec. LEXIS 4 (Dep't Banking and Fin. Bureau of Sec. July 22, 1996).

Washington: Statement of Policy, Securities Offering on the Internet, PS-16, 3A Blue Sky L. Rep. (CCH) P 61,788 (May 23, 1996).

Wisconsin: Order exempting certain offers of securities made on the Internet from securities registration, 3A Blue Sky L. Rep. (CCH) P 64,992 (May 22, 1996).

(n25)Footnote 25. In Kansas, for example, the Office of the Securities Commissioner has by an "interpretive opinion or no action position" declared its concurrence with the NASAA Internet Resolution, such that "listings" on the Internet will not be viewed as offers under the Blue Sky law if the conditions are met. No-Action Letter, 2 Blue Sky L. Rep. (CCH) P 26,571 (June 25, 1996).

Although Florida has not taken a specific position on the NASAA Resolution, Rule 3E-100.010(1) (Internet or Other Electronic System Information) under the Florida Blue Sky law declares that registration requirements do not prevent the use of the Internet provided:

- (a) The posted information or communication, directly or indirectly, indicates that the securities are not being offered to any person in this state;
- (b) The posted information or communication is not directed to any person in this state; and
- (c) No sales occur as a result of the posted information or communication.

(n26)Footnote 26. Pa. Sec. Comm. Order, *In re Offers Effectuated Through Internet That Do Not Result In Sales in Pennsylvania*, 3 Blue Sky L. Rep. (CCH) P 48,684U, 1995 Pa. Sec. LEXIS 71 (Aug. 31, 1995).

(n27)Footnote 27. Alaska Stat., § 45.55.900(g).

As discussed above, *see* note 25, *supra*, this is also the approach taken in Florida. Other states following the Pennsylvania lead on exemption orders include:

Indiana: Order, Securities Offered On the Internet, But Not Sold In Indiana, 2 Blue Sky L. Rep. (CCH) P 24,687 (Ind. Sec. Div. Nov. 15, 1995).

Maryland: Order, In the Matter of Offers of Securities Through the Internet, 2 Blue Sky L. Rep. (CCH) P 30,595, 1996 Md. Sec. No-Act. LEXIS 4 (Md. Sec. Div. Apr. 22, 1996).

Texas: 7 Tex. Admin. Code § 139.17 (Offers disseminated through the Internet).

Utah: Utah Admin. Code R164-14-24s (Internet solicitations exemption).

(n28)Footnote 28. Wyo. Stat. § 17-4-114(b)(xiv).

(n29)Footnote 29. *See also*:

Massachusetts: Wormhole Technologies, No-Action Letter, 1996 Mass. Sec. No-Act. LEXIS 8 (Aug. 16, 1996). In this letter, the Securities Division instructed that Internet offers do not require registration in that state so long as the following conditions are met:

1. The Internet Offer indicates, directly or indirectly, that the securities are not being offered to persons in Massachusetts;
2. An offer is not otherwise specifically directed to any person in Massachusetts by, or on behalf of the issuer; and
3. No sales of the issuer's securities are made in Massachusetts as a result of the Internet Offer.

New Jersey: In re Internet Offers, Sec. Bureau Letter, 1995 N.J. Sec. LEXIS 41 (Nov. 29, 1995).

(n30)Footnote 30. *In re Kevin G. Duffy*, Ohio Div. Sec. Order No. 97-259, 1997 Oh. Sec. LEXIS 213 (July 10, 1997).

(n31)Footnote 31. *Thurman Financial Group*, Ill. Sec. Dep't No. 9800231, 1998 Il. Sec. LEXIS 645 (Dec. 14, 1998); *Synergos International Oil and Gas LLC, et al.*, Ill. Sec. Dep't No. 9800471, 1998 Il. Sec. LEXIS 604 (Nov. 6, 1998).

(n32)Footnote 32.

California: See, e.g., Cal. Corp. Code § 25102(n)(5) (permitting a "general announcement" of a proposed limited offering by a written document meeting certain content criteria).

Arizona: But see In re Offering of Securities by Federal Funding Foundation Corp., Dkt. Nos. S-3175-I; S-3180-I, Decision No. 61138, 1998 Ariz. Sec. LEXIS 55 (Ariz. Corp. Comm'n Sept. 25, 1998) (information concerning an intended private offering posted on an Internet website described the offering with specificity, and was not merely a generic description; the advertisement was a general solicitation when it was placed on the Internet along with other information concerning the issuer).

(n33)Footnote 33. Hyperlinks, which allow for immediate connection to information within and between websites, present a further set of liability issues, separate from just the question whether an unrestricted offering is made. The use of hyperlinks may, for example, make an issuer responsible for the content of material on a third party's website under an "adoption" theory. Hyperlinks could also be used to provide apparent legitimacy to fraudulent information or activities, and, in general, to cause confusion concerning information and its presentation. These are issues properly addressed under Blue Sky antifraud regulatory authority.

(n34)Footnote 34. Admin. Proc. File No. 3-10331, Sec. Act Rel. No. 7904, 2000 SEC LEXIS 2081 (Sept. 29, 2000).

(n35)Footnote 35. *See* note 30, *supra*, and accompanying text.

(n36)Footnote 36. Ill. Sec. Dep't, Statement of Position, 1996 Il. Sec. LEXIS 298 (Sept. 25, 1996).

(n37)Footnote 37. For further consideration of user registration or validation procedures, *see Internet Capital Corp.*, SEC No-Action Letter, 1997 SEC No-Act. LEXIS 1061 (Dec. 18, 1997).

(n38)Footnote 38. *See, e.g.*, *Weapon Golf, Inc.*, 1997 Nev. Sec. LEXIS 1 (Apr. 10, 1997) (website designed to sell the company's stock pursuant to an effective registration statement was restricted to Nevada residents, and directed persons responding to a Nevada-licensed intermediary).

(n39)Footnote 39. SEC No-Action Letter, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,226, 1996 SEC No-Act. LEXIS 566 (June 24, 1996).

(n40)Footnote 40. In 1998 the SEC staff also issued a no-action letter in regard to the for-profit operation of such a bulletin board by a third party. In *Internet Capital Corp.*, SEC No-Action Letter, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,445, 1998 SEC No-Act. LEXIS 18 (Jan. 13, 1998), the website operator proposed establishing a passive bulletin board to provide information to prospective buyers and sellers of companies participating in the service.

Although the operator of the system would be paid by those companies for the service, no transaction-based compensation was involved, and no information concerning the advisability of purchasing or selling any of the securities was provided. The securities involved were all listed on one or more national securities exchanges or the Nasdaq Stock Market, although as with *Real Goods Trading Corp.*, discussed above, the stocks were thinly traded. The SEC analysis focused on intermediary registration issues, and did not address the question of securities registration. Significantly, however, in seeking no-action advice the bulletin board sponsor represented:

State Securities Laws. Any offer made or transaction consummated using the Bulletin Board is subject to compliance with applicable state securities laws. Offers may be made or accepted only to the extent lawful in the states involved. Each participant is responsible for ascertaining the availability of its own state securities law exemption.

See also Angel Capital Electronic Network, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 812 (Oct. 25, 1996). The Angel Capital Electronic Network was organized and is operated by several universities and non-profit entities under the general sponsorship of the U.S. Small Business Administration. The network allows qualified accredited investors to access a listing of small corporate offerings. The SEC staff concluded that registration as a broker-dealer or investment adviser would not be required where no securities services were provided other than a listing or matching service.

The Angel Capital Network, or ACE-NET, has received favorable consideration at the state level as well. See, e.g., *Pennsylvania: Securities Offerings On the Angel Capital Network and the Pennsylvania Securities Act of 1972*, Pa. Sec. Comm'n Rel. No. 99-CF-3, 3 Blue Sky L. Rep. (CCH) P 48,685S (Jan. 1, 2000).

(n41)Footnote 41. Ill. Admin. Code tit. 14, § 130.211(c).

This regulation and others like it are based directly upon a 1997 NASAA *Interpretive Order Concerning Broker-Dealers, Investment Advisers, Broker-Dealer Agents and Investment Adviser Representatives Using the Internet for General Dissemination of Information on Products and Services*, NASAA Reports (CCH) P 2191 (Apr. 23, 1997). The NASAA Interpretive Order is discussed further under the mantle of intermediary licensing issues in section 12.02[2], *infra*.

(n42)Footnote 42. See, e.g., Unif. Sec. Act § 201(a), which declares: "It is unlawful for any person to transact business in this state as a broker-dealer ... unless he is registered under this act." "Broker-dealer" under the Act means "any person engaged in the business of effecting transactions in securities for the account of others..." *Id.* § 401(c).

(n43)Footnote 43. In Exchange Act Rel. No. 40760, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 86,101, 1998 SEC LEXIS 2794 (Dec. 8, 1998) ("Regulation of Exchanges and Alternative Trading Systems"), the SEC adopted new rules (including new Regulation ATS, 17 C.F.R. §§ 300-303) and amended existing rules to determine the extent to which regulation shall be applied to ATSs, and, where applied, to provide for an election by an ATS whether to register as a national securities exchange, or as a broker-dealer subject to additional requirements under the rules based upon their activities and trading volume. For those ATSs electing not to register as national securities exchanges, Regulation ATS establishes three levels of requirements. If a system has less than five percent of the trading volume in all securities it trades, it is required only: (1) to file with the SEC a notice of operation and quarterly reports; (2) to maintain records, including an audit trail of transactions; and (3) to refrain from using the words "exchange," "stock market" or similar terms in its name. If the system has five percent or more of the volume in "national market system securities," it must be linked with a registered market in order to disseminate the best-priced orders in those national market system securities displayed in their systems into the public quote stream. Finally, if a system has twenty percent or more of the trading volume in any single security, whether equity or debt, it must (1) grant or deny access based on objective standards established by the ATS and applied in a non-discriminatory manner; and (2) establish procedures to ensure adequate systems capacity, integrity, and contingency planning.

(n44)Footnote 44. Order No. B-01-001, Colo. Sec. Comm'r, Blue Sky L. Rep. (CCH) P 74,210, 2000 Colo. Sec. LEXIS 3 (Aug. 10, 2000).

(n45)Footnote 45. *Id.*, Blue Sky L. Rep. (CCH) P 74,211, at 77,954.

(n46)Footnote 46. Utah Sec. Div. File No. B00083915, 1998 Utah Sec. No-Act. LEXIS 5 (Sept. 9, 1998).

(n47)Footnote 47. SEC No-Action Letter, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,830, 2000 SEC No-Act. LEXIS 359 (Mar. 13, 2000).

(n48)Footnote 48. *Id.* (citations omitted).

See also Oil-N-Gas, Inc., SEC No-Action Letter, 2000 SEC No-Act. LEXIS 758 (June 8, 2000); Transfer Online, Inc., SEC No-Action Letter, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,862, 2000 SEC No-Act. LEXIS 660 (May 13, 2000).

(n49)Footnote 49. *See* note 44, *supra*, and accompanying text.

(n50)Footnote 50. *See* note 46, *supra*, and accompanying text.

(n51)Footnote 51. Texas State Sec. Bd., Board Order No. CP-1226, Blue Sky L. Rep. (CCH) P 74,150, 1997 Tex. Sec. LEXIS 62 (Oct. 1, 1997).

(n52)Footnote 52. Blue Sky fraud concerns arising out of the Internet are specifically considered in more detail in section 12.03, *infra*.

(n53)Footnote 53. *See* note 23, *supra*.

(n54)Footnote 54. NASAA, *Interpretive Order Concerning Broker-Dealers, Investment Advisers, Broker-Dealer Agents and Investment Adviser Representatives Using the Internet for General Dissemination of Information on Products and Services*, NASAA Reports (CCH) P 2191 (Apr. 23, 1997).

(n55)Footnote 55. Ala. Sec. Comm. Rules, *Policy Statement Concerning Broker-Dealers, Investment Advisers, Broker-Dealer Agents and Investment Adviser Representatives Using the Internet for General Dissemination of Information on Products and Services*, 1 Blue Sky L. Rep. (CCH) P 7569.

(n56)Footnote 56. NASAA Model Interpretive Order, note 54, *supra*.

(n57)Footnote 57. Investment Management & Research, Inc., note 36, *supra*.

(n58)Footnote 58. S.D. Div. Sec., No-Action Letter, 1999 S.D. Sec. No-Act. LEXIS 44 (Mar. 12, 1999).

(n59)Footnote 59. *Id.*

(n60)Footnote 60. Unif. Sec. Act § 401(f). There are variations in exclusions, but the central focus is the same, *see, e.g., Washington*: Wash. Rev. Code § 21.20.005(6).

(n61)Footnote 61. In Kansas, for example, the definition of investment adviser does not include:

[A] publisher of any bona fide newspaper, news column, news magazine, newsletter, or business or financial publication or service, whether communicated in hard copy form or by electronic means, or otherwise that does not consist of the rendering of advice on the basis of the specific investment situation of each client.

Kan. Stat. Ann. § 17-1252(l)(5).

See also Minnesota: Minn. Stat. § 80A.14, Subd. 9(4).

(n62)Footnote 62. 472 U.S. 181 (1985).

(n63)Footnote 63. *Id.*, 472 U.S. at 203-04.

(n64)Footnote 64. NetProphet™ Electronic Internet Publications, No-Action Letter, 1996 Ky. Sec. LEXIS 7 (Ky. Div. Sec. Oct. 28, 1996).

(n65)Footnote 65. *Id.* The Kentucky Division of Securities reached this conclusion despite the fact that the provider of the service permitted broker-dealers to purchase advertising space on the website. The publisher received no revenue from such broker-dealers other than from advertising, and there was no affiliation or other relationship between them. Moreover, each broker-dealer advertiser was required to certify compliance with the Blue Sky law in connection with advertising directed into the state.

See also Neural Applications Corp., No-Action Letter, 1996 Del. Sec. No-Act. LEXIS 39 (Del. Div. Sec. May 22, 1996).

(n66)Footnote 66. 996 P.2d 1254 (Ariz. Ct. App. 2000).

(n67)Footnote 67. 996 P.2d at 1260 (emphasis in original).

(n68)Footnote 68. *Id.*



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§ 12.03 Securities Fraud on the Internet

Although surveillance of the Internet by state securities administrators for illegal offers of securities, and for securities activities by unlicensed entities and persons, involves significant enforcement initiatives in and of itself, the primary mission of Blue Sky regulation in cyberspace is the prevention of fraud. Armed with general antifraud enforcement authority,ⁿ¹ state administrators confront Internet frauds and investment scams ranging from the sale of shares in non-existent enterprises by con artists, to sophisticated pyramid schemes, international transactions, and investments touting high guaranteed rates of return. In 1998 the NASAA Internet Committee conducted a survey of all member jurisdictions and reported securities being offered and sold in the following types of enterprises as involving the most suspected investment frauds: ATM machines, "prime bank" schemes, Internet gambling, advance fee schemes, oil and gas interests, and entertainment ventures.ⁿ² Through the Internet, scam artists can instantly reach millions of people at little cost. E-mail, "newsgroups,"ⁿ³ and websites are vastly more efficient than the telephone "boiler rooms" of old in touting investments and promoting investment schemes. Running investment scams over the Internet also provides numerous other benefits to scam artists. For example, Internet promoters can effectively hide their identities. Also, the interactivity of the Internet allows investors to effectuate their investment decisions immediately through websites that are graphically impressive. In addition, the use of hyperlinks allowing for immediate connection to information within and between websites can add the appearance of legitimacy to fraudulent information.

On the other hand, Internet fraud is more visible. The Internet is subject to on-going monitoring by federal and state securities regulators. A state agency, for example, can establish e-mail addresses to go "shopping" for fraudulent Internet solicitations to obtain information to pursue in enforcement cases.ⁿ⁴ In Ohio, the Division of Securities, which was one of the first state agencies to establish a formal program to monitor the Internet, identifies and lists online securities offerings not in compliance with Ohio law on its own website.ⁿ⁵ The U.S. Securities and Exchange Commission, through its Division of Enforcement, also has undertaken to place warnings in newsgroups and securities-related areas of commercial online services to alert investors to enforcement actions affecting stocks under discussion. The objective is to inform Internet investors of concerns with regard to particular securities, and to demonstrate active SEC monitoring.

In a 1997 report to Congress on the impact of technological advances on the securities markets, the Securities and Exchange Commission noted that fraudulent offering cases may involve the Internet either as the means by which representations are disseminated, or as the *subject* of the misrepresentations. As to the latter, the SEC observed that fraud artists often purport to offer an interest in "hot" new areas that are already the subject of extensive media coverage, and which can be promoted as involved in high technology ventures whose likelihood of success few members of the public would be able to evaluate.ⁿ⁶ More common issues, however, arise today out of the use of the

Internet and related methods of electronic communication to disseminate fraudulent solicitations about entities not otherwise involved with the Internet. These schemes, the SEC Report noted, may be seen as a predictable evolution from the more traditional methods of reaching investors through cold calls and mass mailings. They often promise high rates of return on investments described as risk-free, but instead often represent interests in non-existent businesses in which the proceeds are simply misappropriated.ⁿ⁷

It is this area with which state securities regulators are most concerned. The SEC has led the way with enforcement cases brought under antifraud provisions of the federal securities laws against promoters operating "Ponzi" schemes over the Internet;ⁿ⁸ fraudulent promotional activities involving the "hyping" of new products never developed beyond a concept;ⁿ⁹ and a variety of phony investment programs involving looting of investor funds.ⁿ¹⁰ States have followed with a significant number of enforcement actions against online investment offerings that involve false or materially misleading advertisements or solicitations. In *BJO Enterprises, Ltd.*,ⁿ¹¹ for example, the Texas State Securities Board issued a Cease Publication Order in regard to an Internet advertisement seeking to sell stock and evidences of indebtedness that the Board found intentionally failed to disclose facts concerning the criminal background of the promoter and other business history information. Similarly, in *Tri-West Investment Club*,ⁿ¹² the Ohio Division of Securities cited numerous false and misleading statements contained on a website offering "prime bank" instruments in issuing a Cease and Desist Order. Among other things, the website failed to disclose information concerning other state enforcement actions taken against the promoter on the basis of fraud. The Division also found that the U.S. Securities and Exchange Commission had repeatedly announced that such offerings of "prime bank" programs are non-existent and fraudulent.ⁿ¹³

Advisory publications over the Internet are subject to Blue Sky antifraud authority whether or not the adviser is itself subject to licensing. State administrators can be expected to follow the lead of the SEC in pursuing instances of "touting" of stocks over the Internet by persons who pose as objective third parties, but who are in fact only paid promoters. In *SEC v. Chelekis*,ⁿ¹⁴ for example, the Commission sued the publishers of certain Internet "Hot Stocks" newsletters who failed to disclose their receipt of at least \$1.1 million from more than 150 issuers, and 275,000 shares of stock from ten issuers, as compensation for making "buy" recommendations in their newsletter. The defendants consented to an order enjoining them from future violations and requiring the payment of disgorgement and civil money penalties.

Despite the antifraud enforcement weapons available to state and federal securities regulators, the most significant initiatives, particularly at the state level where the range of remedies is more limited, have undertaken to prevent Internet fraud through investor education, largely because after-the-fact remedies for Internet securities fraud are far less effective than preventive measures. The international and potentially anonymous qualities of the Internet add impediments to obtaining return of investor funds once they are paid. As the SEC has observed: "An Internet address may be a mere electronic blind concealing individuals who are not readily traceable after their fraud comes to light, who are located outside the United States, and whose domestic bank accounts are no more than conduits for transmission of investor funds to foreign financial institutions."ⁿ¹⁵

FOOTNOTES:

(n1)Footnote 1. Both the Uniform Act and Revised Uniform Act broadly proscribe "fraudulent and other prohibited practices in connection with the offer, sale or purchase of securities." Uniform Act section 101 declares:

It is unlawful for any person, in connection with the offer, sale, or purchase of any security, directly or indirectly

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not

misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

See also Rev. Unif. Sec. Act § 501.

(n2)Footnote 2. Testimony of Peter C. Hildreth, NASAA President, Before the Senate Permanent Committee on Investigations of the Governmental Affairs Committee, NASAA Reports (CCH) P 17,036, at 17,059 (Mar. 23, 1999) [hereinafter Hildreth Testimony].

(n3)Footnote 3. "Newsgroups" are text-based Internet discussion groups, much like bulletin boards, which contain postings from users on particular topics. Newsgroups are accessed through the Internet on a network known as "Usenet."

(n4)Footnote 4. Hildreth Testimony, *supra*, note 2, at 17,059.

(n5)Footnote 5. See "On-Line Securities Offerings that Ohio Residents Should Avoid," available at <<<http://www.securities.state.oh.us>>>.

(n6)Footnote 6. SEC Report to the Congress: "The Impact of Recent Technological Advances on the Securities Markets," available at <<www.sec.gov/news/studies/techrp97.htm>> (1997) [hereinafter SEC Report].

(n7)Footnote 7. *Id.*

(n8)Footnote 8. See, e.g., SEC v. Western Executive Group, Inc., SEC Litig. Rel. No. 15134, 1996 SEC LEXIS 2999 (Oct. 23, 1996) (use of the Internet to sell \$3.49 million of securities involving the sale and leaseback of automated teller machines, in what was essentially a classic Ponzi scheme).

(n9)Footnote 9. SEC v. Internet Solutions for Business, Inc., SEC Litig. Rel. No. 16916, 2001 SEC LEXIS 379 (Feb. 28, 2001) (promotional statements regarding "cutting edge" new products).

(n10)Footnote 10. SEC v. Brycar Financial Corp., SEC Litig. Rel. No. 16713, 2000 SEC LEXIS 1966 (Sept. 20, 2000) (operation of Internet website on which phony investment programs were promoted and which allowed customers to access fictitious account information).

See also SEC v. Sellin, SEC Litig. Rel. No. 15004, 1996 SEC LEXIS 2069 (Aug. 7, 1996) (fraudulent offering of promissory notes through "newsgroup" postings on the Internet).

(n11)Footnote 11. SSB Docket No. 98-009, Order No. CP-1257, 1998 Tex. Sec. LEXIS 12 (Tex. State Sec. Bd. Mar. 13, 1998).

(n12)Footnote 12. Ohio Div. Sec. Order No. 01-098, 2001 Oh. Sec. LEXIS 98 (Mar. 28, 2001).

(n13)Footnote 13. "Prime bank" trading and financing schemes hold out the prospect of wildly profitable and essentially riskless returns through investment in a secret trading market in bank notes conducted among the world's largest financial institutions. There is no evidence that such a bank note trading market exists, let alone provides profitable investment opportunities.

(n14)Footnote 14. SEC Litig. Rel. No. 15264, 1997 SEC LEXIS 423 (Feb. 25, 1997).

(n15)Footnote 15. SEC Report, *supra*, note 6, at 69.



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§ 12.04 Online Trading Issues Under Blue Sky Laws

The proliferation of online brokerage firms and online trading by individual investors creates special concerns for state securities regulators. Many online investors are new both to investing and to the Internet, and many of these people have turned to Internet trading because they do not trust brokers to give them accurate, impartial advice. State securities regulators have identified the major issues associated with online trading as falling into three categories: (1) execution; (2) investor suitability; and (3) surveillance.ⁿ¹

Trade execution concerns focus on the risk of technology failures. Typical technological problems of this kind include a failure in an online trading system resulting in an inability to execute a trade, or the inability of an investor to access Internet trading websites during times of market volatility. Such risks are magnified under circumstances in which increasing numbers of persons are trading highly volatile stocks on margin and the timing of their trades, indeed the passage of mere seconds, can have a tremendous impact on the results. At the same time, despite the risks and limitations in the current system, constant technological innovation portends greater speed and accuracy. Inexperienced investors need to learn how these innovations work, and online firms must be willing to provide them with the tools to do so.ⁿ²

In the context of licensing and inspections, state regulators can be expected to focus on the capacity of online firms, that is, whether a particular broker-dealer has the infrastructure to allow for continued growth. The concern is particularly acute given aggressive marketing initiatives by online firms seeking to sign up ever more accounts. At the same time, investor education as to both the technological risks and the rewards of online trading will be increasingly addressed with the objective of ensuring uninterrupted market access by a more aware clientele. "Speed bumps" increasingly are utilized to provide information to investors about potentially serious consequences or situations before a trade may be executed.

Investor suitability--the obligation of brokers to "know" their customers and to match recommendations with investment objective, financial profile and risk tolerance--has risen to a new level of regulatory concern for online trading. Most states include among Blue Sky regulations an affirmative suitability obligation for brokers modeled after NASD and stock exchange rules.ⁿ³

The rules regarding suitability are triggered when a broker-dealer makes a recommendation. The difficulty presented by technological advances in online trading lies in defining the parameters of a "recommendation" where there is no personal interaction between a broker and an online customer. Generally, suitability is not an issue for unsolicited transactions. However, online trading firms increasingly offer research on their websites, and also avail themselves of

so-called "push technology" that enables a firm to send investors information based on previous transactions and expressed interests. Non-traditional "recommendations" might be found on the basis of information being made available, particularly information or research that is a result of such push technology. Investment-related messages posted on broker-dealer-sponsored forums or chat rooms made available on a website may also be seen in terms of non-traditional recommendations when the broker-dealer effects trades in the securities for the customers involved.ⁿ⁴ Yet, overly strict application of suitability rules would discourage the dissemination of useful information, and state regulators focused on investor protection in the online environment face the challenge of striking a balance to accommodate both protection and innovation.

Suitability concerns under Blue Sky laws also abound in regard to "day trading" and the firms that promote it to individual investors by offering desk space, high-speed market access, and loans. State regulators are concerned about day-trading firms operating as unlicensed broker-dealers, making false, misleading or unrealistic advertisements about the profitability of day trading, and running firms that are undercapitalized.ⁿ⁵ Several states have pursued enforcement actions against day-trading firms for a variety of reasons, all, however, grounded in the baseline concern that inexperienced investors have been lured into day trading with promises of false profits, and have consequently incurred losses that they can ill afford.ⁿ⁶ Online trading in general has been heavily advertised, suggesting that trading is easy and produces quick returns. Marketing in regard to day trading has caused particular concerns relating to inadequate risk disclosure and suitability. A Massachusetts enforcement action, for example, focused on the alleged falsification of financial information on a customer's new account documents to create the impression that day trading was appropriate for the customer, and to support loan arrangements to pursue such trading.ⁿ⁷

What promotes or pushes investors in online trading generally, and day trading in particular, will certainly be the subject of increasing initiatives by state regulators in surveillance, and in policing the Internet. Investor education, suitability assessments, and close attention to the role of operators or sponsors of Internet platforms who effectively engage in the securities business without being licensed are initiatives closely tied to the historic investor protection mission of Blue Sky laws. All of this, however, is more often subsumed in the dominant role of Blue Sky regulation in cyberspace, namely, the prevention of fraud.

FOOTNOTES:

(n1)Footnote 1. *See, e.g.*, Testimony of G. Philip Rutledge, Deputy Chief Counsel, Pennsylvania Securities Commission, U.S. Senate Permanent Committee on Investigations, NASAA Reports (CCH) P 17,037 (Mar. 22, 1999) [hereinafter Rutledge Testimony].

(n2)Footnote 2. A 1999 report of the New York Attorney General highlighted a variety of concerns expressed by online investors regarding access to online firms and accounts, technical glitches, downtime and outages. The report recommended that online firms do more to educate their customers about the online trading process, and take steps to address capacity issues. *See* "From Wall Street to Web Street: A Report on the Problems and Promise of the Online Brokerage Industry," Office of New York State Attorney General Eliot Spitzer (Nov. 22, 1999).

(n3)Footnote 3. In Ohio, for example, no securities dealer or salesperson shall:

Sell, purchase, or recommend the sale or purchase of any security without reasonable grounds to believe that the transaction or recommendation is suitable for the customer, based upon reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other relevant information known to dealer or salesperson.

Ohio Admin. Code, Rule 1301:6-3-19(5). *See also*:

Georgia: Ga. Code Ann. § 10-5-12.

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:4.

Washington: Wash. Admin. Code § 460-24A-220.

(n4)Footnote 4. Evolving "data mining" technology will likely add still another dimension to suitability responsibility in e-commerce, as online investment firms develop the capability to map a customer's account history, patterns, goals and the like to discover gaps and automatically send a notice or suggestion to the customer in regard to filling those gaps.

(n5)Footnote 5. Rutledge Testimony, *supra*, note 1.

(n6)Footnote 6. *Id.*

(n7)Footnote 7. *Id.*

Regulators have expressed concern that certain aggressive advertising by broker-dealers could lead investors to have unrealistic expectations about the risks and rewards of online investing. In a September, 1999 Report concerning the advertisement of online brokerage services, NASD Regulation Inc. opined:

NASD members have a duty to manage investor expectations about the risks and rewards of online investing. Advertisements that mislead or confuse investors about the risks and rewards of online investing, or that attempt to incite a trading frenzy, harm the investing public and undermine investor confidence in the integrity of the markets. They even will dampen interest in the very online services that these investors are being asked to use, and thus could impede further development of those services.

Report of NASD Regulation: Public Policy Sessions Concerning the Advertisement of Online Brokerage, available at <<<http://www.nasdr.com/3810-sessions.htm>>> (Sept. 21, 1999).

NASDR has taken initiatives to ensure that the advertisement of online brokerage services is fair, balanced and not misleading. These include Notices to Members and Regulatory and Compliance Alerts reminding member firms of the need to portray accurately the manner in which trades are executed online; to disclose the risks associated with online trading; and to fairly present the fees that will be charged.

In October 2000 the NASD also adopted Conduct Rules requiring member firm approval procedures in the opening of day-trading accounts, and mandating specific risk disclosures concerning day trading. NASD Conduct Rule 2360, "Approval Procedures for Day-Trading Accounts," NASD Manual (CCH) 4296-97 (Oct. 16, 2000), now requires that any member firm directly or indirectly promoting a day-trading strategy must, among other things, have reasonable grounds for believing that the strategy is appropriate for the customer, and exercise reasonable diligence to ascertain facts concerning the customer that support the determination. The rule further requires that any account opened for a non-institutional customer who intends to engage in day trading must be approved for such by the member firm, and that a record of the basis for approval must be maintained. Rule 2361, "Day-Trading Risk Disclosure Statement," *Id.* at 4297-99, mandates that a member firm may not open an account for a non-institutional customer who intends to pursue a day-trading strategy promoted by the firm unless that customer is first provided with a risk disclosure statement containing prescribed content describing risks and other considerations attendant to day trading. The application of Rules 2360 and 2361 is triggered when a firm is deemed directly or indirectly to be promoting a day-trading strategy. However, simply promoting efficient execution services or costs based upon multiple trades, or providing general investment research or advertising its quality or availability does not amount to promoting a day-trading strategy for the purpose of the rules. Nor does having a website that provides general financial information or news that allows the multiple entry of intra-day purchases or sales of the same security amount to promotion of the strategy.



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§ 12.05 Federal E-Sign and Blue Sky Regulation

With the enactment in June 2000 of the Electronic Signatures in Global and National Commerce Act ("E-Sign"),ⁿ¹ Congress declared that information in electronic form relating to a transaction in or affecting interstate or foreign commerce "may not be denied legal effect, validity or enforceability solely because it is in electronic form." E-Sign places electronic records and signatures on a legal par with their paper and ink counterparts. It provides that records and signatures relating to transactions in or affecting interstate or foreign commerce may not be denied legal effect, validity or enforceability solely because they are in electronic form or because an electronic signature or electronic record is used in forming them.

E-Sign contains specific provisions restricting state enactment of conflicting laws, and preempts state law governing issues of electronic commerce. The Act ensures a large degree of uniformity among electronic transactions, enabling financial institutions and other e-commerce entities to transact business on an interstate basis more efficiently and predictably. However, E-Sign does allow states to "modify, limit or supersede" the Act by adopting the Uniform Electronic Transactions Act (UETA), as approved by the National Conference of Commissioners on Uniform State Laws in 1999. Nevertheless, states may not act under UETA to create exceptions beyond those that are allowed by E-Sign, unless they are not inconsistent with E-Sign and are technologically neutral. Nor may states override E-Sign under provisions of the UETA by preserving non-electronic delivery requirements as a means of requiring non-electronic transactions and handwritten signatures. E-Sign also includes a provision permitting state regulatory agencies to interpret its key provision, and to provide guidance or issue regulations that are consistent with the Act.ⁿ²

Many state securities statutes, rules and regulations require a physical signature on contracts and other official documents. These rules and requirements generally mirror the requirements of the NASD and the New York Stock Exchange. However, technological developments, particularly in the area of online trading, called into question the efficiency and regulatory value of handwritten signature requirements and generally challenged the necessity for manual delivery of documents. Those same advances also prompted an assessment of record-keeping requirements and the manner of both generating and retaining books and records. By creating an overall federal framework for electronic commerce, E-Sign principally impacts state Blue Sky requirements relating to delivery of an offering circular or prospectus by sellers of securities, and requirements that broker-dealers, investment advisers and/or issuers generate and maintain certain records. Each of these areas of impact on state securities regulation is examined more closely below.

[1] Electronic Delivery of Disclosure Documents In the securities regulatory setting, electronic delivery of

disclosure documents has received increasing attention since being first specifically addressed by the U.S. Securities and Exchange Commission in 1995, and again in 1996.ⁿ³ By its releases the SEC outlined the manner in which prospectuses, proxy statements and other disclosure documents may be delivered electronically, with a key requirement being the consent of the recipient to receive such information by electronic means. In April 2000 the Commission addressed the subject again in an interpretative release,ⁿ⁴ confirming that, subject to certain conditions, issuers, broker-dealers and other intermediaries may obtain "global" consents from investors for electronic delivery of all documents for any company. The SEC recognition of global consent procedures is particularly meaningful for underwriters and dealers who have responsibilities to furnish disclosure documents in the offering context.

In its April 2000 release the SEC did not specifically address electronic delivery of disclosure documents in the offering context. However, through a combination of the definitions in the Securities Act of 1933 and the SEC rules under the Act, electronic communications are equated with written communications.ⁿ⁵ Thus, as a matter of compliance with the prospectus provisions under the federal Securities Act, electronic delivery of such "written" materials as are permitted in the course of an offering poses no issue where requisite consent is in place. However, states maintain their own requirements for delivery of disclosure documents in the offering context, generally referring to delivery of prospectuses or offering documents that are in writing or recorded, but providing no broader definitions that clearly encompass electronic communications.ⁿ⁶

At the state level, section 304(b)(12) of the Uniform Securities Act, governing registration by qualification, provides that a copy of any prospectus, pamphlet, form letter, advertisement or other sales literature intended to be used in connection with an offering of securities be filed as part of the registration statement. Section 304(d) of the Uniform Act further provides:

The [Administrator] may by rule or order require as a condition of registration under this section that a prospectus containing any designated part of the information specified in subsection (b) be sent or given to each person to whom an offer is made before or concurrently with (1) the first written offer made to him (otherwise than by means of a public advertisement) by or for the account of the issuer or any other person on whose behalf the offering is being made, or by any underwriter or broker-dealer who is offering part of an unsold allotment or subscription taken by him as a participant in the distribution, (2) the confirmation of any sale made by or for the account of any such person, (3) payment pursuant to any such sale, or (4) delivery of the security pursuant to any such sale, whichever first occurs.

States commonly incorporate NASAA Form U-7, the uniform Small Corporate Offering Registration Form ("SCOR"), as prescribing the content of a required offering document or prospectus.ⁿ⁷ They make no provision, however, for electronic delivery of the document as satisfying a "sent or given" or similarly stated requirement. The requirement of E-Sign that information in electronic form relating to a transaction in or affecting interstate or foreign commerce may not be denied legal effect, validity or enforceability would appear to require that states permit prospectuses or offering circulars to be delivered electronically when the issuer and investor agree to that means of delivery. The key consideration under E-Sign is consent.

An overarching consideration in the application of E-Sign is whether securities transactions are "consumer" transactions. Key provisions of E-Sign regarding consent to electronic delivery of documents and information focus on whether "a statute, regulation, or other rule of law requires that information relating to a transaction ... be provided or made available to a *consumer* in writing."ⁿ⁸ "Consumer" is defined in the Act as "an individual who obtains, through a transaction, products or services which are primarily for personal, family, or household purposes."ⁿ⁹ If securities transactions are not in fact "consumer" transactions, states would be free to continue to apply their own disclosure and consent requirements regarding the delivery of documents. On the other hand, assuming E-Sign is applicable, and that there is no issue concerning the form of consent mandated by E-Sign, state requirements and regulations will necessarily be superseded, and issuers and intermediaries may deliver offering documents electronically without regard to particular state requirements. State administrators can be expected further to address the implications and application

of E-Sign to their Blue Sky laws.

[2] Broker-Dealer Records Requirements Broker-dealer record-keeping and retention requirements under Blue Sky laws are discussed in Chapter 11.ⁿ¹⁰ All states require that broker-dealers generate and retain certain records. E-Sign now mandates:

If a statute, regulation, or other rule of law requires that a contract or other record relating to a transaction in or affecting interstate or foreign commerce be retained, that requirement is met by retaining an electronic record of the information in the contract or other record that--

(A) accurately reflects the information set forth in the contract or other record; and

(B) remains accessible to all persons who are entitled to access by statute, regulation, or rule of law, for the period required by such statute, regulation, or rule of law, in a form that is capable of being accurately reproduced for later reference, whether by transmission, printing, or otherwise.ⁿ¹¹

States must therefore permit broker-dealers to retain required records by electronic means, and the preemptive language of E-Sign will likely require state agencies to revise and reissue rules allowing broker-dealers and investment advisers to generate and retain records electronically. However, E-Sign also prescribes that state regulators may "specify performance standards to assure accuracy, record integrity, and accessibility of records that are required to be retained."ⁿ¹² State securities administrators are thus permitted some discretion to require paper, specific technologies (e.g., non-rewriteable, non-eraseable formats), or both in connection with their record retention requirements. Rules and regulations for electronic record-keeping will likely follow the guidance of the NASD already available, such that permitted systems:

(a) Will allow examiners immediate access to required records and will contain appropriate indexing and cross-referencing capabilities to assure access to all relevant documents;

(b) Will permit examiners to download documents, records and information, and permit printing these documents in hard copy; and

(c) Will provide for adequate security and restricted access to authorized employees and principals only.ⁿ¹³

Interpretive authority granted under E-Sign also allows agencies to require retention of records in a "tangible printed or paper form" when there is a compelling government interest in law enforcement for imposing such a requirement. Where broker-dealers are required to keep and maintain certain originally executed customer account documents, for example, the continuing paper mandate would be appropriate. This would not, however, require manually signed documents in order for agreements to be valid, effective and legally enforceable. Thus, online brokerage agreements, for example, are no less effective in the enforcement of obligations between a broker and customer.

FOOTNOTES:

(n1)Footnote 1. Pub. L. No. 106-229, 114 Stat. 464 (2000), codified at 15 U.S.C. §§ 7001-7031.

(n2)Footnote 2. 15 U.S.C. § 7004(b).

(n3)Footnote 3. See "Use of Electronic Media for Delivery Purposes," Sec. Act Rel. No. 7233, 1995 SEC LEXIS 2662 (Oct. 6, 1995). The SEC 1995 Release was followed in 1996 with the further release, "Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information," Sec. Act Rel. No. 7288, 1996 SEC LEXIS 1299 (May 9, 1996).

(n4)Footnote 4. "Use of Electronic Media," Sec. Act Rel. No. 7856, 2000 SEC LEXIS 847 (Apr. 28, 2000).

(n5)Footnote 5. Securities Act section 2(a)(9), 15 U.S.C § 77b(a)(9), includes in the definition of "written" any means of "graphic communication." That term is defined in Rule 405 under the Act, 17 C.F.R. § 230.405, specifically to include "magnetic impulses or other forms of computer data compilation."

(n6)Footnote 6. In California, for example, "prospectus or offering circular" means:

[A]ny written or printed prospectus, offering circular, proxy statement, notice, advertisement, letter, financial statement, report or communication (including any exhibits or attachments incorporated therein) and any communication by radio, television, movie, magnetic recording or similar medium of communication issued, circulated or distributed, in connection with the offer or sale of a security.

Cal. Code Regs., tit. 10, § 260.504.2.1(c).

(n7)Footnote 7. *See, e.g., Maine*: Code Me. R. § 02-029-525, Sec. 5.

(n8)Footnote 8. 15 U.S.C. § 7001(c) (emphasis added).

(n9)Footnote 9. *Id.*, § 7006(1).

(n10)Footnote 10. *See* § 11.02[4], *supra*.

(n11)Footnote 11. 15 U.S.C. § 7001(d)(1).

(n12)Footnote 12. 15 U.S.C. § 7004(b)(3)(A).

(n13)Footnote 13. *See* Interpretive Letter, American Express Financial Corp. (NASD Office of General Counsel, Nov. 26, 1997), available at <<<http://www.nasdr.com/2910/3110-02.htm>>>.



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CHAPTER 13 Fraud and Prohibited Practices

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CHAPTER 13 Fraud and Prohibited Practices

2-13 Blue Sky Regulation § 13.01

§ 13.01 The Scope of Blue Sky Fraud--Generally

The historic mission of state Blue Sky Laws has always been to protect individual investors from fraud and abusive practices.ⁿ¹ Every aspect of state securities regulation has that singular purpose. Registration of securities, though now significantly preempted by the National Securities Markets Improvement Act of 1996 (NSMIA),ⁿ² is regulatory intervention aimed at assuring the quality of securities offered and sold regardless of the extent and manner of disclosure. The most common standard for judging the "merit" of offerings in that process is whether the offering would work or tend to work a fraud upon purchasers.ⁿ³ Intermediary licensing requirements are likewise aimed at assuring that persons of integrity and good repute interact with potential investors in the actual offering process. Over-arching all of this, every version of the Uniform Securities Act, and every other Blue Sky Law, contains a broad antifraud provision typified today by section 501 of the 2002 Uniform Securities Act, which provides:

- (1) to employ a device, scheme, or artifice to defraud;
- (2) to make an untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it is made, not misleading; or
- (3) to engage in an act, practice, or course of business that operates or would operate as a fraud or deceit upon another person.ⁿ⁴

The operative notion was explained early in the history of state securities regulation:

While certain practices are declared by the act to be fraudulent, the definition of a fraudulent practice goes not further than to say that a fraud or violation of law which would operate as a fraud is a fraudulent practice, which may be enjoined, and we must gather from other sources the meaning of the word "fraud." In a broad sense, the term includes all deceitful practices contrary to the plain rules of common honesty.

The purpose of the law is to prevent all kinds of fraud in connection with the sale of securities and to defeat all unsubstantial and visionary schemes in relation thereto whereby the public is fraudulently exploited... . The words "fraud" and "fraudulent practice" in this connection, should therefore be given a wide meaning, so as to include all acts, although not originating in an actual evil design or contrivance to

perpetuate fraud or injury upon others, which do by their tendency to deceive or mislead the purchasing public come within the purpose of the law. *People v. Federated Radio Corporation*, 244 N.Y. 33, 154 N.E. 655, 657 (1926) .

The 2002 Uniform Act also makes clear, by definition, that "fraud," "deceit," and "defraud" are not limited to common law deceit.ⁿ⁵

The general antifraud provisions in state Blue Sky Laws apply to any securities offer, sale and in many cases purchase, of a security. Registration exemptions for particular securities or transactions do not exempt any transaction from coverage of antifraud provisions. Likewise, even where NSMIA "covered securities" are involved, the antifraud provisions of state securities laws continue to apply by reason of the NSMIA "savings" clause,ⁿ⁶ which provides:

Fraud Authority--Consistent with this section, the securities commission (or agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker-dealer, in connection with securities or securities transactions.

It is NSMIA, with its express preservation of state antifraud enforcement authority that best puts the scope of fraud addressed under Blue Sky Laws in perspective today. There are no limitations imposed on the states' antifraud enforcement authority that is preserved by NSMIA. Legislative history confirms that none was intended. Indeed, there are repeated statements making clear that the preemption language in NSMIA was "subject to" the savings clause. For example, the report of the House Committee on Commerce states that "Section 18(a) prohibits State governments from requiring the registration of, or otherwise imposing conditions on, offerings of "covered securities" as defined in Section 18(b), subject to Section 18(d), which preserves State authority to investigate and bring enforcement actions with respect to fraud or deceit... ." ⁿ⁷ Prior to NSMIA, of course, states were free to bring enforcement actions to redress fraud, and private civil remedies were available in the same context, without regard to what would become "covered securities" after NSMIA. It is thus certain that the preservation of authority under and application Blue Sky Laws is a particularly powerful notion.

The scope of preserved of state antifraud enforcement authority after NSMIA was examined in *Capital Research and Management Company v. Brown*, ⁿ⁸ in circumstances in which the exercise of authority by the California Attorney General to address disclosure deficiencies in the offer and sale of mutual fund shares clashed with NSMIA preemption regarding the use of offering documents prepared by or on behalf of an issuer of covered securities.ⁿ⁹ In *Brown* the Attorney General brought an enforcement action for injunctive relief against Capital Research and Management Company (CRMC), which is the investment adviser for 29 mutual funds comprising the American Funds mutual fund complex, and the American Funds Distributors, Inc. ("AFD"), the broker-dealer wholesale distributor of shares of those constituent mutual funds. The Attorney General alleged that the defendants were participants in undisclosed "shelf space" or "revenue-sharing" agreements" that the mutual fund complex had entered into with broker-dealers, and which involved the payment of additional compensation to broker-dealers in the offer and sale of the fund shares in order gain heightened visibility and access to broker-dealer sales representatives. The Attorney General alleged among other things that the failure to disclose these agreements or arrangements prevented prospective mutual fund investors from recognizing a potential conflict of interest, and prevented mutual fund directors from effectively regulating their funds' distribution practices to protect shareholders.

The Attorney General did not sue the issuer, and did not directly claim that the issuer's offering documents contained false or misleading information, although in its opinion the *Brown* court noted that the shelf-space agreements were not accurately or fully disclosed in the American Funds disclosure documents.ⁿ¹⁰ Rather, the Attorney General alleged that CRMC and AFD had connived in making oral shelf space agreements with broker-dealers, and that in selling the mutual fund shares AFD and CRMC, they failed to disclose to purchasers the facts about the shelf space agreements that would allow purchasers to understand the import of statements that were made by the issuer in its disclosure documents.

At the same time, CRMC and AFD brought an action against Attorney General for declaratory and injunctive relief concerning the legality of certain commissions and fees paid to broker-dealers selling shares in the American Fund complex mutual funds. Responding to the Attorney General's enforcement action against them CRMC and AFD demurred, contending that NSMIA expressly or impliedly preempted any enforcement action challenging the adequacy of disclosures made by or on behalf of the issuer of covered securities. The Attorney General, on the other hand, relied upon the NSMIA savings provision, and claimed free reign to bring an enforcement action against CRMC and AFD, as intermediaries who were alleged to have engaged in fraud. Both cases were consolidated in the trial court, where the NSMIA preemption issue was the entire focus. The trial court concluded that NSMIA implicitly preempted the Attorney General's enforcement action against CRMC and AFD and did not fall within the NSMIA savings provision. On the Attorney General's appeal, the Court of Appeals reversed the trial court determination, concluding instead that the enforcement action was plainly within the NSMIA savings clause:

The plain language of the savings clause and its legislative history persuade us that Congress intended to preserve the states' antifraud authority to control the conduct of brokers and dealers, notwithstanding that the exercise of such controls might prospectively influence the disclosures made by a covered security. Put another way, the Attorney General's action has all of the attributes necessary to bring it squarely within the ambit of the savings clause. It is (1) an enforcement action (2) brought by a state officer performing the functions of a securities commission, (3) under California law (4) with regard to fraud and deceit (5) in connection with covered securities transactions.ⁿ¹¹

NSMIA preemption of state enforcement action with respect to offering documents prepared by or on behalf of an issuer of covered securities encompasses any direct or indirect prohibition, limitation, or condition upon use. It was apparent in *Brown* that at least indirectly the Attorney General's enforcement action sought relief that would impact the use of the issuer's offering documents by its investment adviser and wholesale broker-dealer, and if successful could, as the court noted, indirectly "encourage" the issuer itself to modify its offering documents.ⁿ¹² Nevertheless, the court concluded that the Attorney General's enforcement action, which challenged broker-dealer conduct, could not reasonably be construed as an effort to regulate the non-party issuer. Responding to the assertion that permitting the enforcement act would render NSMIA preemption provisions superfluous, the court declared:

We agree with CRMC and AFD that NSMIA must not be construed so as to render any of its provisions superfluous, but observe that it is their construction that would do precisely that by rendering the savings clause superfluous. Noticeably absent from their brief is any suggestion about what it is the savings clause might permit if construed to permit a challenge to a distributor's failure to disclose the existence and effect of its own oral shelf-space agreements and the conflicts allegedly created by such agreements. The accepted purpose of NSMIA is to prevent the states from subjecting covered securities to registration requirements, whereas the purpose of the savings clause is to allow the states, in an exercise of their historic police function, to take such action as is necessary to prevent fraud in the sale of covered securities.ⁿ¹³

A Connecticut state court also examined the scope of preserved state antifraud authority after NSMIA. In *Papic v. Burke*,ⁿ¹⁴ plaintiff, the co-manager of an investment company, appealed in court from a cease-and-desist order and civil money penalty imposed in administrative proceedings by the Commissioner of the Connecticut Department of Banking with respect to the offer and sale of limited partnership interests. The parties agreed that the securities were exempt from federal and state registration requirements by Rule 506 of Regulation D under the federal Securities Act, and were thus NSMIA covered securities. The Commissioner acted on the basis of a "Confidential Offering Circular" provided to actual and prospective investors, which he found violated the antifraud provision of the Connecticut Uniform Securities Act by failing to inform investors regarding several material facts. Challenging the Commissioner's order in court, plaintiff argued NSMIA preemption. The enforcement action directly related to the offering document of an issuer of a NSMIA covered security, but the plaintiff more broadly alleged that the Commissioner was not permitted

to find a Blue Sky statutory violation based upon an omission of a material fact in the offering of a federal covered security.

As the California Court of Appeals had done in *Capital Research and Management Company v. Brown*, discussed above, the court in *Papic* concluded that the state's authority to enforce its securities law in connection with fraud and/or material omissions which would mislead investors in connection with the offer, sale or purchase of NSMIA covered securities remains intact. While NSMIA prohibits state regulators from commenting upon or imposing requirements on the contents of prospectuses and other offering documents, legislative history makes clear the intention not to alter or limit state law with respect to fraud or deceit. The court went on to conclude that there was substantial evidence to support the Commissioner's findings that the Confidential Offering memorandum omitted material facts and made untrue statements of material facts. After rejecting other due process challenges, the court dismissed the plaintiff's appeal.

These cases illustrate that the scope of fraud under Blue Sky Laws has not been constrained by NSMIA. In fact, the NSMIA savings provision is a clear statement by Congress that the protections against fraud in state securities laws, and the enforcement powers of state administrators, must not be impaired. Both *Brown* and *Papic* demonstrate that the preserved authority of state securities regulators to deal with fraud and deceit prevails over asserted federal preemption, even when the exercise of that authority impacts the disclosures made or being made in regard to NSMIA covered securities. To be sure, the exercise of authority as to fraud may not be a means to circumventing basic NSMIA preemption of state regulation of offering processes and procedures in regard to federal covered securities. However, it is just as clear that fraud under Blue Sky Laws will be defined for purposes of regulatory authority in a way that is consistent with the historic mission of investor protection that has always defined the reach of Blue Sky Laws.

As broadly defined as is the notion of "fraud" under Blue Sky Laws, civil remedies for fraud under Blue Sky laws are also more liberal and, on balance, more easily proved than common law tort remedies for fraud and deceit. They too are liberally construed so as to assure effectuation of the broad remedial purpose of Blue Sky Laws.ⁿ¹⁵ Thus, for example, substantive elements of common law fraud and deceit such as *scienter*, reliance and causation are prescribed, if at all, in civil remedy provisions. Section 509(b) of the 2002 Uniform Securities Act, for example, establishes civil liability of a seller to a purchaser for false or misleading statements as follows:

A person is liable to the purchaser if the person sells a security in violation of Section 301 or, by means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statement made, in light of the circumstances under which it is made, not misleading, the purchaser not knowing the untruth or omission and the seller not sustaining the burden that the seller did not know and, in the exercise of reasonable care, could not have known of the untruth or omission.ⁿ¹⁶

Section 509 likewise prescribes the extent of what may be recovered as, for example, "actual damages" in the amount that would be recoverable upon a tender of the security less the value when the purchaser disposed of it, along with interest, costs and reasonable attorneys' fees.ⁿ¹⁷

An important goal of the Uniform Securities Act in all of its iterations is to effectuate uniformity in securities matters among federal and state authorities and self-regulatory organizations.ⁿ¹⁸ As the scope of activity encompassed within the antifraud provisions of state Blue Sky Laws has evolved, so too has federal regulation and jurisprudence expanded the scope of coverage of general antifraud provisions in both the Securities Act of 1933 and the Securities Exchange Act of 1934, principally section 10(b) of the Exchange Act and SEC *Rule 10b-5* adopted under it. As discussed earlier, SEC *Rule 10b-5* was the model for general antifraud provisions contained the Uniform Act from the outset.ⁿ¹⁹ Blue Sky Law general antifraud provisions likewise have roots in section 17(a) of the Securities Act of 1933,ⁿ²⁰ and most general antifraud provisions in state securities laws are in fact amalgams of the two federal provisions. The scope of fraud, fraudulent, or manipulative acts and practices coming within the ambit of the federal securities laws, and determinations of essential elements of liability thus contribute significantly in defining the scope of fraud under Blue

Sky Laws. In *TriVectra v. Ushijima* n21 for example, the Hawaii Supreme Court relied on federal jurisprudence to determine the requisite state of mind required to prove a violation in a civil enforcement action brought by the Commissioner of Securities. State courts will do likewise when looking to define the scope of conduct or activity that amounts to fraud, or the sufficiency of allegations made in regard to it.n22

This is not to say that everything defined by federal courts to be fraudulent, deceptive or manipulative conduct must automatically be considered as such under general antifraud provisions in state securities laws. It is certain, however, that the scope of fraud or fraudulent activity that is recognized as actionable under the federal securities laws will, if for no reason other than mandated attention to uniformity, weigh heavily in state court or regulatory agency assessments. And clearly in those states such as Ohio and Texas, where fraud is essentially defined as anything courts have determined it to be, federal authority will directly shape the boundaries of antifraud provisions.n23 It is against this backdrop that particular fraudulent and abusive acts and practices directly addressed in Blue Sky Laws are considered below. However, the scope of Blue Sky Law antifraud provisions is not determined by what is or is not specifically addressed in a statute. These are *general* antifraud provisions. In the same manner that general antifraud provisions of the federal securities laws have been applied to a full range of fraudulent, deceptive or manipulative acts and practices occurring in connection with the purchase or sale of securities, the breadth of state securities law antifraud provisions is limited in most states only by the necessity of a security being involved, and the requisite connection between fraud or fraudulent activity, whatever they may be determined to be, and the offer, sale or purchase of that security.

FOOTNOTES:

(n1)Footnote 1. *See, e.g.;*

California: People v. Simon, 9 Cal. 4th 493, 37 Cal. Rptr. 2d 278, 886 P.2d 1271(1995) .

Florida: Data Lease Financial Corp. v. Barad, 291 So. 2d 608, 612 (Fla. 1974) .

Illinois: Lucas v. Downtown Greenville Investors Ltd. Pshp., 284 Ill. App. 3d 37, 219 Ill. Dec. 475, 671 N.E.2d 389, 1996 Ill. App. LEXIS 764 , Blue Sky L. Rep. (CCH) P74139 (Ill. App. Ct. 2d Dist. 1996).

New York: People v. Lurie, 249 A.D.2d 119, 673 N.Y.S.2d 60, 1998 N.Y. App. Div. LEXIS 4314 (N.Y. App. Div. 1st Dep't 1998) , *appeal denied*, 92 N.Y.2d 893, 92 N.Y.2d 900, 680 N.Y.S.2d 57, 680 N.Y.S.2d 64, 702 N.E.2d 849, 702 N.E.2d 842, 1998 N.Y. LEXIS 3468 (1998) , *affirmed in part and reversed in part, on other grounds*, *Lurie v. Wittner*, 228 F.3d 113, 2000 U.S. App. LEXIS 23792 (2d Cir. 2000) .

Ohio: State v. Taubman, 78 Ohio App. 3d 834, 606 N.E.2d 962, 1992 Ohio App. LEXIS 1243 (Ohio Ct. App. 1992) .

(n2)Footnote 2. Pub. L. No. 104-290, 110 Stat. 3416 (1996). NSMIA and its impact on state securities regulation are addressed throughout this treatise. NSMIA amended section 18 of the Securities Act of 1933 and other elements of the federal securities laws by providing for limited preemption of state regulatory authority where securities and markets are national in character. The legislation preempted state authority to require registration of "federal covered securities" and limits state regulation of securities disclosure documents and certain intermediaries.

(n3)Footnote 3. *See, e.g.*, Unif. Sec. Act § 306(E).

(n4)Footnote 4. 2002 Unif. Sec. Act § 501; *see also* Unif. Sec. Act § 101; Rev. Unif. Sec. Act § 501.

Section 501 of the 2002 Uniform Act, like general antifraud provisions in both the original and revised Uniform Securities Acts is modeled on SEC *Rule 10b-5* adopted under the federal Securities Exchange Act of 1934 and, to a somewhat lesser extent on Section 17(a) of the Securities Act of 1933. These are broadly stated general antifraud provisions that, without defining "fraud," proscribe any act, practice or course of business that operates or would operate as such.

(n5)Footnote 5. 2002 Unif. Sec. Act § 101(9); *see also* Unif. Sec. Act § 401(d); Rev. Unif. Sec. Act § 101(6).

None of the versions of the Uniform Act defines fraud in any way other than to make clear it is not to be limited by the common law. This is intentional. The drafters of the original Uniform Securities Act deemed it prudent not to attempt any more exacting definition, so as to give courts greater latitude in ascertaining fraudulent practices and applying the law consistent with its remedial purpose. *See* Draftsmen's Commentary to Uniform Securities Act § 401(d); *see also* L. Loss, Commentary on the Uniform Securities Act (Little Brown & Co. 1976).

In Ohio the scope of fraud addressed under the Blue Sky Law is evidenced by the definition of "fraud," "fraudulent," "fraudulent acts," and "fraudulent practices" as meaning: "[A]nything recognized on or after July 22, 1929, as such in courts of law or equity." *See Ohio Rev. Code § 1707.01(J)*. With that open-ended incorporation of anything determined by a court to be fraud, the Ohio definition goes on specifically to include:

[A]ny device, scheme, or artifice to defraud or to obtain money or property by means of any false pretense, representation or promise; any fictitious or pretended purchase or sale of securities; and any act, practice, transaction or course of business relating to the purchase or sale of securities that is fraudulent or that has operated or would operate as a fraud upon the seller or purchaser. *Id.*

See also Tex. Rev. Civ. Stat. Ann. art. 581-4(F):

The terms "fraud" or "fraudulent practice" shall include any misrepresentations, in any manner, of a relevant fact; any promise or representation or prediction as to the future not made honestly and in good faith, or an intentional failure to disclose a material fact; the gaining, directly or indirectly, through the sale of any security, of an underwriting or promotion fee or profit, selling or managing commission or profit, so gross or exorbitant as to be unconscionable; any scheme, device or other artifice to obtain such profit, fee or commission provided, that nothing herein shall limit or diminish the full meaning of the term "fraud," "fraudulent" and "fraudulent practice" as applied or accepted in courts of law or equity.

See also Cal. Corp. Code § 25006; Mass. Gen. L. ch. 110A, § 401(d); 70 Pa. Cons. Stat. § 1-102(h).

(n6)Footnote 6. Securities Act of 1933 § 18(c)(1), 15 U.S.C. § 77r(c)(1).

(n7)Footnote 7. *See* H.R. Rep. No. 104-622, at 29 (1996). The House Committee made its intentions clear: The relationship between Section 18(d) [the savings clause] and Section 18(a) [the preemption clause] is especially important. The Committee intends to preserve the ability of the States to investigate and bring enforcement actions under the laws of their own State with respect to fraud and deceit (including broker-dealer sales practices) in connection with any securities or any securities transactions, whether or not such securities or transactions are otherwise preempted from state regulation by Section 18. *Id.*, at 34 .

(n8)Footnote 8. 147 Cal. App. 4th 58, 53 Cal. Rptr. 3d 770 2d Dist. App. 2007) .

(n9)Footnote 9. Securities Act § 18(a)(2), 15 U.S.C. § 77r(a)(2), provides in pertinent part:

Except as otherwise provided in this section, no law, rule, regulation or order, or other

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administrative action of any State or any political subdivision thereof--

(2) shall directly or indirectly prohibit, limit or impose any conditions upon the use of--

(A) with respect to a covered security described in subsection (b), any offering document that is prepared by or on behalf of the issuer... .

(n10)Footnote 10. *See* 147 Cal. App. 4th at 64, 53 Cal. Rptr. 3d at 774.

(n11)Footnote 11. 147 Cal. App. 4th at 66-67, 53 Cal. Rptr. 3d at 776.

(n12)Footnote 12. *See* 147 Cal. App. 4th at 67-68, 53 Cal. Rptr. 3d at 776.

(n13)Footnote 13. 147 Cal. App. 4th at 69-70, 53 Cal. Rptr. At 778 (citations omitted).

(n14)Footnote 14. 2007 Conn. Super. LEXIS 820 (New Britain Dist. 2007) .

(n15)Footnote 15. *See, e.g., Alford v. Pierno*, 27 Cal. App. 3d 682, 104 Cal. Rptr. 110, 114 (1972) ; *Carlson v. Bear, Stearns & Co., Inc.*, 906 F.2d 315 (7th Cir. 1990) (interpreting Illinois law); *First Energy Leasing Corp. v. Att'y Gen.*, 496 N.E.2d 875 (N.Y. 1986) .

But see Moross Limited Partnership v. Fleckenstein Capital, Inc., 466 F.3d 508 (6th Cir. 2006) . In *Moross* the court concluded that common law fraud requires proof of the same basic elements as a claim under the antifraud provisions of the Michigan Uniform Securities Act. Those elements identified by the court are:

(1) [t]hat the defendant made a material misrepresentation; (2) that it was false; (3) that when he made it he knew that it was false, or made it recklessly without any knowledge of its truth and as a positive assertion; (4) that he made it with the intention that it should be acted upon by plaintiff; (5) that the plaintiff acted in reliance upon it; and (6) that he thereby suffered injury.

466 F. 3d at 515-516, quoting *U.S. Fidelity & Guaranty Co. v. Black*, 313 N.W.2d 77, 82 (Mich. 1981) .

(n16)Footnote 16. 2002 Unif. Sec. Act § 509(b).

The elements of fraud under Blue Sky Laws are *considered in more detail in § 13.02[1], infra*.

(n17)Footnote 17. *Id.*, § 509(b)(3).

(n18)Footnote 18. *See, e.g.,* 2002 Unif. Sec. Act 608(a).

(n19)Footnote 19. SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

To make any untrue statement of a material fact or to omit 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, or

To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.

(n20)Footnote 20. 15 U.S.C. § 77q. Section 17(a) provides in pertinent part:

It shall be unlawful for any person in the sale of any securities ... by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly--

(1) to employ any device, scheme or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission 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, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

(n21)Footnote 21. 112 Haw. 90, 144 P.3d 1 (2006) .

(n22)Footnote 22. See, e.g., *Trooien v. Mansour*, 2007 U.S. Dist. LEXIS 8901 (D.Minn 2007) (Pleading a claim for fraud under the Minnesota Securities Act analog to SEC Rule 10b-5).

(n23)Footnote 23. See, e.g., *In re Columbus Skyline Securities, Inc.*, 74 Ohio St. 3d 495, 660 N.E.2d 427 (1996) . In *Columbus Skyline* the Ohio Supreme Court concluded that the definition of fraud derives from all securities cases defining fraudulent conduct in both state and federal courts. The Court added this observation:

This is sagacious for several reasons. First, the securities market is constantly evolving. By incorporating into the statute a larger body of law by which to define fraudulent conduct, the General Assembly has provided for inevitable changes in market structure that might otherwise require redrafting of the statute. This has the desirable effect of preventing Ohio securities law from developing in a vacuum, and furthers the goal of unifying securities laws. 74 Ohio St. 3d at 499.

Moreover, said the Court, federal standards on certain points are more well developed than state standards, and that:

Federal courts and administrative tribunals like the Securities and Exchange Commission have a greater experience with, and a more continuous exposure to, the complicated field of securities fraud cases and, consequently, provide a more extensive body of law to draw from in defining fraud. *Id.*



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CHAPTER 13 Fraud and Prohibited Practices

2-13 Blue Sky Regulation § 13.02

§ 13.02 Prohibited Acts and Practices

[1] Introduction

The general antifraud provisions in state Blue Sky Laws, particularly those in non-Uniform Act states, may expressly address particular fraudulent or deceptive practices. In Florida, for example, after broadly stating the basic prohibitions against devices schemes and artifices to defraud, the antifraud provision goes on to declare it is unlawful:

To publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, communication or broadcast which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received directly or indirectly from an issuer, underwriter or dealer, or from an agent or employee of an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount of the consideration.ⁿ¹

And it is likewise unlawful:

In any matter within the jurisdiction of the department, to knowingly and willfully falsify, conceal, or cover up, by any trick, scheme, or device, a material fact, make any false, fictitious, or fraudulent statement or representation, or make or use any false writing or document, knowing the same to contain any false, fictitious, or fraudulent statement or entry.ⁿ²

In New York, under the Martin Act:

It shall be illegal and prohibited for any person, partnership, corporation, company, trust, or association, or any agent or employee thereof, to use or employ any of the following acts or practices:

(a) Any fraud, deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale ...

(c) Any representation or statement which is false, where the person who made such representation or statement: (i) knew the truth; or (ii) with reasonable effort could have known the truth; or (iii) made no reasonable effort to ascertain the truth; or (iv) did not have knowledge concerning the representation

or statement made; where engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation or purchase within or from this state of any securities or commodities, as defined in section three hundred fifty two of this article, regardless of whether issuance, distribution, exchange, sale, negotiation or purchase resulted.ⁿ³

California specifically addresses conduct by a broker-dealer:

If such person is a broker-dealer or other person selling or offering for sale or purchasing or offering to purchase the security, to make, for the purpose of inducing the purchase or sale of such security by others, any statement which was, at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or which omitted to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, and which he knew or had reasonable ground to believe was so false or misleading.ⁿ⁴

Many states today also specifically address unlawful conduct by an investment adviser. The 2002 Uniform Securities Act includes under the heading "Prohibited Conduct in Providing Investment Advice" the following:

It is unlawful for a person that advises others for compensation, either directly or indirectly or through publications or writings, as to the value of securities or the advisability of investing in, purchasing, or selling securities or that for compensation and as a part of a regular business, issues or promulgates analyses or reports relating to securities:

- (1) to employ a device, scheme or artifice to defraud another person; or
- (2) to engage in an act, practice, or course of business that operates or would operate as a fraud or deceit upon another person.ⁿ⁵

A particular state securities law may, of course, spell out numerous violations or prohibited acts or practices without reference to an antifraud provision.ⁿ⁶ All versions of the Uniform Act identify conduct that is unlawful or prohibited, but is not necessarily fraudulent.ⁿ⁷

On the other hand, the scope of antifraud provisions enacted in many states is not as clear cut. California courts, for example have held that a seller impliedly represents that the security is sold in compliance with the law, and it is a negligent misrepresentation actionable in fraud if the security should be registered and is not.ⁿ⁸ Similarly, in New York the Martin Act makes any violations, including violations of the registration provisions, fraudulent acts. The Martin Act lists many activities which are declared to be "fraudulent practices." Breaking the statute down, these encompass the purchase or sale of securities by:

- (1) Any person employing "any device, scheme or artifice to defraud or for obtaining money or property by means of any false pretense, representation or promise";
- (2) Any person making "fictitious or pretended purchases or sales of securities";
- (3) Any person employing "any deception, misrepresentation, concealment, suppression, fraud, false pretense or false promises";
- (4) Any person engaging in "any practice or transaction or course of business ... which is fraudulent or in violation of law and which has operated or which would operate as a fraud upon the purchaser"; or
- (5) Any broker, dealer or salesman, or employee or agent thereof selling or offering securities in violation of the

registration provisions for such persons or in violation of any other provision of the Blue Sky laws.ⁿ⁹

It is clear that what constitutes fraud in one state may be an unlawful act in another, but may not constitute fraud. Further, a number of states that have enacted the basic element of the Uniform Act's antifraud section have extended the provisions to include additional specific practices deemed "fraudulent" or "unlawful."ⁿ¹⁰ It is probable that many, if not all, of these specified practices would be similarly prohibited by the broad language of the Uniform Act provision.

[2] Information Failures: The Elements of Blue Sky Fraud

State securities statutes tend to expand the definition of securities fraud to include acts not considered fraudulent under the more traditional common law concept of fraud. Of course, the traditional common law "misstatement of a material fact" concept of fraud could not anticipate today's sophisticated market place or complex securities schemes. The antifraud provisions of Blue Sky laws, however, are applicable "whether or not the artifices employed involve a garden-type variety of fraud, or present a unique form of deception ..." and the use of novel or atypical methods will not provide immunity from their coverage.ⁿ¹¹ Nonetheless, most securities fraud, even in a complex and sophisticated investment environment, involves a misrepresentation of one type or another by a person seeking to induce another to purchase a security and thus falls within the traditional common law concept of fraud, albeit with statutory enhancement.ⁿ¹² Accordingly, a review of the elements of common law fraud as they apply to securities law transactions is essential to further understanding the scope of Blue Sky fraud and its elements.

For purposes of this discussion, the elements of common law are reorganized and consolidated into the following:

- (1) What constitutes a *misrepresentation*;
- (2) What is *materiality*;
- (3) *Scienter*, that is, knowledge of the speakers that there is a misrepresentation and the speaker's intent that the misrepresentation be acted upon by those who receive it;
- (4) *Reliance* on the misrepresentation by those who hear it; and
- (5) *Proximate cause* of loss or injury.

The degree to which the person seeking relief must show each and every element of fraud depends in part on the type of relief sought. Generally, in order to obtain injunctive relief or impose criminal sanctions in securities cases, there is often no need to prove reliance or an injury proximately caused by the violation.ⁿ¹³ Rather, the party seeking relief (most often the state administrator) need only show fraudulent conduct in connection with the sale of securities which presents a potential for damages.ⁿ¹⁴ The Uniform Securities Act adopts this approach by making it unlawful "to make any untrue statement of a material fact or to omit to state a material fact or to omit to state a material fact necessary in order to make the statement made, in light of the circumstances under which they are made, not misleading..."ⁿ¹⁵ This provision does not make reference to the elements of reliance or injury nor does the express language of the statute require an intent to defraud. A strict reading of Section 101 of the Uniform Act, therefore, makes securities fraud a strict liability offense with regard to criminal sanctions and requires that no intent or damage occur before courts in those states adopting the Uniform Act may grant injunctive relief.ⁿ¹⁶

In contrast, if the remedy sought is money damages in a civil suit, the Uniform Act makes the proof more difficult. The Act provides that:

Any person who ... offers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the

circumstances under which they are made, not misleading (the buyer not knowing of the untruth or omission), and who does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission, is liable to the person buying the security from him... .n17

This provision, substantially adopted in a number of states,ⁿ¹⁸ alters the elements necessary to prove common law fraud and shifts the burden of proof to the person defending the action. However, the traditional elements are retained to such an extent as to warrant their discussion as they apply to civil actions for the fraudulent sale of securities.

[a] Misrepresentation

"[I]n every case either civil or criminal arising under the ... 'Blue Sky' laws the essential element of the offense is either an affirmative misrepresentation or a concealment of material fact or silence amounting to fraud."ⁿ¹⁹

Obviously, an "affirmative misrepresentation" or an "out and out lie" will, when other elements of proof are met, sustain a fraud action.ⁿ²⁰ Misrepresentations concerning material existing facts are the easier type fraud cases to prove. However, when there is something less than an affirmative misrepresentation, two questions immediately arise. Does silence or failure to disclose constitute a misrepresentation? Can promises or opinions as to future events rise to the level of misrepresentation?

To some degree, an affirmative misrepresentation and a failure to disclose overlap. For example, a lie about the value of stock is necessarily nondisclosure of the stock's true worth.ⁿ²¹ The same is true of misrepresentations about financial conditions and the character and value of property.ⁿ²² The section of the Uniform Securities Act making it fraudulent to omit "a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading,"ⁿ²³ is intended to bring the "half-truth" within the scope of the Act.ⁿ²⁴ However, the Act's reference to omissions does not impose an affirmative obligation to disclose except where there is an express or implied statement having the effect of a half-truth unless something is added.ⁿ²⁵ This principle applies in both the Uniform Act and non-Uniform Act states. One court applied this concept by stating that the duty to disclose does not arise unless affirmative representations would become misleading in the absence of the information not so stated.ⁿ²⁶ Similarly, there exists "a duty to make full disclosure in these circumstances where such disclosure is necessary to dispel misleading impressions that are or might have been created by a partial revelation of the fact."ⁿ²⁷ The purpose for such a disclosure requirement is to make sure that all parties are on equal footing with respect to the transaction.ⁿ²⁸ If a person voluntarily makes a statement concerning a securities transaction that is correct when issued, that person has a duty to update the statement if it becomes materially misleading in light of subsequent events.ⁿ²⁹ Examples of omissions constituting misrepresentations include:

- failure to reveal that the issuer is operating at a loss;ⁿ³⁰
- failure to deliver a prospectus to a solicited purchaser;ⁿ³¹
- failure to disclose the existence of prior SEC or securities regulatory enforcement proceedings;ⁿ³²
- failure to disclose prior existing litigation;ⁿ³³
- failure to disclose a prior bankruptcy;ⁿ³⁴ and
- failure to disclose compensation to management.ⁿ³⁵

The courts, in at least a few states, have held that there is an implied representation that securities are registered under

the state's Blue Sky law and that failure to disclose that the securities are not registered is a misrepresentation actionable in fraud.ⁿ³⁶

Opinions and promises as to future events to induce the sale of securities, while not always considered material misrepresentations, are generally frowned upon.ⁿ³⁷ A few states have attempted to enact legislation against such statements, but for the most part these provisions make such practices fraudulent or unlawful only if they consist of "any promise or representation or prediction not made honestly or in good faith"ⁿ³⁸ or when "any promise or representation as to the future which is beyond reasonable expectation or is unwarranted by existing circumstances."ⁿ³⁹

Again, not all promises or opinions constitute misrepresentations. The Mississippi Supreme Court has held statements that business is "good," "growing," "successful," or "going to be a million dollar proposition" to be merely opinions expressing relative terms upon which reasonable men may differ. According to the court, such statements are "vague, indefinite and uncertain" and "fall far short of proving false and fraudulent statement of existing material facts."ⁿ⁴⁰ However, the same court, twenty years later, opined that a promise that a future market for the stock would be created constituted a misrepresentation.ⁿ⁴¹ The court noted that a promise for future fulfillment will be considered a misrepresentation where there is a present undisclosed intention of not performing it.ⁿ⁴² Further, in view of the liberal interpretations given Blue Sky laws, if a question exists as to whether a statement is of fact or opinion, the statement is likely to be found to be a statement of fact.

The state court decisions, however, are far from uniform on the issue of when an expression constitutes misrepresentation. For example, a Florida appellate court held that a representation that stock was being sold at bottom dollar and the price would triple in six months was no more than an expression of opinion relating to a future event which could not be the basis of fraud.ⁿ⁴³ On the other hand, an Illinois appellate court said that although "statements of opinion which have a firm historical or factual basis are not actionable ... unfounded predictions of future performance are impermissible."ⁿ⁴⁴ The Illinois court cited the growing recognition that specific predictions of price increases or dividends may be in violation of antifraud provisions and held that a promise of a fifteen percent return on stock in a business not yet started was a fraudulent misrepresentation.ⁿ⁴⁵

The distinction between liability for the misrepresentation of a fact and the mere expression of an opinion is important if sometimes difficult to discern. The courts have expressed reluctance to permit any person to escape antifraud liability by recourse to the opinion-fact dichotomy. Under the existing testsⁿ⁴⁶ a reasoned and justified statement of opinion, one with a sound factual or historical basis, is not actionable. Where there exists a gross disparity between prediction and fact, the courts have not been loath to find predictions or opinions to be actionable.ⁿ⁴⁷ Nor have they been reluctant to find predictions of future events and statements of opinion actionable when they are part of a scheme to defraud.ⁿ⁴⁸

In several cases courts have been confronted with arguments that the seller's representations were mere "puffing" and therefore constituted nonactionable opinion.ⁿ⁴⁹ The doctrine of "puffing" as an excuse for misleading statements has found little application in a securities context. The puffing notion is derived from the doctrine of *caveat emptor* and most often arises in connection with the sale of goods where the purchaser's ability to examine the goods will tend to temper the salesperson's or seller's opinion. In light of the securities acts notion of materiality, the "puffing" doctrine should have little application to the offer, purchase and sale of securities.

All of the discussion above suggests that "misrepresentation" as fraud under Blue Sky Laws involves *scienter*, that is, a mental state embracing intent to deceive or defraud. *Scienter* is an element of Blue Sky fraud, and is discussed specifically in § 13.02[1](c) below. However, it is important to note that states also recognize common law claims for negligent misrepresentation.ⁿ⁵⁰ Negligent misrepresentation may also be actionable fraud under Blue Sky Laws. As already discussed, for example, many civil liability provisions in state securities laws include a reasonable care or reasonable diligence defense for secondary actors or intermediaries named as defendants in connection with another's violation of antifraud provisions. Moreover, the 2002 Uniform Securities Act, in its prescription of liability of a seller to a purchaser, or purchaser to a seller, for false or misleading statements includes a reasonable care defense. As in the

case of liability of a seller, for example, § 509(b) of the 2002 Uniform Act provides in pertinent part:

A person is liable to the purchaser if the person sells a security in violation of section 301 or, by means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it is made, not misleading, the purchaser not knowing the untruth or omission *and the seller not sustaining the burden of proof that the seller did not know and, in the exercise of reasonable care, could not have known of the untruth or omission.* n51

[b] Materiality

Courts employ a variety of language to define "materiality."ⁿ⁵² However, despite the divergence, a common theme runs through all the definitions: the representation must be one which a reasonable person would consider in determining his or her course of action. The cases reveal various representations as being material or not material. For example, to one federal court (applying state law), the failure to reveal the true liabilities of a company in which securities are sold is the suppression of a material fact.ⁿ⁵³ Similarly, a balance sheet which inflates the true worth of the issuer and fails to disclose that bare legal title to claimed real property has been transferred (but equitable title retained) contains misrepresentations of material facts.ⁿ⁵⁴

In an Illinois case,ⁿ⁵⁵ the seller represented to the purchasers that the issuer had a capitalization of \$190,000. However, the seller did not reveal that the issuer had entered into a repurchase agreement for its securities for \$25,000 with another shareholder. The court found that in view of the fact that there were only six subscribers to the stock and that one of them had serious doubts about proceeding with the venture, there was a material fact which should have been disclosed to other investors. In a fraud action brought by a seller of securities, a Washington court held that the failure of the buyer, a corporate insider, to reveal that outside buyers had made offers to purchase a controlling interest in the company constituted a misrepresentation of a material fact.ⁿ⁵⁶

The more interesting cases are those where the courts have held that although a misrepresentation may have taken place, it was not of a material fact and therefore a fraud action would not lie. In *Guyann v. Shulters*,ⁿ⁵⁷ the Mississippi Supreme Court examined a situation in which an outstanding loan was not revealed to investors in a corporation and the loan agreement pledged part of the corporate assets as collateral. In holding that failure to reveal the loan was not a misrepresentation of a material fact, the court noted that the entire loan was used in the business, the pledge of assets was not legally binding and that the loan was also secured by the outside earnings of one of the principals.ⁿ⁵⁸ The court also considered pertinent that more than half of the loan had been repaid and no financial loss resulted to the business as a result of the transaction.ⁿ⁵⁹

In a Washington caseⁿ⁶⁰ a contract for stock representing a controlling interest in a nursing home stated that the facilities of the home were in accordance with all governmental regulations. However, the purchaser subsequently discovered that emergency electrical equipment required by the Social Security Administration was not installed. The court held that the lack of equipment was not a material contractual misrepresentation since the home had been certified by both state and federal governments and neither certification was imperiled due to the missing equipment. The Court also considered pertinent the facts that the operators could obtain a waiver of the equipment purchase requirement from the applicable official and that from the purchasers examination of the premises, it should have been apparent the equipment was missing.ⁿ⁶¹

Not all omissions or misstatements are actionable under the blue sky laws' antifraud provisions. Those provisions do not prohibit the making of any misstatement. Instead, they only prohibit the making of material ones. Whether statements of opinion or predictions of future events are material statements must be decided in the context of the offer made.

Usually, a jury decides whether a statement is one of fact or opinion.ⁿ⁶² Seemingly, the United States Supreme Court has resolved the question of the test for materiality in its 1976 decision in *TSC Industries, Inc. v. Northway, Inc.* ⁿ⁶³ In

time the distinctions between *would* or *might* consider important will be resolved. It is, however, important to note that there are some facts which have been deemed to be so obviously material that to omit them constitutes fraud.ⁿ⁶⁴

[c] Scienter

In civil actions for fraud, the Uniform Securities Act does not dispose with the common law element of scienter. Instead it lifts the burden of proof from the shoulders of the securities buyer and requires that the seller prove that he or she was unaware of any material misrepresentations or omissions and "in the exercise of reasonable care could not have known" of the untruth or omission.ⁿ⁶⁵ Theoretically, if the seller sustains this burden of proof, he or she will escape liability even if there were material misrepresentations or omissions made in connection with the sale.ⁿ⁶⁶ Equally important, the "reasonable care" clause has the effect of extending scienter to include not only intent to defraud, but mere negligence as well.

In states adopting the Uniform Act provisions a number of courts consistently hold that a defrauded purchaser need not show that the seller acted with fraudulent intent.ⁿ⁶⁷ However, with respect to a defendant's avoiding liability due to negligence or lack of intent to defraud, there is at least some difference of opinion. A few courts hold to the letter of the Uniform Act provision and agree that recovery is not warranted where the sellers are able to show that any material misrepresentation or omissions they may have made were made without negligence, innocently and in good faith.ⁿ⁶⁸ Other courts apply common law equity principles in these cases and conclude that there can be liability even where the statement or omission which ultimately proves to be injurious is made without knowledge or reason to believe that injury would result (in other words, a form of strict liability).ⁿ⁶⁹ This divergence is especially apparent in Arkansas where a federal court, interpreting the state statute, opined that a seller who can prove that statements and omissions were made innocently and non-negligently is not liable.ⁿ⁷⁰ However, the Arkansas Supreme Court has held that a buyer may rescind a sale even where the seller's statements were made without knowledge of falsity and without moral guilt or evil intention.ⁿ⁷¹

There is, as one can readily see, a similarity in the Uniform Act sections making misrepresentation and omissions of material fact unlawful and the section imposing civil liability for such representations and omissions. The latter, Uniform Act § 410(a)(2) describes elements of proof which must be met by the parties in a civil action alleging such actions. Nevertheless, at least one state that has substantially adopted the Uniform Act section making fraud generally unlawful has not adopted the section spelling out the elements of proof required in civil cases, but rather provides that a private civil action may be brought for any violation of the Blue Sky law.ⁿ⁷² This statute, in effect, allows private civil actions for any fraudulent act affecting the sale of securities as well as those based on untrue statement or omissions of material facts. In actions based on the latter concept, the statute is silent on questions of whether a fraud action may be based on negligent misrepresentation or omission and whether or not there is a shift in the burden of proof.ⁿ⁷³

A federal court looking at virtually the same provision in the Connecticut Blue Sky law determined that proof of negligence will not suffice to hold a seller liable; the purchaser must prove actual scienter on the part of the seller.ⁿ⁷⁴

In Washington, which has adopted the Uniform Act's antifraud provision,ⁿ⁷⁵ and which permits private civil suits for any "fraud or misrepresentation" involving securities,ⁿ⁷⁶ the courts have ruled that any material misrepresentation or omission is fraudulent *per se*.ⁿ⁷⁷

California, which requires a level of proof in civil actionsⁿ⁷⁸ comparable to that required under the Uniform Securities Act, has declared that fraud actions may be maintained for negligent misrepresentationsⁿ⁷⁹ even where the wrongdoer did not profit by his actions.ⁿ⁸⁰ The Florida provisions making it unlawful to sell securities by means of material untrue statements or omissionsⁿ⁸¹ may also be the basis of a civil action under a statute permitting such proceedings for any violation of the Blue Sky law.ⁿ⁸² A federal court interpreting Florida's statute noted that it would appear that under the provisions, the common law element of scienter had been relaxed, although fraud by means of negligence had not yet reached the level of official policy.ⁿ⁸³ A Florida appellate court later indicated via dictum that scienter was not

essential to recovery under the Florida Blue Sky law and suggested that mere negligence might be an acceptable criterion.ⁿ⁸⁴ In a similar vein, a federal court decision ruled that common law principles of fraud would apply to actions under the state Blue Sky law, but that the common law of Ohio had developed to such an extent that proof of wrongful intent is not required in fraud actions.ⁿ⁸⁵

Before leaving the subject of proof of scienter in civil actions, it should be mentioned that virtually all the decisions discussed so far deal with defrauded purchasers suing sellers.ⁿ⁸⁶ However, some states permit actions by defrauded sellers against their buyers. Generally, these statutes provide that the level of proof that defrauded seller must meet is no different than that required of a defrauded purchaser.

With respect to injunctive actions brought by state officials, recall that proof of scienter is not ordinarily required. New York especially has a long line of cases holding to this principle.ⁿ⁸⁷

In criminal cases, questions of scienter usually arise when a defendant is accused of "willfully" or "intentionally" or "knowingly" violating the statute. The usual argument is that there is no intention to defraud and that therefore the blue sky law was not violated. However, the courts have uniformly held that such terms refer to the acts of the defendant and not to the violation of the law. In other words, the proof required is that the defendant was aware of his or her actions; proof of intent to violate the law or of intention to defraud is not required.ⁿ⁸⁸

It is generally true that a more culpable mental state of mind is required in criminal cases than the courts require in civil cases under the state securities antifraud laws. While the state courts in criminal cases typically require some element of scienter or *mens rea*, proof of a specific intent, evil motive or guilty knowledge that the law was being violated is not the standard. Intent to deceive in criminal cases means "intent to say something that is expected to be relied on, that is not believed to be true by the seller, or, if strictly true, is hoped will be understood in an untruthful sense." This is expressed as a "willful" violation. A seller can willfully violate a securities law without knowing of its existence. Knowledge that the act is in violation of the securities laws, or that the instrument in question is a security, is not a relevant fact requiring proof by the state.

[d] Reliance

The Uniform Act requirement for civil actions sounding in fraud contains a statement to the effect that a defrauded purchaser of securities must not know of the untruths or omissions in order to recover.ⁿ⁸⁹ Any fair reading of this provision produces the conclusion that it is not intended as a requirement that the buyer prove reliance on the untrue statement or the omission. Rather he or she must show only that he did not know of it.

Of the states adopting this provision, some acknowledge that proof of reliance, as understood at common law, is not a requirement under the securities acts.ⁿ⁹⁰ On the other hand, courts in Washington have made clear that reliance is an element of a claim for misrepresentation under the Washington Securities Act, and, moreover, that reliance must be reasonable.ⁿ⁹¹ In either case, certain requirements bearing on reliance, aside from proof of the true facts, do come into play. For example, a buyer may not recover on the basis of misrepresentations upon which he or she had no concern and placed no reliance.ⁿ⁹² One state supports this position by saying that a party claiming fraud is presumed to be aware of all the facts which would have been discovered by a reasonably prudent person in the same position, and that total reliance on the honesty of the person against whom fraud has been alleged does not excuse the failure to exercise due diligence.ⁿ⁹³ However, the fact that a defrauded party can learn the truth by independent investigation does not defeat the action unless such person had knowledge of facts that would cause a reasonable man to be suspicious of the representation made to him. Thus, as a Texas appellate court observed:

Where one has been induced to enter into a contract by fraudulent representations, the person committing the fraud cannot defeat a claim for damages based thereon by a plea that the party defrauded might have discovered the truth by the exercise of proper care. There is no duty on the defrauded party to

make any investigation as to the truth or falsity of the statements made to them... .n94

Knowledge of facts that would cause a reasonably prudent person to make inquiry which would lead to a discovery of the fraud is in law knowledge of the fraud. One cannot be charged with lack of diligence in failing to make inquiry until he has knowledge of some fact that should have aroused his suspicion.n95 That the defrauded party conducts an investigation does not necessarily mean that complete reliance was placed in the investigation and that no reliance was placed on the fraudulent statements.

In states adopting the Uniform Act provision, the courts of at least one state hold that a buyer of securities may accept statements made to him at face value and rely upon them.n96 However, where the buyers are knowledgeable of the type of business they are purchasing via the securities in question and conduct an inspection of the premises involved, they are no longer relying on representations made to them, but on their own judgment. Thus, they cannot recover on the basis of untrue statements or omissions.n97

Generally, in criminal actions and cases seeking injunctions, proof of reliance is not required.n98 However, one court has adopted the position that a criminal conviction for fraud in the sale of securities cannot be upheld where the allegedly injured party had the opportunity to and did in fact conduct an independent investigation.n99

Federal courts sitting in review of state antifraud civil securities litigation, too often attempt to force upon the state's remedial securities statutes the requirements of *Rule 10b-5*. Such attempts are misplaced and stem from an absence of understanding and appreciation of the statutory scheme, versus the implied right of action under *Rule 10b-5*, of state securities regulation. Consistently, state courts have rejected the imposition of *Rule 10b-5* requirements upon state securities statutes. The scienter requirement has been rejected time and again. The policies reflected in the state securities laws are protective of investors and are expressions of the concerns of state legislatures whose residents often fall prey to peripatetic swindlers and con-artists

Attempts to constrain state securities civil remedies by imposing upon them the transaction causation and loss causation requirements of *Rule 10b-5* fail to heed the fundamental distinction between the nature of implied causes of action and express statutory remedies adopted by legislators in each of the states. Additionally, the trend in recent federal cases to equate *Rule 10b-5* requirements with state securities civil remedies miss the point manifested in state statutes. These statutes were designed to protect the general investing public from those who are too eager to divest them of their funds on the promise of profits. If the state law remedies appear harsh to unsuspecting swindlers and overly protective of resident investors when compared to the federal laws, it is because they were intended to be so. It is for this reason that they are devoid of references to scienter, proximate cause and other requirements of *Rule 10b-5*.

[e] Proximate Cause of Loss or Injury

Under common law, the injury suffered by a person claiming fraud must be consequently and proximately caused by the person against whom the allegation is made. It is not the purpose of this chapter to ascertain the amount or level of damages recoverable in fraud actions, but to see how this common law element applies to the Blue Sky laws.

It appears that, to an extent, the concept of proximate and consequent injury meshes with the Uniform Securities Act provision allowing a seller of securities to escape liability for fraud if the seller can prove that he or she did not know, or, by exercising reasonable care, could not have know, of any material misrepresentations or omissions made by him or her.n100 Under this provision, according to at least one court, a person selling securities cannot be liable for repeating information provided by others where the seller had no knowledge of its falsity.n101 If such a sale takes place through a principal-agent relationship, the principal who gave his innocent agent the false information has been held responsible.n102

In New York, where a causal link between fraudulent conduct and resultant injury is essential,n103 recovery for fraud

will not be allowed where the practices complained of did not occur until after the person claiming fraud purchased the securities.ⁿ¹⁰⁴ A New York court reached a similar result where the purchaser did not buy the securities from the misrepresenting broker, but rather from another broker.ⁿ¹⁰⁵ In that setting the court observed: "To place the responsibility for the possible purchase of unlimited number of shares from an unlimited number of brokers on the defendants is unreasonable and unrealistic."ⁿ¹⁰⁶

A Utah court concluded that the purchaser of securities may not hold the issuer's accountant liable for negligently preparing financial statements relied on by the purchaser on the grounds that future purchasers of securities constitute an unlimited class who could not be reasonably foreseen as relying on the statements.ⁿ¹⁰⁷ In a particularly interesting Oregon case, the plaintiff, a minority stockholder and former employee of the defendant, brought an action for damages on the grounds that he was fired because he refused to sell his stock to the defendant at a price below the market price.ⁿ¹⁰⁸ He claimed that such actions on part of the defendant were fraudulent under the Oregon Blue Sky law and demanded damages for loss of earnings and retirement benefits. In affirming dismissal of the case, the court said that the recovery sought by the plaintiff is consistent with his status as an employee, but not as a stockholder. The Blue Sky law allows for recovery for fraud in the purchase and sale of securities, not for loss of employment.ⁿ¹⁰⁹

It may be that injury is not always essential to a civil action for fraud. In a fraud suit brought in federal court under the former Maine Blue Sky law alleging that a prospectus relied on by the plaintiff contained untruths and omissions,ⁿ¹¹⁰ the defendant sought dismissal of the complaint on the grounds that the alleged omissions were beneficial to the plaintiff. Refusing to dismiss the complaint, the court held that the provision in the Act allowing civil suits for fraud is an express liability provision. Allegations of material omissions or misstatements are all that are needed to establish a prima facie case under the statute, and there is no requirement that causation be alleged or proved.ⁿ¹¹¹ Maine has since adopted the 2002 Uniform Securities Act, but its former provision is substantially the same as the Uniform Securities Act provision allowing civil actions for fraud.ⁿ¹¹² Thus, the decision may continue to carry weight. A nuanced change from the Uniform Securities Act to the 2002 Uniform Act is the qualification for recovery of "actual" damages rather than simply damages. The actual damages qualifier appears in a number of other state securities laws, and arguably implies a causation element.

[3] Specific Acts by Intermediaries and Issuers

The prohibited acts and practices discussed in the preceding section are directed to any and all persons involved in the offer, sale or purchase of securities. A number of states, however, have enacted additional antifraud provisions intended to apply to persons who are in the business of dealing in securities. These statutes and regulations are specifically directed toward broker-dealers, investment advisers, and issuers.

A note of caution is warranted. The subject of fraud in this chapter deals with fraud as an unlawful act which may result in criminal conviction, civil liability or injunctions. Concomitantly, under the Uniform Securities Act, registration of broker-dealers, agents and investment advisers may be denied, suspended or revoked if the person "has engaged in dishonest or unethical practices in the securities business."ⁿ¹¹³ Several states have also promulgated rules or regulations which set forth acts that are deemed dishonest or unethical practices for the purpose of denying, suspending or revoking registration, or imposing discipline on intermediaries.ⁿ¹¹⁴ Many of these practices would probably be deemed fraudulent under the general antifraud statute enacted in the state as well. However, a discussion of fraudulent practices relating to the registration provisions exclusively is omitted from this chapter.

Similarly, securities registration can be denied, suspended or revoked if "the offering has worked or tended to work a fraud upon purchasers or would so operate."ⁿ¹¹⁵ Acts and practices which are considered fraudulent for purposes of denying, suspending or revoking a securities registration are also separately covered in this Treatise.ⁿ¹¹⁶

[a] Broker-Dealers

The Blue Sky laws in several states contain antifraud provisions specifically applicable to broker-dealer transactions. These statutes prohibit broker-dealers from effecting transactions or inducing or attempting to induce the purchase or sale of securities "by means of any manipulative, deceptive or other fraudulent scheme, device or contrivance."ⁿ¹¹⁷ Despite the intent of these provisions to thwart certain broker-dealer practices, there does not seem to be anything in these statutes which would not be included within the general fraud prohibitions of the Uniform Act applicable to all persons. Nevertheless, three of the states adopting the broker-dealer antifraud section have also enacted the Uniform Act's general antifraud section.ⁿ¹¹⁸

Broker-dealer practices are governed in several states by regulations promulgated under either an antifraud provision applicable to broker-dealers only or the more common general antifraud provision applicable to all persons. These regulations are often modeled after rules promulgated by the SEC under the federal Securities Exchange Act of 1934. For example, some states have regulations based on the former SEC rule making it a fraudulent practice for a broker-dealer to fail to make written disclosure to a customer of the capacity in which the broker-dealer is acting in executing transactions.ⁿ¹¹⁹ This rule requires disclosure of whether the broker-dealer is acting solely for the customer, as a dealer for his or her own account, for another person, or for both the customer and another person.ⁿ¹²⁰

In addition, a broker-dealer must disclose to its customers when it recommends a stock in which it is a market maker.ⁿ¹²¹ The failure to disclose such a fact indicating the possibility of adverse interests would deny prospective investors of an opportunity to make an informed decision about the recommended investment. The investor must be permitted to evaluate possible conflicts of interest in such recommendations. Facts which would reveal or tend to reveal the lack of objectivity on the part of the broker-dealer will be deemed material facts, the nondisclosure of which may render the broker-dealer liable to his or her client.

Such disclosure, however, may not be required where the securities involved in the transaction consist of U.S. government obligations.ⁿ¹²² California also provides an exemption where the transaction involves specified securities issued by certain companies registered under the federal Investment Company Act of 1940.ⁿ¹²³

States have also adopted SEC Rule 15c-1-5 under the 1934 Act,ⁿ¹²⁴ making it a fraudulent practice for a broker-dealer to fail to make written disclosure to a customer when the broker-dealer is controlled by, controlling or under common control with the issuer of the security.ⁿ¹²⁵ Similarly, Rule 15c-1-6 under the 1934 Act,ⁿ¹²⁶ which requires disclosure of any participation or financial interest which the broker-dealer has in a transaction, has been adopted by some states.ⁿ¹²⁷

These approaches illustrate that the philosophy embodied in the antifraud provisions of the states' securities laws is that decisions by investors be based upon an analysis of all material facts--or at least an opportunity to make such an analysis. To effectuate this purpose broker-dealer nondisclosure of their economic self-interests which are at variance with an investors' are deemed to be material, and, if withheld, actionable.

The practice of "churning" discretionary accounts is also deemed to constitute fraud by both state administratorsⁿ¹²⁸ and the SEC under the federal securities laws.ⁿ¹²⁹ Churning is the practice of controlling or influencing the volume and frequency of trading in an account by purchasing or selling securities which are excessive in size or frequency in view of the financial resources and character of such account. Further, the failure of a broker-dealer to keep records of any trading in a discretionary account is considered fraudulent under state¹³⁰ and SEC rules.ⁿ¹³¹

The giving of a fictitious quotation by a broker-dealer has been specifically banned by a few states.ⁿ¹³² Similarly, the sale of a security at a price not reasonably related to the market price constitutes fraud in one jurisdiction.ⁿ¹³³ Another, more common, rule under state¹³⁴ and federalⁿ¹³⁵ securities laws is to deem fraudulent a representation by a broker-dealer that a security is being offered "at the market" unless the broker-dealer knows or has reasonable grounds to believe that such a market exists without it being created or controlled by the broker-dealer or by any person associated or in a control relationship with him.

The SEC rule against the hypothecation of securities, Rule 15c-2-1 under the 1934 Act,ⁿ¹³⁶ has been described as perhaps the most complicated of all SEC rules.ⁿ¹³⁷ The basic purpose of the rule is to prevent broker-dealers from pledging or disposing of securities they are holding for customers (or other persons) as collateral or for safekeeping. There are numerous exceptions to these prohibitions and notice and certification requirements when exceptions are used.ⁿ¹³⁸ This rule has been substantially adopted in the regulations of some states.ⁿ¹³⁹

A far less complicated provision making hypothecation of customers' securities unlawful has been enacted in New York.ⁿ¹⁴⁰ Under the Martin Act, it is unlawful for a broker-dealer in possession of a customer's securities, without a lien on them or a special property interest in them, to pledge or dispose of the securities without the customer's consent. Even when the broker-dealer has a lien on the securities, it may not pledge or dispose of them for an amount greater than the amount owed by the customer without the customer's consent. However, such a pledge or disposal may be made when the broker-dealer has possession or control of the same type and kind of securities which can be delivered to the customer in the event that the customer tenders the amount of the debt owed to the broker-dealer and demands the return of the securities.ⁿ¹⁴¹

Rule 15c2-4 under the Securities Exchange Act of 1934 Act is partially aimed at broker-dealers acting as underwriters.ⁿ¹⁴² The rule makes it a fraudulent practice for any broker-dealer to fail to transmit money received from the sale of securities to the persons entitled to it. Alternatively, if the broker-dealer is acting as an underwriter on a "best efforts" basisⁿ¹⁴³ and the securities are sold on an "all or none" basisⁿ¹⁴⁴ or in accordance with an agreement that the underwriter is not to turn over received consideration until some future event occurs, then the money must be placed in a separate trust or escrow account.ⁿ¹⁴⁵ Several states have substantially adopted this rule.ⁿ¹⁴⁶

Minnesota has adopted an additional rule affecting "all or none" or contingency distributions.ⁿ¹⁴⁷ Under this provision it is considered deceptive to make a representation:

[t]o the effect that the security is being offered or sold on an "all or none" basis, unless the security is part of an offering or distribution being made on the condition that all or a specified amount of the consideration paid for such security will be promptly refunded to the purchaser unless all of the securities being offered are sold at a specified price within a specified time, and the total amount due to the seller is received by a specified date.

Investors whose funds are not returned on a timely basis under the Minnesota rule may nevertheless lose the right to bring an action based upon the violation of the rule, if the seller delivers to the investor a written offer of rescission. Under section 410(e) of the Uniform Act no buyer of securities may bring suit if she has received a written offer to refund the consideration paid together with interest from the date of his or her investment. Section 607 of the Revised Uniform Act provides that the purchaser may not bring suit if he receives a written offer stating the basis on which liability may have arisen, apprising the purchaser of his or her rescission rights, providing all information necessary to correct any material misstatements or omissions made, and offering to repurchase the security for cash, equal to the consideration paid, plus interest (less income received), or, if the purchaser no longer owns the security, offering an amount equal to damages computed under section 605(a) of the Revised Act, and the purchaser fails to accept in writing within 30 days of receipt of the offer.

Most state regulators would consider such a written offer of rescission to require yet another investment decision be made by residents of their states. Some would require that the rescission offer be registered prior to permitting the offer to be circulated. Rescission offers which do not afford investors an opportunity to make an informed investment decision may be actionable. Persons who do not accept the offer to rescind their investment and elect instead to retain their investment may, by virtue of a purchaser-seller requirement, be denied an opportunity to bring an action based on the fraudulent rescission offer. They may, however, claim that the fraudulent rescission offer was but a part of an ongoing scheme to defraud.

Issuers and broker-dealers who may have violated both the antifraud and registration requirements of state securities law may not escape liability by use of a rescission offer which does not detail the basis of both violations. If only the failure to register the issue is addressed in the repurchase offering materials, the investor's ability to institute an action under the civil liabilities section of the state securities act is not cut off with respect to any fraud claim. To the extent, however, that the rescission offer materials embrace both the failure to register the issue and the violations of the anti-fraud provisions, an investor who retains his or her investment after the receipt of adequate disclosure would not be permitted to bring a subsequent state securities act claim.

Some states have adopted other federal rules applicable to broker-dealers as the basis for "fraud" determinations. These include making use of an inter-dealer quotation system without regard to established procedures,ⁿ¹⁴⁸ and the publication of quotations for securities by broker-dealers in the absence of appropriate filings by the issuer under the federal securities laws.ⁿ¹⁴⁹

Of course, states have their own rules regarding fraud by a broker-dealer outside of those under the federal Act. It has already been mentioned, for example, that a few states consider it fraudulent to offer or sell securities which are not registered or exempted by the state's Blue Sky law. Some state have a rule one step removed from this rather onerous provision. In these states it is considered a fraudulent business practice for a dealer to accept any compensation in connection with the purchase or sale of a security which is not registered or exempted.ⁿ¹⁵⁰

New York has a statutory scheme which specifically defines a number of broker-dealer practices as fraudulent. It is, for example, unlawful for a broker-dealer to intentionally trade against purchase or sale orders submitted by customers.ⁿ¹⁵¹ It is also unlawful for an insolvent broker-dealer to accept securities or money from a person ignorant of the insolvency unless such property is for liquidation of, or security for, an existing debt.ⁿ¹⁵²

Although other specific acts are condemned by statutes and regulations, it is readily apparent that such activities would properly belong within the broad antifraud provision of the Uniform Act applicable to all persons dealing in securities. In fact, the Supreme Court of Arkansas has declared that under the Uniform Act provision excessive markups in the price of securities and the churning of accounts by a broker-dealer constitute fraud.ⁿ¹⁵³

It should be emphasized that it is possible the acts described in this section as specifically prohibited by regulation would be equally fraudulent in states having no more than a general antifraud provision. The practices described are no more than examples of the many types of fraud capable of being perpetrated on the investing public. It should also be reiterated that the states may revoke, deny or suspend broker-dealer registrations for "unethical practices." A number of the activities described in this section are specifically included among the antifraud provisions prohibited by rule or statute in many states. There is little doubt they would also be considered fraudulent in most states having only the general antifraud prohibition.

[b] Investment Advisers

The provision most often enacted covering prohibited activities of investment advisers is taken from the Uniform Securities Act.ⁿ¹⁵⁴ This particular section is divided into three parts, each dealing with contemplated general practices which are deemed unlawful. The first portion of the section deals specifically with fraud, and provides:

It is unlawful for any person who receives any consideration from another person primarily for advising the other person as to the value of securities or their purchase or sale, whether through the issuance of analyses or reports or otherwise,

- (1) to employ any device, scheme, or artifice to defraud the other person, or
- (2) to engage in any act, practice, or course of business which operates or would operate as a fraud

or deceit upon the other person.ⁿ¹⁵⁵

Of initial significance is the fact that this provision applies not only to "investment advisers" but to any person giving investment advice for consideration. Since there are a number of exceptions to the various statutory definitions of "investment adviser,"ⁿ¹⁵⁶ this provision has enlarged the group of persons covered to insure that there are no exceptions from the statute's antifraud provisions.ⁿ¹⁵⁷ Although a large number of states have adopted this provision substantially as recommended,ⁿ¹⁵⁸ many have changed it to make it applicable only to investment advisers, as defined under the statute.ⁿ¹⁵⁹ In one state, the statute deems it fraudulent if a person violates any provision of the blue sky law with respect to the giving of investment advice.ⁿ¹⁶⁰

A few states have supplemented the basic antifraud provision with a statement making it unlawful for an investment adviser "to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative."ⁿ¹⁶¹ This seemingly redundant phrase has been used for the issuance of regulations prohibiting specific advertising practices by investment advisers that are deemed fraudulent, deceptive or manipulative.ⁿ¹⁶² Interestingly, these same prohibitions against deceptive advertising have been adopted by some states having the basic Uniform Act provision.ⁿ¹⁶³ In these provisions deceptive advertising is simply declared "a device, scheme or artifice to defraud,"ⁿ¹⁶⁴ or "an act, practice or course of business which operates or would operate as a fraud."ⁿ¹⁶⁵

In relation to deceptive advertising, the prohibitions declare as fraudulent any advertisementⁿ¹⁶⁶ which contains a testimonial concerning the investment adviser or contains any advice, analysis, report or other service rendered by the adviser. Advertisements may not refer to past recommendations which were or would have been profitable, but they may set forth or offer a list to readers of all recommendations. Any such list must contain all the recommendations made within the immediately preceding twelve-month period. With respect to each recommendation, there must appear therein the name of the security, the date and nature of the recommendation (e.g., whether to buy, sell or hold), the market price at which the recommendation was acted upon and the market price of each security as of the most recent practicable date. In addition, the front page of any such list must contain a statement to the effect that future recommendations may not be as profitable.

The legend is to be in print or type as large as the largest print or type used in the body or text of the list. The required wording is: "It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities in this list." The regulations also prohibit the advertiser from representing that any offered chart, graph, formula, or other device can be used by itself to determine which securities should be bought or sold. Nor may it be represented that any such chart, graph, formula or device can be used to assist in making decisions as to which securities should be bought or sold unless the difficulties and limitations in using such devices are prominently disclosed.

Investment adviser advertising may not contain a statement that any service will be furnished free unless such service is in fact free and without any condition or obligation. No statement in the advertisement may be untrue or otherwise false or misleading. Pennsylvania also disallows the advertisement from recommending the purchase or sale of any security unless it is coupled with an offer to furnish specified information about the security.ⁿ¹⁶⁷

Some states have added the following statutory prohibition to the first part of the Uniform Act's recommendation:

It is unlawful for any investment adviser, directly or indirectly, in this state:

Acting as principal for his own account, knowingly to sell any security to or purchase any security from a client for whom he is acting as investment adviser, or, acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of the transaction the capacity in which he is acting and obtaining the written consent of the client to such transaction.ⁿ¹⁶⁸

This provision, taken from the federal Investment Advisers Act of 1940,ⁿ¹⁶⁹ was purposely omitted from the Uniform Act. In the opinion of the Act's drafters, such conduct would fall within the prohibitions of the investment adviser antifraud provision of the Uniform Act.ⁿ¹⁷⁰

Also omitted from the Uniform Act is a prohibition against an investment adviser holding himself or herself out as an "investment counsel." Under the Investment Advisers Act of 1940, an investment adviser may not represent him or herself as an investment counsel unless "(1) his or its principal business consists of acting as an investment adviser, and (2) a substantial part of his or its business consists of rendering investment supervisory services."ⁿ¹⁷¹ This omission from the Uniform Act was based on two grounds. First, at the time the Act was drafted, only two states had similar provisions. Second, and perhaps more important, was the objection raised by some non-qualifying investment adviser firms that such a provision put them at a competitive disadvantage against smaller firms with a primary business of individual supervisory services.ⁿ¹⁷² Nevertheless, a few states currently prohibit the use of the term "investment counsel" unless the investment adviser is rendering, as a substantial part of his or her business, investment advisory services on the basis of the individual needs of clients.ⁿ¹⁷³

The second part of the Uniform Act's provision applies to investment advisers in particular, as opposed to those giving investment advice in general, and is related to the contents of the advisory contract executed between the investment adviser and his client. It provides that an investment advisory contract must provide in writing that:

(1) the adviser's fee will not be based on the capital gains or capital appreciation of the client's funds;ⁿ¹⁷⁴ (2) the contract may not be assigned by the adviser without the consent of the client;ⁿ¹⁷⁵ and (3) if the investment advisory firm is a partnership, the client will be notified of any change in membership within a reasonable time.ⁿ¹⁷⁶

These principles have been substantially enacted in a number of states.ⁿ¹⁷⁷

With respect to an investment adviser's compensation, the prohibition against basing the adviser's fee on capital gains or capital appreciation does not bar a contract provision "which provides for compensation based upon the total value of a fund averaged over a definite period."ⁿ¹⁷⁸ This Uniform Act provision has been extensively enacted by the states. In Illinois, the one state with an investment adviser compensation rule not based on the Uniform Act, the compensation must be "fair and reasonable and ... determined on an equitable basis adequately disclosed to each client in writing."ⁿ¹⁷⁹

California, which has substantially enacted the Uniform Act's compensation provision,ⁿ¹⁸⁰ has added a few exceptions by regulation. These exceptions make it possible for certain investment advisers to be compensated on the basis of capital gains or capital appreciation of a client's funds. The first exception is available if the conditions of Rule 205-3 under the Investment Adviser's Act of 1940 are met, including the requirement that the client be a natural person or company as defined in the regulation who has at least \$750,000 under the management of an investment adviser, or who the investment adviser believes has a net worth exceeding \$1,500,000 immediately prior to entering into the contract, and if the compensation formula, disclosure and arms-length transaction conditions of Rule 205-3 are met.ⁿ¹⁸¹ Compensation exceptions are also available to investment advisers contracting with most types of institutional investors.ⁿ¹⁸²

A handful of states that have enacted the Uniform Act provision have granted compensation exceptions if the investment advisory contract satisfies the exemptions under the federal Investment Advisers Act of 1940.ⁿ¹⁸³ Pennsylvania will allow any fee arrangement permitted in the Investment Advisers Act of 1940 and any rules promulgated thereunder.ⁿ¹⁸⁴ Pennsylvania will also suspend the Uniform Act compensation rules when the investment advisory contract is with an institutional investor.

The second Uniform Act requirement for contract provisions, which makes it unlawful for an investment adviser to

assign a client's contract without the client's consent, is a recognition that a person seeking investment advice is relying on the expertise of a particular adviser. An assignment of the contract deprives the client of the advice of the person on which he or she wanted to rely.

An interesting aspect of the assignment prohibition is the definition of "assignment" provided in the Uniform Act. Under the definition, an assignment will result not only when the contract is transferred or hypothecated, but also if the advisory firm is a corporation or other form of stock company and a transfer of a controlling block of the firm's outstanding voting securities by a security holder occurs. On the other hand, if the advisory firm is a partnership, the withdrawal or death of a minority of the partners or the admission of a new partner having only a minority interest does not constitute an assignment. Note, however, that under the third Uniform Act contract requirement, any change in the membership of the partnership means that the client must be notified of the same within a reasonable time.

The final prohibition under the Uniform Act section states that:

It is unlawful for any investment adviser to take or have custody of any securities or funds of any client if

- (1) the Administrator by rule prohibits custody; or
- (2) in the absence of rule, the investment adviser fails to notify the Administrator that he has or may have custody.ⁿ¹⁸⁵

Of the states enacting this provision,ⁿ¹⁸⁶ few have issued appropriate rules governing such a situation.ⁿ¹⁸⁷ It must therefore be assumed that in the states having no such regulation, possession of a client's securities or funds is permitted upon notification to the administrator. However, a state which has regulations promulgated under the Uniform Act provision prohibits investment advisers from taking custody of clients' funds or securities.ⁿ¹⁸⁸

In states with provisions that differ from the Uniform Act's recommendation, some permit an investment adviser to take possession of clients' securities or funds where the adviser is also a licensed broker-dealer.ⁿ¹⁸⁹ Others have regulations permitting investment advisers to have custody of client's securities and funds on the condition that such property is segregated by the investment adviser.ⁿ¹⁹⁰ In some states, however, the adviser need not meet the segregation requirements if he or she is also a broker-dealer.ⁿ¹⁹¹

Under the segregation rules, it is uniformly required that any client's securities held by an investment adviser be segregated and marked to identify the client having the beneficial interest therein.ⁿ¹⁹² Some states require the securities to be held in safekeeping in some place reasonably free from risk of destruction or other loss, and others require the investment adviser to comply with the requirements set forth in Rule 206(4)-2 under the Investment Adviser's Act of 1940, including that the securities are so segregated.ⁿ¹⁹³ If the property consists of funds of the client, each state, as well as the federal regulation, requires that they be deposited in one or more bank accounts containing only client's funds under the name of the investment adviser as agent or trustee for such clients. The investment adviser is then required to maintain a separate record for each such account showing the name and address of the bank for each account, the dates and amounts of deposits and withdrawals and the amount of each client's beneficial interest in the account.ⁿ¹⁹⁴

Whether the property consists of funds or securities, Rule 206(4)-2 under the federal Investment Advisers Act and some states require the investment adviser to give the client immediate written notice of the place and manner in which the property is held, and similar notice whenever there is a change in the place or manner in which it is held.ⁿ¹⁹⁵ All of these states require that a periodic report be sent to the client itemizing the funds and/or securities in possession of the investment adviser at the end of the period, and indicating all debts, credits and transactions in the client's account

during the period, as does the federal regulation.ⁿ¹⁹⁶ In addition, the funds and securities are required to be periodically verified by an independent certified public accountant. A certificate of the accountant verifying the fact and nature of his or her examination is required to be filed with the respective securities administrators.ⁿ¹⁹⁷

[c] Issuers

Fraudulent acts by issuers would, of course, be subject to the general antifraud provisions of most states. However, Wisconsin has developed a series of regulations aimed specifically at issuers, which deserve separate consideration. The regulations deem it a fraudulent act for an issuer, and officers, directors or controlling persons thereof, to apply money received from the sale of securities to a use other than those specified in the prospectus offering the securities and not reasonably related to the business of the issuer as described in the prospectus.ⁿ¹⁹⁸

If the securities are registered by coordinationⁿ¹⁹⁹ or qualificationⁿ²⁰⁰ in Wisconsin, or are eligible for a non-issuer transaction exemption by virtue of the fact that they are registered under the Securities Act of 1933, or are securities exempted in non-issuer transactions pursuant to documents filed with the securities administrator, the issuer's failure to provide adequate facilities for transferring the securities either directly or through a transfer agent is deemed a "device, scheme or artifice to defraud the purchaser."ⁿ²⁰¹

States have addressed particular corporate acts or transactions in terms of antifraud prohibitions. A reverse stock split by a publicly held corporation seeking to go private, for example, can be unfair to stockholders. To control the possible damage to security holders, Wisconsin has promulgated a regulation which makes issuers seeking to repurchase their own equity securities meet fairly stringent standards if the result or intended result of the repurchase plan is to:

- (1) cause the securities to be delisted from a national securities exchange or the Nasdaq Stock Market;
- (2) cause the securities to be eligible for registration termination or cessation of reporting requirements under the Securities Exchange Act of 1934; or
- (3) cause the securities to be no longer registered under the Wisconsin Blue Sky law.ⁿ²⁰²

The regulation is aimed at issuers who have, or have had, a class of equity securities registered under the Wisconsin Blue Sky law or Section 12 of the Securities Exchange Act of 1934, when one hundred or more record holders of such securities reside in Wisconsin, and such one hundred shareholders are equivalent to twenty per cent or more of the total number of shareholders of the same class of the issuer.ⁿ²⁰³ Issuers meeting this description who, through themselves or their affiliates,ⁿ²⁰⁴ are purchasing their securities for the purpose of "going private," must meet certain tests laid down by the securities administrator.

Basically, these tests require that the transactions be fair to the entire class of the security holders,ⁿ²⁰⁵ and contain the stipulation that security holders not affiliated with the issuer be treated not less favorably than those who are affiliated. Subject to notice requirements to shareholders and the securities administrators, going private transactions will be permitted if not disallowed by the administrator as fraudulent.

The Wisconsin approach to antifraud regulation in this area is not precisely aimed at issuers, but rather is directed to persons distributing, as a stock dividend, securities of another issuer. Unless the securities are registered under the Wisconsin Securities Law or the Securities Act of 1933, it is deemed a "device, scheme or artifice to defraud" the purchasers of the securities in broker-dealer transactions if the issuer of the distributed securities was organized, or the securities were acquired, by the distributor or controlling person thereof, strictly for the purpose of distribution or in connection with such a distribution.ⁿ²⁰⁶ It is equally fraudulent if the securities distributed as the stock dividend are of an issuer which has nominal assets or income at the time of the distribution.ⁿ²⁰⁷ In either case, the distribution is fraudulent only if the distributor has reason to believe that the distributed securities will be followed by transactions in

such securities that are executed through broker-dealers. The obvious purpose of this regulation is to prevent unregistered securities given as a stock dividend from being offered to the public.

The states' ability, and flexibility, in defining acts and practices of issuers and intermediaries as fraudulent or deceptive for purposes of antifraud prohibitions are well illustrated in these examples of Wisconsin provisions. Antifraud protections under state securities laws have always been more directed at acts and practices than the content of disclosure documents or the dissemination of information generally. That, of course, is the essence of "merit" regulation of securities offerings which historically characterized state regulation of issuers in the distribution of securities, and which is thoroughly considered elsewhere in this treatise.ⁿ²⁰⁸ Broad approaches to defining fraud or fraudulent acts and practices as applicable to issuers produced tension in increasingly national and global financial markets, and ultimately led to the enactment of the National Securities Market Improvements Act (NSMIA), by which some aspects of state investor protection authority were preempted. The particular impact of NSMIA on state antifraud authority is discussed later in this chapter.ⁿ²⁰⁹ It remains certain, however, that "fraud" under state Blue Sky laws is still an expansive concept by which states, consistent with constitutional and jurisdictional limits, address the conduct and affairs of issuers and intermediaries.

[d] Senior-Specific Acts and Practices

Ongoing efforts by state regulators have been aimed at expanding protections under Blue Sky laws in order to protect seniors from investment fraud. As the population ages, seniors have increasingly been the targets of investment-related fraud and abuse. Among state securities regulators, regulatory initiatives aimed at specific acts and practices targeting seniors include the use of senior-specific professional designations, which create an impression that the salesperson has special qualifications or education in providing financial planning and other financial services to senior investors. Regulators have also placed special emphasis on sales of annuity contracts to seniors, and suitability considerations in particular. Legislation in Florida and Texas is indicative of the national trend to bring new discipline to the offer and sale of these products. All of these initiatives are discussed further below.

[i] Senior Certifications and Professional Designations

In March 2008, the North American Securities Administrators Association (NASAA) adopted its *Model Rule on the Use of Senior-Specific Certifications and Professional Designations*.ⁿ²¹⁰ The Model Rule prohibits the misleading use by any person of senior and retiree designations, while also providing a means by which state regulators may recognize the use of certain designations that have actually been accredited. Specifically, under the Model Rule, the use of a senior-specific certification or designation in connection with the offer or sale of securities, or in advising as to the purchase or sale of securities that indicates or implies that the user has special certification or training in advising or servicing senior citizens or retirees, in such a way that misleads any person. Among specific certifications or professional designations, the Model Act prohibits:

- Use of a certification or professional designation by a person who has not actually earned or is otherwise ineligible to use such certification or designation;
- Use of a nonexistent or self-conferred certification or professional designation; and
- Use of a certification or professional designation that indicates or implies a level of occupational qualifications obtained through education, training, or experience that the person using the certification or professional designation does not have.ⁿ²¹¹

The Model Rule also prohibits the use of any certification or professional designation that was obtained from a designating or certifying organization that fails to meet certain standards. For example, an organization that does not have "reasonable standards or procedures for assuring the competency of its designees or certificants" does not

qualify.ⁿ²¹² Also, there must be reasonable standards and procedures for monitoring and disciplining designees, and requiring their involvement in continuing education. The Model Rule does not, however, provide any specific guidance concerning the standards and procedure in each of these areas that may suffice. However, there is a rebuttable presumption in the Model Rule that a designating or certifying organization will not be disqualified when it has been accredited by:

- The American National Standards Institute; or
- The National Commission for Certifying Agencies; or
- An organization that is on the U.S. Department of Education list of "Accrediting Agencies Recognized for Title IV Purposes," and the designation or credential issued by it does not primarily apply to sales and/or marketing.ⁿ²¹³

The NASAA Model Rule is the basis for a senior-specific certifications and professional designations rule adopted in 2008 in Alabama, Virginia, and Washington. It is also the basis for senior-specific investor protection legislation enacted in 2008 in California and New Hampshire. Prior to the NASAA Model Rule, Massachusetts and Nebraska had adopted their own positions dealing with senior-specific certifications and designations.ⁿ²¹⁴ With the NASAA Model Rule now available as a straightforward approach to concerns over senior-specific designations and certifications, it is likely that it will be adopted by legislation or regulation in many more states.

[ii] Marketing and Suitability

State securities regulators, and indeed regulators generally, are aggressively pursuing what are considered to be abusive sales and marketing practices targeting seniors. The concern is fueled by demographics, and the fact that the number of Americans who are at or nearing retirement age is growing at an unprecedented pace. U.S. Census data indicate that the population aged 65 years and older is expected to double over the next 25 years, and that by 2030 nearly one out of every five Americans will be 65 years old or older. The data also indicate that those who are 85 years old and older are the fastest growing segment of the U.S. population.ⁿ²¹⁵ It is also the case that fewer and fewer retirees can rely on traditional company pension plans to provide for a meaningful portion of their retirement needs.

For senior investors, securities regulators place most of their focus on investor suitability. For example, FINRA--the Financial Industry Regulatory Authority--cautioned its member firms:

As investors age, their investment time horizons, goals, risk tolerance and tax status may change. Liquidity often takes on added importance. And, depending on their particular circumstances, seniors and retirees may have less tolerance for certain types of risk than other investors. For example, retirees living solely on fixed incomes may be more vulnerable to inflation risk than those still in the workforce, depending on the number of years those retirees are likely to rely on fixed incomes. Likewise, investors whose investment time horizons afford less time or opportunity to recover investment losses may be disproportionately affected by market fluctuations.ⁿ²¹⁶

A point underscored by FINRA is that these investors must fully understand the products recommended to them, and they must be given a fair and balanced picture of the risks, costs, and benefits associated with the product transactions that are recommended to them.ⁿ²¹⁷ Particular recommendations to seniors targeted by FINRA examiners are:

- Products that have withdrawal penalties or otherwise lack liquidity, such as deferred variable annuities, equity indexed annuities, some real estate investments, and limited partnerships;
- Variable life settlements;

- Complex structured products, such as collateralized debt obligations (CDOs);
- Mortgaging home equity for investment purposes; and
- Using retirement savings, including early withdrawals from IRAs, to invest in high risk investments.ⁿ²¹⁸

The particular focus on suitability of investment recommendations to seniors has increasingly been on the sale of annuity products, which involve high commissions that may drive sales rather than investor suitability. Particular suitability concerns for annuities include switching, in which a salesperson switches the customer's annuity, receives another commission, and may cause the customer to pay early liquidation penalties. Another suitability concern involves placing annuities in tax-deferred accounts such as individual retirement accounts. Other suitability concerns involve carrying costs, holding periods, and allocations in variable annuity sub-accounts.

In 2007, Texas enacted legislation requiring the application of suitability requirements to all individually recommended annuity sales, and which requires specific disclosures in annuity sales. Section 1115.051 of the Texas Insurance Codeⁿ²¹⁹ provides, among other things, that before the execution of a purchase or exchange of an annuity resulting from a recommendation, and agent, or the insurer if an agent is not involved, must make reasonable efforts to obtain information from the consumer as to financial status, tax status, and investment objectives, along with such other relevant information used or considered to be reasonable in making the recommendation.ⁿ²²⁰ This requirement applies to any recommendation to purchase or exchange an annuity made to a consumer by an agent or insurer, and which results in the recommended purchase or exchange of the annuity. In addition, in making a recommendation the agent or insurer must have reasonable grounds for believing the recommendation is suitable based on facts disclosed by the consumer regarding investments and other insurance products, and financial situation and needs.ⁿ²²¹

By the same legislative initiative, Texas also established disclosure and acknowledgment requirements applicable to the sale of annuity contracts as well as all insurance products. Under these provisions, if a prospective purchaser has existing policies or contracts, the agent must present the applicant with a required notice approved by the Insurance Commissioner that lists all the life insurance policies and annuities the applicant proposes replacing, the name of the insured or annuitant, and whether that policy will be used as a financing source for the new policy or annuity contract. The applicant and agent both must sign the notice and attest that the notice was read aloud to the applicant or the applicant waived reading. The notice must be left with the applicant. If the notice is presented to the applicant via the Internet, the insurer must mail the applicant a copy of the notice within three business days of receiving the application. The agent must also leave with the applicant all sales materials used in presenting the new life insurance policy or annuity.ⁿ²²²

At the national level, FINRA adopted a specific variable annuity sales rule, which became effective in May 2008. FINRA Conduct Rule 2821ⁿ²²³ creates recommendation requirements (including a suitability obligation), principal review and approval requirements, and supervisory and training requirements tailored specifically to transactions in deferred variable annuities. The FINRA rule requires that a registered representative have a reasonable basis to believe that the customer would benefit from certain features of deferred variable annuities, such as tax-deferred growth, annuitization, or a death or living benefit. Representatives also must have a reasonable basis to believe that the customer has been informed, in general terms, of the material features of a deferred variable annuity, such as potential surrender period and surrender charge, potential tax penalty mortality and expense fees, charges for and features of enhanced riders, insurance and investment components, and market risk.

In its legislation addressing suitability in the sale of annuities, Texas expressly provided that compliance with the FINRA conduct rules relating to suitability will satisfy the requirements applicable to recommendations of variable annuities in that state.ⁿ²²⁴ This approach is likely to be followed in other states.

Focusing more generally on senior-specific concerns, in May 2006, the SEC and the North American Securities Administrators Association (NASAA) announced a coordinated national initiative designed to protect seniors from investment fraud and sales of unsuitable securities. The combined initiative includes three components: active investor education and outreach to seniors and those nearing retirement age; targeted examinations to detect abusive sales tactics aimed at seniors; and aggressive enforcement of securities laws in cases of fraud against seniors. An early coordinated initiative involved examinations of broker-dealers, investment advisers and other financial services firms that offer so-called "free lunch" sales seminars. These seminars are widely offered by financial services firms seeking to sell financial products, and they often include a free meal for attendees. The purpose of the examinations was to review firms that offer sales seminars targeted to seniors and retirees for compliance with securities laws and rules designed to protect investors

The combined regulatory examinations uncovered a number of major concerns leading to the conclusions that firms should redouble efforts to ensure that the investment recommendations they make to seniors are suitable in light of the particular customer's investment objectives. They were particularly concerned that senior investors should understand that these are *sales* seminars--that is, they are intended to result in the sales of financial products, and they may be sponsored by an undisclosed company with a financial interest in product sales. As a result of the examinations carried out primarily by state securities regulators, a significant number of firms received deficiency letters or letters of caution that outlined apparent rule violations and deficiencies and requested that the firms examined take corrective actions. A report issued based on these examinations²²⁵ includes a list of supervisory practices that were identified during examinations and that appeared to be effective, and which will assist firms going forward, but it also made clear that regulators participating in these examinations will continue to focus examination, enforcement, and regulatory efforts on the use of sales seminars targeted to seniors.

[4] Other Specific Prohibitions

With the focus on fraudulent and abusive practices that operate in a manner tantamount to fraud from the perspective of investors who are the intended beneficiaries of Blue Sky Law protections, there are certain other acts and conduct that have been addressed either directly as prohibited conduct or indirectly as fraudulent under Blue Sky laws. Securities market manipulation and insider trading, for example, have developed as a matter of federal securities law, and may not immediately be seen as falling within the ambit of Blue Sky laws that are primarily directed at the offer and sale of securities in the distribution setting. On the other hand, to the extent that such conduct is carried out so as to be directly connected to securities transactions of others who are defrauded in terms of the value of what they buy or sell; or where there is a cognizable legal duty owed to market participants, such conduct may fall within general antifraud provisions in Blue Sky laws or, as seen below, may be addressed more specifically.

[a] Market Manipulation

Although the original Uniform Act does not specifically prohibit it, the practice of market manipulation is deemed fraudulent and unlawful in a number of states. In New Hampshire, for example:

It is unlawful for any person to effect any transaction in, or to induce the purchase or sale of any security by means of any manipulative, deceptive, or otherwise fraudulent device or contrivance, including any fictitious quotation. The terms "manipulative, deceptive, or otherwise fraudulent device or contrivance" shall include, but shall not be limited to, the following practices:

I. Effecting any transaction in a security which involves no change in the beneficial ownership thereof, or entering any order or orders for the purchase or sale of any security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the sale or purchase of the security, have been or will be entered by or for the same or affiliated persons, for the purpose of creating a false or misleading appearance of active trading in the

security or a false or misleading appearance with respect to the market for the security;

II. Effecting, alone or with one or more other persons, a series of transactions in any security creating actual or apparent active trading in the security or raising or depressing the price of the security for the purpose of inducing the purchase or sale of the security by others; or

III. Inducing the purchase or sale of any security by the circulation or dissemination of information to the effect that the price of the security will or is likely to rise or fall because or [sic] market operations of any one or more persons conducted for the purpose of raising or depressing the price of the security, if he is selling or offering to sell, or purchasing or offering to purchase the security or is receiving a consideration directly or indirectly, from any such person.ⁿ²²⁶

The Revised Uniform Act does expressly prohibit market manipulation.ⁿ²²⁷ A specific provision addressing market manipulation was not, however, carried into the 2002 Uniform Act. The drafters of the 2002 Uniform Act were satisfied that the general antifraud provision in section 501 of the Act, like SEC *Rule 10b-5* under the federal Securities Exchange Act, reaches market manipulation, and that there was no reason to include the Revised Uniform Act provision in the new Act.ⁿ²²⁸

As indicated, market manipulation involves conduct designed to create the appearance of an active market in particular securities for the purpose of inducing the purchase or sale of the securities by others.ⁿ²²⁹ Market manipulation can result in the rise or fall of the price of the securities, thereby inducing others to buy or sell the security. Such practices are prohibited when they are for purposes of creating a false or misleading appearance of active trading in any security or a false or misleading appearance with respect to the market for any security. Specific prohibited practices include security transactions where there is no change in beneficial ownership ("wash sales"), and the placing of orders for the purchase or sale of securities with the knowledge that an opposite order at approximately the same time and same price will be placed by the same or affiliated persons ("matched orders"). California addresses such conduct explicitly by making it unlawful for any person, directly or indirectly, in the state:

(a) For the Purpose of creating a false or misleading appearance of active trading in any security or a false or misleading appearance with respect to the market for any security, (1) to effect any transaction in a security which involves no change in the beneficial ownership thereof, or (2) to enter an order or orders for the purchase of any security with the knowledge that an order or orders of substantially the same size, at substantially the same time and at substantially the same price, for the sale of any such security, has been or will be entered by or for the same or different parties, or (3) to enter an order or orders for the sale of any security with the knowledge that an order or orders of substantially the same size, at substantially the same time and at substantially the same price, for the purchase of any such security, has been entered or will be entered by or for the same or different parties.

(b) To effect, alone or with one or more persons, a series of transactions in any security creating actual or apparent active trading in such security or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.ⁿ²³⁰

Market manipulative acts and conduct need not fit within one of the specific categories identified in statutes. Some states effectively address market manipulation in terms of fictitious or pretended purchases or sales of securities in general antifraud provisions.ⁿ²³¹

"Touting" is another form of market manipulation and is addressed as actionable fraud under general antifraud provisions since it involves dissemination of false or misleading information.

Some of the more elaborate statutes also make it unlawful to tout a market manipulation, that is to say it is unlawful for a person who has knowledge of a market manipulation to induce others to buy or sell a security by informing them that

the price is likely to rise or fall because of the manipulation.ⁿ²³² However, in New Hampshire the circulation or dissemination of such information is unlawful only when the person making the inducement "is selling or offering to sell or purchasing or offering to purchase the security or is receiving a consideration, directly or indirectly, from any such person." So called pump-and-dump schemes also fall within the ambit of market manipulation. In these schemes false or misleading information is disseminated to the marketplace with the intention of causing the market price to rise, or be driven down, to an artificial level, at which time the perpetrators "dump" their shares in the marketplace and realize substantial gains on holdings or short positions while other holders suffer as the share price drops to reflect true value. Pump-and-dump schemes may also be executed using other manipulative activities in combination with the dissemination of false or misleading information.ⁿ²³³

Virtually every manipulation case involves an antifraud violation. Seldom do the persons engaged in the manipulation disclose the existence of their scheme. As a practical matter, however, few state regulatory agencies possess sufficient investigative and prosecutorial resources to undertake market manipulation cases. These cases are left to the Securities and Exchange Commission for handling under the provisions of the Securities Exchange Act of 1934. In a few instances the state securities regulators have attempted, through the North American Securities Administrators Association and a liberal interpretation of section 412(b) of the Uniform Act, to pool their resources for the purpose of reviewing the multi-state activities of selected broker-dealers. The results of these joint state investigative efforts have not proven entirely successful, and some joint efforts have actually led to orders limiting state securities regulatory agencies' ability to share information.ⁿ²³⁴ The newly aggressive state and multi-state efforts directed at the integrity of securities markets and market-related conduct in general, as well evidenced by the 2003 global settlement of market analyst issues, in which New York and other state regulators played the prominent role, indicates, however, that joint, market-directed efforts can, and will, result in significantly broader applications of market-related antifraud provisions in state Blue Sky laws.

[b] Insider Trading

California,ⁿ²³⁵ New Mexico,ⁿ²³⁶ and Pennsylvanianⁿ²³⁷ have statutory sanctions against insider trading. Others address it under general antifraud provisions. By rule in Minnesota, for example, it is a "fraudulent or deceptive device or contrivance" for any person to:

[U]se information about an issuer, learned from the issuer's officers, directors, or key employees, which is not generally available to the public and which would significantly affect the market price of the issuer's securities for personal benefit, directly or indirectly, in the offer, sale or purchase of the issuer's securities.ⁿ²³⁸

All of these provisions prohibit insider trading by officers, directors, and other persons having a relationship with the issuer through which inside material information may be obtained. As to what constitutes inside information, this too is spelled out in the statutes. It must have the potential to significantly affect the market or the security price; and it must be known by the insider to be generally unavailable to the public. However, there is no prohibition against trading with a person who is reasonably believed to be in possession of the same information.

Although the Uniform Act does not contain a provision specifically prohibiting insider trading, it should be noted that the Act's general antifraud provision is substantially the same as *Rule 10b-5*, the general antifraud rule under section 10(b) of the Securities Exchange Act of 1934.ⁿ²³⁹ *Rule 10b-5* has been broadly interpreted as being an impediment against the use of inside information in a variety of situations involving the sale or purchase of securities.ⁿ²⁴⁰ For example, it has been interpreted to prohibit the use of inside information by majority shareholders to the detriment of minority stockholders,ⁿ²⁴¹ a particular viewpoint adopted by the courts of one state as being a valid interpretation of the enacted Uniform Act antifraud provision.ⁿ²⁴²

[c] False or Misleading Statements In Filed Documents

Two states explicitly deem it a fraudulent practice to file documents with the state securities administrator containing false or misleading statements.ⁿ²⁴³ Under the Uniform Act:

It is unlawful for any person to make or cause to be made, in any document filed with the Administrator or in any proceeding under this act, any statement which is, at the time and in the light of the circumstances under which it is made, false or misleading in any material respect.ⁿ²⁴⁴

In states that have substantially enacted this recommended provisionⁿ²⁴⁵ such acts are unlawful without necessarily being fraudulent. The same is true in a number of states that have enacted variations of the Uniform Act provision.ⁿ²⁴⁶ As a practical matter, whether such acts are declared fraudulent or unlawful, or whether the provision adopted is the Uniform Act's or some derivation thereof, the effect of these statutes is the same.

[d] Fraudulent Misrepresentation Regarding Registration or Exemption

A final example of a specific act involving fraudulent acts or omissions being deemed unlawful is the Uniform Act prohibition against fraudulent representations concerning the registration of securities.ⁿ²⁴⁷ Substantially enacted in most states, this provision prohibits a person from representing that the securities administrator has passed upon the merits of the securities offered for sale when the only basis for such a representation is the fact that the security has been registered or is subject to an exemption.ⁿ²⁴⁸ A representation by a seller of securities that registration of the offered securities is not required when no exemption from registration is available or that the offered securities have been registered when they have not, may result in seller liability under the antifraud provisions of the Uniform Act.

FOOTNOTES:

(n1)Footnote 1. *Fla. Stat. § 517.301(1)(b)*.

(n2)Footnote 2. *Fla. Stat. § 517.301(1)(c)*.

(n3)Footnote 3. *N.Y. Gen. Bus. Law 352-c(1)(a), (c)*.

(n4)Footnote 4. *Cal. Corp. Code §§ 25400(d)*.

(n5)Footnote 5. 2002 Unif. Sec. Act § 502(a).

(n6)Footnote 6. *See, e.g., Ohio Rev. Code § 1707.44* (listing numerous "violations" without regard to conduct involving fraud or deceit).

(n7)Footnote 7. *See* Draftsmen's Commentary to Unif. Sec. Act § 401(d):

[I]n a statute which has well-developed provisions on registration of broker-dealers and securities, it is both artificial and pointless to say that every violation is also a "fraud." Something does not have to be fraudulent to be unlawful, and calling conduct "fraudulent" does not make it any more unlawful.

Rev. Unif. Sec. Act § 501 simply states: "a person may not ..." engage in the listed acts.

(n8)Footnote 8. *Bowden v. Robinson*, 67 Cal. App. 3d 705, 711, 136 Cal. Rptr. 871 (Ct. App., 4th Dist., 1977) ; *Gormly v. Dickenson*, 178 Cal. App. 2d 92, 2 Cal. Rptr. 650, 658 (1960) .

(n9)Footnote 9. *N.Y. Gen. Bus. Law. § 352*.

See also *People v. Florentino*, 456 N.Y.S.2d 638, 641 (N.Y. City Crim. Ct. 1982) . In the first application of the

criminal sanctions of New York's Martin Act to insider trading, the Criminal Court of the City of New York held that Section 352(c) was applicable to a lawyer who, in breaching his fiduciary obligation, used confidential information about pending corporate takeovers to trade in shares of:

- (1) clients of his law firm,
- (2) targets his law firm's clients intended to acquire, and
- (3) an issuer in which a client of his law firm intended to liquidate its substantial investment.

The court held that Section 352(c) applied to insider trading and that criminal enforcement of this provision does not require a finding of privity between the buyers and sellers of securities. The court, in dicta, stated that proof of intentional or knowledgeable conduct on the part of the defendant rather than scienter is the standard of proof that would be required. *See also People v. Lurie*, 249 A.D.2d 119, 673 N.Y.S.2d 60, 1998 N.Y. App. Div. LEXIS 4314 (N.Y. App. Div. 1st Dep't 1998) , *appeal denied*, 92 N.Y.2d 893, 92 N.Y.2d 900, 680 N.Y.S.2d 57, 680 N.Y.S.2d 64, 702 N.E.2d 849, 702 N.E.2d 842, 1998 N.Y. LEXIS 3468 (1998) , *affirmed in part and reversed in part, on other grounds*, *Lurie v. Wittner*, 228 F.3d 113, 2000 U.S. App. LEXIS 23792 (2d Cir. 2000) (sponsor, manager and majority shareholder of five cooperative apartment buildings convicted under Martin Act, N.Y. Gen. Bus. Law art. 23-A, § 352 *et seq.*, requiring sponsors of real estate syndication offerings to file offering statement with Department of Law detailing the terms of transaction as will afford potential investors an adequate basis upon which to found their judgment and shall not omit any material fact or contain any untrue statement of a material fact).

(n10)Footnote 10. Some of these states in fact have enacted the Uniform Act section verbatim and have then embellished these provisions with other "unlawful" acts, *see, e.g., Fla. Stat. § 517.301*; Ill. Comp. Stat. ch. 815, § 5/12(F), (I); 70 Pa. Cons. Stat. § 1-402 & 1-403.

(n11)Footnote 11. *Buffo v. State*, 415 So. 2d 1158, 1165 (Ala. 1982) .

See also Greenhill v. State, 199 Ga. App. 218, 404 S.E.2d 577, 1991 Ga. App. LEXIS 469 [1991-1993 Transfer Binder], Blue Sky L. Rep. (CCH) P 73,566 (Ga. App.), *cert. denied*, (Ga. Sup. Ct. 1991) (prosecution did not abate with repeal and reenactment of securities fraud statute without saving clause because new statute, which provided nearly verbatim as old statute, continued criminalization of defendant's conduct).

(n12)Footnote 12. *See Mannos v. Moss*, 155 P.3d 1166, 2007 Ida. LEXIS 44 (Idaho 2007) . In *Mannos* the Idaho Supreme Court reviewed the dismissal of claims under the general antifraud provision of the Idaho Securities Act. (Idaho has enacted the 2002 Uniform Securities Act.) Those claims had been dismissed on the identical grounds as had been applied to dismiss common law fraud claims. The Supreme Court concluded that dismissal of the common law fraud claim was inappropriate in light of certain fact discrepancies that should have been considered in the trial court. The same rationale was adopted and applied by the Court to vacate the dismissal of the Idaho Securities Act claim, with the Court noting that the same reasons would apply to either claim.

(n13)Footnote 13. *See, e.g., Commodity Futures Trading Com'n v. American Metals*, 775 F. Supp. 767, 784 (D.N.J. 1991) , *modified*, 991 F.2d 71 (3d Cir. 1993) ; *Rosenthal v. Dean Witter Reynolds, Inc.*, 908 P.2d 1095, 1995 Colo. LEXIS 763 , Blue Sky L. Rep. (CCH) P 74,087 (Colo. 1995). *Buffo v. State*, *supra* at 1162-1165 ; *Lynch v. Cook*, 148 Cal. App. 3d 1072, 196 Cal. Rptr. 544, 1983 Cal. App. LEXIS 2384 , [1982-1984 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,904 at 70,276 (Cal. Ct. App. 1983).

(n14)Footnote 14. *People v. Royal Securities Corporation*, 5 Misc. 2d 907, 165 N.Y.S.2d 945 (1955) ; *see also In re Howard Perloff*, Blue Sky L. Rep. (CCH) P 74,104 (Pa. Adm. Proc., 5-30-96).

(n15)Footnote 15. Unif. Sec. Act § 101(2).

(n16)Footnote 16. *Buffo v. State*, 415 So. 2d 1158 (Ala. 1982) ; In the Matter of Rickie Owen Troxel, Blue Sky L. Rep. (CCH) P 74,192 (Ariz. Corp. Comm., Aug. 27, 1999).

Cf. *People v. Simon*, 9 Cal. 4th 493, 37 Cal. Rptr. 2d 278, 886 P.2d 1271, 1995 Cal. LEXIS 6 , Blue Sky L. Rep. (CCH) P 74,010 (1995) (statute prohibiting fraudulent sale of securities modeled on federal scheme required proof of scienter, overruling *People v. Johnson*, 213 Cal.App.3d 1369 (1989) , and progeny to extent inconsistent in making offense one of strict liability).

(n17)Footnote 17. Uniform Securities Act. § 410(a)(2); *see also* Rev. Unif. Sec. Act § 605, which is substantially similar to §§ 410(a) and (b) of the 1956 Act.

(n18)Footnote 18. *See, e.g., Conn. Gen. Stat. § 36b-29(a)(2); Mass. Gen. L. ch. 110A, § 410(a)(2); N.J. Stat. Ann. § 49:3-71(a)(2); 70 Pa. Cons. Stat. § 1-501(a)(ii).*

Similar requirements concerning proof in civil actions are contained in the statutes of a handful of other states, although there is some variance in the wording and format of the statutes, *see, e.g., Fla. Stat. §§ 517.211, 517.301*; Ill. Comp. Stat. ch. 815, § 5/12(G), dropping the shifting burden of proof language; *Tex. Rev. Civ. Stat. Ann. art. 581-33(A)(2).*

(n19)Footnote 19. *Bogges v. Commonwealth*, 447 S.W.2d 88, 92 (Ky. Ct. App. 1969) .

See also Rousseff v. E.F. Hutton Co., Inc., 843 F.2d 1326, 1331 (11th Cir. 1988) , *answered*, 537 So. 2d 978 (Fla. 1989) , *answer conf.*, 867 F.2d 1281 (11th Cir. 1989) (nondisclosure of unfavorable projection of natural gas reserves); *Hatrock v. Edward D. Jones & Co.*, 750 F.2d 767, 1984 U.S. App. LEXIS 15576 , [1984-1985 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,170 (9th Cir. 1985) (representation of rumor as verified fact was a misrepresentation of a material fact); *Carl v. Galuska*, 785 F. Supp. 1283, 1992 U.S. Dist. LEXIS 1168 , [1991-1993 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,652 (N.D. Ill. 1992) (failure to disclose perilous financial condition of a utility company); *Baker v. Conlan*, 585 N.E.2d 543 (Ohio Ct. App. 1990) , *dism.* 558 N.E.2d 57 (Ohio 1990) (nondisclosure of stud fee liens on mare intended to be purchased thorough sale of limited partnership interests for purposes of breeding and sale of subsequent offspring); 89 Or. App. 236, 748 P.2d 551, 1988 Ore. App. LEXIS 53 , *Wicks v. O'Connell*, [1987-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,712 (Or. Ct. App. 1988) (nondisclosure of insolvent condition of corporation); *Jenkins v. Jacobs*, 748 P.2d 1318, 1987 Colo. App. LEXIS 868 , [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,644 (Colo. Ct. App. 1987) (failure to disclose the deduction of a commission that amounted to one-third of profits).

(n20)Footnote 20. *See, e.g., Lucas v. Downtown Greenville Investors Ltd. Pshp.*, 284 Ill. App. 3d 37, 219 Ill. Dec. 475, 671 N.E.2d 389, 1996 Ill. App. LEXIS 764 , Blue Sky L. Rep. (CCH) P 74,139 (Ill. App. Ct. 2d Dist. 1996); *Hubbard v. Hibbard Brown & Co.*, 633 A.2d 345, 349 (Del. 1993) .

(n21)Footnote 21. *Kaas v. Privette*, 12 Wash. App. 142, 529 P.2d 23, 28-29 (1974) .

(n22)Footnote 22. *Benolkin v. Guthrie*, 87 N.W. 466, 467 (Wis. 1901) .

See also Boam v. Trident Fin. Corp., 6 Cal. App. 4th 738, 8 Cal. Rptr. 2d 177, 1992 Cal. App. LEXIS 628 , [1991-1993 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,636 (Cal. Ct. App. 1992) (failure to disclose degree of disrepair of building and misrepresentation of the financial condition of partnership); In the Matter of Tristar Corp., Blue Sky L. Rep. (CCH), P 73,868 (S.C. Admin. Pro. 1993) (failure to disclose dependence on corporation's supplier who owned majority share of company's common stock and affirmative misrepresentation as to company's fiscal earnings violate state antifraud provisions).

(n23)Footnote 23. Uniform Securities Act §§ 101(2), 410(a)(2).

(n24)Footnote 24. See Draftsmen's commentary to Uniform Securities Act § 101; *Ollerman v. O'Rourke Co.*, 288 N.W.2d 95, 102 (Wis. 1980); *American General Insurance Co. v. Equitable General Corp.*, 493 F. Supp. 721, 744 (E.D. Va. 1980) .

(n25)Footnote 25. *Butterworth v. Quick & Reilly*, Blue Sky L. Rep. (CCH) P 74,174 (D.C. Fla. 1998) (broker failure to notify of address change not material omission).

But see Trimble v. American Sav. Life Ins. Co., 733 P.2d 1131, 1136 (Ariz. Ct. App. 1986) (company selling securities has affirmative duty not to mislead potential investors).

(n26)Footnote 26. *Sibley v. Horn Advertising, Inc.*, 505 S.W.2d 417, 421 (Tex. Civ. App. 1974) , cert. denied, 420 U.S. 929 (1975) .

(n27)Footnote 27. *Connelly v. Balkwill*, 174 F. Supp. 49, 58 (N.D. Ohio 1959) , aff'd, 279 F.2d 685 (6th Cir. 1960) ; see also *Lucas v. Downtown Greenville Investors Ltd. Pshp.*, 284 Ill. App. 3d 37, 219 Ill. Dec. 475, 671 N.E.2d 389, 1996 Ill. App. LEXIS 764 , Blue Sky L. Rep. (CCH) P 74,139 (Ill. App. Ct. 2d Dist. 1996); *Webb v. First Michigan Corp.*, [1991-1993 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,673 (Mich. Ct. App. 1992) (full disclosure in prospectus of investment risks and financial hazards involved in the offering precluded recovery by investors who claimed they were fraudulently induced into investing in an oil and gas fund).

(n28)Footnote 28. *Kaas v. Privette*, 12 Wash. App. 142, 529 P.2d 23, 27(1974) :

Silence is not fraud when the purchaser is on equal footing with the seller in the opportunity to be aware of the material aspects of the subject matter of the sale... . The rule has been that silence as to a material fact does not constitute fraud where there was no duty to disclose ... but that once a duty to speak is found, a vendor's suppression of a material fact is tantamount to an affirmative misrepresentation.

(n29)Footnote 29. *Sharp v. Coopers & Lybrand*, 83 F.R.D. 343, 346 (E.D. Pa. 1979) , aff'd, 649 F.2d 175 (3d Cir. 1981) ; see also *Sano v. Bjelland*, 796 P.2d 1240 (Or. Ct. App. 1990) (silence can be a form of misrepresentation).

(n30)Footnote 30. *Strom v. Black*, 22 Ariz. App. 102, 523 P.2d 1339, 1341 (1974) .

(n31)Footnote 31. *State v. Martin*, 85 S.D. 587, 187 N.W.2d 576, 578 (1971) .

(n32)Footnote 32. *Wilson v. Southward Investment Co.*, 675 S.W.2d 10 (Ky. Ct. App. 1984) ; *Upton v. Trinidad Petroleum Corp.*, 468 F. Supp. 330 (N.D. Ala. 1979) , aff'd, 652 F.2d 424 (5th Cir. 1981) .

(n33)Footnote 33. *Anvil Investment Ltd. v. Thornhill Condominiums, Ltd.*, 407 N.E.2d 645 (Ill. App. Ct. 1980) .

(n34)Footnote 34. *SEC v. Carriba Air, Inc.*, 681 F.2d 1318, 1323 (11th Cir. 1982) .

(n35)Footnote 35. *Prince v. Heritage Oil Co.*, 311 N.W.2d 741 (Mich. Ct. App. 1981) .

See also *Kennedy v. Tallant*, 710 F.2d 711, 719 (11th Cir. 1983) ; *Mueller v. Sullivan*, 141 F.3d 1232, 1998 U.S. App. LEXIS 7825 , Blue Sky L. Rep. (CCH) P 74,161 (7th Cir. 1998) (failure to disclose seller company's debt, cash flow problems and unprofitability material omission); *Hines v. Data Line Sys.*, 787 P.2d 8, 16 (Wash. 1990) (failure to disclose failing health of chief executive officer); *Aspelund v. Olerich*, 784 P.2d 179 (Wash. Ct. App. 1990) (failure to disclose cancellation of account constituting 10% of gross revenue and probation by another customer constituting 50% of revenues).

(n36)Footnote 36. *See, e.g., Wiley v. Hughes Capital Corp.*, 746 F. Supp. 1264, 1301 (D.N.J. 1990) (New Jersey law); *Towne v. Friedman*, 207 Cal. App. 2d 205, 24 Cal. Rptr. 400, 404 (1962) .

(n37)Footnote 37. *Norville v. Alton Bigtop Restaurant, Inc.*, 317 N.E.2d 384, 389 (1974) .

See also Peterson v. Baloun, 715 F. Supp. 212, 216 (N.D. Ill. 1989) (puffing is actionable under Illinois law), *citing Alton Bigtop Restaurant, Inc., supra*).

But see Howard v. Haddad, 962 F.2d 328, 331 (4th Cir. 1992) (puffery including statement by golfing buddy that bank was "good investment" lacked materiality under Virginia law).

(n38)Footnote 38. *Ind. Code* § 23-2-1-1(d).

(n39)Footnote 39. *N.J. Stat. Ann.* § 49:3-49(e)(2); *N.Y. Gen. Bus. Law* § 352-c(1)(b).

See also Private Securities Litigation Reform Act of 1995 ("PSLRA"), Pub. L. No. 104-67, 190 Stat. 737, providing a safe harbor for certain forward looking statements.

(n40)Footnote 40. *Guyann v. Shulters*, 223 Miss. 232, 78 So. 2d 114, 122-123 (1955) .

See also Allen v. Schauf, 202 Kan. 348, 449 P.2d 1010 (1960) , where the presentment to prospective investors of a proposed operational plan was said to be a hope of what was to be accomplished and not a representation of a material fact.

(n41)Footnote 41. *First Mobile Home Corporation v. Little*, 298 So. 2d 676, 679 (Miss. 1974) ; *see also Johnson v. Yerger*, 612 F.2d 953 (5th Cir. 1980) .

(n42)Footnote 42. 298 So. 2d at 681 .

(n43)Footnote 43. *Sparks v. State*, 256 So. 2d 537, 538 (Fla. Dist. Ct. App. 1972) ; *see also First Union Discount Brokerage Serv. v. Milos*, 997 F.2d 835, 844 (11th Cir. 1993) (under Florida law, false representation relating to future conduct only fraudulent if defendant made promise without intent to perform).

(n44)Footnote 44. *Norville v. Alton Bigtop Restaurant, Inc.*, 22 Ill. App. 3d 273, 317 N.E.2d 384, 390 (1974) ; *see also United States v. Hart*, Fed. Sec. L. Rep. (CCH) 91,647, 273 F.3d 363, 2001 U.S. App. LEXIS 25367 (3d Cir. 2001) (convictions for fraud based on cold calls by brokers to customers making baseless predictions of future growth).

(n45)Footnote 45. 317 N.E.2d 384 at 391 . ("While mere opinion or expression of the seller's views on a future situation is not actionable under the Act, an expression of opinion, which is coupled with other statements, may be a statement of material fact even if it is framed technically to be a mere opinion.").

(n46)Footnote 46. *See, e.g., Lane v. Midwest Bancshares Corporation*, 337 F. Supp. 1200, 1208 (E.D. Ark. 1972) , applying Arkansas law. ("A misstatement of fact or nondisclosure is considered to be material if it concerns something that a reasonable man would consider important in deciding what he should do in a particular transaction. The concept of materiality "encompasses those facts" which in reasonable or objective contemplation might affect the value of the corporation's stock or securities... ") (Citation omitted).

See also Lutheran Broth. v. Kidder Peabody & Co., Inc., 829 S.W.2d 300, 307 (Tex. Ct. App. 1992) , *vacated*, 840 S.W. 2d 384 (Tex. 1992) (without reference to merits) ("To be material, a misrepresentation must have influenced the buyer's action to the extent that the buyer would not have entered into the transaction had the representation not been made"); *Norville v. Alton Bigtop Restaurant, Inc.*, 22 Ill. App. 3d 273, 317 N.E.2d 384 (1974) ("A fact is material if its existence or nonexistence is a matter to which a reasonable man would attach importance in determining his choice of

action in the transaction in question, or the maker of the representation knows that its recipient is likely to regard the fact as important although a reasonable man would not so regard it.") (Citation omitted); *Lundin v. Shimanski*, 368 N.W.2d 676, 684 (Wis. 1985) (Statements of opinion are actionable as fraud if the speaker is aware of facts which are incompatible with his opinion); cf. *Nathenson v. Zonagen Inc.*, Fed. Sec. L. Rep. (CCH) 91, 548, 267 F.3d 400, 2001 U.S. App. LEXIS 20902 (5th Cir. 2001) (under federal scheme materiality element requires plaintiff to demonstrate how reasonable investor would have viewed defendants' statements and omissions).

(n47)Footnote 47. See, e.g., *Marx v. Computer Sciences Corp.*, 507 F.2d 485 (9th Cir. 1974) ; *SEC v. Haffenden-Rimar International, Inc.*, 362 F. Supp. 323, 327 (E.D. Va. 1973) , *aff'd*, 496 F.2d 1192 (4th Cir. 1974) .

(n48)Footnote 48. See, e.g., *United States v. Hart*, Fed. Sec. L. Rep. (CCH) 91,647, 273 F.3d 363, 2001 U.S. App. LEXIS 25367 (3d Cir. 2001); *Myzel v. Fields*, 386 F.2d 718, 734 n.8 (8th Cir. 1967) , *cert. denied*, 390 U.S. 951 (1968) ; *Green v. Jonhop, Inc.*, 358 F. Supp. 413, 418-19 (D. Or. 1973) .

See also *General Motors Acceptance Corp. v. Central National Bank of Mattoon*, 773 F.2d 771, 780 (7th Cir. 1985)

(n49)Footnote 49. See, e.g. *Kirkland v. E.F. Hutton & Co.*, 564 F. Supp. 427, 440 (E.D. Mich. 1983) .

(n50)Footnote 50. See, e.g., *Ponthier v. Manalla*, 951 So.2d 1242, 2007 La. App. LEXIS 114 (La. App. 5th Cir. 2007) (For the cause of action to arise, there must be a legal duty on the part of the defendant to supply correct information; there must be a breach of that duty, and the breach must have cause plaintiff damage).

(n51)Footnote 51. 2002 Unif. Sec. Act § 509(b) (emphasis added).

The 2002 Uniform Securities Act is now enacted in Missouri, Oklahoma, Idaho, South Dakota, Iowa, Kansas, the US Virgin Islands, South Carolina, Maine, Vermont, Minnesota. Hawaii and, most recently in 2007, Indiana.

(n52)Footnote 52. See, e.g., *Aspelund v. Olerich*, 784 P.2d 179 (Wash. Ct. App. 1990) ("facts to which a reasonable person would attach importance in determining his or her choice of action in the transaction... ."); see also *Lutheran Broth. v. Kidder Peabody & Co., Inc.*, 829 S.W.2d 300, 307 (Tex. Ct. App. 1992) , *vacated*, 840 S.W. 2d 384 (Tex. 1992) (without reference to merits) (buyer would not have entered into the transaction otherwise); *Trimble v. American Sav. Life Ins. Co.*, 733 P.2d 1131 (Ariz. Ct. App. 1986) (reasonable buyer standard); *Norville v. Alton Bigtop Restaurant, Inc.*, 22 Ill. App. 3d 273, 317 N.E.2d 384 (1974) ("A fact is material if its existence or nonexistence is a matter to which a reasonable man would attach important in determining his choice of action in the transaction in question, or the maker of the representation knows that its recipient is likely to regard the fact as important although a reasonable man would not so regard it." Citation omitted.).

(n53)Footnote 53. *Lane v. Midwest Bancshares Corporation*, 337 F. Supp. 1200, 1210 (E.D. Ark. 1972) , applying Arkansas law.

See also *Mueller v. Sullivan*, 141 F.3d 1232, 1998 U.S. App. LEXIS 7825 , Blue Sky L. Rep. (CCH) P 74,161 (7th Cir. 1998) (failure to disclose seller company's debt, cash flow problems and unprofitability material omission); *In re Columbus Skyline Sec.*, 660 N.E.2d 427, 1996 Ohio LEXIS 86 , Blue Sky L. Rep. (CCH) P 74,084 (Ohio 1996) (failure to disclose OTC market price of stock); *Hines v. Data Line Sys.*, 787 P.2d 8, 16 (Wash. 1990) (failure to disclose failing health of chief executive officer); *Aspelund v. Olerich*, 784 P.2d 179 (Wash. Ct. App. 1990) (failure to disclose cancellation of account constituting 10% of gross revenue and probation by another customer constituting 50% of revenues). *State v. Fashion Place Assoc.*, 224 A.D.2d 280, 638 N.Y.S.2d 26, 1996 N.Y. App. Div. LEXIS 1105 , Blue Sky L. Rep. (CCH) P 74,118 (N.Y. App. Div. 1996) (failure to disclose expiration date of tax benefits and pending waiver litigation in cooperative conversion).

(n54)Footnote 54. *Smith v. Manausa*, 385 F. Supp. 443, 449 (E.D. Ky. 1974) , modified on other grounds, 535 F.2d 353 (6th Cir. 1976) (applying Kentucky law).

(n55)Footnote 55. *Hidell v. International Diversified Investments*, 520 F.2d 529 (7th Cir. 1975) (applying Illinois law).

(n56)Footnote 56. *Shermer v. Baker*, 2 Wash. App. 845, 472 P.2d 589 (1970) .

(n57)Footnote 57. 223 Miss. 232, 78 So.2d 114 (1955) .

(n58)Footnote 58. 78 So. 2d. at 123-124 .

(n59)Footnote 59. *Epstein v. Washington Energy Co.*, 83 F.3d 1136, 1996 U.S. App. LEXIS 11214 , Blue Sky L. Rep. (CCH) P 74,091 (9th Cir. 1996) (utility failure to disclose prior denial of rate increase application not material misrepresentation); *Bramblewood Inv. Ltd. v. C & G Assoc.*, 619 A.2d 1332 (N.J. Super. Ct. Law Div. 1992) (no material misrepresentation regarding inflated values of real estate when investor admitted lack of knowledge of any misrepresentation at time of offering and received all relevant information before investing); *Sano v. Bjelland*, 796 P.2d 1240 (Or. Ct. App. 1990) (evidence not sufficient to support claim that defendants misrepresented loan was obtained rather than loan commitment only).

(n60)Footnote 60. *Clausing v. De Hart*, 83 Wash. 2d 70, 515 P.2d 982 (1973) .

(n61)Footnote 61. 515 P.2d at 985.

(n62)Footnote 62. *Neas v. Siemens*, 102 N.W.2d 259, 265 (Wis. 1960) .

(n63)Footnote 63. 426 U.S. 438, 96 S. Ct. 2126, 48 L. Ed 2d 757 (1976) .

(n64)Footnote 64. *U.S. v. Shindler*, 173 F. Supp. 393, 395 (S.D.N.Y. 1959) . Chief among these obviously material facts are prior securities convictions and injunctions.

(n65)Footnote 65. Unif. Sec. Act § 410(a)(2).

See also Official Code Comment to Rev. Unif. Sec. Act § 501, which notes that while the federal courts have articulated a variety of requirements necessary for recovery under *Rule 10b-5*, the Committee did not intend state courts to be bound with regard to some of the federal doctrines, such as the necessity of showing scienter, in order to state a cause of action under Rev. Unif. Sec. Act § 501.

(n66)Footnote 66. See *Hines v. Data Line Sys.*, 787 P.2d 8, 18 (Wash. 1990) (Affirmative defense to control person or director liability for person who did not know and in exercise of reasonable care could not have know of existence of untruth or omission did not relieve defendants of duty to investigate facts beyond actual knowledge; defense available only to extent defendants prove that even by exercise of reasonable care they would have remained ignorant).

(n67)Footnote 67. See, e.g., *Mueller v. Sullivan*, 141 F. 3d 1232, 1998 U.S. App. LEXIS 7825 , Blue Sky L. Rep. (CCH) P 74,161 (7th Cir. 1998); *Messer v. E.F. Hutton & Co.*, 833 F.2d 909, 920 (11th Cir. 1987) , amended, 847 F.2d 673 (11th Cir. 1988) ; *State v. Harry*, 873 P.2d 1149, 1994 Utah App. LEXIS 56 , Blue Sky L. Rep. (CCH) P 72,121 (Utah Ct. App. 1994); *Foster v. Alex*, 572 N.E.2d 1242, 1245 (Ill. Ct. App. 1991) ; *McCowan v. Sears, Roebuck & Co.*, 722 F. Supp. 1069 (S.D.N.Y. 1989) (allegations of scienter not necessary under Virginia Blue Sky law); *Aspelund v. Olerich*, 784 P.2d 179, 182 (Wash. Ct. App. 1990) .

Cf. *People v. Simon*, 9 Cal. 4th 493, 37 Cal. Rptr. 2d 278, 886 P.2d 1271, 1995 Cal. LEXIS 6 , Blue Sky L. Rep.

(CCH) P 74,010 (1995) (statute prohibiting fraudulent sale of securities modeled on federal scheme required proof of scienter, overruling *People v. Johnson*, 213 Cal.App.3d 1369 (1989) and progeny to extent inconsistent in making offense one of strict liability).

(n68)Footnote 68. See, e.g., *Lane v. Midwest Bancshares Corporation*, 337 F. Supp. 1200, 1209 (E.D. Ark. 1972) (applying Arkansas law) In *Arthur Young & Co. v. Reves*, 937 F.2d 1310 (8th Cir. 1991) , *aff'd*, 507 U.S.170, 113 S. Ct. 1163, 122 L. Ed 2d 525 (1993) , applying Arkansas law, the no knowledge defense was held subsumed in the jury instruction that defendant had to have originated the linchpin of the securities fraud.

(n69)Footnote 69. *Trimble v. American Sav. Life Ins. Co.*, 733 P.2d 1131 (Ariz. Ct. App. 1986) (defendants have affirmative duty not to mislead investors); *Titan Oil & Gas, Inc. v. Shipley*, 517 S.W.2d 210, 219 (Ark. 1975) . ("[T]he cause of action under the statute is not a great deal broader than the common law actions of fraud and deceit and the equitable proceeding for cancellation of a contract and rescission, particularly when we consider that type of fraud ... i.e., misrepresentations having a tendency to deceive others, but made as true without knowledge of their falsity and without any moral guilt or evil intention.").

See also *Mueller v. Sullivan*, 141 F.3d 1232, 1998 U.S. App. LEXIS 7825 , Blue Sky L. Rep. (CCH) P 74,161 (7th Cir. 1998); cf. *People v. Simon*, 9 Cal. 4th 493, 37 Cal. Rptr. 2d 278, 886 P.2d 1271, 1995 Cal. LEXIS 6 , Blue Sky L. Rep. (CCH) P 74,010 (1995) (state statute prohibiting fraudulent sale of securities modeled on federal scheme required proof of scienter, overruling *People v. Johnson*, 213 Cal.App.3d 1369 (1989) and progeny to the extent inconsistent in making offense one of strict liability).

See also *Arthur Young & Co. v. Reves*, *above*, approving a jury instruction that assured a finding of accountant's liability for aiding and abetting fraudulent securities sales in violation of Arkansas Blue Sky law could be made only if the jury concluded that the accounting firm (1) originated the allegedly false statements or omissions; (2) knew that the statements were communicated to plaintiffs and (3) knew that plaintiffs would rely on them in purchasing the securities.

(n70)Footnote 70. *Lane v. Midwest Bancshares Corporation*, N. 245, *above*.

(n71)Footnote 71. *Titan Oil & Gas, Inc. v. Shipley*, N. 246, *above*.

(n72)Footnote 72. See *Hawaii Rev. Stat. § 485-20(a)*.

(n73)Footnote 73. See *Ah Moo v. A.G. Becker Paribas, Inc.* 857 F.2d 615 (9th Cir. 1988) , in which the Court upheld imposing liability under *Haw. Rev. Stat. § 485-20(a)* on dealer for salesman's misrepresentation, but with no discussion of knowledge of falsity. However, since primary liability rested on sale of unregistered securities, which is automatic, it is unclear what weight was given to misrepresentations.

(n74)Footnote 74. *Hitchcock v. deBruyne*, 377 F. Supp. 1403 (D. Conn. 1974) .

See also *Hubbard v. Hibbard Brown & Co.*, 633 A.2d 345, 349 (Del. 1993) (Scienter is necessary to establish a violation of Delaware Blue Sky statute).

(n75)Footnote 75. *Wash. Rev. Code § 21.20.010*.

(n76)Footnote 76. *Wash. Rev. Code § 21.20.430(1)*. Montana has a similar provision, see *Mont. Code Ann. § 30-10-307(1)*.

(n77)Footnote 77. See, e. g., *Kaas v. Privette*, 12 Wash. App. 142, 529 P.2d 23, 29 (1974) . However, *Wash. Rev. Code § 21.20.430(7)* provides that the plaintiff must prove scienter in an action based on a material misstatement or omission in connection with an initial offer or sale of securities by the state or its agencies or political subdivisions, when the action is against a public or quasi-public officer or agent of such a person acting on the person's behalf (but

excluding a bond counsel or an underwriter.) The provision is retroactive to any action not final before July 27, 1985. For a decision upholding the provision, see *In re Washington Public Power Supply Systems Securities Litigation*, 1988 U.S. Dist. LEXIS 16536, [1988-1990 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,961 (W.D. Wash. 1988).

(n78)Footnote 78. In California the plaintiff's claim will be upheld on proof of material misrepresentations or omissions "unless the defendant proves that the plaintiff knew the facts concerning the untruth or omission or that the defendant exercised reasonable care and did not know (or if he had exercised reasonable care would not have known) of the untruth or omission." *Cal. Corp. Code* § 25501.

(n79)Footnote 79. See *Towne v. Friedrich*, 207 Cal. App. 2d 205, 24 Cal. Rptr. 400, 404 (1962); *Gormly v. Dickinson*, 178 Cal. App. 2d 92, 2 Cal. Rptr. 650 (1960).

Cf. *People v. Simon*, 9 Cal. 4th 493, 37 Cal. Rptr. 2d 278, 886 P.2d 1271, 1995 Cal. LEXIS 6, Blue Sky L. Rep. (CCH) P 74,010 (1995) (Provision in *Cal. Corp. Code* § 25501 permitting a defendant to avoid civil liability on showing that he or she exercised reasonable care and did not know (or if he had exercised reasonable care would not have known) of false or misleading nature of a statement or omission in order to avoid civil liability, leads to conclusion that either criminal negligence or actual knowledge also must be an element of a criminal violation of *Cal. Corp. Code* § 25401, prohibiting offer, sale or purchase of securities by means of untrue statement or omission of material fact).

(n80)Footnote 80. *Gormly v. Dickenson*, N. 256, *above*.

(n81)Footnote 81. *Fla. Stat.* § 517.301(1)(a)(2).

(n82)Footnote 82. *Fla. Stat.* § 517.211(2) provides for a civil action by defrauded buyer or seller.

(n83)Footnote 83. *Hudak v. Economic Research Analysts, Inc.*, 499 F.2d 996, 1000 (5th Cir. 1974), *cert. denied*, 419 U.S. 1122 (1975), applying Florida law.

See also *Messer v. E.F. Hutton & Co.*, 833 F.2d 909, 920 (11th Cir. 1987), *amended*, 847 F.2d 673 (11th Cir. 1988) (violation of Florida's Blue Sky law requires proof of negligence rather than scienter).

(n84)Footnote 84. *Merrill, Lynch, Pierce, Fenner & Smith v. Byrne*, 320 So. 2d 436, 440 (Fla. Dist. Ct. App. 1975); see also *Kittilson v. Ford*, 608 P.2d 264, 1980 Wash. LEXIS 1274, [1978-1981 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,533 (Wash. 1980). The *Kittilson* court held that while scienter is an element of a common law fraud action, that standard is not required for proof of fraud or misrepresentation under the Washington Securities Act. The court found the U.S. Supreme Court decision in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S. Ct. 1375, 47 L. Ed. 2d 668 (1976), holding that the "manipulative and deceptive" language of Section 10(b) of the Exchange Act clearly connotes intentional misconduct, inapplicable to the state's Blue Sky law because the "manipulative or deceptive" language is not included in the Washington statute.

(n85)Footnote 85. *Connelly v. Balkwill*, 174 F. Supp. 49 (N.D. Ohio 1959).

(n86)Footnote 86. There are one or two exceptions, see, e.g., *Shermer v. Baker*, 2 Wash. App. 845, 472 P.2d 589 (1970).

(n87)Footnote 87. See *People v. Federated Radio Corporation*, 244 N.Y. 33, 154 N.E. 655, 658 (1926), Blue Sky L. Rep. (CCH) P 74,083 (1994); *People v. Landes*, 600 N.Y.S. 2d 292 (N.Y. App. Div. 1993); *People v. Cadplaz Sponsors, Inc.*, 69 Misc. 2d 417, 330 N.Y.S.2d 430 (1972).

(n88)Footnote 88. See, e.g., *Buffo v. State*, 415 So. 2d 1158, 1165 (Ala. 1982) (Under the willful standard, "all that is required is proof that the person acted intentionally in the sense that he was aware of what he was doing. Proof of evil motive or intent to violate the law, or knowledge that the law was being violated, is not required.")

See also *Commodity Futures Trading Com'n v. American Metals*, 775 F. Supp. 767, 784 (D.N.J. 1991) , modified, 991 F.2d 71 (3d Cir. 1993) (applying Florida and New Jersey law); *State v. Sheets*, 610 P.2d 760, 770 (N.M. 1980) .

(n89)Footnote 89. Unif. Sec. Act § 410(a)(2); see also *Haralson v. E.F. Hutton Group, Inc.*, 919 F.2d 1014, 1032 (5th Cir. 1990) , modified, 1991 U.S. App. LEXIS 1029 (5th Cir. Jan. 25, 1991) ; *Lutheran Broth. v. Kidder Peabody & Co., Inc.*, 829 S.W.2d 300, 308 (Tex. Ct. App. 1992) .

(n90)Footnote 90. See *Gohler v. Wood*, 919 P.2d 561, 1996 Utah LEXIS 64, 294 Utah Adv. 25 , Blue Sky L. Rep. (CCH) P 74,106 (Utah 1996) (certified question as to whether reliance was essential element of private cause of action under antifraud provisions of state securities act answered in negative: decision is in accord with significant majority of other courts' interpretations of statutes which were modeled after Uniform Act § 410(a)(2) or Rec. Unif. Act § 605(a), citing cases); *Trimble v. American Sav. Life Ins. Co.*, 733 P.2d 1131, 1136 (Ariz. Ct. App. 1986) .

Cf. *Toombs v. Leone*, 777 F.2d 465, 1985 U.S. App. LEXIS 24970 , [1984-1985 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,320 (9th Cir. 1985), applying California and Alaska law (both require a plaintiff to prove his reliance on misrepresentations or omissions of material fact in order to establish a claim for fraud).

See also *Rousseff v. E.F. Hutton Co., Inc.*, 843 F.2d 1326, 1331 (11th Cir.) , answered, 537 So. 2d 978 (Fla. 1989) , answer conf., 867 F.2d 1281 (11th Cir. 1989) (while reliance is required, proof of loss causation is not required under Florida law); *In re Sahlen & Assoc., Inc.*, 773 F. Supp. 342 (S.D. Fla. 1991) (actual reliance required); *Kaufman v. I-Stat Corp., Fed. Sec. L. Rep. (CCH) 91,028*, 165 N.J. 94, 754 A.2d 1188, 2000 N.J. LEXIS 993 (2000) (court found no compelling reason to deviate from current standard of proof for reliance element in common-law fraud action, and declined to permit use of fraud-on-the-market theory); *Carney v. Mantuano*, 554 N.W.2d 854, 1996 Wisc. App. LEXIS 1188 . Blue Sky L. Rep. (CCH) P 74,122 (Wis. Ct. App. 1996) (reliance required).

(n91)Footnote 91. *Trimble v. Holmes Harbor Sewer District*, CCH Blue Sky L. Rep. P 74,629, 2007 Wash. App. LEXIS 585 (Wash. App. 2007) ; *Hines v. Data Line Systems, Inc.*, 114 Wn. 2d 127, 787 P.2d 8 (1990) ; *Stewart v. Estate of Steiner*, 93 P.3d 919 (Wn. App. 2004) .

In *Stewart* the court identified eight factors in making a determination whether one reasonably relies on representations or omissions in connection with the sale of a security, as follows:

- (1) the sophistication and expertise of the plaintiff in financial and securities matters, (2) the existence of longstanding business or personal relationships, (3) access to the relevant information, (4) the existence of a fiduciary relationship, (5) concealment of the fraud, (6) the opportunity to detect the fraud, (7) whether the plaintiff initiated the stock transaction or sought to expedite the transaction, and (8) the generality or specificity of the misrepresentations. 122 Wn. App. at 274.

See also *Foster v. Alex*, 572 N.E.2d 1242, 1245 (Ill. Ct. App. 1991) ; *Geisenberger v. John Hancock Distributors*, 774 F. Supp. 1045, 1051 (S.D. Miss. 1991) (Mississippi law); *S & F. Supply Company v. Hunter*, 527 P.2d 217 (Utah 1974) .

See also *Epstein v. Washington Energy Co.*, 83 F.3d 1136, 1996 U.S. App. LEXIS 11214 , Blue Sky L. Rep. (CCH) P 74,091 (9th Cir. 1996) (reliance on predictive statements regarding regulatory proceedings inherently unreasonable).

(n92)Footnote 92. See *Zelman v. Cook*, 616 F. Supp. 1121, 1134 (S.D. Fla. 1985) . In *Zelman* a Plaintiff who signed a consent form and waiver and sent in his proxy for merger failed to establish a right to rely, or actual reliance on, the alleged misrepresentations as required by Florida law.

(n93)Footnote 93. *Ladd v. Knowles*, 505 S.W.2d 662 (Tex. Civ. App. 1974) (plaintiffs knew of speculative status of stock).

See also *Lutheran Brotherhood, above*, 829 S.W.2d at 308 . In an arm's length transaction, the party alleging fraud must exercise ordinary care for the protection of his own interests, and he is charged with knowledge of all facts which would have been discovered by a reasonably prudent person similarly situated. And a failure to exercise reasonable diligence is not excused by mere confidence in the honesty and integrity of the other party.

(n94)Footnote 94. *Bierschwale v. Oakes*, 497 S.W.2d 506, 513 (Tex. Civ. App. 1973) , *rev'd on other grounds sub nom, Meadows v. Bierschwale*, 516 S.W.2d 125 (Tex. 1974) .

(n95)Footnote 95. See *Peterson v. Baloun*, 715 F. Supp. 212, 218 (N.D. Ill. 1989) (Illinois law).

(n96)Footnote 96. *Kaas v. Privette*, 12 Wash. App. 152, 529 P.2d 23, 26 (1974) .

But see *Adler v. William Blair & Co.*, 613 N.E. 2d 1264, 1272 (Ill. Ct. App. 1993) . (Information provided in subscription agreement and private placement memorandum precluded reliance on oral statement).

(n97)Footnote 97. See *Clausing v. DeHart*, 83 Wash. 2d 70, 515 P.2d 982 (1973) ; *Mirkin v. Wasserman*, 858 P.2d 568, 581 (Cal. 1993) (State securities law permits "fraud on the market" doctrine of reliance); *Smith v. Central Bank and Trust Co.*, Blue Sky L. Rep. (CCH) P 73,845 (Colo. Dist. Ct. 1992) (court permits investors in assessment lien bonds to use "fraud created the market" theory of reliance, stating that the existence of a market indicates to investors that the securities are genuine and marketable.).

But see *In re Sahlen*, 773 F. Supp. at 371 ; *Kahler v. E.F. Hutton & Co*, 558 So. 2d 144, 145 (Fla. Dist. Ct. App. 1990) (Reliance based on fraud on the market theory unavailable in Florida) *Kaufman v. I-Stat Corp.*, Fed. Sec. L. Rep. (CCH) 91,028, 165 N.J. 94, 754 A.2d 1188, 2000 N.J. LEXIS 993 (2000) (Court found no compelling reason to deviate from current standard of proof for reliance element in common-law fraud action, and declined to permit use of fraud-on-the-market theory).

(n98)Footnote 98. See, e.g., *State of North Carolina v. Davidson*, Blue Sky L. Rep. (CCH) P 74,171 (N.C. Ct. App. 1998) (Evidence supported nexus between broker's actions and misrepresentation).

(n99)Footnote 99. *Sparks v. State*, 256 So. 2d 537, 538 (Fla. Dist. Ct. App. 1972) .

(n100)Footnote 100. Unif. Sec. Act § 410(a)(2); see also Rev. Unif. Sec. Act § 605.

(n101)Footnote 101. *Farida v. Zahar*, 50 Mich. App. 137, 212 N.W.2d 739, 742 (1973) .

(n102)Footnote 102. See *Queen v. Commonwealth*, 434 S.W.2d 318, 322 (Ky. 1968) .

(n103)Footnote 103. See *Herzfeld v. Laventhal, Krekstein, Horwath and Horwath*, 378 F. Supp. 112 (S.D.N.Y. 1974) , *aff'd in part, rev'd in part*, 540 F.2d 27 (2d Cir. 1976) (applying New York law).

(n104)Footnote 104. *Corporate Finders and Consultants, Inc. v. Universal Container Corporation*, 39 A.D.2d 533, 330 N.Y.S.2d 862, 863 (1972) ; see also *Hubbard v. Hibbard Brown & Co.*, 633 A.2d 345, 351 (Del. 1993) .

(n105)Footnote 105. *Herdegen v. Paine, Webber, Jackson & Curtis*, 31 Misc. 2d 104, 220 N.Y.S.2d 459 (1961) .

(n106)Footnote 106. 220 N.Y.S.2d at 460 .

(n107)Footnote 107. *Milliner v. Elmer Fox and Co.*, 529 P.2d 806, 808 (Utah 1974) .

(n108)Footnote 108. *Campbell v. Ford Industries, Inc.*, 226 Or. 479, 513 P.2d 1153 (1973) .

(n109)Footnote 109. 513 P.2d at 1157.

(n110)Footnote 110. *Emmi v. First-Manufacturers Nat'l Bank of Lewiston & Auburn*, 336 F. Supp. 629 (D. Maine 1971) (applying Maine law).

(n111)Footnote 111. 336 F. Supp. at 637 , 638.

See also *StorMedia, Inc. v. Werczberger*, 976 P.2d 214, 1999 Cal. LEXIS 2973, 84 Cal. Rptr. 2d 843 , Blue Sky L. Rep. (CCH) P 74,185 (Cal. 1999) (market manipulation unlawful regardless of whether person actually purchased stock); *Rousseff v. E.F. Hutton Co., Inc.*, 843 F.2d 1326, 1331 (11th Cir.) , answered, 537 So. 2d 978 (Fla. 1989) , answer conf., 867 F.2d 1281, 1282 (11th Cir. 1989) (Proximate cause not required under Florida law); *Hines v. Data Line Sys.*, 787 P.2d 8, 16 (Wash. 1990) (proximate cause not required).

But see *Giammanco v. Giammanco*, 253 Ill. App. 3d 750, 192 Ill. Dec. 835, 625 N.E.2d 990, 1993 Ill. App. LEXIS 1874 (Ill. App. Ct. 2d Dist. 1993) , in which plaintiff alleged that he was tricked into selling 50% share in family business to what he thought was independent third party (but who turned out to be his brother). The court opined that plaintiff had adequately stated damage element of fraud claim. Plaintiff's "right to bargain with whoever he desired, and to know with whom he was bargaining, is of pecuniary character, and the deprivation of this right constitutes damage" for which plaintiff was entitled to seek compensation.

(n112)Footnote 112. See Unif. Sec. Act § 410(a)(2).

(n113)Footnote 113. Unif. Sec. Act § 204(a)(2)(G); see also Rev. Unif. Sec. Act § 212; 2002 Unif. Sec. Act § 412(d) ("Grounds for discipline").

(n114)Footnote 114. See Chapter 11, *above*.

(n115)Footnote 115. Unif. Sec. Act § 306(a)(2)(E); see also Rev. Unif. Sec. Act § 306(a)(5); 2002 Unif. Sec. Act § 306(a)(7).

(n116)Footnote 116. See § 5.07, *above*.

(n117)Footnote 117. See, e.g., *Cal. Corp. Code* §§ 25216(a), (b); *Iowa Code* § 502.404; 70 Pa. Cons. Stat. § 1-403. These states make their respective provisions also applicable to agents.

(n118)Footnote 118. 70 Pa. Cons. Stat. § 1-401. Even California has adopted general antifraud provisions containing much of the language of the Uniform Act section, see *Cal. Corp. Code* §§ 25400(d), 25401.

(n119)Footnote 119. Rule 15c1-4, 17 C.F.R. § 240.15c1-4 (rescinded 1978).

(n120)Footnote 120. See, e.g., *Cal. Admin. Code* tit. 10, § 260.216.2(a)(1); *Ill. Admin. Code* tit. 14, § 130.827; *Iowa Admin. Code* Rule 191-50.12(502)(1)(b).

(n121)Footnote 121. But see *Hubbard v. Hibbard Brown & Co.*, 633 A.2d 345 (Del. 1993) (Phrase "We Make a Market in This Security" on purchase confirmation slips was sufficient disclosure of broker-dealer's market maker status).

(n122)Footnote 122. See *Minn. R.* 2875.1150(A).

(n123)Footnote 123. *Cal. Admin. Code* tit. 10, § 260.216.2(b).

(n124)Footnote 124. 17 C.F.R. § 240.15c1-5.

(n125)Footnote 125. See Cal. Admin. Code tit. 10, § 260.216.3; Minn. R. 2875.1150 (B); 64 Pa. Code § 403.010(d)(5).

(n126)Footnote 126. 17 C.F.R. § 240.15c1-6.

(n127)Footnote 127. See, e.g., Cal. Admin. Code tit. 10, § 260.216.4; Minn. R. § 2875.1150(C); 64 Pa. Code § 403.010 (d)(4).

(n128)Footnote 128. See, e.g., Cal. Admin. Code tit. 10, § 260.216.5; Ill. Admin. Code tit. 14, § 130.853; 64 Pa. Code § 403.010 (d)(1).

See also *Kravitz v. Pressman, Frohlich & Frost, Inc.*, 447 F. Supp. 203, 210 (D.C. Mass. 1978) ; *Taylor v. First Jersey Securities, Inc.*, 533 So. 2d 1383 (La. Ct. App., 4th Cir. 1988) , cert. denied, 538 So. 2d 593, 594 (1989) (allegations that broker made excessive purchases on investor's account stated cause of action for churning under Louisiana law).

(n129)Footnote 129. Rule 15c1-7(a), 17 C.F.R. § 240.15c1-7(a).

(n130)Footnote 130. See, e.g., Cal. Admin. Code tit. 10, § 260.216.6; Ill. Admin. Code tit. 14, § 130.827(b); Iowa Admin. Code R. 191-50.12(502)(1)(a).

(n131)Footnote 131. Rule 15c1-7(b), 17 C.F.R. § 240.15c1-7(b).

(n132)Footnote 132. See, e.g., Cal. Corp. Code § 25216(b); Iowa Code § 502.404; 70 Pa. Cons. Stat. § 1-403.

(n133)Footnote 133. 64 Pa. Code § 403.010(a). Florida considers such a sale a prohibited business practice, subjecting a dealer to revocation, denial, or suspension of its registration. Rule 3E-600.013(l), Fla. Div. Sec.

(n134)Footnote 134. See, e.g., Cal. Admin. Code tit. 10, § 260.216.7; Minn. R. 2875.1150(E); 64 Pa. Code § 403.010(d)(2).

(n135)Footnote 135. See Rule 15c1-8, 17 C.F.R. § 240.15c1-8.

(n136)Footnote 136. Rule 15c2-1, 17 C.F.R. § 240.15c-2-1.

(n137)Footnote 137. 2 Loss, Securities Regulation at 1193 (1961); see also 7 Loss & Seligman, Securities Regulation 3179-90 (Little Brown & Co., 3d ed.).

(n138)Footnote 138. See Rule 15c2-1.

(n139)Footnote 139. See, e.g., Cal. Admin. Code tit. 10, § 260.216.8.

(n140)Footnote 140. N.Y. Gen. Bus. Law § 339-e.

(n141)Footnote 141. See also *Passman v. Oliphant*, 77 Misc. 2d 431, 353 N.Y.S.2d 117 (Sup. Ct.) , rev'd, 46 A.D.2d 878, 362 N.Y.S.2d 18 (1st. Dept. 1974) for an application of § 339-e.

(n142)Footnote 142. Rule 15c2-4, 17 C.F.R. § 240.15c2-4.

(n143)Footnote 143. A best efforts underwriting relieves the underwriter from buying and paying for all the securities taken from the persons on whose behalf the offering is made. Where the underwriter is committed to take and pay for all the securities, it is considered a "firm commitment" underwriting. See Weiss, Registration and Regulation of

Brokers and Dealers § 13-6 (1965).

(n144)Footnote 144. Securities are considered sold on an all or none basis when the underwriter has agreed with the persons on whose behalf the offering is made to return the money to subscribers in the event an agreed minimum number of securities is not sold by a specified time.

(n145)Footnote 145. See Exchange Act Rule 15c2-4, 17 C.F.R. § 240.15c2-4.

For example, Broker-dealer XYZ borrows money to fulfill the escrow requirements in an "all or none" or "part or none" offering and thereby obtains the release of the escrowed investor funds. Through this device the broker-dealer receives a commission, the issuer obtains the investor's funds and the investors' expectation of the return of their escrowed funds is extinguished. In these cases the broker-dealer is usually affiliated with the issuer and expects to repay the loan with the proceeds of the recently released investor funds. The scheme may also involve the use of purchases through nominee accounts or purchases by persons with whom the issuer or the broker-dealer has agreed to guarantee against loss which devices are designed to create the appearance of a successful offering.

(n146)Footnote 146. See, e.g., Cal. Admin. Code tit. 10, § 260.216.9; *Minn. R. 2875.0930*; Pennsylvania: 64 Pa. Code § 403.010(d)(3).

(n147)Footnote 147. *Minn. R. 2875.1040(A)*.

(n148)Footnote 148. Exchange Act Rule 15c2-7, 17 C.F.R. § 240.15c2-7; see Cal. Admin. Code tit. 10, § 260.216.11; *Minn. R. 2875.1080*.

(n149)Footnote 149. Exchange Act Rule 15c2-11, 17 C.F.R. § 240.15c2-11; See, e.g., *Minn. R. 2875.1090*.

(n150)Footnote 150. See Rule 3E-600.013(n), Fla. Div. Sec.; *Ill. Admin. Code tit. 14, § 130.851*.

(n151)Footnote 151. *N.Y. Gen. Bus. Law § 339-c*.

(n152)Footnote 152. *N.Y. Gen. Bus. Law § 339-d*.

(n153)Footnote 153. *Selig v. Novak*, 256 Ark. 278, 506 S.W.2d 825, 830 (1974) ; see also *Taylor v. First Jersey Securities, Inc.*, 533 So. 2d 1383 (La. App. 1988) , cert. denied, 538 So. 2d 593 (1989) .

(n154)Footnote 154. Unif. Sec. Act § 102. The regulation of federal covered investment advisors was pre-empted, in part, by the National Securities Markets Improvements Act ("NSMIA"), Pub. L. No. 104-290, 110 Stat. 3416 (1996), effective October 11, 1996. See § 8.02[2][c] below; see also 70 Pa. Cons. Stat. § 1-404, limiting effect of provisions that apply to federal covered advisors to prohibit conduct involving fraud or deceit. Wis. Adm. Code DFI-Sec. 5.06 (same). See also Rev. Unif. Sec. Act § 503, which is substantially similar to the 1956 Act provision, except that it is specifically applicable to investment advisers or persons who represent them in that capacity. Rev. Unif. Sec. Act § 101(7) defines an investment adviser as a person who, for compensation, engages in the business of advising others as to the value of securities or the advisability of investing in them, or one who, for compensation and as part of a business, analyzes or reports concerning securities. The definition excludes employees of investment advisers; depository institutions; lawyers, accountants, engineers or teachers who offer advice incidentally to the practice of their profession; broker-dealers in the same circumstances if they receive no special compensation; specified media professionals if the information is made available to the general public and is not advice geared to the specific investment situation for each client; a person advising with regard to exempt securities only and others the state Administrator may designate.

See *Lowe v. SEC*, 472 U.S.181, 105 S. Ct. 2557, 86 L. Ed. 2d 130 (1985) , in which the Supreme Court, invoking the *First Amendment*, held that the exclusion of a "bona fide newspaper, news magazine or business or financial

publication of general and regular circulation" from the definition of investment adviser in the Federal Investment Adviser's Act (15 U.S.C. 80-1), prevented the SEC from enjoining publication of such newsletters for alleged violations of the Act. *See* Wall Street Digest, [1984-1985 Transfer Binder], Blue Sky L. Rep. (CCH) P 72,278 (Fla. Div. of Sec. Admin. Proc. 1985) (Although Florida Blue Sky investment adviser sections did not contain analog of IAA exemption, Florida Act did not reach such publications because of *First Amendment* concerns articulated in *Lowe*).

(n155)Footnote 155. Unif. Sec. Act § 102(a).

(n156)Footnote 156. *See* Chapter 8 *above*.

(n157)Footnote 157. Official Commentary to Unif. Sec. Act § 102(a); *but see* Rev. Unif. Sec. Act § 101(7) for exclusions from the definition of investment advisers.

See also Ohio Rev. Code § 1707.42:

Whoever, with intent to secure financial gain to self, advises and procures any person to purchase any security, and received any commission or reward for such advice or services without disclosing to the purchaser the fact of the person's agency or interest in such sales, shall be liable to the purchaser... .

(n158)Footnote 158. *See, e.g.* Mass. Gen. L. ch. 110A, § 102; Minn. Stat. § 80A.02(1); N.H. Rev. Stat. Ann. § 421-B:4(1); N.J. Stat. Ann. § 49:3-53(a).

(n159)Footnote 159. *See, e.g.* Cal. Corp. Code § 25235; Ill. Comp. Stat. ch. 815, § 5/12 (J); *see also* Rev. Unif. Sec. Act § 503.

(n160)Footnote 160. N.Y. Gen. Bus. Law § 352.

(n161)Footnote 161. *See, e.g.*, Cal. Corp. Code § 25235(d); Ill. Comp. Stat. ch. 815, § 5/12J; 70 Pa. Cons. Stat. § 1-404(a)(4).

(n162)Footnote 162. Cal. Admin. Code tit. 10, § 260.235; 64 Pa. Code § 404.010.

(n163)Footnote 163. Minn. Stat. § 80A.02(1); Wash. Rev. Code. § 21.20.020.

(n164)Footnote 164. Minn. R. 2875.0560.

(n165)Footnote 165. Wash. Admin. Code § 460-24A-100.

(n166)Footnote 166. Each of these statutes, for purposes of the regulation, defines "advertisement" substantially as follows:

[A]ny notice, circular, letter or other written communication given to more than one person, or any notice or other announcement in any publication or by radio or television, which offers (a) any analysis, report or publication concerning securities, or which is to be used in making any determination as to when to buy or sell securities, or (b) any graph, chart, formula or other device to be used in making any determination concerning when to buy or sell any security, or which security to buy or sell, or (c) any other investment advisor service with regard to securities.

(n167)Footnote 167. 64 Pa. Code § 404.010.(a)(6). The required information consists of:

[A] tabular presentation of: (i) the total number of shares or other units of such security held by the

investment adviser for its own account or for the account of officers, directors, trustees, partners or affiliates of the investment adviser or for discretionary accounts of the investment adviser maintained for customers; [and] (ii) the price or price range at which the securities listed in (i) of paragraph 6 above were purchased; and (iii) the date or range of dates during which the securities listed in response to (i) above were purchased.

(n168)Footnote 168. *See, e.g., Cal. Corp. Code § 25235(c); Minn. Stat. § 80A.02(1)(b); 70 Pa. Cons. Stat. § 1-404(a)(3).*

(n169)Footnote 169. *15 U.S.C. § 80b-6(3).*

(n170)Footnote 170. Draftsmen's Commentary to Unif. Sec. Act § 102(a):

The omission of a comparable clause here does not indicate that conduct of this kind would not be fraudulent under § 102(a). It seems clear that such conduct would violate both clauses of § 102(a) unless the client's consent were obtained on the basis of at least an oral disclosure, and even a written disclosure might be necessary to avoid a violation under some circumstances.

(n171)Footnote 171. *15 U.S.C. § 80b-8(c).*

(n172)Footnote 172. Draftsmen's Commentary to Unif. Sec. Act § 401(f).

(n173)Footnote 173. *See, e.g., Cal. Corp. Code § 25235(e); Ill. Admin. Code tit. 14, § 130.854; 70 Pa. Cons. Stat. § 1-404(a)(6).*

(n174)Footnote 174. Unif. Sec. Act § 102(b)(1):

It is unlawful for any investment adviser to enter into, extend, or renew any investment advisory contract unless it provides in writing

(1) that the investment adviser shall not be compensated on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client... .

(n175)Footnote 175. Unif. Sec. Act § 102(b)(2) provides: "It is unlawful for any investment adviser to enter into, extend, or renew any investment advisory contract unless it provides in writing ... that no assignment of the contract may be made by the investment adviser without the consent of the other party to the contract... ."

(n176)Footnote 176. Unif. Sec. Act § 102(b)(3) provides: "It is unlawful for any investment adviser to enter into, extend, or renew any investment advisory contract unless it provides in writing ... (3) that the investment adviser, if a partnership, shall notify the other party to the contract of any change in the membership of the partnership within a reasonable time after the change."

(n177)Footnote 177. *See, e.g., Cal. Corp. Code § 25234; Conn. Gen. Stat. § 36b-5(b); see also Conn. Agencies Regs. § 36b-31-5c; Hawaii Rev. Stat. § 485-25(c); N.J. Stat. Ann. §§ 49:3-53(b)-(d).* New Jersey allows certain advisers to be compensated on a capital gains or capital appreciation basis if authorized by the bureau chief, *see also* Cal. Admin. Code tit. 10 § 260.234(a).

The provision has also been adopted by regulation in some states, *see, e.g.,* N.H. Code Admin. R. 606.01.

(n178)Footnote 178. Unif. Sec. Act § 102(b).

(n179)Footnote 179. *Ill. Admin. Code tit. 14, § 130.852.*

(n180)Footnote 180. *Cal. Corp. Code § 25234(a)(1).*

(n181)Footnote 181. *Cal. Admin. Code tit. 10, § 260.234(a); see also 17 C.F.R 275.205-3.*

(n182)Footnote 182. *Cal. Admin. Code tit. 10, § 260.234(b).* The exception is not available to a pension or profit sharing fund with gross assets of less than \$1,000,000 according to the most recent audited financial statement.

(n183)Footnote 183. *See 15 U.S.C. § 80b-5.* For the most part, the requirements of an investment advisory contract as set forth in Unif. Sec. Act § 102(b) are based on the cited section of the federal Act. *See* Official Comment to Unif. Sec. Act § 102(b).

(n184)Footnote 184. *70 Pa. Cons. Stat. § 1-405.*

(n185)Footnote 185. *Unif. Sec. Act § 102(c).*

(n186)Footnote 186. *See, e.g., Conn. Gen. Stat. § 36b-5(c); Del. Code Ann. tit. 6, § 7317(c); Mich. Comp. Laws § 451.502(e).*

(n187)Footnote 187. For example, there are no regulations under this provision in Connecticut.

(n188)Footnote 188. *Mo. Code Regs. tit. 15, § 30-51.100.*

(n189)Footnote 189. *See, e.g., Tenn. Rule 0780-4-3.07.*

(n190)Footnote 190. *See, e.g., Cal. Admin. Code tit. 10, § 260.237; Minn. R. 2875.1020.*

(n191)Footnote 191. *See, e.g., Minn. R. 2875.1020(2),* which provides:

Subpart 1 shall not apply to an investment adviser also registered as a broker-dealer under Section 15 of the Securities Exchange Act of 1934 if such broker-dealer is subject to and in compliance with Rule 15c3-1 (Reg. 240.15c3-1) under the Securities Exchange Act of 1934; or such broker-dealer is a member of an exchange whose members are exempt from Rule 15c3-1 under the provisions of paragraph(b)(2) thereof, and such broker-dealer is in compliance with all rules and settled practices of such exchange imposing requirements with respect to financial responsibility and the segregation of funds or securities carried for the account of customers.

See also 70 Pa. Cons. Stat. § 1-404(a)(7):

It is unlawful for any investment adviser, directly or indirectly, in this State:

Unless an adviser is registered as a broker-dealer under this act, to take and have custody of any securities or funds of any client if he fails to meet such requirements therefor as may be prescribed by the commission by regulation.

(n192)Footnote 192. *See, e.g., Cal. Admin. Code tit. 10, § 260.237(a); Minn. R. 2875.1020(1)(A).*

(n193)Footnote 193. *64 Pa. Code § 404.013* makes it a fraudulent act for an investment adviser not registered as a broker-dealer to have custody of customer funds or securities unless the investment adviser has complied with the requirements of Rule 206(4)-2 under the Investment Adviser's Act of 1940. *See 17 C.F.R. § 275.206(4)-2.*

(n194)Footnote 194. *See, e.g.*, Cal. Admin. Code tit. 10, § 260.237(b); *Minn. R. 2875.1020(1)(B)*.

(n195)Footnote 195. Cal. Admin. Code tit. 10, § 260.237(c); *Minn. R. 2875.1020(1)(C)*.

(n196)Footnote 196. Cal. Admin. Code tit. 10, § 260.237(d); *Minn. R. 2875.1020(1)(D)*. The period in California and Minnesota is not less than once every three months.

(n197)Footnote 197. Cal. Admin. Code tit. 10, § 260.237(e); *Minn. R. 2875.1020(1)(E)*. California and Minnesota require the examination at least once a year, and California and the federal regulation require the accountant to choose the time for the examination without prior notice to the investment adviser.

(n198)Footnote 198. Wis. Admin. Code DFI-Sec § 6.01. A similar rule is in effect in Iowa, *see* Iowa Admin. Code R. 191-50.43.

The Wisconsin regulation is couched in terms of material changes in the application of proceeds and would thereby permit insignificant alterations to the use of investor funds. For example, issuers should not feel threatened by imminent suit should the legal fees be less than projected. The insertion of the materiality standard into the regulation permits some deviation from the description of the application of investor funds in the prospectus.

(n199)Footnote 199. Wis. Stat. § 551.25.

(n200)Footnote 200. Wis. Stat. § 551.26.

(n201)Footnote 201. Wis. Admin. Code DFI-Sec § 6.03.

(n202)Footnote 202. Wis. Admin. Code DFI-Sec. § 6.05(2).

(n203)Footnote 203. Wis. Admin. Code DFI-Sec. § 6.05(1).

(n204)Footnote 204. Wis. Admin. Code DFI-Sec. § 6.05(3) defines "affiliate" for purposes of the regulation:

"[A]ffiliated" refers to persons who are partners, officers or directors of the issuer (or persons occupying a similar status or performing similar functions), or directly or indirectly in control of, controlled by, or under common control with, the issuer. Control may be presumed by ownership of, or the power to vote, more than 5 percent of the outstanding voting securities of the issuer (either alone or pursuant to an arrangement or understanding with one or more other persons).

(n205)Footnote 205. Wis. Admin. Code DFI-Sec. § 6.05(1)(a).

(n206)Footnote 206. Wis. Admin. Code DFI-Sec. § 6.02(a).

(n207)Footnote 207. Wis. Admin. Code DFI-Sec. § 6.02(b).

(n208)Footnote 208. The securities registration process, and the role of merit regulation today in particular, are discussed in detail in Chapters 5 ("Securities Registration") and 6 ("Merit Regulation"), *above*.

(n209)Footnote 209. *See* section 13.05, *below*.

(n210)Footnote 210. CCH NASAA Reports P 4791, at 3491.

(n211)Footnote 211. NASAA Model Rule P 1 (a)-(c).

(n212)Footnote 212. NASAA Model Rule P 1 (d)(iii).

(n213)Footnote 213. NASAA Model Rule P 2

The Model Rule also accommodates job titles within an organization that is licensed or registered by a state or federal financial services regulatory agency. For purposes of the Rule, a certification or professional designation does not include a job title in such an organization that indicates seniority or standing within the organization, or specifies an individual's area of specialization within the organization. NASAA Model Rule P 4.

(n214)Footnote 214. In Massachusetts, provisions added to 950 CMR 12.204(2)(i), addressing dishonest and unethical practices in the securities business, now includes among such practices:

Using a purported credential or professional designation that indicates or implies that a broker-dealer agent has special certification or training in advising or servicing senior investors, unless such credential or professional designation has been accredited by an accreditation organization recognized by the Secretary by rule or order. For the purposes of this subsection 12.204(2)(i), the term "senior investor" shall include a person 65 years of age or older.

Nebraska has done the same by an Interpretive Opinion that recognizes particular designations or certifications as being permitted, but as to any others declares that their use on business cards, stationery or advertising materials will be considered a violation of the Securities Act of Nebraska, *see* Interpretive Opinion No. 26, "Use of Certifications and Designations In Advertising by Investment Adviser Representatives and Broker-Dealer Agents" (Dept. Securities, as amended Nov. 17, 2007).

(n215)Footnote 215. U.S. Census Bureau, Current Population Reports, *65+ in the United States: 2005* (U.S. Govt. Printing Office 2005).

(n216)Footnote 216. FINRA Regulatory Notice 07-43, *Senior Investors*, 2 (Sept. 2007).

(n217)Footnote 217. FINRA Regulatory Notice 07-43, *Senior Investors*, 3 (Sept. 2007).

(n218)Footnote 218. FINRA Regulatory Notice 07-43, *Senior Investors*, 3 (Sept. 2007).

(n219)Footnote 219. *Tex. Ins. Code § 1115.051*.

(n220)Footnote 220. *Tex. Ins. Code § 1115.051(a)(1)-(2)*.

(n221)Footnote 221. *Tex. Ins. Code § 1115.051(b)*.

(n222)Footnote 222. *Tex. Insurance Code, § 1114.051*.

(n223)Footnote 223. *See* FINRA Regulatory Notice 07-53, *Deferred Variable Annuities* (Nov. 2007).

(n224)Footnote 224. *Tex. Insurance Code, § 1114.051*.

(n225)Footnote 225. *Protecting Senior Investors: Report of Examinations of Securities Firms Providing "Free Lunch" Sales Seminars* (Sept. 2007). The Report is available from each of the participating regulators, and specifically at www.NASAA.org.

(n226)Footnote 226. *N.H. Rev. Stat. Ann. § 421-B:5(I)*; *see also Cal. Corp. Code § 25400(a)*.

(n227)Footnote 227. Rev. Unif. Sec. Act § 502 provides:

(a) Without limiting the general applicability of Section 501, a person may not:

(1) quote a fictitious price with respect to a security;

2-13 Blue Sky Regulation § 13.02

(2) effect a transaction in a security which involves no change in the beneficial ownership of the security for the purpose of creating a false or misleading appearance of active trading in a security or with respect to the market for the security;

(3) enter an order for the purchase of a security with the knowledge that an order of substantially the same size, and at substantially the same time and price for the sale of the security has been, or will be entered by or for the same, or affiliated, person for the purpose of creating a false or misleading appearance of active trading in a security or with respect to the market for the security;

(4) enter an order for the sale of a security with the knowledge that an order of substantially the same size, and at substantially the same time and price for the purchase of the security has been, or will be entered by or for the same, or affiliated, person for the purpose of creating a false or misleading appearance of active trading in a security or with respect to the market for the security;

(5) employ any other deceptive or fraudulent device, scheme or artifice to manipulate the market in a security.

The Official Comment observes that although the coverage of the general antifraud section of the Revised Act sec is comprehensive, section 502 was been added specifically to delineate the elements of market manipulation, but with a focus on remedies and sanctions with respect to securities primarily of an intrastate nature.

(n228)Footnote 228. Official Comments No. 4, 2002 Unif. Sec. Act § 501.

(n229)Footnote 229. Market manipulation is most often addressed under provisions of the federal securities laws. Section 9 of the Securities Exchange Act of 1934 expressly proscribes manipulative activities, and such conduct likewise falls within the ambit of *Rule 10b-5*, see *Davis v. Pennzoil Company*, 438 Pa. 194, 264 A.2d 597 (1970) . As a result, some state courts have declined to accept jurisdiction over such claims, see, e.g., *Finkel v. D.H. Blair & Co., Inc.*, 213 A.D. 2d 588, 623 N.Y.S. 2d 930 (2d Dept. 1995) (Cause of action sounding in market manipulation is within the exclusive jurisdiction of federal courts).

(n230)Footnote 230. *Cal. Corp. Code § 25400*. *Cal. Corp. Code § 25500* creates a remedy for any person who purchases or sells a security at a price which was affected by such market manipulation. The California Supreme Court has held that the remedy is available to the general investing public, and that the "in this state" language of § 25400 does not preclude out-of-state purchasers and sellers of securities the price of which has been affected by manipulative activities from invoking it. See *Stormedia Inc. v. Superior Court*, 20 Cal. 4th 449, 84 Cal. Rptr. 2d 843, 976 P.2d 214 (1999) ; *Diamond Multimedia Systems, Inc. v. Superior Court*, 19 Cal. 4th 1036, 80 Cal. Rptr. 2d 828, 968 P.2d 539, 1999 Cal. LEXIS 1 (1999) .

But see Kamen v. Lindly, 94 Cal. App. 4th 197, 114 Cal. Rptr. 2d 127 (6th Dist. Cal App. 2001) (*Cal. Corp. Code §§ 25400 and 25500* do not apply to defendants who did not both (1) sell and/or offer to sell or buy and/or offer to buy, and (2) make misleading statements for the purpose of inducing the purchase or sale of a security).

See also 70 Pa. Stat. § 1-402.

(n231)Footnote 231. See, e.g., *N.Y. Gen. Bus. Law § 352*; see also *N.Y. Gen. Bus. Law §§ 339, 339-b*. which describe market manipulations in further detail.

See also *Ohio Rev. Code Ann. § 1707.01(J)*.

(n232)Footnote 232. See, e.g., *N.H. Rev. Stat. Ann. 421-B:5(III)*; 70 Pa. Cons. Stat. § 1-402(c).

See also Cal. Corp. Code §§ 25400(c), (e).

(n233)Footnote 233. *People v. D.H. Blair & Co., Inc.*, Index No. 3282/2000, 2002 N.Y. Misc. LEXIS 317 (S.Ct, N.Y. Co. 2002) .

(n234)Footnote 234. *S.W. DeVanney & Co., Inc. v. Griffin*, [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,714 (Colo. Ct. App. 1988) (The Colorado securities administrator may not disclose data derived from broker-dealer examinations to administrators in other states). *But see Griffin v. S.W. Devanney & Co.*, 775 P.2d 555, 1989 Colo. LEXIS 229 (Colo. 1989) (purpose of § 11-51-117(2) was not to prohibit petitioner from disclosing to other regulatory and law enforcement agencies information of law violations obtained in course of examination of books and records of broker-dealer, but rather to prohibit officials charged with responsibility of administering and enforcing statutory scheme from making use of or improperly disclosing information obtained in their official capacities for the personal gain of themselves or anyone else, reversing lower court.)

(n235)Footnote 235. *Cal. Corp. Code § 25402.*

(n236)Footnote 236. *N.M. Stat. Ann. § 58-13B-32.*

(n237)Footnote 237. *70 Pa. Cons. Stat. § 1-406.*

(n238)Footnote 238. *Minn. Sec. R. 2875.1050H.*

(n239)Footnote 239. *17 C.F.R. § 240.10b-5*; *see also* Official Commentary to Unif. Sec. Act 101.

(n240)Footnote 240. *See Courtland v. Walston & Co.*, 340 F. Supp. 1076, 1083 (S.D.N.Y. 1972) (*Rule 10b-5* "is now ... considered to support private litigation for practically any sin of omission or commission which may be imagined in connection with the purchase or sale of a security").

But see In re Advanta Corp. Sec. Litig., 180 F.3d 525 (3d Cir. 1999) (securities fraud class action alleging 10b-5 claim must meet stringent pleading requirements in accordance with the Private Securities Litigation Reform Act).

(n241)Footnote 241. *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951) :

The rule is clear. It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgment of the sellers. The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed minority stockholder. It is an attempt to provide some degree of equalization of bargaining position in order that the minority may exercise an informed judgment in any such transaction. Some courts have called this a fiduciary duty while others state it as a duty imposed by the "special circumstances." One of the primary purposes of the Securities Exchange Act of 1934 ... was to outlaw the use of inside information by corporate officers and principal stockholders for their financial advantage to the detriment of uninformed public security holders. 99 F. Supp. at 828-29 .

(n242)Footnote 242. *See Shermer v. Baker*, 2 Wash. App. 845, 472 P.2d. 589, 593 (1970) .

(n243)Footnote 243. *See Ariz. Rev. Stat. Ann. § 44-1992*; *N.D. Cent. Code § 10-04-15(1).*

(n244)Footnote 244. Unif. Sec. Act § 404; *see also* Rev. Unif. Sec. Act § 504, which adds the phrase "the person knows or has reasonable grounds to know" as a condition of liability. This change removes the strict liability standard

existing under the 1956 Act, *see* Official Code Comment to Rev. Unif. Sec. Act § 504.

(n245)Footnote 245. *See, e.g., Conn. Gen. Stat. § 36b-23; Del. Code Ann. tit. 6, § 7310; D.C. Code Ann. § 3-3608; Mass. Gen. L. ch. 110A, § 404; N.J. Stat. Ann. § 49:3-54.*

(n246)Footnote 246. *See, e.g., Cal. Corp. Code § 25166; Fla. Stat. § 517.301(1)(c); Ill. Comp. Stat. ch. 815 § 5/12 (E); Ohio Rev. Code Ann. § 1707.44(B); 70 Pa. Cons. Stat. § 1-407(a); Tex. Rev. Civ. Ann. Stat. art. 581-29(E).*

(n247)Footnote 247. Unif. Sec. Act § 405; Rev. Unif. Sec. Act § 505; 2002 Unif. Sec. Act § 506.

(n248)Footnote 248. *See, e.g., Cal. Corp. Code § 25243; Fla. Stat. § 517.311(1).* The Florida provision makes it unlawful to "misrepresent" that the state securities administrator has passed on the merits of any securities offered for sale.

See also Ill. Comp. Stat. ch. 815, § 5/12(E); *Mass. Gen. L. ch. 110A, § 405; N.J. Stat. Ann. § 49:3-55.*



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Blue Sky Regulation

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CHAPTER 13 Fraud and Prohibited Practices

2-13 Blue Sky Regulation § 13.03

§ 13.03 Liability for Blue Sky Violationsⁿ¹

[1] Scope of Liability--Generally

Liability under Blue Sky laws is most often considered in terms of the scope of private remedies, which generally address specific categories of persons who may be held liable in actions. Thus, under Section 410 of the Uniform Securities Act, the purchaser may sue the immediate seller of the security and all who directly or indirectly control that seller. A number of courts have defined as "sellers" persons who are a substantial factor in the sale or materially aid the sale, and these same notions have been typically applied to the scope of administrative enforcement authority. The Arizona Corporation Commission, for example, found that even though an insurance salesman was not registered as a securities dealer in the state of Arizona, his actions in concert with those of a broker-dealer require a finding that the insurance salesman was acting as an agent of the broker dealer, and therefore should be subject to penalties associated with the fraudulent sale of securities under the Arizona Blue Sky Law.ⁿ²

Commonly, civil liability under Blue Sky Laws extends to five categories of persons beyond the primary violator: (1) each person who directly or indirectly controls a person liable under the relevant provisions; (2) each partner, officer, or director of the person; (3) each person occupying a similar status or performing similar functions; (4) each employee of a person who materially aids in the conduct creating liability; and (5) each broker-dealer or agent who materially aids in the conduct. Only the latter two categories require actual facilitative participation in a transaction. Partners, officers, directors or controlling persons need not aid or participate to be liable.ⁿ³

However, although "control persons"ⁿ⁴ and others may be liable without reference to any participation in the sale, they commonly have the defense that they did not know of the fraud, and exercising reasonable care, could not have known of it.ⁿ⁵ The 2002 Uniform Securities Act amalgamates all common provisions for extending liability beyond primary violators under the heading "Joint and Several Liability."ⁿ⁶ The categories include control persons; executive officers and directors; persons employed or associated with a primary violator and who materially aid the conduct; as well as broker-dealers, agents, investment advisers or investment adviser representatives who materially aid the conduct giving rise to liability. The 2002 Uniform Act includes a reasonable care defense for each of these categories.ⁿ⁷ Providing for a reasonable care defense operates to establish a statutory standard for liability applicable to secondary actors. It has always been a part of the Uniform Act with regard to the liability of "non-sellers."

Secondary liability language in many Blue Sky Laws is phrased in terms of materially aiding or participating in a

violation.ⁿ⁸ None, however, expressly addresses aiding and abetting liability, although in practical terms there may be no significant difference. Aiding and abetting, however, is a secondary liability theory derived from common law to the extent it is applicable in state securities law settings, and state courts differ in determining whether it should be available. This is particularly true in the wake of the United States Supreme Court decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*,ⁿ⁹ in which the Court held that in a private action brought under section 10(b) of the Securities Exchange Act of 1934, and SEC Rule 10b-5, liability may not be based on aiding and abetting. Blue Sky Law antifraud provisions are based in large part on SEC Rule 10b-5, and thus the *Central Bank* holding carries considerable weight in determining the scope of civil liability for secondary actors when it is not clear that one of the specific secondary actor liability provisions in a state statute applies. State courts have differed in approaching aiding and abetting liability claims. In *Grubaugh v. DeCosta* ⁿ¹⁰ an Arizona appeals court concluded that in spite of *Central Bank* a private claim for aiding and abetting under the Arizona Securities Act should be allowed because Arizona courts have consistently viewed the state securities law as imposing broader liability than exists under the federal securities laws, and for that reason *Central Bank* should not be persuasive in limiting any liability.ⁿ¹¹ On the other hand, in *Kamen v. Lindly* ⁿ¹² a California court rejected a broad aiding and abetting claim for fraud that would be made in addition to other express secondary liability provisions. Because the California statute contains other secondary provisions, said the Court, the legislature was well able to do so with respect to liability for false and misleading statements in the inducement to purchase or sell securities if that was intended. The Supreme Court of South Carolina came to the same conclusion that an aiding and abetting claim for fraud was foreclosed because the South Carolina Uniform Securities Act expressly provided that although the rights and remedies provided in the Act are in addition to any other rights and remedies that may exist at law or in equity, the Act did not create any new causes of action not specified. Because a private plaintiff could not maintain an aiding and abetting claim under section 10(b) and Rule 10b-5 of the federal Securities Exchange Act of 1934, the claim would not be allowed under the Blue Sky law. An important element in the Court's decision, however, was the fact that a defrauded plaintiff was not without a remedy in the statute against one who materially aids another in the commission of securities fraud.ⁿ¹³

Under the original Uniform Securities Act, and in several non-Uniform Act states as well, those who are culpable in violations of antifraud provisions answer only to defrauded buyers of securities. Section 410(a)(2) of the Uniform Act provides only for liability of a seller to the person buying the security from that seller. Drafters of the original Uniform Act saw no need to provide for civil liability of buyers for violation of section 101--the general antifraud provision.ⁿ¹⁴ A majority of the states follow the approach of the original Uniform Act and provide a private civil remedy only to defrauded purchasers.ⁿ¹⁵ Some states, however, permit civil actions by anyone defrauded in a securities transaction: buyer or seller,ⁿ¹⁶

In New York, the Martin Act contains no provision for a private civil remedy for either a buyer or seller of securities.ⁿ¹⁷ and this is the approach taken by the 2002 Uniform Securities Act. The 2002 Uniform Act contains express civil remedies for both defrauded purchasers and sellers of securities.ⁿ¹⁸

As discussed earlier, buyers of securities seeking recovery under section 410 of the Uniform Securities Act, or its equivalent in their state, have a right of action against the immediate seller and every person who directly or indirectly controls that seller. In most cases the identity of the seller is readily ascertainable because he or she is the person who sold the securities to the buyer. In some states a right of action, whether for fraud, failure to register securities or the failure to obtain a proper license is limited to the person in privity with the buyer.ⁿ¹⁹ However, in these states it is common for courts, using an agency theory, to find an issuer liable for its agents' sales.

Secondary liability in these instances is based upon a party's relationship to the seller.ⁿ²⁰ When attempting to determine whether a party is a seller, some state courts have transposed onto Section 410 the federal court test adopted in *Hill York Corp. v. American International Franchises, Inc.*,ⁿ²¹ the so called "but for," or "substantial factor" or "substantial contributive factor" test.ⁿ²² While some secondarily liable persons would also be liable as sellers using this approach, not all secondarily liable parties would necessarily be sellers.ⁿ²³ An increasing number of states, however, have refined the somewhat unwieldy *Hill York* substantial factor test in favor of the broader interpretation found under the

"materially aided" standard.ⁿ²⁴

The difference between the two tests lies in the scope of their coverage. The substantial contributive factor in the sale test (the *Hill York* "but for" rule) focuses upon whether the inquiry to the plaintiff flowed directly and proximately from the actions of the person sought to be held liable. The "materially aids" in the sale test holds that a defendant need not be a substantial factor in the sale to plaintiff to have materially aided the sale.ⁿ²⁵

[2] "Control Person" Liability

Section 410(b) of the original Uniform Act imposes secondary liability upon control persons-partners, officers, and directors -without regard to whether they actually participate in a sale. "Control person" liability is the most frequently asserted basis for secondary liability under Blue Sky Laws. These provisions do not include any actual *culpability* requirement. Control person liability is, on its face, a status-based liability. Control persons are presumed to be so closely connected with a seller that they owe a duty of care to the buyer to prevent violations of the state securities law. To this end, Section 410(b) and most control person provisions in Blue Sky Laws generally, afford them an affirmative defense in fraud cases that they did not know and in the exercise of reasonable care could not have known of the basis of the alleged fraud.ⁿ²⁶ It is not clear, however, whether a title alone requires passive partners or outside directors, for example, to assert the affirmative defense to Section 410(b) civil liability, or whether actual control over the seller in regard to the violation is required. The central question is whether the control person must possess the necessary mental culpability by either knowing, or failing to know by reason of recklessness or negligence, of the alleged wrongdoing.ⁿ²⁷

Arizona courts have answered the question with a strongly worded rejection of the argument that culpable participation in a fraud is required for control person liability: In *Eastern Vanguard Forex, Ltd. v. Arizona Corporation Commission* ⁿ²⁸ the court affirmed an administrative order that certain of the plaintiff corporate officers were liable under the control person liability provision of the Arizona Securities Act. The court declared:

As did the Commission, we reject the "actual participation" requirement as "too restrictive to guard the public interest as directed by our state legislature ..." First, § 44-1999(B) imposes presumptive liability for "every person who, directly or indirectly, controls any person liable for a violation of §§ 44-1991 or 44-1992" The plain language of the statute does not support a requirement that a "controlling person" must have actually participated in the specific action upon which the securities violation is based. Second, interpreting § 44-1999(B) to require "actual participation" in the underlying conduct would frustrate the intent behind the creation of controlling person liability: to impose accountability on those actors who had the authority to control primary violators but were not legally liable under extant legal principles.ⁿ²⁹

In *Semrad v. Edina Realty, Inc.*, ⁿ³⁰ on the other hand, a Minnesota appellate court rejected any *per se* rule as to control person liability. That court instead elected to adopt a test articulated by a federal district court that rejected a culpable participation requirement, but nevertheless was based on actual participation by a control person to the extent of actually exercising control over the violator in general, and having the power to control the particular activity at issue:

[Plaintiff] must establish, first, that the defendant ... actually participated in the (i.e., exercised control over) the operations of the [violation] in general; then he must prove that the defendant possessed the power to control the specific transaction or activity upon which the primary violation is predicated, but he need not prove that the this latter power was exercised.ⁿ³¹

As illustrated by *Semrad*, an individual may be liable for fraud as a control person if she has either the power to control, whether or not exercised, or actual control.ⁿ³² Further, the control required to impose liability may be indirect as well as direct, and it is not limited to stock ownership or immediate managerial authority.ⁿ³³ More than one person can

control a corporation.ⁿ³⁴ Persons acting together for a common purpose with sufficient power in the aggregate to be considered a controlling person will be deemed members of a controlling group. As a consequence, each group member is treated as a controlling person. Directors and officers, for example, would normally constitute a controlling group.ⁿ³⁵

While a majority shareholder might as a matter of law be held to "control" a corporation regardless of actual participation in management decisions and the specific transaction in question, the absence of a substantial ownership of shares does not foreclose liability as a controlling person.ⁿ³⁶ An attorney, for example, could be found to be a controlling person even though she is not the owner of a substantial number of shares of the corporation violating the securities laws.ⁿ³⁷ The issue is whether there is control in fact. In *Felts v. National Account Systems Association, Inc.*,ⁿ³⁸ an attorney who had no direct contact with the purchasers was held to have been a control person of the corporation because of his rendering legal services to the issuer and allowing his name to be used as "president" of the corporation when he in fact performed no management functions.ⁿ³⁹

Clearly, the issue of "control" is a complex fact question which requires an examination of the relationships of the various alleged "controlling persons" to the person or entity which actually engaged in the sale of securities. A director, for example, without any effective day-to-day control and without knowledge is not likely to be liable as a controlling person.ⁿ⁴⁰ However, as discussed earlier with regard to Arizona, where there is control there may be presumptive liability. Section 410(b) of the Uniform Act imposes liability on control persons, partners, and directors without regard to whether they actively participate in a sale. That is the case with the 2002 Uniform Act as well. There is ample support for the proposition that merely by holding a position of actual influence, officers, directors and controlling shareholders owe a duty to ensure compliance with securities laws, and will not escape control person liability for fraud simply because they do not participate actively or directly in the transaction or conduct.ⁿ⁴¹ But in any case the reasonable care defense will operate to assure that attention is focused on an actual failure by a control person to exercise his or her responsibility. It is also true that the acts or inaction of any person alleged to be secondarily liable under Blue Sky Law antifraud provisions will be assessed in the context of provisions, and case law, that deal with whether a defendant materially aids in a sale in violation of the Blue Sky laws,ⁿ⁴² or who "participates" in a purchase or sale. It may be that "participates in the sale" or "materially aid in the sale" can equate with an officer's or director's failure to carry out a duty; that is to say, but for the failure to act with due care, the securities would not have been foisted upon unsuspecting investors. As is the case with the control person liability provisions of the federal securities laws, the extent of culpability of a control person under Blue Sky Laws continues to evolve, albeit with the balance tipped in favor of the least strict standard.

FOOTNOTES:

(n1)Footnote 1. The scope of liability under Blue Sky laws is considered here separately from *culpability* in a violation. Culpability standards applied in determining liability for violations of Blue Sky Laws is considered in detail in Chapter 14.06, as to criminal prosecutions, and Chapter 15-Civil Liabilities. In addition to expanded consideration of culpability standards and the scope of civil liability, Chapter 15 also includes extensive discussion of the defenses against civil liability claims that are available under Blue Sky Laws.

(n2)Footnote 2. In the Matter of the Securities Offering by Franklin Lord, 1994 Ariz. Sec. LEXIS 47 (Dec. 21, 1994).

(n3)Footnote 3. See *Kirchoff v. Selby*, 688 N.E.2d 1284, 1997 Ind. App. LEXIS 1748, Blue Sky L. Rep. (CCH) P 74,154 (Ind. Ct. App. 1997) *aff'd in part and vacated in part, on other grounds*, 703 N.E.2d 644, 1998 Ind. LEXIS 612 (Ind. 1998).

See also *Badger v. Paulson Inv. Co.*, 311 Ore. 14, 803 P.2d 1178, 1991 Ore. LEXIS 7 (1991) (Oregon statute provides for derivative liability of every non-selling person who (a) directly or indirectly controls seller, and (b) every person who participates or materially aids in sale but controlling non-seller can escape liability if the non-seller sustains burden of proof that the non-seller did not know, and, in exercise of reasonable care, could not have known, of existence

of the facts on which liability is based); *Sherrel v. Paulson Investment Co.*, Blue Sky L. Rep (CCH) P 73,820 (D. Ore. 1993) (brokers and agents function as "sellers" of securities under Oregon Act when selling stock in limited partnership interests; seller liability can exist for broker who actively solicits a potential investor).

But see Biales v. Young, 432 S.E.2d 482, 1993 S.C. LEXIS 122, Blue Sky L. Rep. (CCH) P 73, 843 (S.C. 1993) (attorney not seller of securities under South Carolina Securities Act because attorney did not persuade or urge the investor to purchase securities).

(n4)Footnote 4. The liability of "control persons" is specifically discussed in further detail below, § 13.03 [2].

(n5)Footnote 5. *See, e.g., Summers v. Welltech, Inc.*, 935 S.W.2d 228, 1996 Tex. App. LEXIS 5431, Blue Sky L. Rep. (CCH) P 74,137 (Tex. Ct. App. 1996).

See also Unif. Sec. Act § 410(b).

(n6)Footnote 6. *See* 2002 Unif. Sec. Act § 509(g).

(n7)Footnote 7. *Id.*, §§ 509(g)(1)-(4).

(n8)Footnote 8. *See, e.g., Ohio: Ohio Rev. Code* § 1707.43.

(n9)Footnote 9. 511 U.S. 164, 114 S.Ct. 1439, 128 L.Ed. 2d 119 (1994) .

(n10)Footnote 10. 1999 Ariz. App. LEXIS 35 (Ariz. App. 1999) .

(n11)Footnote 11. *See also* *State v. Diacide Distributing*, 96 N.W.2d 532, CCH Blue Sky L. Rep. § 74,188 (Iowa 1999); *Granewich v. Harding*, 945 P.2d 1067 (Ore. App. 1997) , *rev'd in part*, 329 Ore. 47, 985 P.2d 788 (1999) .

(n12)Footnote 12. 114 Cal. Rptr. 2d 127 (Cal. App. 2001) .

(n13)Footnote 13. *Atlanta Skin & Cancer Clinic, P.C. v. Hallmark General Partners, Inc.*, 320 S.C. 113 , 463 S.W.E. 2d 600 (1995).

(n14)Footnote 14. The Draftsmen's Commentary to Uniform Securities Act § 101, explains:

[T]here is no clear need to create any *civil liability* against buyers as distinct from sellers. Although the lower federal courts have uniformly implied a civil cause of action against fraudulent buyers under the rule, the federal courts when applying federal law do not have at their disposal all of the common-law and equitable remedies of deceit and rescission which are available to the state courts without benefit of statute. In the area of civil liability, moreover, it seems not only unnecessary but unwise to disturb the general jurisprudence which has been developing with reference, for example, to the obligation of corporate insiders to make affirmative disclosure when purchasing from existing stockholders. On the other hand, the general law is not adequate to deal with flagrant cases of fraud by buyers on a *criminal* level, and there can, of course, be no public action for an *injunction* against such practices with specific statutory authority.

To insure that no implied cause of action arises under the Act in favor of defrauded sellers, it is also provided that the only civil causes of action permitted are those expressly provided for in the Act, *see* Unif. Sec. Act § 410(h). The purpose of the clause is to prevent civil suits against purchasers from being brought under the Act. *See* Official Comment to Unif. Sec. Act § 410(h), *see also* Rev. Unif. Sec. Act §§ 501, 609.

(n15)Footnote 15. *See, e.g., Ill. Comp. Stat. ch. 815, § 5/13(A) Mass. Gen. L. ch. 110A, § 410(a)(2); N.J. Stat.*

Ann. § 49: 3-71(a)(2); *Ohio Rev. Code Ann. § 1707.41, 1707.43.*

See also Space v. E.F. Hutton, Inc., 544 N.E.2d 67 (Ill. App. 1989) , *appeal denied*, 128 Ill. 2d 664 (1989) (call options writer had no standing to sue his unregistered sales agent since the court characterized plaintiff as a seller and not a purchaser of securities).

(n16)Footnote 16. *See, e.g., Cal. Corp. Code §§ 25500, 25501; Fla. Stat. § 517.211; Tex. Rev. Civ. Stat. Ann. art. 581-33(A)(2).*

(n17)Footnote 17. *See Limited, Inc. v. McCrory Corp.*, 683 F. Supp. 387 (S.D.N.Y. 1988) ; *CPC Int'l, Inc. v. McKesson Corp.*, 70 N.Y.2d 268, 519 N.Y.S.2d 804, 514 N.E.2d 116, 1987 N.Y. LEXIS 18546 (1987) .

(n18)Footnote 18. *See* 2002 Unif. Sec. Act §§ 509(b)-(c).

(n19)Footnote 19. *See, e.g., Kirchoff v. Selby*, 688 N.E.2d 1284, 1997 Ind. App. LEXIS 1748 , Blue Sky L. Rep. (CCH) P 74,154 (Ind. Ct. App. 1997), *aff'd in part and vacated in part, on other grounds*, 703 N.E.2d 644, 1998 Ind. LEXIS 612 (1998) ; *Griffin v. Ramtek Corp.* 1988 U.S. Dist. LEXIS 16344 , [1988-1990 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,960 (N.D. Cal. 1988); *In re Catanella & E.F. Hutton and Co.*, 583 F. Supp. 1388, 1440 (E.D. Pa. 1984) (Pennsylvania securities statute's privity requirement likened to that found in section 12(2)); *cf. Ging v. Parker-Hunter, Inc.*, 544 F. Supp. 49, 52 (W.D. Pa. 1982) (under Pennsylvania common law, injured party is not limited to suit against one in privity with him, but may sue any individual or legal equity who aided or abetted perpetration of fraud).

(n20)Footnote 20. *Haberman v. Washington Public Power Supply System*, 744 P.2d 1032, 750 P.2d 254, 1987 Wash. LEXIS 1330 [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,662 (Wash. 1987).

(n21)Footnote 21. 448 F.2d 680, 692-93 (5th Cir. 1971) .

But see Pinter v. Dahl, 486 U.S. 622, 108 S. Ct. 2063, 100 L. Ed. 2d 658 (1988) in which the Supreme court held that the substantial factor test was not an appropriate standard for assessing liability as a statutory seller under § 12(1) of the Securities Act of 1933, and overruling cases construing § 12(1) otherwise. The Supreme Court's ruling is not, however, controlling for construction of analogous state law.

(n22)Footnote 22. *Wade v. Skipper's, Inc.*, 915 F.2d 1324, 1328 (9th Cir. 1990) (substantial factor-proximate cause analysis is test under Washington law); *Haberman*, N. 173 above; *Anders v. Dakota Land and Development Co.*, 380 N.W.2d 862, 868 (Minn. Ct. App. 1986) .

(n23)Footnote 23. *See Haberman*, N.173 above at 72,744; *Dade County v. Goldstein*, 384 So. 2d 183, 190 (App. Ct. Fla. 3d D.C.A. 1980) .

(n24)Footnote 24. *See, e.g., Banton v. Hackney*, 557 So. 2d 807, 816 (Ala. 1989) ; *Quick v. Woody*, 295 Ark. 168, 747 S.W.2d 108, 1988 Ark. LEXIS 162 , [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,718 (Ark. 1988); *In re Gas Reclamation, Inc. Sec. Litig.*, Fed. Sec. L. Rep. (CCH) 93,217, 659 F. Supp. 493, 1987 U.S. Dist. LEXIS 2871 [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,617 at 72,551 (S.D.N.Y. 1987).

(n25)Footnote 25. *See, e.g., Banton v. Hackney*, 557 So. 2d 807, 816 (Ala. 1989) .

(n26)Footnote 26. *See, e.g., North Carolina:*

Every person who directly or indirectly controls a person liable under subsection (a), (b) or (b)(1) of this section, every partner, officer, or director of the person, every person occupying a similar status or performing similar functions, and every dealer or salesman who materially aids in the sale is also liable

jointly and severally with and to the same extent as the person, unless able to sustain the burden of proof that the person did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist. *N.C.G.S. § 78A-56(c)(1)*.

(n27)Footnote 27. To the extent that the "every person who directly or indirectly controls a seller" language of § 410(b) is based upon the federal securities laws, a review of the federal case law is instructive. Section 15 of the 1933 Securities Act, 15 U.S.C. § 77(o), imposes joint and several liability on persons who control other persons who are liable under the Securities Act. Section 20 of the Securities Exchange Act of 1934, 15 U.S.C. § 73(t), imposes similar liability on persons who control other persons who violate substantive provisions of the Exchange Act and the regulations promulgated thereunder. Section 20(a) of the Exchange Act, 15 USC § 78t(a), provides:

Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlled person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

The control person provisions of the Securities Acts are remedial and must be construed liberally. *Myzel v. Fields*, 386 F.2d 718, 738 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); accord, *SEC v. First Securities Co. of Chicago*, 463 F.2d 981, 987 (7th Cir. 1972), cert. denied, 409 U.S. 880 (1972). Federal courts have held that the control person liability provisions require only some indirect means of discipline or influence short of actual direction to hold a "controlling person" liable. *Myzel*, 368 F.2d at 738; *SEC v. First Securities Co. of Chicago*, 463 F.2d at 987.

However, the extent of culpable participation, if any at all, required under the federal control person liability provisions is not at all clear. See *SEC v. First Jersey Securities, Inc.*, 101 F.3d 1450, 1472 (2d Cir. 1996) (Plaintiff must show that a controlling person was in some meaningful sense a culpable participant in the fraud perpetrated by the controlled person); *Suez Equity Investors L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 101 (2d Cir. 2001) (Section 20(a) liability requires culpable participation by the control person in the perpetration of the fraud).

But see *In re Paramalot Sec. Litigation*, 414 F.Supp. 2d 428, 439 (S.D.N.Y. 2006) ("This court has repeatedly held that plaintiffs need not allege culpable participation by the controlling person").

(n28)Footnote 28. 206 Ariz. 399, 79 P. 3d 86 (Ariz. App., Div. 1, 2003).

(n29)Footnote 29. 206 Ariz. at 412 (citations omitted).

See also *Hines v. Data Line Systems, Inc.*, 114 Wn. 2d 127, 787 P.2d 8 (1990) (Directors are liable under the Blue Sky Law to the same extent as the issuing corporation, subject only to the due diligence defense).

(n30)Footnote 30. 470 N.W.2d 135, 1991 Minn. App. LEXIS 461 (Minn. App. 1991).

(n31)Footnote 31. 470 N.W.2d at 141, quoting *Metge v. Baehler*, 577 F.Supp. 810, 817-18 (S.D. Iowa 1984).

(n32)Footnote 32. *Savino v. E.F. Hutton & Co.*, 507 F. Supp. 1225, 1242-43 (S.D.N.Y. 1981); *Sharp v. Coopers & Lybrand*, 457 F. Supp. 879, 892 (E.D. Pa. 1978).

See also *Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1325 (8th Cir. 1991), aff'd, 507 U.S. 170, 113 S. Ct. 1163, 122 L. Ed. 2d 525 (1993) (test for control person liability is whether defendant actually participated in, i.e. exercised control over, operations of corporation in general and if so whether defendant possessed power to control specific

transaction upon which primary violation was predicated, whether or not exercised); *Degulis v. LXR Biotech, Inc.*, *Fed. Sec. L. Rep. (CCH) P 99,260* (S.D.N.Y. 1996); *Lilley v. Charren*, *Fed. Sec. L. Rep. (CCH) 99,092*, 936 F. Supp. 708, 1996 U.S. Dist. LEXIS 16714 (N.D. Cal. 1996).

But see Durham v. Kelly, 810 F.2d 1500, 1505 (9th Cir. 1987) (complainant must show relationship between controlling and controlled person and that actual power exerted over controlled person).

(n33)Footnote 33. *Wiley v. Hughes Capital Corp.*, 746 F. Supp. 1264, 1281 (D.N.J. 1990) ; *Harriman v. E.I. DuPont De Nemours & Co.*, 372 F. Supp. 101, 104-05 (D. Del. 1974) . The plaintiff does not have to prove that the controlling person approved or knew of the offending act. *G. A. Thompson & Co. v. Partridge*, 636 F.2d 945, 957-58 (5th Cir. 1981) ; *Snyder v. Newhard, Cook & Co., Inc.*, 764 F. Supp. 612, 620 (D. Colo. 1991) ; *Metge v. Baehler*, 577 F. Supp. 810, 816 (S.D. Iowa 1984) , *aff'd*, 762 F.2d 621 (8th Cir.) , *cert. denied*, 474 U.S. 1057, 1072, 88 L. Ed 2d 774, 106 S. Ct. 798, 832 (1985) ; *Leff v. CIP Corp.*, 540 F. Supp. 857, 867 (S.D. Ohio 1982) .

(n34)Footnote 34. *See, e.g. Ronson Corp. v. Liquifin Aktiengesellschaft*, 483 F.2d 846, 849 (3d Cir. 1973) , *cert. denied*, 419 U.S. 870 (1974) .

(n35)Footnote 35. *Safeway Portland Employees' Federal Credit Union v. C.H. Wagner, Co.*, 501 F.2d 1120 (9th Cir. 1974) (summary judgment against two of three directors affirmed); *Kemmerer v. Weaver*, 445 F.2d 76, 79 n.2 (7th Cir. 1971) (control status of directors and officers conceded); *Nelson v. National Republic Bank of Chicago*, 1984 U.S. Dist. LEXIS 17527 , [1984 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 91,481* (N.D. Ill. 1984); *Degulis v. LXR Biotech Inc.*, *Fed. Sec. L. Rep. (CCH) P 99,260* (S.D.N.Y. 1996).

(n36)Footnote 36. *See Klapmeier v. Telecheck International, Inc.*, 315 F. Supp. 1360, 1361 (D. Minn. 1970) , *aff'd*, 482 F.2d 247 (8th Cir. 1973) .

(n37)Footnote 37. *Seidel v. Public Service Co. of New Hampshire*, 616 F. Supp. 1342, 1362 (D.C.N.H. 1985) ; *Westlake v. Abrams*, 504 F. Supp. 337, 349 (N.D. Ga. 1980) .

(n38)Footnote 38. 469 F. Supp. 54, 68 (N.D. Miss. 1978) .

(n39)Footnote 39. *But see Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 494 (7th Cir. 1986) (ability of law firm and accounting firm to persuade and give counsel to client corporation selling notes and bonds in violation of securities laws is not control of corporation under controlling person liability provisions of the federal securities laws).

(n40)Footnote 40. *Dennis v. General Imaging, Inc.*, 918 F.2d 496, 509-10 (5th Cir. 1990) ; *Cameron v. Outdoor Resorts of America, Inc.*, 608 F.2d 187, 194-95 (5th Cir. 1979) , *modified*, 611 F.2d 105 (5th Cir. 1980) .

See also Frank v. Bear Stearns Co., 11 S.W.3d 380, 2000 Tex. App. LEXIS 255 , Blue Sky L. Rep. (CCH) P 74,202 (Tex. Ct. App. 2000) (underwriters without knowledge of violation or control of seller not control persons).

(n41)Footnote 41. *See, e.g., James v. Erlinder Mfg. Co.*, 398 N.E.2d 1225 (App. Ct., 1st Dist. Ill. 1979) , *citing Stevens v. Crystal Lake Transportation Sales, Inc.*, 332 N.E.2d 727 (Ill. 1975) ; *Gilbert v. Meason*, 222 S.E.2d 835 (Ga. 1975) , *aff'd*, 226 S.E.2d 49 (Ga. 1976) ; *Dehler v. Setliff*, 266 S.E.2d 516 (Ga. Ct. App. 1980) , *citing Boddy v. Theiling*, 199 S.E.2d 379 (Ga. 1973) ; *Moore v. Manufacturers Sales Co.*, 56 N.W. 2d 397 (Mich.1953) .

See also Southwestern Oklahoma Dev. Auth. v. Sullivan Engine Works, 910 P.2d 1052, 1996 Okla. LEXIS 7 , Blue Sky L. Rep. (CCH) P 74,081 (Okla. 1996); *Steeblik v. Lichfield*, 906 P.2d 872, 1995 Utah LEXIS 71 , Blue Sky L. Rep. (CCH) P 74,074 (Utah 1995).

But see Paracor Fin., Inc., v. General Electric Capital Corp., 96 F.3d 1151, 1996 U.S. App. LEXIS 24726 , Blue

Sky L. Rep. (CCH) P 74,088 (9th Cir. 1996).

(n42)Footnote 42. *See, e.g., Banton v. Hackney*, 557 So. 2d 807, 816 (Ala. 1989) , modified, 557 So. 2d 807, 1990 Ala. LEXIS 32 (Ala. 1990) ; *Quick v. Woody*, 295 Ark. 168, 747 S.W.2d 108, 1988 Ark. LEXIS 162 , [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,718 (Ark. 1988); *In re Gas Reclamation, Inc. Sec. Litig., Fed. Sec. L. Rep. (CCH) 93,217*, 659 F. Supp. 493, 1987 U.S. Dist. LEXIS 2871 [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,617 at 72,551 (S.D.N.Y. 1987).



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CHAPTER 13 Fraud and Prohibited Practices

2-13 Blue Sky Regulation § 13.04

§ 13.04 Federal Limitations on the Scope of Liability Beyond NSMIA

Congress responded to the national, indeed increasingly global, character of investments and financial markets, as well as the explosion of litigation under antifraud provisions of both state and federal securities laws, with legislation impacting certain applications of state Blue Sky fraud provisions. The National Securities Markets Improvement Act of 1996 ("NSMIA"), has already been discussed. Most importantly, although NSMIA significantly preempts state authority and the application of Blue Sky Laws to impose registration requirements on securities offerings that are considered national in character, under NSMIA the states retain their authority to bring enforcement actions with respect to "fraud or deceit" or unlawful conduct by intermediaries.ⁿ¹ In the wake of NSMIA states may not use their retained antifraud authority to circumvent preempted regulation. As discussed earlier in § 13.01, however, state courts interpret retained antifraud enforcement authority broadly.

NSMIA does not bar private plaintiffs from bringing state law actions predicated on common law fraud with regard to either federal covered securities or those that remain within the purview of state regulation.ⁿ² However, certain derivative or implied rights of action based upon other violations of Blue Sky laws preempted by the federal legislation may not be available to private plaintiffs.ⁿ³

While NSMIA substantially preempted state regulation of the distribution of federal covered securities, it did not interfere with state jurisdiction to prosecute fraudulent activity with regard to either state regulated or federal covered securities.ⁿ⁴ State regulators and the SEC have cooperated to coordinate enforcement and avoid conflict in potentially overlapping or unsettled areas of jurisdiction.ⁿ⁵

Congress also enacted the Private Securities Litigation Reform Act of 1995 ("PSLRA"); and the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"). Each impacts the application of Blue Sky fraud provisions and the scope of antifraud protection under state securities laws. Each is discussed further below.

[1] Private Securities Litigation Reform Act of 1995 ("PSLRA")

Congress passed the Private Securities Litigation Reform Act of 1995ⁿ⁶ in order to control the filing of frivolous federal class action suits for securities fraud. The statute amends the federal securities laws by instituting, among other changes, the following restrictions:

- heightened pleading requirements;
- discovery stay during the pendency of a motion to dismiss;
- a safe harbor for "forward looking" statements;
- criteria for lead plaintiff selection based on financial stake;
- a mandatory Rule 11 inquiry; and
- judicial scrutiny of settlement provisions.

The PSLRA has no preemptive impact as such in regard to state securities law fraud actions, and indeed, the PSLRA federal pleading hurdle resulted in a substantial increase in state law fraud claims filed in state courts. After PSLRA, state common law offered plaintiffs relaxed pleading requirements and lower scienter burdens, as well as alternative theories of recovery, such as negligent misrepresentation, constructive fraud and secondary or aiding and abetting liability claims that are foreclosed or limited by federal courts.ⁿ⁷ PSLRA thus changed the landscape of securities fraud litigation, with a new emphasis on the role of state claims, yet all the while the preemptive message of NSMIA loomed large. Until the passage of the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"),ⁿ⁸ class action securities fraud plaintiffs bringing actions that were decidedly national in scope could avoid the PSLRA bar by filing in state court. SLUSA addressed the matter and is discussed in further detail below.

[2] Securities Litigation Uniform Standards Act of 1998 ("SLUSA")

In 1998, to curb the perceived migration of class action securities fraud claims to state court, Congress enacted the Securities Litigation Uniform Standards Act of 1998 ("SLUSA").ⁿ⁹ SLUSA provides that no covered class action based upon state statutory or common law, alleging: (1) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security or (2) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security, can be maintained by a private plaintiff in state or federal court

The legislation limits preemption to "covered securities" under Section 18(b)(1), (2) of the Act,ⁿ¹⁰ while retaining state court jurisdiction over class action securities fraud claims arising from the offer or sale of NSMIA sanctioned state regulated securities, as well as certain claims arising from transactions between an issuer and its security holders under the law of the issuer's state of incorporation.ⁿ¹¹ SLUSA also permits actions to be brought by states, state political sub-divisions and state pension plans involving covered securities on behalf of a class comprised solely of such entities, as well as allowing certain actions under contractual agreements between issuers and indenture trustees. The Act defines a "covered class action" as any single lawsuit in which:

- (1) damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of individualized reliance on an alleged misstatement or omission, predominate over any questions affecting only individual persons or members; or
- (2) one in which one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated, and questions of law or fact common to those persons or members of the prospective class predominate over any questions affecting only individual persons or members; or
- (3) any group of lawsuits filed in or pending in the same court and involving common questions of law

or fact, in which damages are sought on behalf of more than 50 persons; and the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose.

The term does not include an exclusively derivative action brought by one or more shareholders on behalf of a corporation.

SLUSA also extends the discovery stay to state court, preventing the use of an individually filed state court suit to obtain discovery for use in the federal class action. And it specifically preserves the jurisdiction of state securities commissioners to investigate and bring fraud enforcement actions.

With SLUSA, Congress thus imposed national standards on, and mandated an exclusive venue for, virtually all securities fraud class action litigation.ⁿ¹² It has spawned robust debate on whether the problems the Act was designed to counter--migration of frivolous claims to state court and circumvention of the federal discovery stay--were in fact exaggerated. Additionally, one commentator has pointed out that such pre-emption of state law claims deprives plaintiffs of remedies that federal courts, in scaling back private rights of action under federal securities law, assumed to be available to plaintiffs under the explicit preservation of state claims in those same federal statutes.ⁿ¹³ In the end, however, it is clear that SLUSA effectively eliminates claims brought as class actions by private plaintiffs alleging violations of antifraud provisions of Blue Sky laws. Considering the efficacy of the civil remedy provisions in state securities laws, SLUSA preemption of class actions is seen in its most meaningful light.

[3] Conflict Preemption

Under the *Supremacy Clause of the U.S. Constitution*, Congress has the power to preempt state law, and may do so either expressly through clear statutory language, or implicitly. "Conflict preemption" is a type of implied preemption, and occurs when federal law actually conflicts with any state law.ⁿ¹⁴ Conflict preemption analysis examines a federal statute as a whole to determine whether a party's compliance with both federal and state requirements is impossible, or whether, in light of the federal statute's purpose and intended effects, state law poses an obstacle to the accomplishment of congressional objectives.ⁿ¹⁵ In *Whistler Investments, Inc. v. Depositary Trust and Clearing Corp.*,ⁿ¹⁶ plaintiffs sued three registered clearing agencies on a claim that short sellers drove down the market price of Whistler stock without having stock available for delivery, and then intentionally failing to deliver the stock. The practice involved is known as "naked short selling." Plaintiffs claimed that naked short selling of Whistler stock was facilitated by alleged defects in a program operated by National Clearing Corporation. Plaintiffs sued the clearing agencies under various theories based on Nevada law sounding in misrepresentation and market manipulation.

Securities clearing agencies are creations of, and regulated under, federal law. Section 17A of the Securities Exchange Act of 1934ⁿ¹⁷ established a national system for clearance and settlement of securities transactions. Section 17A provides, among other things, for the registration of "clearing agencies" by the Securities and Exchange Commission. The defendant clearing agencies in *Whistler* asserted that with Section 17A, Congress intended to occupy the field of clearing and settling securities transactions, thus raising "field preemption" as a defense against state law claims. That argument was rejected on the basis of Section 17A itself, which, by its language, indicates that Congress did not intend to occupy the entire field of national clearance and settlement of securities transactions. However, the defendants also asserted that imposing requirements implicated by the state law claims made in the case would conflict with the purpose of Section 17A to regulate and control a national clearance and settlement system. Defendants thus asserted conflict preemption.

In the district court, the defendants' conflict preemption argument was upheld, and the case dismissed. On appeal, the Ninth Circuit affirmed, holding that imposing any state standards of efficiency would directly interfere with the federally approved procedures established by national clearing agencies to operate the "Stock Borrow" program that operates in regard to short sales of securities. This interference with the operation as federally approved, said the court, triggers conflict preemption of state law. The court saw other state law claims by plaintiffs as amounting to the same

challenge to the SEC approved operation of the "Stock Borrow" program, and a direct challenge to clearing agency rules.ⁿ¹⁸

The federal securities laws, even after NSMIA, clearly preserve the role of state Blue Sky laws in the field of securities regulation. In the post-NSMIA world, the issue of conflict preemption in matters of state and federal securities laws should not arise except in specialized situations, as *Whistler* illustrates. That case did not involve the invocation of any remedy provision or right of action under the Nevada securities law, but the central point that state law can stand as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress in regard to the federal securities laws must be considered if the state remedy would operate to impose an obstacle to achieving congressional purposes for the federal law.ⁿ¹⁹

FOOTNOTES:

(n1)Footnote 1. Securities Act section 18(c), 15 U.S.C. § 77r(c), declares:

(1) Fraud Authority--Consistent with this section, the securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions.

(n2)Footnote 2. *See, e.g., Zuri-Invest AG v. Natwest Fin. Inc., Fed. Sec. L. Rep. (CCH) 91630, 2001 U.S. Dist. LEXIS 17495* (S.D.N.Y. Oct. 26, 2001) (Although NSMIA precluded states from regulating any national offering of securities, there was no indication that statute was intended to preempt state fraud actions since it did not provide any civil liability or enforcement provisions and did not amend statutes providing that the federal remedy was in addition to other remedies and plaintiff's claims for common law fraud did not interfere with regulatory provisions of NSMIA and were consistent with purpose of federal securities law to deter fraud); *Baron v. Strassner, 7 F. Supp. 2d 871 (S.D. Tex. 1998)*.

(n3)Footnote 3. *See* discussion of civil liabilities generally in Chapter 15, *below*.

(n4)Footnote 4. *See* Securities Act of 1933 section 18(c)(1), reprinted in Securities Primary Law Sourcebook, Volume A, Section B (Matthew Bender).

(n5)Footnote 5. *See* Rutledge, *National Securities Markets Improvements Act ... One Year Later: The States' Response*, 53 Bus. L. 563 (Feb. 1998); *see also* NASAA Reports P 13,047 (CCH), Submission to Jonathan Katz, SEC, for Mandated Study Under NSMIA on the Uniformity of State Regulatory requirements for Securities or Securities Transactions that are not Covered Securities (Aug. 22, 1997).

(n6)Footnote 6. Pub. L. No. 104-67, 190 Stat. 737 (effective December 22, 1995).

(n7)Footnote 7. *See* Branson, *Securities Litigation in State Courts: Something Old, Something New, Something Borrowed...*, 76 Wash. Univ. L. Q. no. 2, p. 509, 512 (Summer 1998).

(n8)Footnote 8. Pub. L. No. 105-353, 112 Stat. 3234 (effective November 3, 1998, adding new 15 U.S.C. § 16(b)).

(n9)Footnote 9. Pub. L. No. 105-353, 112 Stat. 3234 (effective November 3, 1998, adding new 15 U.S.C. § 16(b)).

(n10)Footnote 10. These include nationally traded securities such as those listed or authorized for listing on NYSE, AMEX, other SEC approved exchanges or NASDAQ, or investment securities (excluding certain exempted debt securities), *see* NSMIA sections 18(b)(1),(2).

(n11)Footnote 11. This latter compromise was dubbed the "Delaware carve-out." *See Derdiger v. Tallman, 75 F.*

Supp. 2d 322 (D. Del. 1999) ; R. Painter, *Responding to a False Alarm: Federal Pre-emption of State Securities Fraud Causes of Action*, 84 *Cornell L. Rev.* 56 (Nov. 1998); D. Levine and A. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws*, 54 *The Bus. Lawyer* no. 1, p. 1, 23 (November 1998).

(n12)Footnote 12. See, e.g., *Lander v. Hartford Life & Annuity Ins. Co.*, *Fed. Sec. L. Rep. (CCH)* 91456, 251 *F.3d* 101, 2001 *U.S. App. LEXIS* 10991 (2d Cir. 2001) (variable annuity contracts at issue were "covered securities" as defined by SLUSA, not subject to the anti-preemption rule of the McCarran-Ferguson Act and district court dismissed case pursuant to SLUSA's directive that all such class actions be based exclusively on federal law); *Korsinsky v. Salomon Smith Barney*, 2002 *U.S. Dist. LEXIS* 259 (S.D.N.Y. Jan. 9, 2002) (in order to defeat a motion to remand an action to state court, defendant must show that: (1) the action is a "covered class action" under SLUSA; (2) the action purports to be based upon state law; (3) the action involves a "covered security" under SLUSA; (4) that the defendant is alleged to have misrepresented or omitted a material fact; and (5) the alleged misrepresentation or omission was made "in connection with" the purchase or sale of the covered security); *Shaw v. Charles Schwab & Co.*, 128 *F. Supp. 2d* 1270, 2001 *U.S. Dist. LEXIS* 3494 (C.D. Cal. 2001) (investors' class action against online broker not preempted by 15 *U.S.C. § 78bb(f)* where claims relate to commission rate for and efficacy of broker's web-based trading system, and investors' allegations that broker's fraud induced them to select defendant as their broker, not to invest in particular securities, lay more in realm of consumer protection than securities litigation); *Abada v. Charles Schwab & Co.*, *Fed. Sec. L. Rep. (CCH)* 91294, 127 *F. Supp. 2d* 1101, 2000 *U.S. Dist. LEXIS* 18992 (S.D. Cal. 2000) (remand of investor's original action to state court was appropriate because investor's allegations involved relationship between brokerage firm and its customers regarding timely execution of online trades and did not assert misrepresentations "in connection with purchase or sale of covered security" within meaning of 15 *U.S.C. § 78bb(f)(1)*); *Prager v. Knight/Trimark Group, Inc.*, *Fed. Sec. L. Rep. (CCH)* 91281, 124 *F. Supp. 2d* 229, 2000 *U.S. Dist. LEXIS* 18101 (D.N.J. 2000) (removal of case to federal district court proper even though action charged that "market maker" improperly used information about retail customers' intent to trade particular securities in order to execute own trades for profit before executing customer trades; although 15 *U.S.C. § 77bb(f)* often applies to cases involving issuers or their affiliates it does not follow that Congress intended to limit its application to such cases; investor has pleaded what are in essence securities fraud claims, if framed as state law claims); *Diamond Multimedia Systems, Inc. v. Superior Court*, 19 *Cal. 4th* 1036, 968 *P.2d* 539, 1999 *Cal. LEXIS* 1, 80 *Cal. Rptr. 2d* 828 (1999) (far from restricting market manipulation actions to those brought under federal securities law, Congress left individual actions unrestricted; except to extent SLUSA limits class actions, there is no preemption and federal law in this arena supplements, but does not displace state regulation and remedies).

(n13)Footnote 13. See R. Painter, *Responding to a False Alarm: Federal Pre-emption of State Securities Fraud Causes of Action*, 84 *Cornell L. Rev.* 84, 91 (Nov. 1998).

See also S. Daugherty, *Uncharted Waters: Securities Class Actions in Texas After the Securities Litigation Uniform Standards Act of 1998*, 31 *St. Mary's L. J.* 143 (1999). J. Ratner, *Stockholders' Holding Claim Class Actions under State Law after the Uniform Standards Act of 1998*, 68 *U. Chi. L. Rev.* 1035 (Summer 2001) (discussing resurgence of state common law claims); Ogden and Cooper, *Federal Securities Statutes Trip up Many; But Individual Fraud Suits Booming in State Courts*, *New York Law Journal* (Feb. 7, 2000).

(n14)Footnote 14. *Hillsborough County v. Automated Med. Laboratories, Inc.*, 471 *U.S.* 707, 713, 105 *S. Ct.* 2371, 85 *L. Ed. 2d* 714 (1985) .

(n15)Footnote 15. *Crosby v. National Foreign Trade Council*, 530 *U.S.* 363, 373, 120 *S. Ct.* 2288, 147 *L. Ed. 2d* 352 (2000) .

(n16)Footnote 16. *Whistler Invs., Inc. v. Depositary Trust & Clearing Corp.*, 539 *F.3d* 1159 (9th Cir. 2008) .

(n17)Footnote 17. 15 *U.S.C. § 78q1* (2000).

(n18)Footnote 18. *See Whistler Invs., Inc. v. Depositary Trust & Clearing Corp.*, 539 F.3d 1159, 1166-1167 (9th Cir. 2008) .

(n19)Footnote 19. *See also* *Green v. Fund Asset Mgmt., L.P.* , 245 F.3d 214 (3d Cir. 2001) (plaintiffs' breach of fiduciary duty claims were not conflict preempted by the governance provisions of the federal Investment Company Act of 1940); *but see Olde Discount Corp. v. Tupman*, 1 F.3d 202 (3d Cir. 1993) .(rescission action by state securities commissioner under the Blue Sky law conflicted with enforcement and operation of the Federal Arbitration Act).

See also *Colbert & Winstead, PC 401K Plan v. AIG Financial Advisors, Inc.*, Blue Sky L. Rep. (CCH) P 74,723, at 79,842 (M.D. Tenn. 2008) (the Tennessee Securities Act substantively regulates the offer, sale, or purchase of securities and is not intended to redress harms contemplated by federal ERISA, and is not preempted by ERISA).



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CHAPTER 14 State Enforcement Authority

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CHAPTER 14 State Enforcement Authority

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§ 14.01 Overview

In 2002, following an investigation and proceeding instituted by the Attorney General of the State of New York authorized under the New York Blue Sky Law (the "Martin Act"),ⁿ¹ an agreement of historic proportion in the administration and enforcement of state securities laws was reached between the Attorney General and Merrill Lynch, Pierce, Fenner & Smith, Inc. (Merrill Lynch). By the agreement, Merrill Lynch agreed to implement major changes in practices and procedures relating to its equity research analysts, and to pay the sum of \$100 million in settlement of civil claims brought by the Attorney General, a significant portion of which also to be distributed among all other states in resolution of civil claims of the states under their respective securities laws. The agreement to resolve claims involved requirements and undertakings regarding not only practices and procedures relating to equity research, but also specifically addressed research analyst compensation, the implementation of a Research Recommendations Committee, analyst participation in the solicitation of investment banking business, research related disclosure during solicitation of public equity underwriting, and specific ongoing monitoring of compliance with terms of the agreement.

This agreement in the context of enforcement of a state securities law was unprecedented in its sheer scope. Even more significantly, it demonstrated the power and effectiveness of Blue Sky law enforcement in achieving historic investor protection goals and fairness in markets. Indeed, in the wake of this action taken under New York's Martin Act, a task force of some 40 state securities regulators was formed to investigate possible misconduct associated with conflicts of interest at financial services firms. In this undertaking, a spokesperson for the North American Securities Administrators Association (NASAA) characterized the investigation by the states in simple terms that convey the essence of Blue Sky regulation, that is, whether there was fraud committed against investors by analysts who issued recommendations that did not reflect how they felt about a stock.ⁿ² These actions evidence the vitality of Blue Sky enforcement, and underscore the need to examine more closely all aspects of enforcement authority under these provisions.

Enforcement of state Blue Sky laws is delegated by statute to designated state agencies, whether separately constituted securities commissions or divisions of other departments or agencies of government. The Uniform Act simply provides for enforcement of the Act by a "local administrative agency," the name and any related provisions for which are left to determination by individual states.ⁿ³ Enforcement powers include broad investigative authority and the authorization to proceed against violators in administrative and judicial forums, the latter including provisions for criminal prosecutions either directly or in conjunction with other law enforcement authorities.

Enforcement authority of state regulators is usually categorized in terms of administrative proceedings, civil injunctive authority, and criminal prosecution.ⁿ⁴ Important and widely employed "cease and desist" authority falls under the mantle of administrative proceedings that are governed by their own prescribed procedures and applicable administrative procedure statutes.ⁿ⁵ Broad investigative authority and associated subpoena power attaches to all three categories of enforcement activity.

Enforcement powers under Blue Sky laws derive from legislative authority in the exercise of state police powers. State securities laws were enacted with broadly-stated objectives for the protection of the public from exploitation through the sale of securities, and administrators for that reason enjoy considerable deference and discretion in the exercise of their powers. Indeed, the authority of a state securities administrator has been described as "pervasively discretionary." In *Department of Corporations v. The Superior Court of San Diego County*,ⁿ⁶ a California appeals court held that the Commissioner had no mandatory duty in regard to enforcement of that state's securities law. The court declared:

The Commissioner is required to find that his action is "necessary or appropriate in the public interest or for the protection of investors and consistent with the purposes fairly intended by the policy and provisions" of the Act... This legislative command does not dictate any particular result, but rather explicitly calls upon the judgment, expertise, and discretion of the Commissioner to define what action, if any, is "necessary or appropriate"--again, strongly supporting the conclusion that there is no mandatory duty.ⁿ⁷

Because the Commissioner has no mandatory duty, the court held that no private claim could be asserted by investors that the Department of Corporations had failed to fulfill its duty to protect investors from fraudulent sales of securities.ⁿ⁸

FOOTNOTES:

(n1)Footnote 1. *In re an Inquiry by Elliot Spitzer, Attorney General of the State of New York*, Index No. 02/401522 (N.Y. Sup. Ct. 2002).

(n2)Footnote 2. *Task Force of States Investigating Analyst Conflict Up to 40; 12 Firms Targeted*, 34 BNA Sec. Reg. & L. Rep. 936 (June 10, 2002).

(n3)Footnote 3. Unif. Sec. Act § 406(a). Recognizing variations in nomenclature among state laws, the Uniform Securities Act of 2002 (hereinafter the "2002 Uniform Act") speaks only in terms of an "Administrator." See 2002 Uniform Act § 102(1).

(n4)Footnote 4. Private civil remedies or rights of action authorized in Blue Sky laws for those seeking to recover from violators are considered elsewhere, see Chapter 15, Civil Liabilities.

(n5)Footnote 5. Practice and procedural considerations in regard to administrative enforcement under Blue Sky laws are specifically considered in Chapter 16--"Blue Sky Practice and Procedure."

(n6)Footnote 6. *Department of Corporations v. Superior Court*, 153 Cal. App. 4th 916, 931, 63 Cal. Rptr. 3d 624 (2007).

(n7)Footnote 7. 153 Cal. App. 4th at 933.

(n8)Footnote 8. See also *First Nat'l Bank v. Miller & Schroeder Fin., Inc.*, 709 N.W.2d 295 (Minn. Ct. App. 2006), in which the appellant banks asserted tort claims against the state, claiming the state was liable because a securities registration was approved despite the Commerce Department's knowledge that the offering did not meet registration requirements. Specifically, the banks alleged that the registration of debentures was approved despite the Department's knowledge that the offering would not meet registration requirements without the issuer including cash flow from

borrowing, which is prohibited by *Minn. R. 2875.3500*, subp. 2A.

The banks asserted their claim under the Minnesota Tort Claims Act, under which the state could be liable in damages for torts caused by state employees acting within the scope of their employment where the state, if a private person, would be liable to the claimant. However, the Act provides an exclusion by which the state is immune from tort liability based on the failure of a person to meet the standards for a license, permit, or other authorization issued by the state or its agents. The court concluded that registration of securities for sale in the state amounts to a license, permit, or other authorization and that the type of regulatory failure alleged by the banks regarding securities registration was precisely what the legislature excluded from the Tort Claims Act. Moreover, the Department of Commerce made no express representation to the bank purchasers apart from approving the registration itself. That representation, said the court, comprised only the fact that the debentures had been registered for sale in Minnesota. Dismissal of the claims was thus affirmed.



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Blue Sky Regulation

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CHAPTER 14 State Enforcement Authority

2-14 Blue Sky Regulation § 14.02

§ 14.02 Enforcement Authority

[1] Generally

The Uniform Securities Act confers broad investigative authority on Blue Sky administrators, as well as the power to pursue civil injunctive actions and make criminal referrals to state and local law enforcement agencies. The 2002 Uniform Act expands specifically prescribed enforcement authorityⁿ¹ to include a range of administrative powers, most prominently, the power to issue "cease and desist" orders. In both Uniform and Non-Uniform Act states, cease-and-desist orders or their functional equivalents have become common elements of the enforcement arsenal of state securities regulators. In many instances, these orders may issue summarily, but are subject to follow-up administrative procedures.ⁿ² Administrative cease-and-desist orders may be reviewed through established judicial review procedures. However, if no review is pursued, an administrator may, if necessary, seek enforcement of a cease-and-desist order by converting it to a court judgment.ⁿ³

The scope of enforcement authority established under the Uniform and Revised Uniform Securities Acts is combined in the 2002 Uniform Act, now adopted in several states and under active consideration in others. The 2002 Uniform Act authorizes civil and criminal actions in the courts, as well as administrative proceedings. The securities administrator may, with appropriate procedures, also issue cease-and-desist orders for violations of the Act and obtain enforcement of those orders in court. As with the predecessor Uniform Acts, the 2002 Act also authorizes investigations and the issuance of subpoenas, and specifically provides for assistance to securities regulators in other jurisdictions. The antifraud provisions in the 2002 Uniform Act apply within the state equally to state-registered entities and persons, to federal covered investment advisers, and to anyone else in connection with transactions in any securities, including federal covered securities.

Whether or not grounded in any of the Uniform Acts, all states take an expansive approach in conferring enforcement options. Administrative remedies allow flexibility in enforcement actions, allowing for such thing as bar or suspension orders against intermediaries and associated persons, and in many cases, include the power to impose civil money penalties, including the assessment of the agency's investigative and legal costs in the matter.ⁿ⁴ Civil injunctive authority remains an important tool in the enforcement arsenal of Blue Sky administrators who are typically empowered to obtain temporary and preliminary injunctive orders whenever it appears that there is sufficient evidence of a securities violation.ⁿ⁵ Criminal prosecutions are common fruits of the considerable investigative powers provided under the laws. Still, in the contemporary Blue Sky enforcement environment, administrative remedies have shown

themselves to be the most direct and efficient means of addressing those activities, most commonly, the focus of state securities regulation.ⁿ⁶

At the baseline, enforcement authority is defined by the scope of the Blue Sky law itself. The definition of "security" in each Blue Sky law is the single most limiting factor.ⁿ⁷ Variations in definitions among states can operate to preclude enforcement authority, for example, regarding variable annuity insurance products. The treatment of variable annuities as securities is not uniform among the states. A federal court applying the definition of security under the Kansas Securities Act granted summary judgment dismissing claims on the basis that the Kansas statute excludes from the definition of security "any insurance or endowment policy or annuity contract under which an insurance company promises to pay money either in a lump sum or periodically for life or some other specified period." The court declined to inquire further whether the otherwise clear statutory language should be interpreted to allow variable annuities to fall within the definition of security for purposes of applying the Blue Sky law.ⁿ⁸ The particular treatment in a state regarding "life settlement" contracts or other forms of viatical settlement contracts may also impact the scope of regulatory enforcement authority. It is certain that courts give deference to decisions and interpretations by state securities agencies in the application of their own statutes and regulations.ⁿ⁹ However, in all cases the parameters of enforcement authority must be established by the plain language of the Blue Sky law.

That being said, the scope of investigative authority under Blue Sky laws is not limited to investor protection in the particular state. Courts have described a dual state interest in the enforcement of Blue Sky laws. In *Dolomite Energy, LLC v. Comm. ex rel. Dir. Off. Fin. Institutions*,ⁿ¹⁰ a Kentucky firm challenged the authority of the administrator to issue an investigative subpoena when it was not established that the firm had solicited or sold to Kentucky investors. The court rejected such a limitation on subpoena power under the Blue Sky law:

Although the Commonwealth's subpoena was broad and requested an extensive list of documents under Kentucky's Blue Sky Laws, the Commonwealth has the power to request such extensive lists when the inquiry is within the authority of the agency, the demand is not too indefinite, and the information sought is reasonably relevant. The broad powers granted to the Commonwealth not only protect Kentucky investors but also serve to preserve the reputation of legitimate Kentucky companies and maintain national and international confidence in the Kentucky market.ⁿ¹¹

Thus, the court concluded:

[W]e do not find the residency of the investor to be controlling. Kentucky's adoption of the Blue Sky Laws clearly shows an intent to protect not only Kentucky investors but also to protect the reputation of the Kentucky marketplace by regulating the sale of securities to both Kentucky and non-resident investors.ⁿ¹²

The scope of investigative authority exercised by an administrator regarding conduct committed within the state but taking place outside the state is distinguished from the scope of authority to engage in investigative activity outside the state. Statutory authority most often provides for authority to investigate both within and outside the state. Section 602(a) of the 2002 Uniform Securities Act, for example, makes clear that the administrator may:

Conduct public or private investigations in or out of this state that the administrator considers necessary or appropriate to determine whether any person has violated, is violating, or is about to violate this act or a rule adopted or order issued under this act, or to aid in the enforcement of this act or the adoption of rules and forms under this act.ⁿ¹³

The execution of that authority, however, presents a different challenge. It is for that reason that numerous state Blue Sky laws contain provisions for the administrator to apply for and obtain enforcement of subpoenas in another state. With the 2002 Uniform Act, this has evolved into "assistance" and reciprocity considerations, which are discussed in

more detail in § 14.04[6].

[2] The Scope of Federal Preemption

As discussed throughout this Treatise, the National Securities Markets Improvement Act of 1996 (NSMIA) significantly preempted state securities regulation in regard to federal "covered securities." NSMIA limits states, for example, from imposing registration or merit review requirements in the offer and sale of federal covered securities or imposing any conditions upon the use of offering documents prepared by or on behalf of an issuer of a federal covered security. While NSMIA was crafted by Congress as a direct preemption of state regulatory authority over securities offerings and transactions that are national in character, other federal regulatory schemes can also preempt state authority under Blue Sky laws. For example, a federal court held that regulations issued by the federal Office of Thrift Supervision (OTS) expressly excluding "jumbo" certificates of deposit from the definition of "security" preempted a state administrator's construction of the Blue Sky law to treat those instruments as securities for purposes of state regulation.ⁿ¹⁴

On the other hand, the "Military Personnel Financial Services Protection Act," signed into law in 2006ⁿ¹⁵ expressly affirms state securities regulatory authority with respect to activities conducted on federal land or facilities of the United States and abroad, specifically military installations. Congressional findings cited the need for regulating the marketing and sale of securities (and life insurance products) on military bases and preventing abusive and misleading sales practices, including excessive sales charges. Section 8 of the Act, addressing state insurance and securities jurisdiction on military installations, provides that any law, regulation, or order of a state with respect to regulating the business of securities will apply to all securities activities unless it directly conflicts with any applicable federal law, regulation, or authorized directive, or would not apply if the activity were conducted on state land. The Act also prescribes the manner of determining primary state jurisdiction in instances in which multiple state laws would apply. It stands as a clear statement by Congress as to the importance of state securities laws and regulatory authority in dealing with abuse by persons engaged in the offer and sale of financial products.

Apart from these more oblique approaches to the extent of state authority, it is NSMIA that directly impacts state enforcement authority under Blue Sky laws. That being said, the scope of NSMIA preemption of state enforcement activity is limited in two important ways. First, NSMIA itself has an express savings clause that protects the jurisdiction of states under Blue Sky laws to bring enforcement actions for violation of antifraud provisions. The NSMIA Savings Clause provides:

Consistent with this section, the securities commission (or any agency or officer performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions.ⁿ¹⁶

Preservation of state antifraud enforcement authority encompasses both federal covered and non-covered securities alike.

Second, courts have increasingly recognized state authority to determine the validity of federal "covered security" status in the context of enforcement actions with respect to unregistered securities offered and sold in reliance on Rule 506 of SEC Regulation D under the federal Securities Act of 1933.ⁿ¹⁷ Under NSMIA, offerings covered by Rule 506 are "covered securities" for which state regulatory authority is preempted. Rule 506 offerings, which principally involve accredited investors, are unquestionably the most common form of large-scale exempt "private" or "limited" securities offerings. Including Rule 506 offerings as a category of NSMIA covered securities ostensibly eliminates state authority to impose registration and other requirements. These offerings would otherwise be open to state scrutiny and be subject to registration or to compliance requirements under particular state exemptions. The offer and sale of unregistered, nonexempt securities is a major target of enforcement actions under Blue Sky laws. State and federal courts have

determined that for state regulatory authority to be preempted as to federal Rule 506 offerings, the issuer of the securities must show the actual validity of, and not mere reliance on, the federal exemption. These courts have also recognized that states may determine whether the exemption applies, and exercise enforcement authority where the exemption is ruled invalid. Each of these important limitations on NSMIA preemption of state authority is discussed further below.ⁿ¹⁸

[a] The NSMIA Savings Clause: Antifraud Enforcement Authority

The extent of state antifraud enforcement authority preserved by NSMIA via the savings clause is illustrated in *Capital Research and Management Company v. Brown*,ⁿ¹⁹ which upheld the authority of the California Attorney General to pursue an enforcement action under the California Securities Law against the wholesale (distributor) broker-dealer of a family of mutual funds based on alleged failure to disclose to purchasers and prospective purchasers of fund shares the facts concerning "shelf-space agreements" that increased shareholder costs and created conflicts of interest. The "shelf-space agreements" were undisclosed oral agreements entered into between the distributor and broker-dealers who received cash and directed brokerage for selling the fund's shares. The action was not brought against the fund sponsor, but the essential allegation was that the shelf-space agreements were not accurately or fully disclosed in the fund disclosure documents. The Attorney General sought injunctions, civil penalties, disgorgement of profits, and restitution to purchasers by the fund distributor and the investment adviser to the mutual funds that participated with the distributor in the agreements.

Relying on NSMIA, the distributor and investment adviser defendants in *Capital Research and Management Company* challenged the Attorney General's authority as amounting to impermissible regulation of the mutual fund family's disclosure documents. NSMIA prohibits states from limiting or imposing conditions upon the use of any offering document that is prepared by or on behalf of the issuer of a federal covered security.ⁿ²⁰ Mutual fund shares offered by federally registered investment companies, as was the case here, are federal covered securities under NSMIA. However, the Attorney General argued, and the appeals court agreed, that notwithstanding the fact that the enforcement action might prospectively influence the disclosures made by the mutual fund sponsor, it fell within the preserved antifraud authority of the state and the power to control the conduct of brokers and dealers. As the court explained:

What this means is that the Attorney General cannot sue AF Fund to force it to change its disclosure documents, but it can sue AFD [the distributor] and CRMC [the participating investment adviser] to force them to disclose their oral agreements with the shelf-space brokers. The savings clause is sufficiently broad to permit this action ... and as applied to this case, is entirely consistent with the purpose of NSMIA.ⁿ²¹

The result was the same in *People v. Edward D. Jones & Co.*,ⁿ²² where the California Attorney General also brought an enforcement action under an antifraud provision of the California Corporations Code against a broker-dealer on allegations that the firm failed to disclose that it was receiving additional compensation for selling certain mutual funds.ⁿ²³ As in *Capital Research and Management Company*, the brokerage firm was a party to "shelf space" agreements with preferred funds under which it was compensated for providing heightened visibility of the preferred funds within the firm's mutual fund distribution and sales system. Mutual fund prospectuses and other disclosure documents did not disclose the existence of shelf space agreements, and the brokerage firm also did not disclose them to investors and potential investors to whom the funds were offered and sold.

Challenging state authority, Edward Jones & Co. asserted, among other things, that the enforcement action was preempted by NSMIA. The firm claimed that by his action, the Attorney General was challenging the adequacy of the disclosures made in offering documents prepared by the mutual fund companies. The securities involved, mutual fund shares, were unquestionably NSMIA "covered" securities and NSMIA provides that except as otherwise provided in the statute, no administrative action of a state may directly or indirectly prohibit, limit, or impose any condition upon the use of any offering document prepared by or on behalf of the issuer of covered securities.ⁿ²⁴ Edward Jones maintained

that the enforcement action was a straightaway attempt by the state to dictate and control the content of mutual fund prospectuses. The argument succeeded in the lower court, but was rejected on appeal.

The appellate court recognized that NSMIA expressly prohibits any state action that would even indirectly limit the use of a mutual fund prospectus. However, the court also recognized that the prohibition is not absolute and that NSMIA specifically qualifies it with the phrase "except as otherwise provided in this section." It was necessary therefore, said the court, to look to the remainder of NSMIA in order to determine the true scope of the prohibition. The NSMIA "savings" provision for state antifraud enforcement authority is an express exception to preemption. Thus, the court queried:

What does this savings clause tell us about the scope of the NSMIA's prohibitions as applied here? It tells us that the NSMIA prohibits any state action that would limit the use of a mutual fund prospectus, *except for* "enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions." In other words, an enforcement action of the type described in *subsection (c) of 15 United States Code section 77r* is *expressly* excepted from the prohibitions found in subsection (a) of the statute. Thus, an enforcement action with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions *may* limit the use of a mutual fund prospectus, notwithstanding the prohibition against effecting such a limitation by other methods.ⁿ²⁵

Based on the unambiguous language of NSMIA, the court concluded that the type of action brought by the Attorney General against Edward Jones was the type of enforcement action that NSMIA expressly excepts from its prohibitions. The action unquestionably, said the court, fell within the scope of the NSMIA "savings" provision because, at the very least, the Attorney General alleged "unlawful conduct by a broker or dealer" by alleging that Edward Jones's conduct in offering and selling certain mutual funds violated antifraud provisions of the California Corporations Code.ⁿ²⁶

[b] Determining "Covered Security" Status

State courts in other enforcement settings have also limited the scope of NSMIA preemption. In both *Buist v. Time Domain Corp.* ⁿ²⁷ and *Blue Flame Energy Corp. v. Ohio Department of Commerce, Division of Securities*,ⁿ²⁸ the courts determined that NSMIA does not prevent administrators from directly regulating offerings purportedly carried out pursuant to Rule 506 of Regulation D under the Securities Act of 1933, which are federal covered securities under NSMIA, when in fact the offering does not comply with Rule 506. States may thus determine whether there is a federal covered security in the first place by looking beyond the window dressing of an offering to determine the legitimacy of a purported Rule 506 exemption. The only way to assert federal preemption is first to show that the federal exemption actually applies.

Following the *Buist* lead, several state and federal courts, including the U.S. Court of Appeals for the Sixth Circuit in *Brown v. Earthboard Sports USA, Inc.*,ⁿ²⁹ have held that the plain language of NSMIA preempts state authority only with respect to securities that actually qualify as "covered securities." These courts reject the notion that NSMIA preempts states from acting in regard to Rule 506 offerings simply because the issuer has attempted to qualify or purports to make the offering pursuant to the Rule 506 exemption.ⁿ³⁰

The key consideration here is simply that residual state enforcement authority is considerable after NSMIA. Significant assessments have come from state appellate courts and it is clear that they will continue to examine the preemptive reach of NSMIA in a manner consistent with congressional intent not only to preserve state authority to police fraud, deceit, and unlawful conduct by securities intermediaries, but also to ensure that NSMIA preemption is legitimately applied.ⁿ³¹

Once anchored in a reasonable belief that a violation has occurred, or is occurring, and that enforcement authority is

appropriately exercised, broad investigative authority is provided for administrators,ⁿ³² which is considered in further detail below.

FOOTNOTES:

(n1)Footnote 1. Although not specifically prescribed by the Uniform Act, a wider range of administrative remedies have been implied under its provisions relating to the power to conduct investigations and issue orders, which are considered further below.

(n2)Footnote 2. 2002 Uniform Act § 604(b), is representative in providing:

[Summary Process.] An order under subsection (a) is effective on the date of issuance. Upon issuance of the order, the administrator shall promptly serve each person subject to the order with a copy of the order and a notice that the order has been entered. The order must include a statement whether the administrator will seek a civil penalty or costs of the investigation, a statement of the reasons for the order, and notice that, within 15 days after receipt of a request in a record from the person, the matter will be scheduled for a hearing. If a person subject to the order does not request a hearing and none is ordered by the administrator within 30 days after the date of service of the order, the order becomes final as to that person by operation of law. If a hearing is requested or ordered, the administrator, after notice of and opportunity for hearing to each person to the order, may modify or vacate the order or extend it until final determination.

(n3)Footnote 3. *See, e.g.*, 2002 Uniform Act § 603(f), which provides:

If a petition for judicial review of a final order is not filed in accordance with Section 609, the administrator may file a certified copy of the final order with the clerk of a court of competent jurisdiction. The order so filed has the same effect as a judgment of the court and may be recorded, enforced, or satisfied in the same manner as a judgment of the court.

(n4)Footnote 4. *See, e.g.*, *In re Thrasher Prospect #1*, Blue Sky L. Rep. (CCH) P 74, 186 (Pa. Sec. Comm'n Apr. 7, 1999) (assessment of investigative and legal costs pursuant to section 602.1 of the Pennsylvania Blue Sky law).

(n5)Footnote 5. *See, e.g.*, *Feigin v. Digital Interactive Assocs., Inc.*, 987 P.2d 876 (Colo. Ct. App. 1999) (Securities Commissioner may seek and obtain a temporary restraining order, without notice, whenever there is sufficient evidence of a securities violation and is not required to allege or prove irreparable harm or exigent circumstances to have the notice requirement waived).

(n6)Footnote 6. *But see Olde Discount Corp. v. Tupman*, 1 F.3d 202 (3d Cir. 1993), *cert. denied*, 510 U.S. 1065 (1994), in which the court affirmed an injunction against the Delaware Securities Commissioner from imposing an administrative remedy for the benefit of two investors seeking rescission of transactions, where the investors were required to arbitrate their claims in accordance with broker-customer agreements. The court held that the Commissioner's administrative power to impose a remedy was preempted to the extent that it was in conflict with the Federal Arbitration Act. In doing so, the court noted: "Delaware ... retains many avenues for the exercise of its proper role in dealing with alleged violations of its securities laws."

(n7)Footnote 7. While there are some variations among state Blue Sky laws as to what is included in the definition of security, all definitions for the most part, track the definitions contained in the Uniform Act, as well as the federal securities laws. The statutory definition of "security" in the Delaware Securities Act, which is representative of definitions in all state laws, has been held not to be unconstitutionally vague. In *Carlson v. State*, 902 A.2d 1114 (Del.), *cert. denied*, 127 S. Ct. 687, 166 L. Ed. 2d 534, (2006), a defendant convicted on numerous counts of the sale of

unregistered securities claimed that he was not given fair notice that it was illegal to sell certificates of deposit issued by an offshore bank and stock without registration. Rejecting the argument on appeal, the Delaware Supreme Court affirmed the conviction. The court noted that other courts had rejected void-for-vagueness arguments aimed at Blue Sky laws, and observed:

There is no reason to believe that an "ordinary person" cannot ascertain and understand the meaning of the term "stock." The meaning of "certificate of deposit" is equally comprehensible by an ordinary person. Certificates of deposit are specifically referenced in section 7309 as being exempt only when issued or guaranteed by the United States or a local government in the United States.

(n8)Footnote 8. *Widmer v. Hallier*, 2005 U.S. Dist. LEXIS 43623 (D. Kan. July 29, 2005) . Widmer was a private action asserting claims under both the Kansas Blue Sky law and the Kansas Consumer Protection Act. The court's unwillingness to extend coverage of the Blue Sky law to variable annuities in the face of clear language of the statute that does not contradict legislative intent is equally applicable in administrative enforcement actions.

(n9)Footnote 9. *See, e.g., Steller v. Pa. Sec. Comm'n*, 877 A.2d 518 (Pa. Commw. Ct. 2005) .

(n10)Footnote 10. 2008 Ky. App. LEXIS 389 (Sept. 5, 2008) .

(n11)Footnote 11. 2008 Ky. App. LEXIS 389, at *7 .

(n12)Footnote 12. 2008 Ky. App. LEXIS 389, at *10 .

See also A.S. Goldmen & Co. v. New Jersey Bureau of Sec., 163 F.3d 780, 787-788 (3d Cir. 1999) , in which the court observed:

In particular, we consider two legitimate state interests to be particularly strong ones. First, preventing New Jersey companies from offering suspect securities to out-of-state buyers helps to preserve the reputation of New Jersey's legitimate securities issuers. States that have failed to monitor out-of-state sales by in-state broker-dealers have suffered in the past, as their legitimate broker-dealers suffered from association with suspect firms offering questionable securities... Although this state interest is heightened when the state can prove that the in-state firm has engaged in outright fraud, the interest is nonetheless legitimate when the state seeks to block the sales of securities that it believes might be associated with dubious or manipulative sales practices. (Citations omitted.)

(n13)Footnote 13. 2002 Unif. Sec. Act § 602(a).

(n14)Footnote 14. *See State Farm Bank, F.S.B. v. Burke*, 445 F. Supp. 2d 207 (D. Conn. 2006) .

The larger preemption question in *State Farm Bank* was the extent to which deference would be given to an OTS Opinion Letter interpreting the preemptive effect of its own regulations in regard to state licensing, registration, and other requirements applicable to exclusive agents of federal savings banks. However, an element of the controversy focused on the definition of "security" in the Connecticut Uniform Securities Act (CUSA), which the state administrator concluded was applicable to jumbo CDs. An OTS regulation provided that a "security" does not include an account or deposit insured by the FDIC. However, the CDs involved in the case were not fully insured by FDIC. Nevertheless, on a finding that the OTS regulation excluding jumbo CDs from the definition of security was consistent with federal law and policy evident in the U.S. Supreme Court's decision in *Marine Bank v. Weaver*, 455 U.S. 551, 102 S. Ct. 1220, 71 L. Ed. 2d 409 (1982) , superseded by statute as stated in *Trans Penn Wax Corp. v. McCandless*, 50 F.3d 217 (3d Cir. 1995) holding that a certificate of deposit issued by a federally regulated bank did not constitute a security, the court in *State Farm Bank* concluded that the state administrator's construction of the state securities law was preempted. The

court observed:

The preemptive effect of OTS's regulations as to state statutes concerning the lending and deposit-related activities of federal loan associations applies here to the defendant's construction of CUSA because if defendant is permitted to construe CUSA to include jumbo CDs, all State Farm agents engaged in CD-related activities would be required to comply with various Connecticut registration requirements. As discussed above, according "controlling weight" to OTS's Opinion Letter, OTS's regulations preempt such registration requirements because they relate to the operation of federal loan associations. Thus, given the preemptive effect of OTS regulations in the field of lending and deposit-related activities of federal savings associations generally, defendant's construction of CUSA to include jumbo CDs is also preempted.

State Farm Bank, F.S.B. v. Burke, 445 F. Supp. 2d 207, 220 (D. Conn. 2006) .

(n15)Footnote 15. Pub. L. No. 109-290, 109th Cong., 2d Sess. (Sept. 29, 2006).

(n16)Footnote 16. Securities Act § 18(c)(1), 15 U.S.C. § 77r(c)(1) (2000).

(n17)Footnote 17. See 17 C.F.R. § 230.506 (2008) ("Exemption for Limited Offers and Sales Without Regard to Dollar Amount of the Offering").

(n18)Footnote 18. For an analysis of the limits of NSMIA preemption, see Robert N. Rapp & Fritz E. Berckmueller, *Testing the Limits of NSMIA Preemption: State Authority to Determine the Validity of Covered Securities and to Regulate Disclosure*, 63 Bus. Law. 809 (May 2008) ("Rapp & Berckmueller").

(n19)Footnote 19. *Capital Research & Management Co. v. Brown*, 147 Cal. App. 4th 58, 53 Cal. Rptr. 3d 770 (2007) .

(n20)Footnote 20. Securities Act § 18(a)(2)(A), 15 U.S.C. § 77r(a)(2)(A).

(n21)Footnote 21. *Capital Research & Management Co. v. Brown*, 147 Cal. App. 4th 58, 67, 53 Cal. Rptr. 3d 770 (2007) .

The court went on to explain:

It is the wholesale distributor's conduct that is at issue in this case (and the enabling conduct of the adviser), not the sufficiency of the disclosures made by AF Fund. In fact, the complaint alleges that AFD's and CRMC's disclosures were affirmatively false and misleading because the practice of entering shelf-space agreements was intentionally concealed from investors and also from AF Fund's directors. It is the conduct of the adviser and the distributor that violates [the Blue Sky law] because the purchasers are being induced to purchase AF Fund shares by means of manipulative, deceptive, and otherwise fraudulent contrivances... . The fact that this action, if successful, might indirectly encourage AF Fund to alter its disclosure documents does not affect the application of the savings clause.

Capital Research & Management Co. v. Brown, 147 Cal. App. 4th 58, 67, 53 Cal. Rptr. 3d 770 (2007) .

(n22)Footnote 22. *People v. Edward D. Jones & Co.*, 154 Cal. App. 4th 627, 65 Cal. Rptr. 3d 130 (2007) .

(n23)Footnote 23. Cal. Corp. Code § 25216(a) provides that "[no] broker-dealer or agent shall effect any transaction in, or induce or attempt to induce the purchase or sale of, any security in this state by means of any

manipulative, deceptive or other fraudulent scheme, device, or contrivance."

(n24)Footnote 24. See Securities Act § 18(a)(2), 15 U.S.C. § 77r(a)(2).

(n25)Footnote 25. *People v. Edward D. Jones & Co.*, 154 Cal. App. 4th 627, 638, 65 Cal. Rptr. 3d 130 (2007) (emphasis by the court).

(n26)Footnote 26. 154 Cal. App. 4th at 638 . See also *Papic v. Burke*, [2003-2008 Transfer Binder] Blue Sky L. Rep. (CCH) P 74,627, 2007 Conn. Super. LEXIS 820 (New Britain Dist. Mar. 22, 2007) , in which the court concluded that the state's authority to enforce its securities law in connection with fraud and/or with material omissions which would mislead investors in connection with the offer, sale, or purchase of NSMIA covered securities remains intact. While NSMIA prohibits state regulators from commenting upon or imposing requirements on the contents of prospectuses and other offering documents, legislative history, said the court, makes clear the intention not to alter or limit state law with respect to fraud or deceit.

Taken together, as Rapp & Berckmueller note:

The decisions in *Edward Jones, Brown*, and *Papic* support the proposition that the "savings" clause not only precludes preemption in many circumstances but also permits a state administrator to exercise antifraud enforcement authority in a manner that might indirectly impact disclosures made in an offering document of a NSMIA "covered security." In *Brown* the court characterized the impact as prospective "influence." The court in *Papic* embraced that characterization and concluded that Congress intended for nothing in NSMIA to affect the state's authority to enforce its blue sky law in connection with material misstatements or omissions in an offering. In *Edward Jones*, the court concluded straightaway that an enforcement action for fraud may in fact limit the use of an issuer's prospectus because the NSMIA "savings" provision is an express *exception* to the prohibition against interference with the use of an offering document.

Rapp & Berckmueller, at 834 (citations omitted, emphasis in original).

(n27)Footnote 27. *Buist v. Time Domain Corp.*, 926 So. 2d 290 (Ala. 2005) .

(n28)Footnote 28. *Blue Flame Energy Corp. v. Ohio Dep't of Commerce*, 2006 Ohio 6892, 171 Ohio App. 3d 514, 2006-Ohio-6892, 871 N.E.2d 1227 .

(n29)Footnote 29. *Brown v. Earthboard Sports USA, Inc.*, 481 F.3d 901 (6th Cir. 2007) .

(n30)Footnote 30. See also *Grubka v. WebAccess Int'l, Inc.*, 445 F. Supp. 2d 1259 (D. Colo. 2006) ; *Hamby v. Clearwater Consulting Concepts, LLLP*, 428 F. Supp. 2d 915 (E.D. Ark. 2006) ; *Apollo Capital Fund LLC v. Roth Capital Partners, LLC*, 158 Cal. App. 4th 226, 70 Cal. Rptr. 3d 199 (2007) ; *Risdall v. Brown-Wilbert, Inc.*, 753 N.W.2d 723 (Minn. Ct. App. 2008) ; *Odor v. Rose*, 2008 U.S. Dist. LEXIS 47753 (W.D. Okla. June 20, 2008) .

In the exercise of authority based upon a determination that a Rule 506 exemption is defective, one federal court applied the *Younger* abstention doctrine to decline review of a securities commissioner's desist-and-refrain order. *Consol. Mgmt. Group, LLC v. Dufauchard*, (N.D. Cal. Sept. 20, 2006) . In federal court, the plaintiffs alleged that the California Corporations Commissioner and the Department of Corporations had acted beyond the scope of their lawful authority in finding that the plaintiffs failed to qualify for the federal Rule 506 exemption and in issuing the enforcement order. The federal court invoked the *Younger* abstention doctrine and concluded that state proceedings were on-going; that they implicated an important state interest; and that the state proceedings provided an adequate opportunity to assert the federal preemption argument. See generally Rapp & Berckmueller, at 836-841.

(n31)Footnote 31. See *Target Oil & Gas Corp. v. Commonwealth*, [2003-2008 Transfer Binder] Blue Sky L. Rep. (CCH) P 74,574, 2006 Ky. App. LEXIS 156 (May 26, 2006). In *Target*, the subject of a subpoena duces tecum issued by the Division of Securities maintained that the subpoena exceeded the Director's authority on grounds, among others, that NSMIA preempted the Director's authority. Based on the NSMIA savings provision, however, the argument was rejected. The court concluded that even if NSMIA "covered securities" are involved, the Director is not precluded from investigating claims that a promoter may have misled purchasers.

(n32)Footnote 32. See *Greer v. New Jersey Bureau of Sec.*, 288 N.J. Super. 69, 671 A.2d 1080 (1996) (agency has broad investigatory powers in order to fulfill its responsibility to protect the investing public against fraud or misrepresentation). See also *Alabama Sec. Comm'n v. American Business Club*, 612 So. 2d 1237 (Ala. Civ. App. 1992) (historically broad interpretation of language in enforcement provisions of Blue Sky law conferred authority to issue cease-and-desist orders despite no specific statutory authorization).



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Blue Sky Regulation

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CHAPTER 14 State Enforcement Authority

2-14 Blue Sky Regulation § 14.03

§ 14.03 Investigative Authority

Section 407(a) of the Uniform Act sets the common parameters of investigative authority:

(a) The [Administrator] in [his] discretion (1) may make such public or private investigations within or outside of this state as [he] deems necessary to determine whether any person has violated or is about to violate any provision of this act or any rule or order hereunder, or to aid in the enforcement of this act or in the prescribing of rules and forms hereunder, (2) may require or permit any person to file a statement in writing, under oath or otherwise as the [Administrator] determines, as to all the facts and circumstances concerning the matter to be investigated, and (3) may publish information concerning any violation of this act or any rule or order hereunder.ⁿ¹

The administrator's authority is augmented by the power to

[s]ubpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, agreements, or other documents or records which the Administrator deems relevant or material to the inquiry.ⁿ²

Section 407 grants essentially the same power as given to the Securities and Exchange Commission by section 21(a) through (c) of the Securities Exchange Act of 1934. However, state administrators' authority is not constrained by particular limitations on the substantive scope of analogous SEC jurisdiction. In *Carrington v. Arizona Corp. Commission*,ⁿ³ for example, the authority of the state commissioner to enforce an investigative subpoena against a seller of viatical settlements was upheld despite the fact that federal case law holds that viatical settlements are not securities. Although federal law may supply guidance in the interpretation and application of state securities laws, it is not binding. Moreover, said the court, even if federal case law was deemed to be the law in the state, the Commissioner's authority to investigate in order to determine whether particular arrangements or transactions nevertheless fall within the Blue Sky law would not be impaired.

The subpoena power of state securities administrators is by no means unfettered. In *Galvin v. Gillette Co.*,ⁿ⁴ a Massachusetts court determined that subpoenas drafted by the administrator must be narrowly drawn to "touch the matter under investigation or in question." In *Galvin*, the administrator issued subpoenas demanding the production of a wide array of materials involving a merger transaction involving The Proctor & Gamble Company and Gillette. Among the broad categories of information and material to be produced under the subpoena, the administrator sought

documents relating to fairness opinions involved in the transaction that were formulated and issued by registered broker-dealers. Responding to the subpoena, Gillette argued that mergers are excluded from investigative and enforcement authority under the Massachusetts Blue Sky law. The administrator, on the other hand, urged that his authority under the law clearly extended to investigating whether there had been fraud in connection with issuing the fairness opinions.

The *Galvin* court determined that the administrator did have investigative authority as to whether there was fraud by registered broker-dealers who issued fairness opinions. At the same time, however, the court opined:

An examination of the Subpoena issued to Gillette on March 23, 2005, reveals a breadth of information demanded that reaches far beyond the somewhat narrowly focused investigation that the Secretary announced to the Court in his opposition on April 22, 2005. Much of the mass of materials sought does not, facially at least, appear to touch on or be relevant or material to the matter under investigation or in question, i.e., whether fraud may be present in the UBS or Goldman Sachs fairness opinions based on information provided by Gillette. Consequently, in its present form the Subpoena reaches too far. Further, given its complexity, this Court cannot--and should not--attempt to apply a blue pencil to the sections that appear too far reaching. This is for the discretion of the Secretary, not that of the Court.ⁿ⁵

The court thus quashed the subpoena, but without prejudice to the Secretary to issue a new subpoena consistent with the legal principles recited by the court.

Constitutional considerations also operate to limit the scope of subpoena power under Blue Sky laws. In *Lubin v. Agora, Inc.*,ⁿ⁶ the Maryland Court of Appeals held that a subpoena served by the Commissioner of Securities on the publisher of an e-mail investment newsletter as part of an investigation into whether the publisher was acting in violation of the Maryland Securities Law was an impermissible intrusion on *First Amendment* rights. The Commissioner's subpoena sought disclosure of the publisher's subscriber lists, claiming that the information was relevant and would allow a thorough investigation into whether, among other things, the newsletter publisher was engaged in business as an unregistered investment adviser. The Commissioner argued that having access to subscriber information would facilitate questioning of those persons about their dealings with the publisher. After a thorough analysis of *First Amendment* jurisprudence, the Maryland appeals court concluded that to the extent the Commissioner's subpoena would require the publisher to disclose the identities of those who subscribe to or purchase its materials, the subpoena sought information protected by the *First Amendment*. Enforcement of the subpoena, said the court, would intrude upon the *First Amendment* rights of the publisher's subscribers and customers because disclosure of their status as subscribers and purchasers would destroy their anonymity.ⁿ⁷ In the end, the court concluded that the Commissioner failed to show an overriding and compelling state interest in obtaining the subscriber information. Moreover, no sufficient nexus was shown between the investigation into whether the publisher acted as an unregistered investment adviser and the demand for a list of those subscribers who received the e-mail.

Such limitations on subpoena power notwithstanding,ⁿ⁸ the statutory authority of state administrators is such that courts give administrators "wide berth" when reviewing the validity of investigations. In *Carrington v. Arizona Corp. Commission*,ⁿ⁹ discussed above, the Arizona court emphasized that an appropriately empowered agency can investigate merely on suspicion that the law is being violated "or even just because it wants the assurance that it is not."ⁿ¹⁰ Thus, said the court, the commission must be free without undue interference to conduct an investigation to adequately develop a factual basis to determine whether a particular activity comes within the ambit of regulatory authority.

The focus on viatical settlements in *Carrington* is particularly instructive because of the divergence in federal and state securities law. As a matter of federal securities law, viatical settlements, that is, the sale of life insurance policies of terminally ill persons at a discount, such that when the uninsured dies the purchaser receives the death benefit, were held not to be securities in *SEC v. Life Partners, Inc.*ⁿ¹¹ However, with virtual unanimity, state courts, legislatures, and

Blue Sky administrators have defined such arrangements to be securities, either expressly or by way of investment contract analysis. State enforcement activity related to viaticals ranks near the top of Blue Sky enforcement initiatives generally and is a perfect example of the increasingly vocal notion that state securities administrators are the "cops on the beat" in the protection of investors.

As apt as the "cops on the beat" functional analogy may be, state securities administrators are not police officers. However, in the exercise of their investigative authority and particularly given their power to subpoena witnesses, compel attendance, and require production of relevant materials that may be used in prosecutions, they are assigned police powers. Thus, their investigative activities may impact constitutional rights and require compliance with protections against self-incrimination available to witnesses. Compelling attendance pursuant to an administrative subpoena has been held not to constitute custodial interrogation for purposes of *Miranda* rights.ⁿ¹² However, in some circumstances, state securities investigators may be required to give constitutional warnings.ⁿ¹³ In practice, such warnings are often given in circumstances where attendance and testimony is compelled, whether or not technically required.

The authority of state securities administrators to gain access to documents and information maintained by licensed persons and entities is also considerable. Blue Sky laws and regulations uniformly require registered broker-dealers, for example, to keep specified records open to examination by the administrator and to produce copies to the administrator on request. In *First Providence Financial Group LLC v. Burke*,ⁿ¹⁴ the court interpreted the examination provision of the Connecticut Blue Sky law as empowering the administrator, with or without advance notice, to enter the premises of any firm that has, by seeking to be licensed in the state, voluntarily submitted to its jurisdiction. Upholding the administrator's authority, the court opined:

The very nature of this examination provision requires that it be used to enable examiners to enter the premises of any firm that has voluntarily submitted itself to the jurisdiction of the Banking Commission by seeking registration to conduct examination to ensure that all statutes and regulations designed to protect the investing public are being complied with. If the commissioner were required to give notice or to defer to a firm's determination of a more convenient time for the examination, the effectiveness of these examinations would sharply decline and so would the degree of consumer protection afforded by the [Connecticut Uniform Securities Act].ⁿ¹⁵

The scope and force of "access" authority under Blue Sky laws is perhaps no better illustrated than by the 2002 investigative inquiry undertaken by the Attorney General of New York under that state's securities law with regard to the acts and practices of Merrill Lynch & Co. and others associated with Merrill Lynch in connection with analyst recommendations of stocks. Acting under authority of New York's "Martin Act," the Attorney General compelled access to internal information and documents relating to the "offer, sale, issuance, promotion, advertisement, exchange, marketing, distribution or transfer of, or investment advice for, securities in and from the State of New York."ⁿ¹⁶ The Martin Act is primarily an antifraud statute, the main feature of which is establishing the authority of the Attorney General to act, either upon a complaint or otherwise, and to investigate all forms of fraud and fraudulent practices involving securities transactions.ⁿ¹⁷ The New York statute empowers the Attorney General to investigate generally and to compel the production of all such data and information as he or she may deem relevant. Specifically, the Attorney General or a deputy or designated officer:

[I]s empowered to subpoena witnesses, compel their attendance, examine them under oath before him or a magistrate, a court of record, or a judge or justice thereof and require the production of any books or papers which he deems relevant or material to the inquiry.ⁿ¹⁸

The exercise of this authority to gain access to, among other things, internal e-mails of the firm, produced an historic May 21, 2002 agreement between the New York Attorney General and Merrill Lynch regarding, among other things, research practices, analyst compensation, research recommendations, and disclosures during the offering process, and

the payment of \$100 million as a civil settlement.

Uniform Act section 407, or its equivalent, has been adopted in many states,ⁿ¹⁹ and, subject to constitutional and other reasonable limitations discussed earlier, courts have supported broad investigative authority and the exercise of subpoena authority under these provisions as matters of compelling governmental interest in identifying and rectifying violations of securities laws.ⁿ²⁰ Documents and information gathered in a current and on-going investigative process are generally privileged under state public records laws.ⁿ²¹

Non-Uniform Act states have prescribed their administrators' investigative authority in different ways. In Illinois, for example, the Secretary of State or an appointee is empowered to administer oaths, subpoena witnesses, and take evidence in the conduct of investigations. A state court may treat a violation of such investigative directives as a contempt of court.ⁿ²² In New York, the Martin Act empowers the Attorney General to investigate any fraudulent practices believed to have been carried out.ⁿ²³ The Ohio Securities Law declares that the Division of Securities may, in the best interests of the public and if necessary for the protection of investors, require statements or reports, examine any party under oath, require attendance at hearings, and initiate criminal proceedings.ⁿ²⁴ Oregon has adopted only part of the Uniform Act provisions,ⁿ²⁵ as is the case with Washington, New Mexico,ⁿ²⁶ New Hampshire,ⁿ²⁷ and Rhode Island.ⁿ²⁸ Virginia authorizes the Commissioner to investigate possible violations of the law and to require the person under investigation to pay the investigation costs.ⁿ²⁹

Multi-state investigations and inter-jurisdictional information sharing are increasingly prominent considerations in defining the scope of state authority under Blue Sky laws. The Revised Uniform Securities Act expressly addressed inter-jurisdictional sharing of information, that is, the product of investigative authority,ⁿ³⁰ and today an important element of the 2002 Uniform Act is to promote uniformity and cooperation among agencies. Section 608(a) of the 2002 Uniform Securities Act provides:

The administrator shall, in its discretion, cooperate, coordinate, consult, and subject to Section 607, share records and information with the securities regulator of another State, Canada, a Canadian province or territory, a foreign jurisdiction, the Securities and Exchange Commission, the United States Department of Justice, the Commodity Futures Trading Commission, the Federal Trade Commission, the Securities Investor Protection Corporation, a self-regulatory organization, a national or international organization of securities regulators, a federal or state banking and insurance regulator, and a governmental law enforcement agency to effectuate greater uniformity in securities matters among the federal government, self-regulatory organizations, States, and foreign governments.

Cooperation specifically includes sharing and exchanging information and documents.ⁿ³¹ The original Uniform Act contains no specific sharing or inter-jurisdictional cooperation provision. Rather, it only addresses disclosure of information "when necessary or appropriate in a proceeding or investigation under this act."ⁿ³² Some states adopting the Uniform Act have modified the provision to empower administrators more broadly. Michigan, for example, provides for disclosure of information when necessary or appropriate in a proceeding or investigation, but also "[t]o federal, state, local, or foreign governmental agencies for their own official use."ⁿ³³ New Hampshire provides for generalized "interstate cooperation" so far as it will enhance the purposes of the securities laws.ⁿ³⁴ Louisiana provides that the commissioner "shall cooperate with the administrators of the securities laws of other states and of the United States with a view to assisting those administrators in the enforcement of their securities laws."ⁿ³⁵ Although the Uniform Act does not clearly authorize inter-jurisdictional information sharing, the absence of any prohibition has been interpreted to mean that an administrator should be permitted to do so. In *Griffin v. S.W. Devanney & Co.*,ⁿ³⁶ the Colorado Supreme Court opined that the disclosure of information concerning violations of that state's version of the Uniform Act would substantially contribute to the Act's goal of protecting the public from fraudulent and deceptive practices in securities transactions. Construing the Colorado statute to prohibit disclosure of information to other state and federal regulatory and law enforcement agencies, said the court, would impair this basic objective by shielding from scrutiny illegal practices committed on persons in other jurisdictions by persons acting within the state.

Attention to inter-jurisdictional cooperation and information sharing in cases like this and the specific focus on it in the Revised Uniform Act reflects growing recognition of the realities of mobility between jurisdictions and the multi-jurisdictional impact of conduct in a global marketplace. Joint federal-state and multi-state investigation and enforcement initiatives have shown themselves to be effective today and effective international cooperation among regulatory and law enforcement agencies is developing at a quick pace.ⁿ³⁷

FOOTNOTES:

(n1)Footnote 1. Unif. Sec. Act § 407(a). *See also* 2002 Uniform Act § 602(a)-(b), which is modeled directly on the original section 407. In Official Comments to section 602, the drafters added this further insight into subpoena power under the Act: The scope of subpoena enforcement in each state is a general matter for judicial determination. Under section 602, an individual subpoenaed to testify by the administrator is not compelled to testify within the meaning of these sections simply by service of a subpoena. Under section 602(b), an individual can be subpoenaed and compelled to attend. Once in attendance, the individual can assert an evidentiary privilege or exemption. *See* section 601(c), including the *Fifth Amendment* privilege against self-incrimination. If an individual refuses to testify or give evidence, the administrator may apply (or have the appropriate state attorney apply) to the appropriate court for the relief specified in section 602(c). If the individual invokes the privilege against self-incrimination, section 602(d) allows the administrator to apply to the appropriate court to compel testimony under the "use immunity" provision barring the record compelled or other evidence obtained from being used in a criminal case. *See People v. District Court*, 894 P.2d 739 (Colo. 1995) . The phrase "directly or indirectly" in section 602(e) is intended to include testimony, other evidence, or other information derived from immunized testimony, statements, records, or evidence. Off. Comment No. 2, 2002 Uniform Act.

(n2)Footnote 2. Unif. Sec. Act § 407(b). The subpoena power has been held to include the authority of one state administrator to issue a subpoena at the request of a sister state administrator if the sister state administrator alleges conduct that violates the Blue Sky law of the subpoenaing jurisdiction, *see American Microtel, Inc. v. Nevada*, [1993-1994 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,856 (Nev. Dist. Ct. 1991).

Subpoena enforcement authority is also expressly addressed in section 407 of the Uniform Act:

(c) In case of contumacy by, or refusal to obey a subpoena issued to, any person, the [insert name of appropriate court], upon application by the Administrator, may issue to the person an order requiring him to appear before the Administrator, or the officer designated by him, there to produce documentary evidence if so ordered or to give evidence touching the matter under investigation or in question. Failure to obey the order of the court may be punished by the court as a contempt of court.

In the exercise of their investigative authority, state securities regulators enjoy qualified immunity from suit for actions taken during an investigative search. *See Karel v. Gee*, CCH Blue Sky L. Rep P 74,741, at 79,943 (D. Idaho 2008) (although it was ultimately determined that the Department lacked authority to inspect certain documents, defendant regulators were entitled to qualified immunity because they were carrying out discretionary functions). Qualified immunity of state administrators in the exercise of their authority is discussed further in § 14.07[1].

(n3)Footnote 3. *Carrington v. Arizona Corp. Comm'n*, 199 Ariz. 303, 18 P.3d 97 (Ct. App. 2000) .

(n4)Footnote 4. *Galvin v. Gillette Co.*, 2005 Mass. Super. LEXIS 194 (Apr. 28, 2005) .

(n5)Footnote 5. *Galvin v. Gillette Co.*, 2005 Mass. Super. LEXIS 194, at *24 (Apr. 28, 2005) .

(n6)Footnote 6. *Lubin v. Agora, Inc.*, 389 Md. 1, 882 A.2d 833 (2005) .

(n7)Footnote 7. The court reasoned: If the names of Agora's readers were disclosed to the government, they might be subjected to questioning about their reading habits. Agora's subscribers may be discouraged from reading its materials if they are interviewed by government personnel investigating potential securities violations, even if the readers are told that, individually, they are not under investigation. *Lubin v. Agora, Inc.*, 389 Md. 1, 882 A.2d 833 (2005) .

(n8)Footnote 8. *See also Lubin v. Agora, Inc.*, 389 Md. 1, 882 A.2d 833 (2005) (First Amendment protected a publisher from being compelled to respond to the Securities Commissioner's subpoena).

(n9)Footnote 9. *Carrington v. Arizona Corp. Comm'n*, 199 Ariz. 303, 18 P.3d 97 (Ct. App. 2000) .

(n10)Footnote 10. *Carrington v. Arizona Corp. Comm'n*, 199 Ariz. 303, 18 P.3d 97 (Ct. App. 2000) , quoting *United States v. Morton Salt Co.*, 338 U.S. 632, 642-643, 70 S. Ct. 357, 94 L. Ed. 401 (1950) .

(n11)Footnote 11. *SEC v. Life Partners, Inc.*, 87 F.3d 536, 318 U.S. App. D.C. 302 (D.C. Cir. 1996) .

(n12)Footnote 12. *See Dosek v. United States*, 405 F.2d 405 (8th Cir. 1968) , *cert. denied*, 395 U.S. 943, 89 S. Ct. 2014, 23 L. Ed. 2d 461 (1969) .

(n13)Footnote 13. *See, e.g., Nev. Att'y Gen. Op. No. 88-9* [1988-1990 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,913 (Sept. 12, 1988) (applicability of the *Miranda* rule in questioning or interviewing witnesses by state securities investigators depends upon whether there is custodial interrogation).

(n14)Footnote 14. *First Providence Fin. Group, LLC v. Burke*, Blue Sky L. Rep. (CCH) P 74,243, at 78,120, 2001 Conn. Super. LEXIS 3287 (Nov. 15, 2001) .

(n15)Footnote 15. *First Providence Fin. Group, LLC v. Burke*, Blue Sky L. Rep. (CCH) P 74,243, at 78,126, 2001 Conn. Super. LEXIS 3287 (Nov. 15, 2001) .

The scope of investigative authority generally, and subpoena power in particular, typically relates to both public and private investigations. Administrators may conduct private investigations and impose a requirement of confidentiality. In *State ex rel. Brant v. Bank of America*, Blue Sky L. Rep. (CCH) P 74,236, at 78,084, 62 P.3d 707 (Kan. Ct. App. 2001) , the Kansas Supreme Court held that the Securities Commissioner is empowered to prohibit a bank from notifying customers that bank records have been subpoenaed. The court upheld the Commissioner's decision regarding what is required for an effective investigation in the securities field over the bank's desire to notify its customers that their bank records have been subpoenaed. A reasonable interpretation of the Commissioner's authority to conduct private investigations, said the court, includes the power to require confidentiality. As to the privacy of customer bank records, the court concluded that customers had no reasonable expectation of privacy as a matter of law and that the bank's privacy policy clearly informed customers that they could not always expect notification.

(n16)Footnote 16. The investigation led to the commencement of an enforcement proceeding and the imposition of certain preliminary injunctive relief, *see In re an Inquiry by Elliot Spitzer, Attorney General*, Index No. 02/401522 (N.Y. Sup. Ct. Apr. 8, 2002).

(n17)Footnote 17. N.Y. Con. Law ch. 20, art. 23-A, § 352.

(n18)Footnote 18. N.Y. Con. Law ch. 20, art. 23-A, § 352(2).

(n19)Footnote 19. *See, e.g.:*

Alabama: Ala. Code § 8-6-15.

Arizona: Ariz. Rev. Stat. Ann. §§ 44-1822 through 44-1825.

Arkansas: Ark. Stat. Ann. § 23-42-205.

California: Cal. Corp. Code § 25531.

Delaware: Del. Code Ann. tit. 6, § 7319.

Florida: Fla. Stat. Ann. § 517.201.

Kentucky: Ky. Rev. Stat. Ann. § 292.460.

Louisiana: La. Rev. Stat. Ann. § 51:711.

Massachusetts: Mass. Gen. Laws Ann. ch. 110A, § 407.

Mississippi: Miss. Code Ann. §§ 75-71-707, 75-71-709, 75-71-711, 75-71-7113.

Nebraska: Neb. Rev. Code § 8-1115.

North Carolina: N.C. Gen. Stat. § 78A-46.

Pennsylvania: 70 Pa. Stat. § 1-510.

Texas: Tex. Civ. Stat. ch. 269, § 581-28.

Utah: Utah Code Ann. § 61-1-19.

West Virginia: W. Va. Code Ann. § 32-4-407.

Wyoming: Wyo. Stat. Ann. § 17-4-119.

(n20)Footnote 20. *See Tom v. Schoolhouse Coins, Inc.*, 191 Cal. App. 3d 827, 236 Cal. Rptr. 541 (1987) , in which the court rejected the claim that privacy rights were violated by a subpoena requiring production of names and identifying information of purchasers of coin investments. "[T]he Commissioner has sufficiently compelling governmental interest in identifying and rectifying violations of the securities laws to justify the de minimis intrusion caused by disclosure of coin collectors' names and addresses."

(n21)Footnote 21. *See, e.g., Pecevich v. Mass. Securities Division*, Blue Sky L. Rep. (CCH) P 74,203 (Mass. Super. 2000) (records sought by the subject of an investigation fell within the investigative exemption from disclosure under the public records law). In *Pecevich*, the court also rejected a challenge to the administrator's use of e-mail subpoenas to obtain documents and information from third parties. On this point, although the court found the practice "troubling," the challenge was rejected because the petitioner had no standing to challenge the validity of a subpoena not directed to him. *But see Slade v. Schneider*, 212 Ariz. 176, 129 P.3d 465 (Ct. App. 2006) , in which the court determined that the Arizona Corporation Commission waived the protections that the Arizona Confidentiality Statute provides to names, documents, and information acquired during investigations. Two defendants, charged with securities fraud by the Commission, sought to compel discovery of investor names and other information obtained by the Commission's accountant and its investigator during their investigation. The Arizona Confidentiality Statute protects names of complainants, information, and documents the Commission obtains during an investigation from discovery

unless they are made a matter of public record. The Commission identified the accountant as an expert witness and the defendants thus requested production of all notes, memoranda, and summaries the accountant and the investigator prepared, and which related to specific allegations in the Commission's complaint. The Court of Appeals concluded that the Commission had waived the statutory confidentiality afforded to investors' names, information, and documents by designating the accountant as a testifying expert. The court also concluded that the Commission waived confidentiality for information obtained by the investigator because it had been made a matter of public record by including the investigator's affidavit with the complaint it filed.

(n22)Footnote 22. *See, e.g.: Illinois: Ill. Comp. Stat. ch. 815, § 5/11(d)*. In addition, the Illinois Secretary of State or the Secretary's appointee is authorized to administer oaths, subpoena witnesses, require the production of documents, and take evidence at the request of another state's securities agency, if the alleged violation would violate the Illinois Blue Sky law had the violation occurred within Illinois. *Ill. Comp. Stat. ch. 815, § 5/11(d)*.

(n23)Footnote 23. *See, e.g.: New York: N.Y. Gen. Bus. Law § 352. See In re Book Club for the Martial Arts, Inc., 3 Blue Sky L. Rep. (CCH) P 71,512 (N.Y. Sup. Ct. 1979)*. In discussing the investigative powers of the Attorney General under the Martin Act (*N.Y. Gen. Bus. Law § 352*), the court held that, to sustain the subpoena, the Attorney General must show only that the inquiry is lawfully and properly authorized and that the description of the materials sought is reasonably definite. Furthermore, the burden is on the party objecting to the subpoena to demonstrate that the documents called for are utterly irrelevant to any proper inquiry.

(n24)Footnote 24. *Ohio Rev. Code Ann. § 1707.23. See also Ohio Sec. Bull. Summer Quarter 1989, Blue Sky L. Rep. (CCH) P 45,725 (policy on requests to review investigative materials)*.

(n25)Footnote 25. *Or. Rev. Stat. §§ 59.245, 59.315*. These two subsections are the Uniform Act's first three subsections, but do not contain § 407(d).

(n26)Footnote 26. *N.M. Stat. Ann. § 58-13B-36* (does not contain § 407(d)).

(n27)Footnote 27. *N.H. Rev. Stat. Ann. § 421-B:22* (does not contain § 407(d)).

(n28)Footnote 28. *R.I. Gen. Laws § 7-11-601* (does not contain § 407(d)).

(n29)Footnote 29. *Va. Code Ann. § 13.1-518*. The Virginia statute also permits the disclosure of information collected in an investigation to any quasi-governmental entity substantially associated with law enforcement. *Va. Code Ann. § 13.1-518.B*.

(n30)Footnote 30. *See Rev. Unif. Sec. Act § 704*.

(n31)Footnote 31. States in which the Revised Uniform Act provision or its equivalent is in effect include Montana, Nevada, New Mexico, and Washington. The 2002 Uniform Act has been adopted in Missouri, Oklahoma, Idaho, Iowa, South Dakota, Kansas, South Carolina, Maine, Vermont, Minnesota, Hawaii, Indiana, Wisconsin, and the U.S. Virgin Islands.

(n32)Footnote 32. *Unif. Sec. Act § 406(b)*.

(n33)Footnote 33. *Mich. Comp. Laws § 451.806(b); see also Wis. Stat. § 551.51*.

(n34)Footnote 34. *N.H. Rev. Stat. Ann. § 421-B:31-a*.

(n35)Footnote 35. *La. Rev. Stat. § 51-710*.

(n36)Footnote 36. *Griffin v. S.W. Devanney & Co., 775 P.2d 555 (Colo. 1989)*.

(n37)Footnote 37. *See, e.g.*, "Internationalization of the Securities Markets," Statement of the North American Securities Administrators Association, NASAA Reports (CCH) P 2182 (Apr. 29, 1989).



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CHAPTER 14 State Enforcement Authority

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§ 14.04 Administrative Enforcement Proceedings

In all Blue Sky laws, securities administrators are empowered to proceed administratively against persons or entities engaging in, or that have engaged in, conduct in violation of the law or any rule, regulation, or order issued under it. Administrative proceedings represent the most flexible and efficient means of addressing violations and include the power to issue cease-and-desist orders, to suspend licenses, and in some states, the power to impose fines or civil money penalties.ⁿ¹ These remedies are the product of administrative proceedings and adjudicative procedures that are less formal and considerably more expeditious than litigation conducted in accordance with rules or requirements established as a matter of administrative procedure acts.ⁿ² While procedural due process is an essential element of administrative proceedings under Blue Sky laws, securities administrators act under broadly stated authority in the public interest for the protection of investors. As stated in the Colorado Securities Act:

The purposes of [the Act] are to protect investors and maintain public confidence in securities markets while avoiding unreasonable burdens on participants in capital markets. This article is remedial in nature and is to be broadly construed to effectuate its purposes.ⁿ³

Procedural due process in this setting requires that there be sufficient administrative and statutory standards and safeguards to protect against the exercise of unfettered discretion by administrators. Nevertheless, the "public interest" standard under which administrators act sufficiently establishes the limits of discretion without any further definition so long as the criteria for determining public interest are based on statutory purposes and objectives.ⁿ⁴ Administrative procedure acts in all states prescribe specific notice, hearing, and review requirements applicable to Blue Sky administrators in this process. Given broadly stated legislative mandates, deference by courts to securities administrators in the exercise of their authority is considerable. Where actions are taken, or determinations are made that are consistent with the public interest and based upon reliable, probative, and substantial evidence, the likelihood of judicial reversal is small.ⁿ⁵ That is one factor explaining the prominence of "cease and desist" orders among the weapons in the arsenal of Blue Sky administrators over civil injunctive actions brought in state courts.ⁿ⁶

The most flexible of administrative remedies, the cease-and-desist order is an efficient substitute for civil injunctive proceedings in court. These orders, considered further below, are typically the product of an internally prescribed process and not necessarily subject to hearing requirements prior to issuance.

[1] Cease-and-Desist Orders

Blue Sky laws generally authorize the issuance of cease-and-desist orders, although with some variations in the scope or circumstances in which that authority is allowed. The Ohio provision is typical of those granting the broadest authority:

Whenever it appears to the division of securities, from its files, upon complaint, or otherwise, that any person has engaged in, is engaged in, or is about to engage in any practice declared to be illegal or prohibited ... or defined as fraudulent ... or any other deceptive scheme or practice in connection with the sale of securities, or when the division believes it to be in the best interests of the public and necessary for the protection of investors, the division may ... issue and cause to be served by certified mail upon all persons affected an order requiring the person or persons to cease and desist from the acts or practices appearing to the division of securities to constitute violations of [the statute].ⁿ⁷

The Uniform Act does not expressly provide for cease-and-desist orders, although the power to issue them might be fairly implied under section 412(a), in regard to issuance of such "orders as are necessary to carry out the provisions of [the] act."ⁿ⁸ The Revised Uniform Act does expressly empower administrators to issue the orders based upon a reasonable belief that a violation of the act has occurred or is occurring, but limits the authority to do so without notice and an opportunity for hearing to those situations in which securities are being, or have been, offered or sold in violation of the law, or in which a person is acting as a broker-dealer or investment adviser in violation of licensing provisions.ⁿ⁹ Adopting the broadest view of authority, the 2002 Uniform Securities Act empowers administrators to act summarily to issue a cease-and-desist order not only against any person that has engaged, is engaged, or is about to engage in an act, practice, or course of business that would violate the law or any rule, but also against any person that "has, is, or is about to materially aid an act, practice or course of business" constituting a violation.ⁿ¹⁰ The scope of permitted orders under the 2002 Act includes requiring any other action necessary or appropriate to comply with the Act.ⁿ¹¹ In one form or another, cease-and-desist authority is a feature in most Blue Sky laws.ⁿ¹²

The essential predicate to issuance of a cease-and-desist order is a reasonable belief that a person has engaged in, or is about to engage in, any act or practice (in some jurisdictions, any "transaction")ⁿ¹³ constituting a violation of the Blue Sky law or any rule or order issued thereunder. As the Ohio example above illustrates, the predicate need not be the result of a formal investigative process. Arkansas, another example, requires only "sufficient grounds or evidence satisfactory to the Commissioner" that the violation did occur or is about to occur.ⁿ¹⁴

Several states also expressly require the cease-and-desist order to be "in the public interest or for the protection of investors" as a prerequisite to issuance.ⁿ¹⁵

Cease-and-desist authority is most commonly and effectively employed to deal with the offer and sale of unregistered securities or with the offer or sale of securities by unlicensed persons. California, for example, expressly provides for issuance of an order to "desist and refrain" when the Commissioner is of the opinion that either: (1) the sale of the security is subject to qualification (i.e., registration) under the law and is being offered or sold without first being qualified or (2) any person is acting as a broker-dealer or investment adviser without the proper certificate to act as such.ⁿ¹⁶

Although many cease-and-desist orders are issued following notice and an opportunity to be heard, quick administrative enforcement action by way of summarily issued cease-and-desist orders in emergency circumstances is a means of protecting the public interest.ⁿ¹⁷ As a federal district court observed in response to a challenge to a summary cease-and-desist order issued by the Iowa administrator:

[T]he state has a very strong interest in quick action to protect the public from sales of securities which may violate [the law]. A large volume of securities can be sold in a relatively short period of time. The interest of protecting the public, as weighed against plaintiffs' interests in selling the securities, is paramount. Therefore, any damage to plaintiffs under these circumstances is outweighed by the public's

interest of protection from possible illegal or even fraudulent sales of securities.ⁿ¹⁸

The Revised Uniform Act specifically provides for emergency administrative proceedings in situations involving an immediate danger to the public welfare requiring immediate action. Section 712 authorizes the administrator to take such action as is necessary to prevent or avoid immediate danger to the public welfare that justifies use of emergency procedures. With that limitation, however, the administrator may issue an order that is effective upon issuance, to be followed thereafter as quickly as feasible with complete proceedings that would otherwise be required under the state's administrative procedures act if the matter did not involve an immediate danger.ⁿ¹⁹ Some states place outside limits on the time in which some hearing must be held at which the merits of the order can be evaluated. On the other hand, the 2002 Uniform Act takes a more flexible approach, providing that within 15 days after receiving a written request the matter will be scheduled for hearing. However, if there is no hearing requested and none is ordered by the administrator within 30 days after the date of service of the order, the order becomes final by operation of law.ⁿ²⁰

Typical state procedures for cease-and-desist orders in urgent circumstances follow the Revised Uniform Act model. A "temporary" order may be issued without a hearing,ⁿ²¹ with some provision for notice to the person who is the subject of the order. Notice references vary. Alaska, Montana, and New Hampshire, for example, require "reasonable" notice. Texas, on the other hand, requires notice to each person affected by the order by personal delivery or certified or registered mail. Notice in all cases must include the right of the recipient to request a hearing on the order and, in most states, must also state the reasons for entry of the order. Typically, this procedure also involves a statement, or findings, that the public interest will be irreparably harmed by any delay in issuing the order.ⁿ²²

This is a common requirement for all cease-and-desist orders, not just summary orders. Florida, for example, requires that the order contain a statement of facts. Ohio requires the cease-and-desist order to specify the sections of the Blue Sky law that appear to the Division of Securities to be violated and the facts constituting the violation. Because cease-and-desist orders are predicated on what "appears" to the administrator to be acts or conduct in violation of the Blue Sky law, a more or less complete recitation of the basis for the administrator's conclusion is normal procedure, particularly since the right to a hearing is involved and, if requested, the administrator will be required to justify issuance of the order before an administrative hearing officer.ⁿ²³

An opportunity for a hearing is a critical consideration in the cease-and-desist order process. In most instances a hearing is not required. However, in all cases the opportunity for one is essential in the process and, as discussed above, must be part of the notice of the order. If a hearing is requested, Blue Sky laws generally prescribe time limits within which it must occur.ⁿ²⁴ If a hearing, once requested, is not held within the prescribed time, it may be rescinded by operation of law.ⁿ²⁵ On the other hand, if a hearing is not requested, the cease-and-desist order will typically become permanent and remain in full force and effect unless later modified or vacated. While cease-and-desist orders are highly efficient means of administrative enforcement action, they are not self-executing. As an administrative order they have the force of law, such that non-compliance is a basis for further action. The 2002 Uniform Act, for example, permits a final administrative order under section 604 to be filed with the clerk of any court of competent jurisdiction. Once filed, the order has the same effect as a judgment of the court and may be enforced or satisfied in the same manner as any other judgment of the court. However, the enforcement authority does not stop there as the Act goes on to provide:

If a person does not comply with an order under this section, the administrator may petition a court of competent jurisdiction to enforce the order. The court may not require the administrator to post a bond in an action or proceeding under this section. If the court finds, after service and opportunity for hearing, that the person was not in compliance with the order, the court may adjudge the person in civil contempt of the order. The court may impose a further civil penalty against the person for contempt in an amount not less than \$[] but not greater than \$[] for each violation and may grant any other relief the court determines is just and proper in the circumstances.ⁿ²⁶

This approach to enforcement of cease-and-desist orders is more direct than the common and more general, Blue Sky

law provisions imposing penalties for violation of any rule "or order."ⁿ²⁷ Ultimate enforcement of a cease-and-desist order may also be a matter for civil injunctive proceedings or criminal reference. However, in those states in which administrative civil penalties or assessments are permitted to remedy rule or order violations, administrators have the intermediate authority to impose such assessments, essentially fines, for violation of cease-and-desist orders. Administrative civil penalties are discussed further in the next section.ⁿ²⁸ In many instances, final cease-and-desist orders are the product of negotiated settlements, entered by consent. Some Blue Sky laws expressly address such consent orders. In Connecticut, for example, at any time after the issuance of a cease-and-desist order, the Commissioner may, in his or her discretion, accept an agreement by any person charged with violating any Blue Sky law provision to enter into a written consent order in lieu of the adjudicative hearing process.ⁿ²⁹ The consent order must contain: (1) an express waiver of the right to seek judicial review or otherwise challenge or contest the validity of the order; (2) a provision that the order may be used in construing the terms of the consent order; (3) a statement that the consent order shall become final when issued; (4) a specific assurance that none of the violations alleged in the order shall occur in the future; (5) such other terms and conditions as are necessary to further the purposes and policies of [the Connecticut Uniform Securities Act]; (6) the signature of each of the individual respondents evidencing his or her consent; and (7) the signature of the Commissioner or of his or her authorized representative.ⁿ³⁰ Consent orders also often incorporate obligations on payment of costs associated with the investigative procedure and other affirmative undertakings by respondents.ⁿ³¹

A final cease-and-desist order is a final order of the Administrator, and Blue Sky laws provide for an appeal of an order by any person aggrieved by it. Indeed, section 411 of the Uniform Act provides:

(a) Any person aggrieved by a final order of the [Administrator] may obtain a review of the order in the [insert name of appropriate court] by filing in court, within sixty days after the entry of the order, a written petition praying that the order be modified or set aside in whole or in part. A copy of the petition shall be forthwith served upon the [Administrator], and thereupon the [Administrator] shall certify and file in court a copy of the filing and evidence upon which the order was entered. When these have been filed, the court has exclusive jurisdiction to affirm, modify, enforce, or set aside the order, in whole or in part. The findings of the [Administrator] as to the facts, if supported by competent, material and substantial evidence, are conclusive. If either party applies to the court for leave to adduce additional material evidence, and shows to the satisfaction of the court that there were reasonable grounds for failure to adduce the evidence in the hearing before the [Administrator], the court may order the additional evidence to be taken before the [Administrator] and to be adduced upon the hearing in such manner and upon such conditions as the court considers proper. The [Administrator] may modify his findings and order by reason of the additional evidence and shall file in court the additional evidence together with any modified or new findings or order. [The judgment of the court is final, subject to review by the (insert name of appropriate court).]ⁿ³²

Although cease-and-desist orders are reviewable in the same manner as any other administrative order, one that is supported by reliable, probative, and substantive evidence will generally be upheld,ⁿ³³ and several states mandate by statute that the findings of the administrator as to the facts, if supported by competent, material, and substantial evidence, are conclusive.ⁿ³⁴ Nevertheless, cease-and-desist orders are treated no differently than any other order and may be set aside through trial and appellate court review proceedings in accordance with the state's administrative procedures act.ⁿ³⁵ Blue Sky laws often control the process only to the extent of designating the court of general jurisdiction in which appeals from orders must be lodged.ⁿ³⁶ Normally, the designated court is that for the county in which the state capitol is located.

[2] Administrative Civil Penalties

Several states include civil money penalties as part of the administrative enforcement arsenal. Alabama, for example, provides:

2-14 Blue Sky Regulation § 14.04

(a) The commission may by order, if it finds such order to be in the public interest, impose an administrative assessment upon any person who violates any provision of [the Act] or any rule or order issued under [the Act].

(b) Any administrative assessment imposed under this section shall not exceed \$5,000.00 for each act or omission that constitutes the basis for an order issued under this section, except that the amount of the administrative assessment may not exceed \$50,000.00 for any person subject to the order.ⁿ³⁷

Alabama further provides that for purposes of determining the amount or extent of the administrative assessment to be imposed on any particular respondent, the commission is to consider specific factors including the frequency, persistence, and willfulness of the conduct constituting a violation and the number of persons adversely affected by the conduct.ⁿ³⁸

The Uniform Act makes no mention of civil money penalties. However, indicative of the trend to broaden administrative enforcement powers, the Revised Uniform Act expressly empowers a *court*, upon a showing by the state administrator that a person has violated the act, to impose upon violators:

[A] civil penalty up to a maximum of [\$2500] for a single violation or of [\$25,000] for multiple violations in a single proceeding or a series of related proceedings.ⁿ³⁹ The 2002 Uniform Act likewise expressly provides for the imposition of civil money penalties. However, unlike the Revised Uniform Act, it empowers the administrator to impose the penalty as part of a final order.ⁿ⁴⁰

Civil money penalties are, functionally, fines. Some states refer to them in precisely that manner.ⁿ⁴¹ However characterized, the availability of money penalties allows for valuable flexibility in shaping efficient resolutions of administrative proceedings.

Authority to seek court imposition of a civil penalty, as set out in the Revised Act, is preserved in the 2002 Uniform Act as one form of specifically available relief in a civil enforcement action. However, at the same time, as noted above, the power of the administrator directly to impose a civil penalty (including the costs of investigation) in an administrative enforcement proceeding is also made express in the 2002 Act.ⁿ⁴² In doing so, the drafters of the 2002 Act thus recognize the prevalence of administrative civil penalty authority in Blue Sky laws. Still, a number of states do not provide for such administrative money penalties. Fining authority is sometimes perceived as an opportunity for violators to "buy" their way out of more severe sanctions, such as license terminations or judicial enforcement proceedings. As a practical matter, however, short of license suspensions and revocations, the ability of state securities agencies to impose sanctions in the absence of fining authority is confined by the extent of resources largely to cease-and-desist orders or criminal referrals. As discussed further in *section 14.07 below*, civil injunctive proceedings and ancillary judicial remedies, although available to administrators, are not so widely employed. Administrative money penalties or fining authority bridge the gap in practical application of enforcement remedies.

Administrative penalties are subject to hearing requirements and procedures. Oregon is typical in requiring that an administrative civil penalty under the Blue Sky law may only be imposed after the filing of a complaint and a hearing (or other proceeding) before the Commissioner or his or her representative under rules or orders as adopted by the Commissioner.ⁿ⁴³

After an order for the assessment of a civil penalty becomes final, unless the penalty is paid within 10 days, the order is converted to a judgment against the party and may be filed with any county clerk in the state.ⁿ⁴⁴ After the penalty is entered on the judgment docket, it becomes "a lien upon the title to any interest in property owned by the person against whom the order is entered, and execution may be issued upon the order in the same manner as execution upon a judgment of a court of record."ⁿ⁴⁵ Any amount assessed and collected is to be paid into the general fund of the state treasury. This is typical where money penalties are allowed, although in some instances the money collected from fines

or administrative penalties is dedicated to particular public interest purposes. In New Mexico, for example, civil penalties, costs of investigation, and any other administrative assessments collected by the administrator pursuant to enforcement actions is deposited to a fund used solely for education and training of the public in matters concerning securities laws and investment issues.ⁿ⁴⁶

Blue Sky laws such as these, which empower administrators to assess money penalties against violators, parallel section 21B of the Securities Exchange Act,ⁿ⁴⁷ which grants to the Securities and Exchange Commission the authority to impose a civil penalty (after notice and opportunity for hearing) when it finds that a person has willfully violated or aided, abetted, counseled, commanded, induced, or procured another in the violation of any provision of the federal securities laws. Older state penalty provisions generally do not address the matter of secondary violators, such as aiders and abettors, but rather define the authority as extending simply to those who willfully violate the Blue Sky law, or, tracking the Revised Uniform Act language, who simply are found to have violated it.ⁿ⁴⁸ The 2002 Uniform Act, on the other hand, reflects a modern approach, extending authority to persons who materially aid in an act, practice, or course of business constituting a violation of the Act.ⁿ⁴⁹

Administrative fines are punitive in nature. Administrators may therefore be required to present proof of the violation under a "clear and convincing" standard. In *Dept. of Banking and Fin. v. Osborne, Stern & Co.*,ⁿ⁵⁰ the Florida Supreme Court observed:

[A]n administrative fine deprives the person fined of substantial rights in property. Administrative fines, like the one imposed upon respondents in this case, are generally punitive in nature ... Because the imposition of administrative fines under section 517.221(3), like license revocation proceedings, are penal in nature and implicate significant property rights, the extension of the clear and convincing evidence standard to justify the imposition of such a fine is warranted.ⁿ⁵¹

Nevertheless, it has also been held that administrative fines are not to be considered "prosecutions" or "suits" such that a statute of limitations would apply. In *Maryland Sec. Comm'r v. U.S. Securities Corp.*,ⁿ⁵² a Maryland appellate court held that an administrative proceeding before the commissioner arising out of an alleged scheme to defraud investors had as its purpose the protection of the public from fraudulent and misleading practices of securities broker, and although "quasi-judicial," such a proceeding is neither a prosecution nor a suit to which the state's statute of limitations would apply.

Because civil penalties are punitive in nature, actions by state administrators may have constitutional implications. In *United States v. Halper*,ⁿ⁵³ the U.S. Supreme Court opined that administrative penalties could, under some circumstances, be deemed to constitute criminal punishment, and thus implicate the *double jeopardy clause of the Fifth Amendment* when there was a subsequent criminal prosecution arising out of the same circumstances. However, in *Hudson v. United States*,ⁿ⁵⁴ the Supreme Court determined that absent "the clearest proof" that a civil penalty or sanction was intended to be a criminal punishment, statutes authorizing civil penalties should be taken at face, that is, as a civil remedy not to be converted into the equivalent of a criminal penalty. The Court counseled that the inquiry begins with legislative intent. Unless it is clear that the legislature intended a particular sanction to be criminal, a civil remedy should not be transformed into a criminal penalty for double jeopardy purposes. In making that determination, courts should consider, among other things, whether the civil sanction involves some affirmative disability or restraint such as imprisonment; whether it has been regarded as a punishment in the past; to what extent a mental state embracing intent to deceive or manipulate is involved; and whether the sanction promotes the aims of "punishment," namely deterrence beyond that intended by normal regulation.

[3] Other Administrative Remedies

Whether or not expressly prescribed in Blue Sky laws, state administrators enjoy considerable freedom in crafting and imposing remedies through administrative proceedings that are consistent with the investor protection objectives of the

laws. The imposition of conditions, remedial undertakings, or other case specific requirements is common in the resolution of administrative proceedings. Rescission offers, for example, are commonly imposed as a condition to permitting registration or qualification of an offering of securities previously carried out without compliance with registration provisions or by persons not properly licensed in the state. In the context of agreed orders or negotiated consent settlements, administrators, likewise, have the freedom to obtain investor remedies, such as restitution,ⁿ⁵⁵ special disclosure, supervisory procedures, monitoring, and specific undertakings.ⁿ⁵⁶

It is important to note that the ability in particular instances of a Blue Sky administrator directly to impose a financial remedy for the benefit of investors, such as restitution or rescission, is normally not the result of a specific statutory authorization. Rather, these forms of remedies fall within the range of court-ordered *ancillary* remedies available to administrators in the context of civil injunctive proceedings. However, there are exceptions, as in Montana, where the Commissioner is expressly empowered to order restitution as part of an administrative proceeding.ⁿ⁵⁷

Even where Blue Sky laws empower administrators to impose remedies such as restitution, they do not empower administrators to interfere with or impede private actions. In *Whelen v. Securities Commissioner*,ⁿ⁵⁸ the Delaware Chancery Court overturned an administrative order that suspended broker-dealer and salesperson licenses, imposed fines, and required restitution to investors who had purchased unregistered securities.ⁿ⁵⁹ The investors involved in *Whelen* had entered into customer agreements with the broker-dealer firm that required binding arbitration of claims against the broker-dealer. The Division of Securities Hearing Officer concluded that he could nevertheless award restitution against the president of the broker-dealer firm because the individual was not himself a party to the arbitration agreement. The Chancery Court held that to permit the administrative award of restitution against the individual would effectively "end run" the arbitration agreement and that the Delaware public policy would not support that result.

It may also be that through combinations of Blue Sky laws with other statutory authority, as for example with state anti-racketeering or consumer protection laws, Blue Sky administrators and attorneys general may, in some instances, join to pursue *judicial* remedies for the direct benefit of investors.ⁿ⁶⁰ However, these types of actions are based upon express statutory authority outside Blue Sky laws and are subject to entirely different procedures. Remedies available in purely administrative proceedings are those that are either specifically allowed by the Blue Sky law, imposed by regulation as necessary to carry out an express statutory authority or those that are achieved in negotiated settlements of enforcement actions.

Administrative enforcement remedies also include the power to suspend or to issue a "stop order," as to a registration statement for the distribution of securities. Section 306 of the Uniform Act empowers the administrator to issue a "stop order" denying effectiveness to, or suspending the effectiveness of, any registration statement when it is determined to be in the public interest, and, as an example of several available criteria, that the offering has worked or tended to work a fraud upon the purchasers.ⁿ⁶¹ An order suspending the effectiveness of a registration statement may be issued summarily, but subject to notification upon its entry and the opportunity for hearing thereafter.ⁿ⁶²

But for summary orders suspending effectiveness of a registration, the administrator may only act to issue a "stop order" after notice, hearing, and written findings of fact and conclusions of law. The Act thus makes a distinction between emergency administrative action taken to protect the investing public in the face of an on-going course of conduct pursuant to an already effective registration statement and an order simply denying effectiveness of a registration statement or revoking it.ⁿ⁶³

NSMIA's redefinition of state and federal regulatory roles in regard to securities distributions that are national in character adds another dimension to the significance of state administrative powers in that setting. As presented more thoroughly elsewhere in this treatise,ⁿ⁶⁴ NSMIA preempts state authority to impose registration or qualification requirements on the offering of securities falling within the "covered security" qualifications of the Act. Where a covered security is involved, no "registration statement" will be filed at the state level, and thus, administrative

enforcement powers such as those prescribed in Uniform Act section 306, expressly premised on a registration in the state, are logically preempted as well. However, NSMIA also expressly preserves state antifraud enforcement authority and a state administrator might appropriately act against the offering of an NSMIA covered security in his or her state when it is determined that a fraud is being committed either by reason of the terms of the offering itself or by the conduct of an intermediary. Although state administrators may not act to suspend the registration statement of an NSMIA covered security, whether a cease-and-desist order may be issued against the issuer or an intermediary (or a summary suspension of a broker-dealer license under section 204(c) of the Uniform Act)ⁿ⁶⁵ when it is determined that the offering involves fraud or fraudulent conduct is a different issue.

The contours of state administrative enforcement authority in regard to NSMIA covered securities are yet to be shaped. However, it is clear as a matter of law that while antifraud enforcement authority is not intended effectively to allow the imposition of registration and qualification requirements by the states, the power to act in the face of fraud or fraudulent conduct remains intact. The power to act administratively against intermediaries will likely emerge as not only the logical, but the most appropriately exercised power in the national market setting.

[4] Culpability Standards for Administrative Actions

Blue Sky laws commonly prescribe the authority of the administrator to issue orders and impose administrative remedies or penalties against persons who "willfully" violate the law. Section 412 of the 2002 Uniform Securities Act, for example, outlines administrative sanctions that may be imposed on a party who "willfully violated or willfully failed to comply with [the Act]."ⁿ⁶⁶ However, Blue Sky laws do not define the term "willfully." In the context of administrative actions, state courts have thus grappled with the question whether "willfully" means knowingly and intentionally violating the law versus knowingly and intentionally committing the acts that constitute a violation. In *Cox v. Garvin*,ⁿ⁶⁷ the Georgia Supreme Court addressed the issue and concluded that to require proof in an administrative action that a person knowingly and intentionally violated the Blue Sky law would frustrate the objective of safeguarding investors by making it very difficult to impose civil penalties.ⁿ⁶⁸ The appropriate interpretation of "willfully" in the context of Blue Sky laws, said the court, is that the person intended to do the act prohibited by the statute. Thus, "willfully" simply requires the intentional doing of the wrongful acts--no knowledge of the specific provision or regulation is required. As discussed further below, this is also the approach widely taken in criminal enforcement actions.ⁿ⁶⁹

[5] Appeals

Although judicial appeals by aggrieved personsⁿ⁷⁰ from final administrative orders are provided in all Blue Sky laws,ⁿ⁷¹ the scope of such appeals is generally limited to the agency record to determine whether the order or determination was based upon substantial evidence.

"Substantial evidence" in this context means: "[T]hat quantum of probative evidence that a fact finder would accept as adequate to support a conclusion, without regard to the existence of conflicting evidence."ⁿ⁷² Courts will review the evidence presented to the administrator in order to determine, in traditional administrative law terms, whether the action of the administrator was arbitrary or capricious.ⁿ⁷³ In doing so, the administrator's determination is accorded considerable weight and the reviewing court will not substitute its judgment for that of the administrator as to the weight of the evidence on questions of fact.ⁿ⁷⁴ If a reasonable mind reviewing the evidence could determine that a violation of the Blue Sky law occurred, the administrative determination will not be upset in court.ⁿ⁷⁵

The range of administrative orders and determinations under Blue Sky laws is considerable. Some of the most significant orders from which judicial appeals may be taken are those issued on registration statements or licensing applications. Although not purely enforcement orders, the orders in these contexts have no less impact and the statutory standards on which administrators rely in making them (as defined by their own agency rules) leave little room for judicial review so long as the record discloses some evidence on which the administrator could rationally and

reasonably rely. An Ohio appellate court well illustrated the point in *Fehrman v. Ohio Div. Securities*,ⁿ⁷⁶ in which the administrator's denial of a securities salesperson license was upheld. As in most states, the Ohio Division of Securities is empowered under the Blue Sky law to refuse a license based on broadly stated qualitative or character criteria ("good business repute"), which the administrator may specifically define by rule. An Ohio rule provides that an individual may be found to be not of good business repute if the individual has been the subject of any prior disciplinary action. In *Fehrman*, the administrator applied this criterion to deny a license to an individual solely on the basis of two NASD letters of acceptance, waiver, and consent entered into by the individual that contained no findings of any wrongdoing. The applicant asserted that the denial of a license was not supported by reliable, probative, and substantial evidence when the two letters in question made no specific findings. The court disagreed, holding that the letters put disciplinary actions consistent with the administrative rule into evidence and that nothing more was required. The administrator is not required, said the court, to make any independent findings where the only evidence needed is the fact that the prior letters, with or without findings of wrongdoing, constitute disciplinary actions as provided in the rule.ⁿ⁷⁷

Substantial evidence for purposes of administrative orders and determinations need not, therefore, be the product of investigative proceedings and independent fact-finding and administrators enjoy much latitude. Still, there are limits to the extent to which deference to administrative determinations is accorded. In *Schwaemmie Construction Co. v. Michigan Dept. of Commerce*,ⁿ⁷⁸ for example, the Michigan Supreme Court set aside an administrative order concerning matters that the court found to be unrelated to the issuance, offer, sale, or purchase of securities. The administrative action involved the imposition of conditions on release of impounded proceeds of an offering that the court found was an unwarranted intrusion into the internal affairs of an issuer, rather than a proper exercise of the protective mission of the Blue Sky law to protect investors from fraud.ⁿ⁷⁹ The case makes clear that the exercise of discretion by an administrator in issuing orders and determinations must bear reasonable relation to the legislative purposes of the authorizing statute.

[6] Reciprocal Enforcement and Cooperation

In the Securities Litigation Uniform Standards Act of 1998 (SLUSA),ⁿ⁸⁰ Congress directed the Securities and Exchange Commission, in cooperation with the states, to take steps to encourage the adoption of state laws authorizing reciprocal subpoena enforcement in state securities investigations. Although the original Uniform Securities Act does not include any provision for reciprocal subpoena enforcement, the Revised (1985) Uniform Act did address this issue, to specifically provide:

If the activities constituting an alleged violation for which the information is sought would be a violation of this [Act] had the activities occurred in this State, the [Administrator] may issue and apply to enforce subpoenas in this State at the request of a securities agency or administrator of another state.ⁿ⁸¹

In 1987, the North American Securities Administrators Association (NASAA) adopted this provision, with a minor rewording, as a NASAA amendment to section 407 of the 1956 Act. The NASAA amendment provides:

The (Administrator) may issue and apply to enforce subpoenas in this state at the request of a securities agency or administrator of another state if the activities constituting an alleged violation for which information is sought would be a violation of this (Act) if the activities had occurred in this state.ⁿ⁸²

Several states have enacted a reciprocal subpoena enforcement provision in their Blue Sky laws.ⁿ⁸³ Some of these states also include a further element found in the Revised Uniform Securities Act, providing:

A request for an order of compliance may be addressed to: ... (2) a court of another state able to assert jurisdiction over the person refusing to testify or produce, if the person is not subject to service of process in this State.ⁿ⁸⁴

None of these provisions was carried into the 2002 Uniform Securities Act. Instead, section 602(f) of the 2002 Act provides:

(f) **[Assistance to securities regulator of another jurisdiction.]** At the request of the securities regulator of another State or a foreign jurisdiction, the administrator may provide assistance if the requesting regulator states that it is conducting an investigation to determine whether a person has violated, is violating, or is about to violate a law or rule of the other State or foreign jurisdiction relating to securities matters that the requesting regulator administers or enforces. The administrator may provide the assistance by using the authority to investigate and the powers conferred by this section as the administrator determines is necessary or appropriate. The assistance may be provided without regard to whether the conduct described in the request would also constitute a violation of this [Act] or other law of this State if occurring in this State. In deciding whether to provide the assistance, the administrator may consider whether the requesting regulator is permitted and has agreed to provide assistance reciprocally within its State or foreign jurisdiction to the administrator on securities matters when requested; whether compliance with the request would violate or prejudice the public policy of this State; and the availability of resources and employees of the administrator to carry out the request for assistance.

The drafters of the 2002 Uniform Act concluded that this provision is consistent with SLUSA.⁸⁵ Thus, on a discretionary basis, an administrator may, through the exercise of enforcement authority in that state, provide "assistance" to the administrator of another state in carrying out an investigation. There is no provision, however, for direct application by another administrator for issuance and enforcement of a subpoena. On the other hand, the 2002 Uniform Act provides for assistance without regard to whether the conduct being investigated would constitute a violation of that state's law.

FOOTNOTES:

(n1)Footnote 1. *See, e.g., In re Investors Capital Corp.*, Mass. Div. Sec., No. E-2005-0190 (Dec. 19, 2006) (respondent to pay a \$500,000 fine and offer senior citizens free surrender of equity-indexed annuities to settle charges that it allowed representatives to use unregistered investment advisory services to sell the annuities).

(n2)Footnote 2. Administrative proceedings under Blue Sky laws are neither civil nor criminal in nature, and although sometimes characterized as quasi-judicial, they are not judicial at all. *See Maryland Securities Comm'r v. U.S. Securities Corp.*, 122 Md. App. 574, 716 A.2d 290 (Ct. Spec. App. 1998). Thus, an administrative action is not a "prosecution" or "suit" as those terms are used in application of statutes of limitation, and an action by the Securities Commissioner will not be barred by any statute of limitation. *Maryland Securities Comm'r v. U.S. Securities Corp.*, 122 Md. App. 574, 716 A.2d 290 (Ct. Spec. App. 1998).

(n3)Footnote 3. *Colo. Rev. Stat. § 11-51-101(2)*.

See In re Shelman Securities Corp., et al., No. XY-2003-02, Final Order (Colo. Div. Sec., Nov. 2, 2004), in which the Securities Commissioner explained the public interest analysis undertaken to include the following factors: (1) the egregiousness of the respondent's actions; (2) the isolated or recurrent nature of the infraction; (3) the degree of scienter involved; (4) the sincerity of the respondent's assurances against future violations; (5) the respondent's recognition of the wrongful nature of his conduct; and (6) the likelihood that his occupation will present opportunities for future violations.

(n4)Footnote 4. *Westmark Asset Management Corp. v. Joseph*, 37 P.3d 516 (Colo. Ct. App. 2001) (because Commissioner's interpretation of "public interest" was based on statutorily and judicially established criteria, there were sufficient safeguards against the use of unfettered discretion).

(n5)Footnote 5. It is for this reason as well that resolution of enforcement cases by consent orders is common, *see*,

e.g., In re Thomas Weisel Partners, LLC, Consent Order, [2003-2008 Transfer Binder] Blue Sky L. Rep. (CCH) P 74,571 (N.J. Bur. Sec. 2006).

But see Whelen v. The Securities Commissioner of the State of Delaware, Blue Sky L. Rep. (CCH) P 74,252 (Del. Chancery 2001) (Hearing Officer's findings and administratively imposed remedies for failure of supervision by a broker-dealer and its president were not supported by competent, material, and substantial evidence).

Judicial review of administrative actions and the appeal process involving such orders and determinations generally, are discussed in § 14.06[4].

(n6)Footnote 6. The range of options available to Blue Sky administrators in judicial enforcement actions is discussed in § 14.07.

(n7)Footnote 7. *Ohio Rev. Code § 1707.23(H).*

(n8)Footnote 8. *Unif. Sec. Act § 412(a).*

(n9)Footnote 9. *Rev. Unif. Sec. Act § 602(a)-(b).*

(n10)Footnote 10. *2002 Unif. Sec. Act § 604.*

(n11)Footnote 11. *2002 Uniform Act § 604(a)(1).*

(n12)Footnote 12. *See, e.g.:*

Alaska: Alaska Stat. § 45.55.920(1)(A).

Arkansas: Ark. Stat. Ann. § 23-42-209(a)(1).

California: Cal. Corp. Code § 25532.

Delaware: Del. Code Ann. tit. 6, § 7325(c).

Florida: Fla. Stat. Ann. § 517.221.

Maryland: Md. Code Ann. § 11-701.1(a).

Massachusetts: Mass. Gen. Laws Ann. ch. 110A, § 407A.

Michigan: Mich. Comp. Laws § 451.808(a).

Mississippi: Miss. Code Ann. § 75-71-715(1); see also Miss. Sec. R. 801-803 (administrative hearing procedures).

Montana: Mont. Rev. Code Ann. § 30-10-305(1)(a).

Nevada: Nev. Rev. Stat. § 90.630(2)(a).

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:23(I)(a).

New Jersey: N.J. Stat. Ann. § 49:5-12(a).

New Mexico: N.M. Stat. Ann. § 58-13B-37.

North Carolina: N.C. Gen. Stat. § 78A-47(b)(1).

North Dakota: N.D. Cent. Code § 10-04-16(1).

Oregon: Or. Rev. Stat. § 59.245(4).

Pennsylvania: Pa. Stat. Ann. § 606(c.1).

Rhode Island: R.I. Gen. Laws § 7-11-602(b)(1).

Texas: Tex. Rev. Civ. Stat. Ann. § 581-23(A).

Utah: Utah Code Ann. § 61-1-20(1)(a).

Washington: Wash. Rev. Code § 21.20.390(1).

(n13)Footnote 13. *See, e.g.,* Arizona, Florida, Georgia, New Hampshire, North Dakota, Oregon, and Rhode Island.

(n14)Footnote 14. Ark. Stat. Ann. § 23-42-209(a)(1).

(n15)Footnote 15. *See, e.g.,* Alaska, Georgia, and North Dakota. There are varying approaches. Ohio, for example, permits the Division of Securities to issue a cease-and-desist order when the Division believes it to be "in the best interest of the public and necessary for the protection of investors."

(n16)Footnote 16. *Cal. Corp. Code § 25532(a)-(b).*

See also:

Alabama: Alabama Sec. Comm'n v. American Business Club, 612 So. 2d 1237 (Ala. Civ. App. 1992) (Alabama brokers who sold unregistered, non-exempt investment contracts in violation of Alabama Blue Sky law were unable to show that the Alabama Securities Commission exceeded the scope of its authority by issuing a cease-and-desist order prohibiting continued sales of business club membership).

Alaska: In re Federal Resources Corp., [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,476 (1978) (temporary cease-and-desist order made permanent for selling unregistered securities by unregistered broker/dealer, agent, or investment adviser); *In re Murray*, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) PP 71,417, 71,401 (1978).

Arizona: In re Offering of Securities of International Plant Growers, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,490 (1978).

The Arizona Securities Commission assessed two foreign companies an administrative penalty and ordered them to cease and desist from offering or selling unregistered securities within or from Arizona until the securities and companies became registered under the Arizona Securities Act. A common law trust established as a unit trust under the laws of Belize and a limited liability company operating under the laws of Belize violated the Arizona Blue Sky law by offering and selling unregistered securities within or from Arizona. Neither company was registered as a dealer in Arizona. In addition, the

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companies failed to provide investors with a prospectus, made untrue statements of material fact, and failed to disclose relevant information such as cease-and-desist orders issued by other state securities commissions. *In re* Offering of Securities by Banner Fund Int'l & Swiss Trade & Commerce Trust, Ltd., [1993-1994 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,923 (Ariz. Admin. Pro. 1994).

Connecticut: Banking Comm'r v. Holdings of U.S. Gov't Sec., Inc., [1978-1981 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,524 (1979) (cease-and-desist order made permanent: failure to register persons selling or offering securities for sale and failure to register securities offered for sale).

Florida: *In re* Shekinak Cloister Christian Church, [1978-1981 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,405 (1978) (cease-and-desist order made permanent: failure to register securities and violation of antifraud provisions of the Blue Sky law).

Iowa: *In re* Economou, [1978-1981 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,515 (1979); *In re* Long's Long Life Wormery, Inc., [1978-1981 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,441 (1978).

Michigan: *In re* First Fin. Inv. Co., [1993-1994 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,864 (1993) (cease-and-desist order against unregistered broker for selling unregistered, nonexempt securities).

Oregon: *In re* Cal-Am Corp., [1978-1981 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,437 (1978) (cease and desist from offering unregistered securities and from failing to disclose material facts in connection with the sale of securities).

South Dakota: *In Matter of* Worm World, Inc., [1978-1981 Transfer Binder] Blue Sky L. Rep. (CCH) PP 71,414, 71,419 (1978).

Texas: *In re* Ideal Securities, Inc., Blue Sky L. Rep. (CCH) P 73,688 (Tex. Sec. Comm'n 1993) (sale of unregistered, non-exempt interests in oil and gas leases by unregistered brokers violated provisions of the Texas Blue Sky law; thus, brokers' registrations were revoked and the brokerage was subjected to a cease-and-desist order); *see also In re* Agent Registration of Alvis Mitchell Lewis, Blue Sky L. Rep. (CCH) P 74,011 (Tex. Sec. Comm'n 1995) (sale of unregistered, non-exempt securities by unregistered agent for unregistered dealer violated provisions of Texas Securities Act and was subject to a cease-and-desist order); *In re* Invesco, Inc., Blue Sky L. Rep. (CCH) P 73,679 (Tex. Sec. Comm'n 1992) (Dissemination of advertising materials containing misleading and deceptive information in sale of investment contracts, certificates and other investment vehicles violated Texas blue sky law and provided grounds for the issuance of a cease-and-desist order).

(n17)Footnote 17. *See* Rev. Unif. Act § 602, 712; 2002 Uniform Act § 604(b).

(n18)Footnote 18. *Economou v. Wade*, 515 F. Supp. 813, 815 (S.D. Iowa 1980) ; *see also In re* Economou, [1978-1981 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,515 (1979).

(n19)Footnote 19. Rev. Unif. Act § 712(a),(b),(e).

(n20)Footnote 20. 2002 Uniform Act § 604(b).

(n21)Footnote 21. Such is the case, for example, in Alaska, Montana, and Washington. Other states such as Indiana, Michigan, New Hampshire, and North Dakota provide for the issuance of an order prior to a hearing, but do not

refer to the cease-and-desist order as "temporary." Other states provide for "summary" orders, but all are functionally the same.

(n22)Footnote 22. *See, e.g.:*

North Carolina: N.C. Gen. Stat. § 78A-47(b)(2) (issuance of temporary order conditioned on the administrator making written findings of fact that the public interest will be irreparably harmed).

(n23)Footnote 23. Constitutional challenges in connection with the issuance of cease-and-desist orders have generally failed. In *Knepp v. Lane*, 848 F. Supp. 1217 (E.D. Pa. 1994) , an individual who was the subject of a summary order to cease and desist in the sale of instruments determined by the administrator to be securities claimed deprivation of due process and equal protection of the law. The respondent claimed that the actions of the Pennsylvania Securities Commission damaged his reputation, cost him his job as a securities salesman, and singled him out for enforcement action. The court rejected all of the assertions.

(n24)Footnote 24. *See, e.g.:*

New Hampshire: N.H. Rev. Stat. Ann. § 421-B:23(a) (a hearing must be held not later than 10 days after a request is received by the administrator).

Some procedures regarding hearings are more complex. In New Jersey, for example:

Upon service of a notice of the order issued by the bureau chief, each person subject thereto shall have up to 15 days to respond to the bureau in the form of a written answer and written request for a hearing. The bureau chief shall, within five days of receiving the answer and the request for a hearing, either transmit the matter to the Office of Administrative Law for a hearing or schedule a hearing at the Bureau of Securities. Orders issued pursuant to this section shall be subject to an application to vacate upon 1 days' notice, and in any event a preliminary hearing on the order shall be held within 20 days after it is requested, and the filing of a motion to vacate the order shall toll the time for filing an answer and written request for a hearing. *N.J. Stat. Ann. § 49:3-69(a)(1)(ii)*.

(n25)Footnote 25. *See Cal. Corp. Code § 25532(c)*. If the hearing is not commenced within 15 business days after the request by the person to whom the desist-and-refrain order is directed (or a later date if the person so consents), then the desist-and-refrain order is rescinded.

(n26)Footnote 26. 2002 Uniform Act § 604(g).

See also Wash. Rev. Code § 21.20.400 (any person who willfully violates "any order"); *Wis. Stat. § 551.58* (any person who willfully violates "any order"); *N.H. Rev. Stat. Ann. § 21-B:24* (any person who willfully violates a cease-and-desist order is guilty of a class B felony).

(n27)Footnote 27. *See, e.g.:*

West Virginia: W.Va. Code § 32-4-409.

(n28)Footnote 28. *See § 14.06[2]*.

(n29)Footnote 29. *Conn. Gen. Stat. § 36b-27(f)*.

(n30)Footnote 30. *Conn. Gen. Stat. § 36b-27(f)*.

(n31)Footnote 31. *See, e.g., In re Tom Steve Schey*, [1993-1994 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,904 (Mich. Admin. Proc. 1994), in which a consent order was entered in a Michigan Administrative Proceeding, where an agent was found to have violated Michigan Blue Sky law by selling securities prior to the completion of his registration application. The order required the agent to contribute to the costs of investigating the matter; to employ broker-dealer to strictly supervise his activities for two years; to refrain from acting in any principal, supervisory, or managerial capacity while employed with his brokerage firm; and to refrain from transferring his registration to any other broker-dealer without prior approval from the Michigan Securities Bureau.

(n32)Footnote 32. Unif. Sec. Act § 411.

For more detailed consideration of the appeal process applicable to all administrative orders and determinations, *see* § 14.06[5].

(n33)Footnote 33. *See In re Appeal of Wozniak*, [1984-1985 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,055, 1985 Ohio App. LEXIS 7571 (Apr. 30, 1985) (consent order would not be vacated despite subsequent court findings contradicting a premise for the predicate Blue Sky law violation).

(n34)Footnote 34. *See, e.g.:*

West Virginia: W. Va. Code § 32-4-411.

(n35)Footnote 35. *See Department of Commerce v. De Beers Diamond Investment, Ltd.*, 3 Blue Sky L. Rep. (CCH) P 71,510 (Mich. App. 1979) (order to cease and desist sales of unregistered securities affirmed by lower court, but reversed on appeal).

(n36)Footnote 36. *See, e.g.:*

Arizona: Ariz. Rev. Stat. § 44-1981.

North Dakota: N.D. Cent. Code § 10-04-16(1).

(n37)Footnote 37. *Ala. Code § 8-6-19(j)(1)-(2).*

Similarly, in Arizona:

A person who, in an administrative action, is found to have violated any provision of this chapter or any rule or order of the commission may be assessed an administrative penalty by the commission, after a hearing, in an amount not to exceed five thousand dollars for each violation. *Ariz. Rev. Stat. § 44-2036A.*

See also:

Florida: Fla. Stat. Ann. § 517.221(3) (Department of Banking and Finance may impose an administrative fine not in excess of \$5,000 against any person found to have violated any cease-and-desist order issued by the Department).

New Jersey: N.J. Stat. Ann. § 49:3-70(b) (a person who violates the state's securities law or the rules thereunder is liable to the Chief of the Bureau of Securities to a penalty for a first violation of not more than \$10,000, and for each subsequent violation to a maximum fine of \$20,000).

Mississippi: Miss. Code Ann. § 75-71-715(2)(a). Mississippi may impose an administrative penalty of up to \$25,000 for each violation of state Blue Sky law or a rule or order thereunder, as well as requiring reimbursement for all costs and expenses of investigation of the violation(s) and any institution of administrative proceedings. In determining the penalty, the Secretary of State is directed to consider, without limitation, the frequency, persistence, and willfulness of the violative conduct, the number of persons adversely affected, and the resources of the violator.

(n38)Footnote 38. *Ala. Code § 8-6-19(j)(3).*

(n39)Footnote 39. *Rev. Unif. Sec. Act § 603(a)(1)(ii).*

(n40)Footnote 40. *2002 Uniform Act § 604(d).*

(n41)Footnote 41. *See, e.g.:*

Montana: Mo. Code Ann. § 30-10-305 ("[t]he commissioner may, after giving reasonable notice and an opportunity for a hearing ... impose a fine not to exceed \$5,000 per violation").

(n42)Footnote 42. *2002 Uniform Act § 604(d), (e).*

(n43)Footnote 43. *Or. Rev. Stat. § 59.995(3).*

(n44)Footnote 44. *Or. Rev. Stat. § 59.995(4).*

(n45)Footnote 45. *Or. Rev. Stat. § 59.995(4).*

(n46)Footnote 46. *N.M. Stat. Ann. § 58-13B-57.* Disbursements from the "Securities Education and Training Fund" are made by the administrator.

(n47)Footnote 47. *15 U.S.C. § 78u-2.*

(n48)Footnote 48. *See:*

Arizona: Ariz. Rev. Stat. § 44-2037A.

Indiana: Ind. Code § 23-2-1-19.5(a).

Maryland: Md. Code Ann. § 11-702(b)(3).

Rhode Island: R.I. Gen. Laws § 7-11-602(b)(4).

Texas: Tex. Rev. Civ. Stat. Ann. § 581-23-1.

(n49)Footnote 49. *2002 Uniform Act § 604(a).*

(n50)Footnote 50. *Department of Banking & Fin., Div. of Sec. & Investor Protection v. Osborne Stern & Co., 670 So. 2d 932 (Fla. 1996) .*

(n51)Footnote 51. *Department of Banking & Fin., Div. of Sec. & Investor Protection v. Osborne Stern & Co., 670 So. 2d 932, 935 (Fla. 1996) .*

(n52)Footnote 52. *Maryland Sec. Comm'r v. U.S. Sec. Corp.*, 122 Md. App. 574, 716 A.2d 290 (Ct. Spec. App. 1998) .

(n53)Footnote 53. *United States v. Halper*, 490 U.S. 435, 109 S. Ct. 1892, 104 L. Ed. 2d 487 (1989) , overruled as stated in *United States v. Spellissy*, 2007 U.S. Dist. LEXIS 84162 (M.D. Fla. Nov. 14, 2007) .

(n54)Footnote 54. *Hudson v. United States*, 522 U.S. 93, 118 S. Ct. 488, 139 L. Ed. 2d 450 (1997) .

(n55)Footnote 55. *See, e.g., In re Hylton*, 2002 Ariz. Sec. LEXIS 1 (Sec. Comm'n Jan. 15, 2002) (order, by consent, to make restitution plus interest to investors, as well as a civil money penalty).

(n56)Footnote 56. *See, e.g., In re Alanar Inc.*, 2002 Ind. Sec. LEXIS 105 (Sec. Div. June 12, 2002) (consent agreement to bring about payment of principle and interest on various church bonds and make certain filings in addition to paying civil money penalties).

(n57)Footnote 57. *Mont. Code Ann. § 30-10-309(1)* provides:

The commissioner may, after conducting a hearing ... require a person found to have committed a violation of [the act] to make restitution for all financial losses sustained by any person as a result of the violation. The commissioner may further require a person found to have violated [the act] to pay 10% annual interest on the amount of restitution from the date of the violation, reasonable attorney fees, and costs associated with bringing the administrative action.

The full range of ancillary remedies available to administrators in such proceedings is discussed in § 14.07[2], *below*.

(n58)Footnote 58. *Blue Sky L. Rep.* (CCH) P 74,252 (Del. Ch. 2001).

(n59)Footnote 59. *See Del. Code Ann. § 7316(g)*.

(n60)Footnote 60. Civil or other ancillary remedies that may be available in actions brought under such laws or in the context of criminal prosecutions are discussed further in § 14.08, *below* .

(n61)Footnote 61. *Unif. Sec. Act § 306*.

Other grounds for this administrative remedy include: (1) that the offering involves a violation of the Act by an intermediary or someone acting on behalf of or controlling the issuer; (2) that the issuer is engaged in an illegal business activity; (3) that the registration statement is incomplete or that it contains materially false or misleading information; (4) that the offering was not qualified for a particular type of registration; or (5) that the offering involves unreasonable amounts of intermediary compensation.

(n62)Footnote 62. *Unif. Sec. Act § 306(b)*.

(n63)Footnote 63. The Uniform Act also addresses the power of an administrator to revoke an exemption. Section 402(c) permits the administrator, after notice, opportunity for hearing and written findings of fact and conclusions of law, to revoke certain exemptions.

(n64)Footnote 64. NSMIA and its impact on state authority generally in regard to registration and qualification of securities are discussed in Chapter 5 ("Securities Registration").

(n65)Footnote 65. Administrative power summarily to suspend a broker-dealer license or registration is a significant further administrative enforcement remedy in its own right. Section 204(c) of the Uniform Act expressly empowers administrators to issue summary suspension orders, subject to notification on its entry and opportunity for

hearing thereafter.

(n66)Footnote 66. 2002 Uniform Act § 412.

(n67)Footnote 67. *Cox v. Garvin*, 278 Ga. 903, 607 S.E.2d 549 (2005) .

(n68)Footnote 68. The court observed:

Assertions that the accused party did not knowingly and intentionally sell securities in violation of the Act or that the party believed the securities were exempt from registration would be virtually impossible to overcome; a seller of unregistered securities would likely be able to avoid a finding of "willfulness" unless the seller had been the subject of a prior action for selling virtually the same securities. *Cox v. Garvin*, 278 Ga. 903, 907, 607 S.E.2d 549 (2005) .

(n69)Footnote 69. *But see Ohio Rev. Code § 1707.29*, which provides:

In any prosecution brought under Sections 1707.01 to 1707.45 of the Revised Code, except prosecutions brought for violation of division (A) of Section 1707.042 of the Revised Code, the accused shall be deemed to have had knowledge of any matter of fact, where in the exercise of reasonable diligence, he should, prior to the alleged commission of the offense in question, have secured such knowledge.

(n70)Footnote 70. The securities commissioner has been held not to be an "aggrieved person" for purposes of an appeal under the state Blue Sky law. In *Ropp v. Fletcher King*, [2003-2008 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 74,643, 2007 Del. Ch. LEXIS 109 (New Castle Ch. Ct. July 25, 2007) , the Delaware Securities Commissioner appealed from the determination by a Hearing Officer appointed to act in a matter filed before (and by) the appellant Commissioner. The Hearing Officer determined that the respondents in the proceeding did not violate certain provisions of the Delaware Securities Act. On the Commissioner's appeal, and in connection with dismissing that appeal, the question posed by the Chancery Court was whether the Commissioner can appeal an order that, in essence, is his own order.

The Delaware Securities Act permits an appeal "by a person aggrieved by an order of the Commissioner." Appellate review is available only to persons satisfying the statutory standard. After a thorough analysis of the statute and case law, the court concluded that the Commissioner cannot be "aggrieved" for the purpose of seeking judicial review of his own decision. Any order issued by a Hearing Officer is by law an order of the Commissioner for purposes of judicial review. If an adverse decision is received by the administrative authority in the context of performance of its regulatory function, the appellate option will not be available.

In many instances this situation would be avoided by the provisions for acceptance, rejection, or modification of Hearing Officer's recommendations by the Commissioner that are part of the administrative process under many Blue Sky laws.

(n71)Footnote 71. The Uniform Act, for example, provides in section 411:

(a) Any person aggrieved by a final order of the [Administrator] may obtain a review of the order in the [insert name of appropriate court] by filing in court, within sixty days after the entry of the order, a written petition praying that the order be modified or set aside in whole or in part. A copy of the petition shall be forthwith served upon the [Administrator], and thereupon the [Administrator] shall certify and file in court a copy of the filing and evidence upon which the order was entered. When these have been filed, the court has exclusive jurisdiction to affirm, modify, enforce, or set aside the order, in whole or in

part. The findings of the [Administrator] as to the facts, if supported by competent, material and substantial evidence, are conclusive. If either party applies to the court for leave to adduce additional material evidence, and shows to the satisfaction of the court that there were reasonable grounds for failure to adduce the evidence in the hearing before the [Administrator], the court may order the additional evidence to be taken before the [Administrator] and to be adduced upon the hearing in such manner and upon such conditions as the court considers proper. The [Administrator] may modify his findings and order by reason of the additional evidence and shall file in court the additional evidence together with any modified or new findings or order. [The judgment of the court is final, subject to review by the (insert name of appropriate court).]

(n72)Footnote 72. *Westmark Asset Management Corp. v. Joseph*, 37 P.3d 516 (Colo. Ct. App. 2001) .

See also *Ak's Daks Communs. v. Maryland Secs. Div.*, 138 Md. App. 314, 771 A.2d 487 (Ct. Spec. App. 2001) (under the applicable standard of substantial evidence the court determines whether a reasonable mind could have reached the factual conclusion reached by the Commissioner).

(n73)Footnote 73. *Sec'y of State v. Tretiak*, 117 Nev. 299, 22 P.3d 1134 (2001) (*en banc*).

(n74)Footnote 74. *Sec'y of State v. Tretiak*, 117 Nev. 299, 22 P.3d 1134 (2001) (*en banc*).

See also *Technomedical Labs, Inc. v. Utah Securities Comm.*, [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,647 (Utah Ct. App. 1987) ("[d]eference is afforded to the expertise and experience of the agency in its interpretation of key provisions of the statute it is empowered to administer").

(n75)Footnote 75. Although not the norm, in some jurisdictions judicial review may involve a *de novo* consideration of the case. See e.g., *Doggett v. Alabama Sec. Comm'n*, Blue Sky L. Rep. (CCH) P 72,601 (Ala. Civ. App. 1987) (proper method of judicial review of orders issued by the Securities Commission is by trial *de novo*).

(n76)Footnote 76. *Fehrman v. Ohio DOC*, 141 Ohio App. 3d 503, 2001-Ohio-4225, 751 N.E.2d 1089 .

(n77)Footnote 77. The court declared:

[R]egardless of whether the two letters of acceptance, waiver and consent relied upon by the trial court contained any specific findings of wrongdoing by appellant, it is undisputed that in these letters appellant consented to censures, fines and suspensions. Consequently, the trial court did not abuse its discretion in finding that there were disciplinary actions in evidence that allowed the [Commissioner] to find that appellant is not of good business repute.

Fehrman v. Ohio DOC, 141 Ohio App. 3d 503, 508-509, 2001-Ohio-4225, 751 N.E.2d 1089 ; see also *Westmark Asset Mgmt. Corp. v. Joseph*, 37 P.3d 516 (Colo. Ct. App. 2001) (decision of securities commissioner to deny an investment adviser license based upon a previous SEC administrative decision disciplining the individual as a securities registered representative was based on substantial evidence because the Commissioner was entitled to adopt another agency's findings).

(n78)Footnote 78. *Schwaemmie Construction Co. v. Michigan Dept. of Commerce*, [1984-1985 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,151 (Mich. 1984).

(n79)Footnote 79. See also *Blinder Robinson & Co., Inc. v. Burton*, [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,630 (Del. Ch. 1987) (stay of administrative order granted where deference was outweighed by specific circumstances showing no actual, current threat to the public).

(n80)Footnote 80. Pub. L. No. 105-353, 112 Stat. 3227. Section 102(e) of SLUSA provides:

The Securities and Exchange Commission, in consultation with State securities commissions (or any agencies or offices performing like functions), shall seek to encourage the adoption of State laws providing for reciprocal enforcement by State securities commissions of subpoenas issued by another State securities commission seeking to compel persons to attend, testify in, or produce documents or records in connection with an action or investigation by a State securities commission of an alleged violation of State securities laws.

(n81)Footnote 81. Rev. Unif. Sec. Act § 601(d).

(n82)Footnote 82. Unif. Sec. Act § 407 (NASAA Rev. 1987).

(n83)Footnote 83. *See, e.g.*, District of Columbia, Illinois, Missouri, Montana, Nebraska, Nevada, North Carolina, Ohio, Rhode Island, and Washington.

(n84)Footnote 84. Rev. Unif. Sec. Act § 601(d).

(n85)Footnote 85. *See* 2002 Unif. Sec. Act § 602(f), Off. Comment 6.



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CHAPTER 14 State Enforcement Authority

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§ 14.05 Judicial Enforcement Actions

[1] Civil Injunctions

The Uniform Act provides:

Whenever it appears to the Administrator that any person has engaged or is about to engage in any act or practice constituting a violation of any provision of this act or any rule or order hereunder, he may in his discretion bring an action in the [insert name of appropriate court] to enjoin the acts or practices and to enforce compliance with this act or any rule or order hereunder. Upon a proper showing a permanent or temporary injunction, restraining order, or writ of mandamus shall be granted and a receiver or conservator may be appointed for the defendant or the defendant's assets. The court may not require the Administrator to post a bond.ⁿ¹

Nearly every state expressly provides for the availability of injunctive reliefⁿ² and many have adopted, in whole or in part, the Uniform Act provision. The 2002 Uniform Act not only continues the provision for civil enforcement authority, but also prescribes the relief available in such proceedings.ⁿ³ By including specific relief provisions, the drafters of the 2002 Uniform Act identify what has become standard practice in civil enforcement actions, in which administrators seek and obtain relief as follows:

- (1) Restraining orders, temporary and permanent injunctions, and declaratory judgments;
- (2) An asset freeze, accounting, writ of attachment, writ of general or specific execution, and an appointment of a receiver or conservator for the defendant or the defendant's assets;
- (3) An order for the administrator to take charge and control of a defendant's property, including investment accounts and accounts in a depository institution, rents, and profits, as well as to collect debts and to acquire and dispose of property;
- (4) Civil money penalties, rescission, restitution, and disgorgement; and
- (5) Payment of prejudgment and post judgment interest.ⁿ⁴

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The range of potential relief available in civil proceedings is conditioned on a proper showing and enables administrators and courts to tailor appropriate sanctions to particular misconduct. Whether or not a particular Blue Sky law spells out the available remedies in an enforcement action, in practice these are the remedies sought and which the courts have ample equitable jurisdiction to impose. Ancillary remedies, that is, the equitable remedies in addition to injunctions, are more particularly *considered in section 14.05[2]*, below.

The authority of administrators to pursue civil enforcement remedies is a matter entirely separate from authority to pursue administrative remedies. As discussed in *section 14.06*, administrative remedies may be more efficient, but are not self-executing. Direct action in court allows the full force of the judiciary to be brought to bear in the enforcement initiative. However, it also requires the availability and commitment of resources. That reason alone often militates in favor of administrative cease-and-desist orders rather than injunctive proceedings.

Section 408 of the Uniform Act and most variants of it among the states are modeled on section 21(d) of the Securities Exchange Act of 1934,ⁿ⁵ which empowers the SEC to obtain temporary and permanent injunctions against persons engaged in or about to engage in acts or practices that violate the law or rules and regulations issued under it. In most states, civil injunctive actions may be brought directly by the administrator,ⁿ⁶ in contrast to criminal prosecutions, which are normally accomplished by referral under the statute to the state attorney general or an appropriate local prosecutor.

In bringing civil injunctive cases, a Blue Sky administrator is not required to make any special showing. Rather, injunctions may be issued upon a "proper showing." However, in *Rondeau v. Mosinee Paper Corp.*,ⁿ⁷ the U.S. Supreme Court counseled that securities laws which grant equitable jurisdiction to trial courts to enforce the laws through injunctions do not abrogate traditional equitable principles guiding a court in the use of its powers. Traditional equitable principles, such as a showing of irreparable harm and the absence of an adequate remedy at law should, said the Court, govern the issuance of injunctions to enforce securities laws. Among other equitable principles, said the Court, injunctions are designed to deter, not to punish violators, notwithstanding the public interest that is involved.

Nevertheless, applicable standards for issuance of injunctive relief vary among the states on matters such as irreparable harm, or whether demonstration of a reasonable likelihood of continuing or recurring conduct must be made. In Ohio, it has been held that the Commissioner must meet the burden of proving both irreparable harm through the inadequacy of legal remedies and a likelihood of future violations. Violations in the past do not support the need for injunctive relief reaching into the future.ⁿ⁸

This relatively heavy burden stands in contrast to the standard applied in SEC injunctive actions, in which the Commission is not required to present proof of irreparable harm, although some showing of a reasonable likelihood of recurrence is necessary. As evidenced by the decision in *UV Industries, Inc. v. Posner*,ⁿ⁹ which considered a request for an injunction by a private plaintiff under the Maine statute, courts are more likely to shape the contours of traditional requirements such as irreparable harm to give full effect to the remedial purpose of the Blue Sky law. In *UV Industries*, the court explained that the rationale for modifying requirements with respect to injunctions that are "creatures of statute" is that the party bringing the suit is acting to vindicate the public interest.ⁿ¹⁰

Whether a state administrator may appropriately obtain a court injunction solely on the basis of a past violation is, at best, uncertain. However, authority to issue cease-and-desist orders is not constrained by traditional equitable principles and the flexibility accorded to administrators in that process militates in its favor versus seeking injunctive relief from a court in situations where the issues of irreparable harm or likelihood of recurring violations might dominate. Although by definition a cease-and-desist order at least implies the interdiction of on-going conduct, the authority to issue them is also expressly premised upon a finding that a person "has engaged" in conduct in violation of the law. A cease-and-desist order addressing past conduct only plainly falls within the statutory authority, and, given the power to enforce it in the future, presents practical and attractive alternative to a civil injunctive case.

When an injunction issues, its scope must conform to the actual enforcement authority conferred by the Blue Sky law. In *Shields v. State*,ⁿ¹¹ the Texas Court of Appeals reversed a trial court judgment granting a permanent injunction which not only restrained the defendant/broker from future violations of antifraud provisions of the Texas Securities Act, but also restrained him from "selling, brokering, or dealing in securities in any manner," without reference to fraud or the terms of the act. The court of appeals held that the terms of the act did not authorize injunctions of such scope and that the issuance of this one amounted to an abuse of discretion. The court rejected the assertion that the broad charge to the securities commissioner in the act to take such measure as are necessary to prevent violations authorized an injunction so broad in scope. Such a construction, said the court, was unreasonable, and would authorize the commissioner and the state attorney general to misapply the law that they are instructed to enforce.

[2] Ancillary Remedies

Civil injunctive authority is augmented by the ability of administrators to obtain remedies such as rescission, restitution, or disgorgement against violators.ⁿ¹² In North Carolina, for example:

In addition to any other remedies provided by this Chapter, the Administrator may apply to the court hearing this matter for an order of restitution whereby the defendant in such action shall be ordered to make restitution of those sums shown by the Administrator to have been obtained by him in violation of any provisions of this Chapter. Such restitution shall be payable, in the discretion of the court, to the Administrator or receiver appointed pursuant to this section for the benefit of those persons whose assets were obtained in violation of this Chapter, or directly to those persons.ⁿ¹³

Section 603 of the 2002 Uniform Securities Act reflects the full breadth of ancillary remedy provisions available under Blue Sky laws by empowering the administrator to obtain an asset freeze, accounting, writ of attachment, writ of general or specific execution, and appointment of a receiver or conservator that may be the administrator, for the defendant or the defendant's assets. Additionally, the administrator may obtain an order to take charge and control of a defendant's property, including investment accounts and accounts in a depository institution, rents, and profits; to collect debts; and to acquire and dispose of property, as well as an order of rescission, restitution, or disgorgement directed to a person that has engaged in an act, practice, or course of business constituting a violation.ⁿ¹⁴

The scope of the administrator's power under such provisions has been extended to the imposition of joint and several liability and recovery of restitution from persons who aid or abet violations of others.ⁿ¹⁵ Whether stated in express terms of secondary liability or more typically in terms of persons "participating" in unlawful conduct, the reach of statutory authority to obtain ancillary relief is considerable.

The California, Colorado, Oregon, Pennsylvania, and Washington Blue Sky Laws empower the securities administrators to bring an action for restitution or for *damages* on behalf of any persons injured by any acts or practices constituting a violation of the law.ⁿ¹⁶ These statutes give the courts in the respective jurisdictions (except California) authority to award such relief if the court finds that enforcement of the rights of such persons by private civil action, whether by class action or otherwise, would be so burdensome or expensive as to be impractical.

Provisions for obtaining restitution are often worded in disgorgement terms, that is, for restitution of ill-gotten money or gains. In Florida, the Department of Banking and Finance may apply to a court having another matter before it (e.g., an action for injunctive relief, appointment of a receiver, etc.) for an order of restitution for those sums shown by the Department to have been obtained in violation of any provision of the Act.ⁿ¹⁷ In New York, upon a showing by the Attorney General that a fraudulent practice has occurred, relief under the Martin Act in a civil or criminal action can include restitution of any monies or property obtained directly or indirectly by the fraudulent practice.ⁿ¹⁸ Delaware, on the other hand merely states the Commissioner may also seek (besides injunctive relief) "orders of restitution."ⁿ¹⁹ As the provisions in these states illustrate, restitution is a remedy normally sought in the context of a civil injunctive action. However, Montana empowers the administrator directly to require restitution through an administrative proceeding:

The commissioner may, after conducting a hearing ... require a person found to have committed a violation of [the act] to make restitution for all financial losses sustained by any person as a result of the violation. The commissioner may further require a person found to have violated [the act] to pay 10% annual interest on the amount of restitution from the date of the violation, reasonable attorney fees, and costs associated with bringing the administrative action.ⁿ²⁰

Restitution as an ancillary remedy is not nearly as common in civil injunctive actions by Blue Sky administrators as in criminal cases. Blue Sky laws generally create express private rights of action for purchasers to recover either damages or rescission in transactions involving a violation of the law. The express remedies are liberalⁿ²¹ and reflect an intention of state legislatures that investors harmed by acts and conduct in violation of Blue Sky laws be directly empowered themselves to seek and obtain meaningful relief. Private rights of action are also subject to varying limitations and requirements and courts are unlikely to circumvent these limitations through a broad order of restitution granted to an administrator in a civil action. On the other hand, the appointment of receivers, whose role includes the marshaling of assets for the ultimate benefit of injured investors, is common. State secured receiverships often work in tandem with private actions under Blue Sky laws.

The Uniform Act and most states provide for ancillary relief through the appointment of a receiver. For example, in *Commonwealth v. Allamanda Investment Co.*,ⁿ²² the court held that the Pennsylvania Securities Commission has the power under state law to seek judicial appointment of a receiver for an investment company, when limited partnership interests in the company were sold without proper registration and the promoter had left the state. In Arizona, an entire article is given to the discussion of the appointment of a receiver or conservator.ⁿ²³ Following the filing of a complaint by the State of Arizona, the court may, at the request of the attorney general, issue a preliminary injunction restraining the subject of the complaint from removing, encumbering, or otherwise disposing of any property located in Arizona.ⁿ²⁴ Thereafter, if a permanent injunction is issued, a conservator may be appointed and empowered "to do all things necessary in furtherance thereof to protect the rights of persons having a direct interest in the properties and affairs of the violator."ⁿ²⁵ The New Jersey Blue Sky law plainly spells out the scope of authority granted to receivers under these provisions:

If the court grants injunctive relief ... it may appoint a receiver with power to sue for, collect, receive and take into his possession all the goods and chattels, rights and credits, moneys and effects, lands and tenements, books, records, documents, papers, choses in action, bills, notes and property of every description, derived by any means or any practice constituting a violation of this act or any rule or order hereunder, including property with which such property has been mingled, if it cannot be identified in kind because of commingling, and to sell, convey and assign the same and hold and dispose of the proceeds thereof under the direction of the court for the equal benefit of all who establish an interest therein by reason of the use and employment by the defendant of any practices constituting a violation of this act or any rule or order hereunder. The receiver may retain an attorney with the consent of the Attorney General and the court.ⁿ²⁶

Some states impose limitations on the appointment of receivers. In Texas, for example, the Commissioner may request the Attorney General to bring an action for the appointment of a receiver only for persons or the assets of persons acting as dealers.ⁿ²⁷ If a person's activities do not qualify him or her as a "dealer" under Texas law, receivership is not an available remedy.ⁿ²⁸

In just a handful of states no provision is made for the appointment of a receiver.ⁿ²⁹ However, in these states, the statutes contain language from which the authority of the commissioner to seek the appointment of a receiver may be inferred.ⁿ³⁰ Moreover, there is ample authority in all states, augmented by a long history of SEC litigation in the federal courts, making clear that courts have general equitable authority to impose receiverships.

Although the appointment of receivers is the most common ancillary remedy sought by administrators under Blue Sky

laws, some states make specific provision for other remedies. Michigan, for example, includes both accounting and disgorgement among the remedies that may be sought through an injunctive proceeding.ⁿ³¹ Mandated rescission offers are also often sought with regard to sales or purchases of securities determined by the court to be unlawful.ⁿ³² In the end, courts will respond to the full extent of their equity jurisdiction to redress acts and conduct in violation of Blue Sky laws. As reflected in the 2002 Uniform act provision discussed earlier,ⁿ³³ and evidenced in modern provisions such as that in place in New Mexico, prescribing the powers of courts to grant relief in the Blue Sky law setting,ⁿ³⁴ ultimately, courts may, and will, fashion such relief as is deemed just in the particular circumstances presented.

FOOTNOTES:

(n1)Footnote 1. Unif. Sec. Act § 408.

(n2)Footnote 2. *See*:

Alabama: Ala. Code § 8-6-16.

Alaska: Alaska Stat. § 45.55.920.

Arizona: Ariz. Rev. Stat. Ann. § 44-2032.

Arkansas: Ark. Stat. Ann. § 23-42-209.

California: Cal. Corp. Code § 25530.

Colorado: Colo. Rev. Stat. § 11-51-602; see also Feigin v. Rephex, Inc., [1993-1994 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,901 (Colo. Dist. Ct. 1994) (material misrepresentations to Colorado investors provide grounds for permanent injunction prohibiting issuers of security interests in a foreign electrode manufacturing company from engaging in business in Colorado that would further violate state Blue Sky law).

Connecticut: Conn. Gen. Stat. § 36b-27.

Delaware: Del. Code Ann. tit. 6, § 7320.

Florida: Fla. Stat. Ann. § 517.191.

Georgia: Ga. Code Ann. § 10-5-13.

Illinois: Ill. Stat. Ann. ch. 121-1/2, § 137.11(K).

Kentucky: Ky. Rev. Stat. Ann. § 292.470.

Louisiana: La. Rev. Stat. Ann. § 51:713.

Massachusetts: Mass. Gen. Laws Ann. ch. 110A, § 408.

Michigan: Mich. Comp. Laws 451.808.

Mississippi: Miss. Code Ann. § 75-71-715.

Montana: Mont. Rev. Code Ann. § 30-10-305. Note that in Montana the applicable limitations periods

for civil injunctive actions by the Commissioner are the same as the two-year and five-year periods governing commencement of a cease-and-desist proceeding. *Mont. Rev. Code Ann. § 30-10-305.*

Nebraska: Neb. Rev. Code § 8-1116.

Nevada: Nev. Rev. Stat. § 90-180.

New Hampshire: N.H. Rev. Stat. § 421-B:23.

New Jersey: N.J. Stat. Ann. § 49:3-69.

New Mexico: N.M. Stat. Ann. § 58-13B-38.

New York: N.Y. Gen. Bus. Law §§ 352(i), 353(1), (2).

North Carolina: N.C. Gen. Stat. § 78A-47.

North Dakota: N.D. Cent. Code § 10-04-16.

Ohio: Ohio Rev. Code Ann. §§ 1707.25, 1707.26.

Oregon: Or. Rev. Stat. § 59.255.

Pennsylvania: 70 Pa. Stat. § 1-509.

Tennessee: Tenn. Code Ann. § 48-2-119.

Texas: Tex. Rev. Civ. Stat. Ann. § 581-32.

Utah: Utah Code Ann. § 61-1-20.

Virginia: Va. Code Ann. § 13.1-519.

Washington: Wash. Rev. Code § 21.20.390.

West Virginia: W. Va. Code Ann. § 32-4-408.

Wyoming: Wyo. Stat. Ann. § 17-4-120.

(n3)Footnote 3. 2002 Uniform Act § 603.

(n4)Footnote 4. 2002 Uniform Act § 603.

(n5)Footnote 5. 15 U.S.C. § 78u(d); see also Official Code Comment, Unif. Sec. Act § 408.

(n6)Footnote 6. But see Tex. Civ. Stat. § 581-32 A.

(n7)Footnote 7. *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49 . 95 S. Ct. 2069, 45 L. Ed. 2d 12 (1975) .

(n8)Footnote 8. *State, Dep't of Sec. v. American Equitel Corp.*, 395 N.E.2d 1355 (C.P. 1979) .

(n9)Footnote 9. *UV Industries, Inc. v. Posner*, 466 F. Supp. 1251 (D. Me. 1979) .

(n10)Footnote 10. 466 F. Supp. at 1256 .

(n11)Footnote 11. *Shields v. State*, 936 S.W.2d 711 (Tex. App. 1996) .

(n12)Footnote 12. Ancillary remedies may also be available to securities administrators simply as a matter of a court's general equitable powers. Prejudgment attachment and garnishment, for example, may be ordered on motion of the administrator under general statutory authority, rather than any specific authorization in the Blue Sky law. In *Squibb v. State ex rel. Davis*, 860 N.E.2d 904 (Ind. Ct. App. 2007) , the court upheld an order of prejudgment and garnishment obtained by the Indiana Securities Commissioner on findings that an individual had sold unregistered securities in a fraudulent and deceitful manner and was removing or about to remove property that would be subject to execution in an action that was brought by the Commissioner that constituted a claim for money. In those circumstances, without regard to any other authority, Indiana law authorized prejudgment garnishment.

(n13)Footnote 13. *N.C. Gen. Stat. § 78A-47*.

(n14)Footnote 14. 2002 Uniform Act § 603(b)(2).

(n15)Footnote 15. *See State ex rel. Goetsch v. Diacide Distribs., Inc.*, 596 N.W.2d 532 (Iowa 1999) .

(n16)Footnote 16. *See, e.g.:*

California: Cal. Corp. Code § 25530(b).

The California provision authorizing actions for restitution has been interpreted also to encompass an action by the Commissioner to seek disgorgement of an intermediary's sales commissions received on the sale of unqualified securities. *People v. Permco*, [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,623 (Cal. App. 1987).

Oregon: Or. Rev. Stat. § 59.225(2).

Pennsylvania: 70 Pa. Stat. § 509(b).

Washington: Wash. Rev. Code § 21.20.390(4).

(n17)Footnote 17. *Fla. Stat. Ann. § 517.191(3)*.

(n18)Footnote 18. *N.Y. Gen. Bus. Law § 353(3)*.

(n19)Footnote 19. *6 Del. Code Ann. § 7320*.

(n20)Footnote 20. *Mont. Code Ann. § 30-10-309(1)*. Although the commissioner is empowered to order restitution, beyond the further provision that an amount ordered to be paid as restitution becomes a lien on the assets and property within the state of the person ordered to pay, the order is not otherwise self-executing. It must be enforced through an action in court. *Mont. Code Ann. § 30-10-309(1)-(3)*.

(n21)Footnote 21. In Kentucky, for example:

Any person, who offers or sells a security in violation of this chapter or of any rules or orders promulgated hereunder or offers or sells a security by means of any untrue statement of a material fact or

any omission to state a material fact necessary in order to make the statements made in the light of the circumstances under which they are made not misleading (the buyer not knowing of the untruth or omission) and who does not sustain the burden of proof that he did not know and in the exercise of reasonable care could not have known of the untruth or omission is liable to the person buying the security from him, who may sue either at law or in equity to recover the consideration paid for the security, together with interest at the legal rate from the date of payment, costs and reasonable attorneys' fees, less the amount of any income received on the security, or for damages if he no longer owns the security. *Ky. Rev. Stat. § 292.480(a)*.

(n22)Footnote 22. *Commonwealth ex rel. Pennsylvania Sec. Com. v. Allamanda Inv. Co.*, 37 Pa. Commw. 33, 388 A.2d 1141 (1978) .

(n23)Footnote 23. *See* Ariz. Rev. Stat. Ann. art. 15, §§ 44-2011 through 44-2017.

(n24)Footnote 24. *See* Ariz. Rev. Stat. Ann. art. 15, § 44-2013(A).

(n25)Footnote 25. *See* Ariz. Rev. Stat. Ann. art. 15, § 44-2015.

(n26)Footnote 26. *N.J. Stat. Ann. § 49:3-69(c)*.

(n27)Footnote 27. *Tex. Rev. Civ. Stat. Ann. § 581-25-1*.

(n28)Footnote 28. *Rio Grande Oil Co. v. State*, 539 S.W.2d 917 (*Tex. Civ. App.* 1976) . The trial court improperly ordered the receiver to take possession of the property of persons acting as salesmen, not dealers. Under Texas law, a "salesman" cannot be a "dealer."

(n29)Footnote 29. The following states have no specific provision for the administrator to apply for the appointment of a receiver: Illinois, North Dakota, Pennsylvania, Rhode Island, Texas, and Virginia.

(n30)Footnote 30. *See, e.g.*, *Tex. Rev. Civ. Stat. Ann. § 581-32* ("in addition to any other remedies").

(n31)Footnote 31. *Mich. Comp. Laws § 451.808(a)*.

(n32)Footnote 32. Illinois expressly includes rescission offers among the remedies the administrator is authorized to pursue, *see* Ill. Comp. Stat. § 11 [5/11] I(2).

(n33)Footnote 33. 2002 Uniform Act § 603 is discussed in § 10.07[1], *above*.

(n34)Footnote 34. *See N.M. Stat. Ann. § 58-13B-38*.



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Blue Sky Regulation

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CHAPTER 14 State Enforcement Authority

2-14 Blue Sky Regulation § 14.06

§ 14.06 Criminal Prosecution

[1] Generally

Under the Uniform Securities Act:

(a) Any person who willfully violates any provision of this act except section 404 [misleading filings], or who willfully violates any rule or order under this act, or who willfully violates section 404 knowing the statement made to be false or misleading in any material respect, shall upon conviction be fined not more than \$5,000 or imprisoned not more than three years, or both; but no person may be imprisoned for the violation of any rule or order if he proves that he had no knowledge of the rule or order... .

(b) The [Administrator] may refer such evidence as is available concerning violations of this act or of any rule or order hereunder to the [attorney general or the proper district attorney], who may, with or without such a reference, institute the appropriate criminal proceedings under this act.

(c) Nothing in this act limits the power of the state to punish any person for any conduct which constitutes a crime by statute or at common law.ⁿ¹

Generally, criminal violations of the state securities laws are not prosecuted directly by the administrator, but rather are referred to the proper state prosecuting agency (e.g., state attorney general or county prosecutor). As the Uniform Act provides, most state laws allow the appropriate state prosecutor to decide whether to bring a criminal action. Even without referral by the administrator or commissioner, most states provide that attorneys general may directly institute criminal proceedings based on evidence gathered by their own agencies.ⁿ² As discussed below, in some states the administrator himself or herself has full or limited criminal enforcement powers.

In one form or another, all Blue Sky laws specifically provide for criminal referrals by administrators of violations to appropriate law enforcement officials.ⁿ³ As noted above, in some instances, the support role of administrators and employees is expressly addressed.ⁿ⁴ Alabama takes the process further by mandating the *duty* of the Securities Commission to assure compliance with the Blue Sky law and to take such measures and make such investigations as will prevent or detect violations. Violations involving evidence of criminality that are detected are to be at once referred to the appropriate District Attorney for action. In the event the District Attorney neglects or refuses to prosecute, the

Alabama statute empowers the Commission itself to institute a prosecution with full grand jury authority.ⁿ⁵

Other states mandate specific follow-up to a criminal reference. In practice, most criminal prosecutions under Blue Sky laws are the result of referrals by administrators and there is considerable reliance on the investigative efforts and expertise of administrators and their staffs in bringing these cases to trial.

[2] Culpability Standards

The Uniform Act specifies two standards of criminal culpability, depending on the violation involved. For violation of any provision of, or rule or order under, the Act other than for filing misleading statements with the Administrator (i.e., except section 404), the standard of culpability is whether the act was "willfully" done.ⁿ⁶ Willfully violating provisions of the Uniform Act requires proof that the person acted intentionally, in the sense that he or she was aware of what he or she was doing. Proof of evil motive or intent to violate the law or knowledge that the law was being violated is not required where the violation is, essentially, a strict liability offense, such as failure to register securities or to be properly licensed as an intermediary.ⁿ⁷ In these circumstances, it has been suggested by one state supreme court that state of mind is of as little relevance in a charge of sale of unregistered securities as it would be in a prosecution for a speeding violation.ⁿ⁸ The same court concluded:

Personal blame on the part of the actor, except in the general sense that he should have known better or exercised a greater degree of care, is not a necessary element of many offenses where the protection of the public against the harm which would result in the absence of regulation is the principal legislative concern.ⁿ⁹

However, in *People v. Salas*,ⁿ¹⁰ the California Supreme Court recast the mold for establishing criminal liability in a case involving the unlawful sale of unregistered securities. In *Salas*, the court overturned the conviction of a defendant charged with the unlawful sale of unregistered securities who claimed he incorrectly believed that the issuer had complied with a registration exemption under the California Blue Sky Law. The court held that a seller is not guilty of this crime if there is a reasonable doubt whether he or she knew that the security was not exempt from registration or was criminally negligent in failing to know there was no exemption. Although the court found that "guilty knowledge" as such is not an element of the crime, it nevertheless held that the absence of a "guilty mind" should be available *as an affirmative defense*. Thus, the defendant was entitled to a jury instruction on the affirmative defense of "absence of guilty knowledge," provided he had presented sufficient evidence to raise a reasonable doubt whether he knew, or was criminally negligent in failing to know, that the security was not exempt. In this assessment, and by effectively reading a guilty knowledge requirement into the California law regarding the sale of unregistered securities, the California Supreme Court departed from the generally accepted meaning of "willfully" under Blue Sky laws.ⁿ¹¹

Putting aside the *Salas* approach to criminal culpability in the unlawful sale of unregistered securities, for criminal penalties to be imposed for violation of *antifraud* provisions such as section 404 of the Uniform Act, which prohibits making or causing to be made a false or misleading statement in a document filed with the administrator, the Act requires proof of willfulness, *and also that the person knew that the statement was false or misleading in some material respect*.ⁿ¹² This heightened standard of culpability, specifically applicable to false or misleading statements in filed documents, introduces an element of specific intent where the nature of the violation logically should involve some degree of awareness of the actor as to an actual information failure. The notion of specific intent, or at least a heightened awareness element, has figured prominently in case law dealing with criminal prosecutions under the general antifraud provisions of Blue Sky laws.

Criminal liability for securities *fraud* under Blue Sky laws is a matter quite different from the more technical registration or licensing violations that are characterized as strict liability offenses. Fraud is not easily construed as a strict liability offense and requiring proof of criminal intent may mean that *scienter*, a mental state encompassing intent to deceive or defraud, must be shown.ⁿ¹³ This does not mean that specific intent to violate the law must be shown. As

with the antifraud provisions of the federal securities laws, where scienter is required, it can generally be shown on proof of at least reckless disregard of the truth.ⁿ¹⁴ The role of knowledge or intent in criminal antifraud liability is discussed further below. However, requisite intent is only one element of liability. Because the antifraud provisions in Blue Sky laws more often than not closely parallel SEC *Rule 10b-5* under the Securities Exchange Act of 1934,ⁿ¹⁵ federal cases construing the elements of antifraud liability--materiality, for example--are instructive in state courts on other elements of an offense. Evidence must be presented to show all essential elements of the crime and that the defendant was the perpetrator of the crime.ⁿ¹⁶

Reliance on parallel federal jurisprudence can even extend to defining criminal behavior under Blue Sky antifraud provisions. In *People v. Napolitano*,ⁿ¹⁷ the conviction of an individual under the basic antifraud prohibition of the New York Blue Sky Law (the "Martin Act") for "insider trading" was affirmed. The New York court opined that insider trading, recognized as a violation of SEC *Rule 10b-5* under the federal Securities Exchange Act of 1934, also violates the Martin Act. Federal law relating to insider trading, said the court, indisputably provides important precedent for state courts "in determining the obligations of persons who trade in securities"ⁿ¹⁸ and the court was satisfied that the law established a duty not to trade on the basis of confidential information received by virtue of a position of confidence and trust. Whether based on "classical" federal corporate insider theory or the more recently developed "misappropriation" theory of liability,ⁿ¹⁹ the duty not to trade was established. Thus, criminal liability as a matter of general antifraud principals under the state Blue Sky law was imposed on the basis of a crime wholly defined by federal law.ⁿ²⁰ *Napolitano* is a further example of the efficacy of applying Blue Sky law antifraud provisions in contemporary market settings. In a narrower, but equally significant sense, it also illustrates the considerable flexibility available to prosecutors and courts under Blue Sky laws in order to achieve investor protection and market fairness objectives through criminal enforcement actions.

Blue Sky laws also play an important role in prosecutions under state anti-racketeering laws. State "RICO" laws typically include offenses under the Blue Sky law as predicate criminal acts for purposes of establishing a pattern of racketeering activity related to the conduct of an enterprise. To prove a RICO violation, the state typically must show that a defendant committed two or more predicate criminal acts of the type specified in the RICO statute as part of an enterprise engaged in a pattern of racketeering activity. The offer and sale of unregistered securities and engaging in securities activity without being licensed are common violations of state Blue Sky laws that become RICO predicate acts.ⁿ²¹ Some limits may be imposed on the extent to which violations of the Blue Sky law alone may suffice as RICO predicate acts. In Ohio, for example, for purposes of private civil actions, the requisite pattern of "corrupt" activity must include at least one other predicate act from the types specified.ⁿ²² However, the importation of Blue Sky violations into state RICO laws generally is a meaningful addition to the criminal enforcement arsenal.ⁿ²³

[3] Intent or Knowledge

As introduced above, provisions for criminal penalties in Blue Sky laws generally follow section 409 of the Uniform Act, which declares:

(a) Any person who *willfully* violates any provisions of this act except section 404, or who *willfully* violates section 404 knowing the statement made to be false or misleading in any material respect shall upon conviction be fined not more than \$5,000 or imprisoned not more than three years or both.ⁿ²⁴

The key consideration in finding criminal liability is "willfulness" associated with the violation. The criminal intent standard for prosecutions under Blue Sky laws in most states parallels that prescribed in the official comments to the Uniform Act, such that:

[a]ll that is required is proof that the person acted intentionally in the sense that he was aware of what he was doing. Proof of evil motive or intent to violate the law, or knowledge that the law was being violated, is not required.ⁿ²⁵

This standard does not require a specific intent to violate the law.ⁿ²⁶ That is to say, when a person intentionally does that which the law declares to be a crime, he or she is acting with general criminal intent, even though the person may not know his or her conduct is unlawful.ⁿ²⁷ A case involving an unlawful sale of securities in violation of the Utah Blue Sky law illustrates the point. In *State v. Larsen*,ⁿ²⁸ the court explained that intent to violate the prohibition against selling unregistered securities is not necessary to sustain a criminal conviction. The court thus affirmed a conviction that was based on a jury instruction that:

[A] person engages in conduct intentionally or with intent or willfully, with respect to the nature of his conduct or to the result of his conduct, when it is his conscious desire to engage in the conduct or cause the result.ⁿ²⁹

This is the law in the overwhelming majority of jurisdictions. Although, as will be seen below, the issue is more complicated in cases involving antifraud violations, no specific intent is required to sustain a criminal conviction for the unlawful sale of unregistered securities.ⁿ³⁰

A markedly different approach was taken, however, in *State v. Casper*,ⁿ³¹ in which a Tennessee criminal appeals court reversed and dismissed a defendant's conviction for violating the Tennessee Securities Act by selling unregistered securities. The defendant had entered into an agreed order with the Tennessee Department of Commerce and Insurance, in which he admitted that he had engaged in the offer and sale of unregistered securities without being registered as a broker-dealer or an agent of a broker-dealer. He was then criminally prosecuted on the same charges, and at his trial the agreed order was introduced as evidence. The defendant was convicted, and on appeal he argued, among other things, that the agreed order was entered into as part of a civil proceeding that requires a different burden of proof than a criminal proceeding. The appeals court concluded that the agreed order had properly been admitted as evidence in the criminal trial, but found that it was not sufficient evidence to support the criminal conviction.

The Tennessee Securities Act, like others, provides for criminal prosecution of a defendant who acts "willfully."ⁿ³² The defendant in *Casper* argued that the evidence showed only that he acted in what he believed to be a lawful manner, and that when he was notified of improper actions, he ceased such actions. As with other Blue Sky laws, the Tennessee Act does not define "willfully." The appeals court concluded that because the statute expressly creates criminal liability for one who willfully violates the Act, the legislature must have intended that proof of something more than simply intentionally selling securities without being properly registered as a securities broker-dealer is necessary. Thus, the court concluded:

[W]e are persuaded that the distinction between criminal and non-criminal offenders means that the legislature intended only to criminalize the selling of securities by an unregistered broker-dealer when the person selling is aware that his or her conduct is prohibited by the [Tennessee Securities Act], and yet nevertheless intentionally sells the security knowing he or she is violating the law.ⁿ³³

Reversing the convictions, the court opined that the appellant had complied with the agreed order entered into with the regulatory agency, and that he did cease and desist from selling the securities. The court found from the evidence that prior to the agreed order, the appellant believed that the securities he offered and sold were exempt from registration, and that he was not required to register as a broker-dealer. Thus, according to the court, the state failed to carry its burden of proving beyond a reasonable doubt that the appellant knew, prior to the agreed order, that his actions violated the law.ⁿ³⁴

In contrast to *People v. Salas*, discussed earlier, in which the California Supreme Court manifested its concern that an element of specific intent should be available for consideration through allowance of an affirmative defense of "absence of guilty knowledge," *Casper* makes it an element of the offense, on which the state has the burden of proof. It stands alone in that regard.

Where violations involve strict liability issues such as securities registration or licensing failures, general intent is a reasonable approach.ⁿ³⁵ However, as introduced earlier, the question of requisite intent for criminal liability is more complex in prosecutions for *fraud* under Blue Sky laws. In cases under antifraud provisions, a requirement that one have knowledge of the falsity or misleading nature of a statement or of the materiality of an omission, or at least be guilty of criminal negligence in failing to investigate or discover them, may logically be implied in the notion of willfulness.ⁿ³⁶ Separately or together they constitute the element of *scienter* and states are divided over whether it is an essential element of criminal antifraud liability. In *People v. Simon*,ⁿ³⁷ for example, the California Supreme Court held that "willful" means having knowledge of the false or misleading nature of a statement or the materiality of an omission. The court rejected a trial court jury instruction that only a general criminal intent was necessary to convict for the crime of willfully selling securities by means of material misrepresentations or omissions.ⁿ³⁸ But in *State v. Larsen*,ⁿ³⁹ noted above, the Utah Supreme Court determined that specific intent is not required for a securities fraud conviction and thus rejected good faith as a defense to criminal liability.ⁿ⁴⁰

As noted earlier, the Official Code Comment under the Uniform Securities Act speaks of "willfully" only in terms of a person acting intentionally in the sense of knowing what one is doing, rather than having an evil motive, specific intent to violate the law, or knowledge that the law is being violated. But willfulness and its analogs such as "knowingly" that are contained in Blue Sky laws are not defined. The judiciary has been left with the task of defining them--a process that, as *Simon* and *Larsen* illustrate, has led to differing approaches. There is tension between the notion of willfulness, as requiring no specific intent to commit an unlawful act, and *scienter*, a mental state embracing intent to deceive, manipulate, or defraud. The latter has prominently developed as an essential element of liability for violation of section 10(b) and SEC *Rule 10b-5* of the Securities Exchange Act of 1934.ⁿ⁴¹ Its role in prosecutions under state Blue Sky laws is addressed because many states and section 101 of the Uniform Act have modeled antifraud provisions on *Rule 10b-5* and other antifraud provisions of the federal securities laws. *Scienter* is, effectively, a specific intent element of an offense.

However state courts may differ on whether proof of *scienter* is necessary in prosecutions under Blue Sky antifraud provisions, it is clear that in interpreting the willfulness requirement generally, criminal liability will not be imposed for conduct that is merely careless, thoughtless, or inadvertent.ⁿ⁴² That is not to say that ignorance is a useful defense. One court has made clear that "[w]hen one is charged with willful misconduct in a series of acts in the promotion or sale of a security, it is to be assumed that he is not devoid of intelligence on the subject of securities."ⁿ⁴³ Moreover, past acts may give rise to the inference that current statements or actions have been done willfully and knowingly. Thus, evidence of a permanent injunction enjoining the defendant consultants or legal advisers from participating in other fraudulent sales or purchases of securities was relevant to the determination of willfulness in a subsequent criminal prosecution.ⁿ⁴⁴

Even if only a general intent is required to convict, evidence of specific intent may be relevant to determining the gravity of the offense. Moreover, specific intent may be shown by circumstantial evidence. In one case, the court found a specific intent to defraud because of a substantial or significant disparity between the actual price of the securities and their selling price (a 3500% differential), coupled with other false representations.ⁿ⁴⁵

The level of culpability required in prosecutions under Blue Sky laws is commonly an issue when the focus of law enforcement is on secondary or peripheral participants in acts and conduct that violate the law. In California, for example, it has been held that an attorney who performed legal services for persons who engaged in the offer and sale of unregistered securities would not be criminally liable as either a participant or an aider and abettor for merely acting in the role of a lawyer. In *People v. Yanez*,ⁿ⁴⁶ the court admonished that "offering advice, giving opinions, and preparing documentation relating to securities offerings are staples in the stock-in-trade of lawyers in this specialized field." To subject them to criminal liability in these circumstances, said the court, "would have a chilling effect on legitimate professional conduct."ⁿ⁴⁷

Criminal liability for one who is involved in circumstances only in the role of attorney, or presumably any other professional service provider, requires a finding of subjective bad faith in the performance of those services. In the end, the *Yanez* court counseled:

We must avoid construing a statute to dispense with mens rea where it would outlaw a number of apparently innocent acts... . Of course, an attorney who participates in an illegal offering without a subjective good faith belief, or in a role as offeror or seller, certainly should not be shielded from criminal liability.ⁿ⁴⁸

On the question of criminal liability of secondary actors or participants generally, Illinois declares that all persons who in any manner knowingly authorize, aid, or assist in any unlawful sale or offering for sale are deemed equally guilty.ⁿ⁴⁹ Criminal aiding and abetting and secondary liability generally is problematic in the absence of a specific culpability standard such as the "knowingly" element in Illinois. The Illinois approach allows for greater flexibility in prosecutions, but in practice would not likely produce more indictments than straightforward application of the willfulness element of penalty provisions for direct or primary criminal liability.

In *State v. Mehling*,ⁿ⁵⁰ a Kansas appeals court endorsed the following jury instruction as to culpability for aiding and abetting a violation of the Blue Sky law:

A person who, either before or during its commission, intentionally aids, abets, advises, hires, counsels, procures another to commit a crime with intent to promote or assist in its commission is criminally responsible for the crime committed regardless of the extent of the defendant's participation, if any, in the actual commission of a crime.

Under this standard, aiding and abetting a securities violation is a specific intent crime. The court explained that if jurors find that a defendant acted as a principal in a scheme to defraud investors, then the mere doing of the act prohibited by the statute supports a conviction without a showing of specific intent. Aiding and abetting, on the other hand, does require specific intent.

The question of scope of criminal liability is also likely to be involved in fraud-based prosecutions, where a defendant's conduct is not clearly tied to the violation of the statute. Whether the notions of "in connection with"ⁿ⁵¹ or nexus are employed, the issue is whether acts and conduct of a particular criminal defendant are sufficiently linked to the subject purchase or sale transaction(s). Courts are willing to interpret the nexus requirement broadly. In *State v. Harry*,ⁿ⁵² for example, a securities salesperson was convicted of violating antifraud provisions of the Utah Securities Act by, among other things, "selling away" from his firm, that is, engaging in the offer and sale of securities outside the knowledge of the broker-dealer firm with which he was licensed. The defendant claimed that he could not be held liable because no fraud was perpetrated upon his firm, which was neither a purchaser nor a seller of the securities in question. The court disagreed, finding that the fraud worked on the broker-dealer firm could be sufficiently linked to the "away" transactions because the fact of those transactions and the fraudulent statements the defendant made to his firm in the course of concealing them subjected the firm to economic harm and the threat of civil liability to disgruntled investors.ⁿ⁵³

[4] Penalties

Criminal penalty provisions vary among the states. The Uniform Act provides for a fine of up to \$5,000 and/or imprisonment for up to three years for a willful violation of the Act or any rule or order under it or for a misleading statement willfully made in any document filed with the Administrator or in any proceeding with knowledge that the statement was false or misleading in any material respect.ⁿ⁵⁴ Many states have adopted the Uniform Act provision nearly verbatim,ⁿ⁵⁵ while others have modified the provision to suit their particular preference.

In most instances, variance from the Uniform Act involves only the extent of the penalty. In Alaska, for example, the sanction is a \$5,000 fine and/or imprisonment for not less than one year and no more than five years.ⁿ⁵⁶ Other states classify penalties into two groups, with a more severe sanction for a violation of the law and a lesser sanction for a violation of any rule or order. Alabama, for example, makes a violation of the Blue Sky law itself a class C felony, while violation of a rule is a class A misdemeanor.ⁿ⁵⁷ Some states impose a mandatory term of imprisonment for certain conduct. In Alaska, for example, the Blue Sky law specifies that for a felony conviction, the sentence must be "not less than one year."ⁿ⁵⁸ Montana provides that a one-year imprisonment is mandatory if the person convicted "has been previously convicted of a felony in any way involving securities."ⁿ⁵⁹ In New Hampshire, a violation of the provisions proscribing fraud, other unlawful activities, and misleading filings, and a violation of a cease-and-desist order or injunction, constitutes a class B felony.ⁿ⁶⁰ Persons violating the registration provisions or making unlawful representations concerning registrations or exemptions are guilty of a misdemeanor, but any subsequent offense constitutes a class B felony.ⁿ⁶¹

Specific offenses and the scope of an offense may be the basis for particular levels of criminal penalties. In Delaware, a fraud causing any investor to suffer losses of \$50,000 or more is punishable by a fine up to \$200,000 and/or imprisonment up to five years, while fraud causing losses of \$10,000 to \$49,999 is punishable by a fine up to \$100,000 and/or imprisonment up to three years.ⁿ⁶² All other violations in Delaware are punishable by fines up to \$100,000 and imprisonment up to two years.ⁿ⁶³ Delaware also expressly provides for an order of restitution to any investor or investors.

New Jersey uniquely sets the range of criminal penalties based upon whether the defendant acts knowingly or recklessly in committing the offense. A knowing violation in New Jersey is a second or third degree crime, depending upon the amount of loss involved. However, one who recklessly violates provisions of the Blue Sky law is guilty of a fourth degree crime.ⁿ⁶⁴

The 2002 Uniform Act follows the approach of the Uniform Act in imposing criminal penalties for any willful violation of the Act, without distinguishing between felonies and misdemeanors in the manner of the Revised Uniform Act. However, it does not specify maximum dollar amounts for criminal fines or maximum terms for imprisonment. Rather, section 508 of the 2002 Act allows for each state to specify appropriate levels of fines and terms of imprisonment, as well as setting a statute of limitations. However, section 508 preserves the bar against imprisonment for an individual convicted of violating a rule or order when the defendant did not have knowledge of the rule or order. The drafters make clear that the "no knowledge" clause of section 508 is relevant only in sentencing. The defendant has the burden to prove no knowledge at the time of sentencing.ⁿ⁶⁵

Florida builds flexibility into its provisions imposing criminal fines by providing for alternatives:

In lieu of a fine otherwise authorized by law, a person who has pleaded guilty or no contest to having engaged in conduct in violation of the provisions of [the Act] may be sentenced to pay a fine that does not exceed the greater of three times the gross value gained or three times the gross loss caused by such conduct, plus court costs and the costs of investigation and prosecution reasonably incurred.ⁿ⁶⁶

Provisions such as this add incentive for guilty or no-contest pleas in smaller criminal cases in which the defendant would otherwise face felony level fines without regard for the scope of the offense committed.ⁿ⁶⁷ Florida is unique in building this flexibility expressly into the Blue Sky law. Plea bargaining under the penalty provisions in other states is enhanced by tiers of offenses between misdemeanors, felonies, and classes of felonies. In a significant number of states, however, there are no tiers or gradations of offenses.ⁿ⁶⁸

By definition in most Blue Sky laws, "person" means an individual, a corporation, a partnership, and other forms of business organizations or associations of individuals.ⁿ⁶⁹ Thus, penalties applicable to persons generally for criminal violations of state securities laws are applicable to institutional defendants. However, because only fines (and ancillary

remedies such as restitution) are possible for such defendants, Illinois has made special provision for fines applicable to them and also to deal with second or subsequent offenses by these defendants.ⁿ⁷⁰

Nearly all Blue Sky laws also include a provision taken directly from Uniform Act section 409(c) that:

Nothing in this act limits the power of the state to punish any person for any conduct which constitutes a crime by statute or at common law.

Acts and conduct in violation of Blue Sky laws may well violate other state laws dealing with consumer protection, theft, commercial transactions, and racketeering.ⁿ⁷¹ There is no preemption by Blue Sky laws as to any of these other offenses simply because securities are involved.

In most states, the Blue Sky law also provides that each criminal act specified "shall constitute a separate offense and a prosecution or conviction for any one of such offenses shall not bar prosecution or conviction for any other offense."ⁿ⁷² The effect of this provision is to preclude the notion of lesser or included offenses being a part of any criminal prosecution or any preemptive impact of a particular prosecution.

[5] Defenses

Exemptions. While the state must prove the elements of any offense charged beyond a reasonable doubt, when the charge involves the sale of unregistered securities, the defendant has the opportunity, albeit also the burden, to prove the availability of any exemption or exception from requirements of the Blue Sky law.ⁿ⁷³ That is the case generally when a defense is based upon the availability of any exemption from, or exception to, any provision, rule, or regulation.ⁿ⁷⁴

However, once competent evidence suggesting entitlement to an exemption has been introduced, the burden typically shifts back to the prosecution. The Supreme Court of Nevada explained the relative burdens:

[T]he State is not required to prove the lack of an exemption until the defendant injects some competent evidence showing his entitlement to the exemption; however, once the defendant produces such evidence, the State bears the burden of proving beyond a reasonable doubt that the exemption does not apply.ⁿ⁷⁵

Advice of Counsel. In a criminal prosecution for a Blue Sky law violation, acting on the advice of counsel has been held not to be a defense. Thus, a defendant could not avoid conviction on the argument that he "acted under advice of counsel and did not know that the instrument he was selling constituted a security."ⁿ⁷⁶ Underlying the rejection of any defense based on advice of counsel is the fact that registration requirements in Blue Sky laws are essential, strict liability provisions. As discussed earlier, *scienter* or willfulness is not required to establish violations of registration requirements and good faith reliance on counsel is not a defense.ⁿ⁷⁷ Advice of counsel may be relevant to the charge of fraud in the sale of securities to the extent that *scienter* is an element of the offense. This element of criminal liability under Blue Sky laws is more thoroughly *considered in section 14.05[3]*.

Good Faith. Much like reliance on counsel, good faith and an honest purpose on the part of the defendant will not be valid defenses.ⁿ⁷⁸ It is increasingly common in both criminal and administrative enforcement proceedings under Blue Sky laws that intermediaries who engage in the offer and sale of instruments or arrangements determined to be securities without compliance with registration and licensing provisions claim either good faith ignorance of the application of securities laws or reliance on other intermediaries who instructed that no security was involved. Conviction for transacting business as an unlicensed broker-dealer or salesperson and for selling unregistered securities is not dependent upon an individual knowing that his or her conduct violated Blue Sky law requirements. Honest mistake, good faith ignorance, and reliance on others will not relieve a person of criminal liability for what amount to strict liability offenses. Liability for violation of Blue Sky laws rests on conduct that is intentional with regard to the

conduct, not that it is specifically unlawful. A Missouri appellate court perhaps best stated the point in affirming a criminal conviction for selling unregistered securities:

Our analysis of the law leads us ineluctably to the conclusion that the prosecution need not show that the accused seller was aware that he was acting in violation of the law in selling unregistered securities. It is as though a culpable mind (at least a reckless state of mind about the law) is conclusively presumed and may not be rebutted by the accused. "But, when an act forbidden by law is intentionally done, the intent to do the act is criminal intent, which imparts to it the character of the offense, and no one who violates a law he is conclusively presumed to know can be heard to say he had no criminal intent in doing it."⁷⁹

Although good faith or reasonable ignorance is not a defense to criminal prosecution under Blue Sky laws, they are considerations that bear on potential penalties resulting from a prosecution. The Uniform Act provides that, although a fine may be levied for violating a *rule or order*, no imprisonment will result if the person "proves that he had no knowledge of the rule or order."⁸⁰ This provision, relating only to violations of rules or orders, tracks penalty provisions in the federal securities laws and the Uniform Act drafters explained the rationale thusly:

Since not all states have an Administrative Procedure Act, and administrative rules and orders are not always easy to find, such a provision seems even more essential at the state level. The burden of proof here is on the defendant; he may still be subjected to fine in any event; and the clause is not applicable when the rule or order on which the prosecution is based has been issued under a provision which is self-operative regardless of the adoption of a rule or the entering of an order.⁸¹

Non-Uniform Act states have comparable provisions.⁸²

Statutes of Limitation. An applicable statute of limitations is a valid affirmative defense available to a criminal defendant. The Uniform Act contains an optional five-year statute of limitations for criminal prosecution.⁸³ Numerous states have adopted the five-year limitation,⁸⁴ while in other states, the period ranges from three to eight years. Illinois, for example, has a three-year statute of limitations.⁸⁵ Michigan, on the other hand, allows six years.⁸⁶ States without a specific statute of limitation for prosecutions under the Blue Sky law may rely instead on a general limitations period under other provisions of state law.⁸⁷ However, a specific statute of limitations contained in the Blue Sky law supersedes application of a general felony limitation included elsewhere in state law.⁸⁸ States also make various provisions for either determining how the time limitation is counted or for extending it in certain circumstances. Thus, in Michigan, the six-year limitation does not include any time during which the person charged was not "usually and publicly resident" in the state,⁸⁹ and Illinois provides for an additional two years to be added to the state's three-year limitation when the accused is found intentionally to have concealed evidence.⁹⁰

Preemption. The scope of state authority to prosecute Blue Sky law violations after NSMIA is subject to some uncertainty. The federal preemption of state authority to regulate in the context of NSMIA covered securities does not extend to enforcement actions under antifraud provisions of Blue Sky laws and to the enforcement of most registration or licensing requirements applicable to investment intermediaries. States likewise retain authority to impose limited "notice" filing and fee requirements for securities distributions. Violations of post-NSMIA provisions, rules or orders in any of these areas may still be subject to criminal investigation and ultimate prosecution, as long as the exercise of state authority is not determined to constitute an indirect attempt to regulate if NSMIA preempted that authority. Under any Blue Sky law, NSMIA preemption is an available defense to state prosecutorial authority where covered securities are involved. There is much to be determined in the courts, and perhaps yet in Congress, on the question of how far antifraud enforcement powers in particular may legitimately extend into matters of "national" securities markets and transactions, but the 2002 investigation by the New York Attorney General into business practices of Merrill Lynch, Pierce, Fenner & Smith, Inc.⁹¹ under the umbrella of the Martin Act clearly demonstrates the intent of state authorities to proceed with an expansive notion. In that process, the defense of preemption will become increasingly meaningful.

Other Defensive Considerations. When multiple transactions are at issue, because each separate sales transaction constitutes a separate offense (at least when the charged fraud, deceit, or misrepresentation was made in each transaction as distinguished from being in the form of a general public advertisement),ⁿ⁹² the defendant must present any available defense to each separate sale.

Multiple transaction prosecutions raise other special issues for both the prosecution and defense. In *People v. Rivera*,ⁿ⁹³ the court reversed a defendant's conviction on one count of securities fraud in circumstances involving more than 20 potential transactions with more than two dozen different investors. In *Rivera*, evidence of multiple acts was presented to the jury, but the defendant was charged and convicted on only one count and jurors were not instructed that they must unanimously agree on the same transaction as the basis for conviction. Because there was substantial variety regarding the nature of the defendant's involvement in the various transactions, the court found there was a reasonable likelihood that jurors could disagree concerning the act or acts the defendant committed. Thus, absent an election by the prosecution or some form of acceptable unanimity instruction, the jury could have convicted the defendant while disagreeing over which acts supported the conviction. This cast serious doubt on the reliability of the conviction and mandated reversal.

FOOTNOTES:

(n1)Footnote 1. Unif. Sec. Act § 409; *see also* 2002 Uniform Act § 508.

(n2)Footnote 2. *See, e.g., Ariz. Rev. Stat. Ann. § 44-2032(4); Colo. Rev. Stat. § 11-51-124(2).*

(n3)Footnote 3. In New Mexico, for example:

The director may refer such evidence as is available concerning violations of the [Act] or any rule or order under that act to the attorney general or the proper district attorney, who may, with or without such a reference from the director, institute appropriate criminal proceedings. *N.M. Stat. Ann. § 58-13B-39B.*

See also Va. Code § 13.1-520.1 ("[c]ommission may transmit record or complaint to locality where violation occurred").

(n4)Footnote 4. *Va. Code § 58-13B-39C.* ("attorney general or district attorney may request assistance from the director or employees of the division").

(n5)Footnote 5. *Ala. Code § 8-6-18(c).*

(n6)Footnote 6. Unif. Sec. Act § 409.

(n7)Footnote 7. *See also* 2002 Uniform Act § 508, Off. Comment 2.

(n8)Footnote 8. *State v. Kreminski*, 178 Conn. 145, 151, 422 A.2d 294 (1979) ; *see also People v. Terranova*, 38 Colo. App. 476, 563 P.2d 363 (1976) .

(n9)Footnote 9. 178 Conn. at 150 ; *see also State v. Andresen*, Blue Sky L. Rep. (CCH) P 74,232 (Conn. 2001) (under the Connecticut Uniform Securities Act).

(n10)Footnote 10. *People v. Salas*, 37 Cal. 4th 967, 38 Cal. Rptr. 3d 624, 127 P.3d 40 (2006) .

(n11)Footnote 11. In *State v. Dumke*, 901 S.W.2d 100 (Mo. Ct. App. 1995) , for example, the court held that a person who sincerely believed his actions were in full compliance with the law could nevertheless be convicted of the unlawful sale of unregistered securities.

See also Fullerton v. State, 116 Nev. 435, 997 P.2d 807 (2000) .

Salas was subsequently applied in *People v. Cole*, 156 Cal. App. 4th 452, 67 Cal. Rptr. 3d 526 (2007) , to overturn convictions of defendants who sold securities without being licensed as broker-dealers. Following *Salas*, the Court of Appeals concluded that the crime of selling securities without a license is not a strict liability offense and that a defendant can assert the affirmative defense of reasonable good faith belief that the licensing requirement did not apply.

(n12)Footnote 12. Unif. Sec. Act § 409.

(n13)Footnote 13. *See, e.g., People v. Burrnell*, Blue Sky L. Rep. (CCH) P 72,240, 2001 Cal. App. Unpub. LEXIS 2144 (Oct. 30, 2001) .

(n14)Footnote 14. Knowledge and intent as elements of criminal liability under Blue Sky laws are specifically considered in § 10.08[2], *below*.

(n15)Footnote 15. 17 C.F.R. § 240.10b-5. Section 101 of the Uniform Act thus declares:

It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

(n16)Footnote 16. *See State v. Davidson*, 131 N.C. App. 276, 506 S.E.2d 743 (1998) .

(n17)Footnote 17. *People v. Napolitano*, 282 A.D.2d 49, 724 N.Y.S.2d 702 (1st Dep't 2001) .

(n18)Footnote 18. 282 A.D. 2d at 53 .

(n19)Footnote 19. *See United States v. O'Hagan*, 521 U.S. 642, 117 S. Ct. 2199, 138 L. Ed. 2d 724 (1997) .

(n20)Footnote 20. In addition to convictions under the Martin Act, the defendant in *Napolitano* was also convicted of criminal possession of stolen property, conspiracy, and a general scheme to defraud. However, all counts derived from the conduct determined to be insider trading.

(n21)Footnote 21. *See, e.g., Mosley v. State*, 253 Ga. App. 710, 560 S.E.2d 305 (2002) (promissory notes offered and sold without registration by an unlicensed dealer established necessary two predicate acts to sustain conviction under state RICO law).

(n22)Footnote 22. *Ohio Rev. Code § 2923.34(B)*. The qualification is not applicable to civil actions brought by the prosecuting attorney or to criminal prosecutions generally under the act.

(n23)Footnote 23. *See Black v. State of Florida*, 819 So. 2d 208 (Fla. App. 2002) (violation of Florida Blue Sky

law antifraud provisions in connection with rendering investment advice and selling securities were predicate offenses in application of state RICO law).

(n24)Footnote 24. Unif. Sec. Act § 409(a) (emphasis added). Specific penalties have been updated and vary. *See, e.g., Connecticut*: Conn. Gen. Stat. Conn. § 36b-28 (\$10,000 fine and/or 10 years imprisonment). Updated approaches in other states vary penalties based upon different felony classifications and, in some cases, allow for lesser penalties on violations defined as misdemeanors, *see, e.g., District of Columbia: D.C. Code § 31-5606.04(a)* (\$1,000 fine and/or one year imprisonment for violation of intermediary licensing provision).

(n25)Footnote 25. Official Code Comment, Unif. Sec. Act § 409, incorporating by reference Official Code Comment, Unif. Sec. Act § 204(a)(2)(B).

(n26)Footnote 26. Some states simply make violations of their Blue Sky law a criminal offense with no mention of a standard of culpability.

See:

Florida: Fla. Stat. Ann. § 517.302 ("violates" provisions).

Illinois: Ill. Stat. Ann. ch. 121-1/2, § 137.14(A), (B) ("violates" provisions). Nevertheless, the Illinois Supreme Court has held that "scienter" is an essential element of a violation under that state's securities laws, despite the absence of any reference to a standard of culpability. *People v. Whitlow*, 89 Ill. 2d 322, 433 N.E.2d 629 (1982) .

New Hampshire: N.H. Rev. Stat. Ann. § 421.40 ("violates" any provision).

New York: N.Y. Gen. Bus. Law § 359-g(1)(a), (2) ("violates" provisions).

Ohio: Ohio Rev. Code Ann. § 1707.99 ("commits" any act described in § 1707.44 ("violations")).

Oregon: Or. Rev. Stat. § 59.991 ("violates" provisions).

Rhode Island: R.I. Rev. Laws Ann. § 7-11-24 (except for statements constituting false representation, no standard).

Texas: Tex. Rev. Civ. Stat. Ann. § 581-29 (except for certain untrue statements, no standard).

See Shappley v. State, 520 S.W.2d 766 (Tex. Crim. App. 1974) . In discussing the particular subsection of the Texas Blue Sky law (Tex. Rev. Civ. Stat. Ann. § 581-29(B)) that prescribes no standard of culpability, the court imposed strict liability. Although this case dealt specifically with strict liability for the sale of unregistered securities, strict liability would appear to apply to other subsections of the Texas Blue Sky law that also do not prescribe any standard of culpability.

(n27)Footnote 27. *See State v. Hodge*, 204 Kan. 98, 460 P.2d 596, 604 (1969) , in which the court stated that "no specific intent is necessary to constitute the offense if one violates the securities act except the intent to do the act denounced by the statute."

See also State v. Kirshner, Blue Sky L. Rep. (CCH) P 73,340 (Kan. App. 1990); *People v. Barysh*, Blue Sky L. Rep. (CCH) P 71,431 (N.Y. Sup. Ct. 1978) (the Martin Act is directed at acts or practices, not at any particular mental state of the wrongdoer. A criminal violation of the state's securities law will lie regardless of intent to defraud); *People v.*

Blair, 195 Colo. 462, 579 P.2d 1133 (1978) ; *People v. Terranova*, 38 Colo. App. 476, 563 P.2d 363 (1976) ; *State v. Cox*, 17 Wn. App. 896, 566 P.2d 935 (1977) .

In *State v. Temby*, Blue Sky L. Rep. (CCH) P 71,754 (Wis. App. 1982) (reversed on other grounds and remanded), the court held that the trial court did not err in instructing the jury that it was not required to find intent to defraud as a necessary element of a criminal offense because the absence of the word "intent" from the statute indicated a clear legislative purpose that it not be an element of the criminal offense.

(n28)Footnote 28. 828 P.2d 487 (*Utah. App.* 1992) , *aff'd*, 865 P.2d 1355 (*Utah* 1993) .

(n29)Footnote 29. 828 P.2d 487 (*Utah. App.* 1992) , *aff'd*, 865 P.2d 1355 (*Utah* 1993) .

See also *Buffo v. State*, 415 So. 2d 1158 (*Ala.* 1982) (knowledge that the act violates the securities laws or that the instrument is a security is not a relevant fact requiring proof); *State v. Cox*, 17 Wn. App. 896, 566 P.2d 935 (1977) (knowledge that the wrongful act actually violates the securities laws is unnecessary).

(n30)Footnote 30. See also *State v. Andresen*, 256 Conn. 313, 773 A.2d 328, 346-347 (2001) ; *Fullerton v. State*, 116 Nev. 435, 997 P.2d 807, 809 (2000) ; *State v. Sheets*, 94 N.M. 356, 610 P.2d 760 (*Ct. App.* 1980) .

(n31)Footnote 31. *State v. Casper*, CCH Blue Sky L. Rep. P 74,721, at 79,827 (*Tenn. Crim. App.* 2008).

(n32)Footnote 32. See *Tenn. Code Ann. § 48-2-123(a)* ("[A]ny person who willfully violates any provision" of the Act is guilty of a Class D felony).

(n33)Footnote 33. *State v. Casper*, CCH Blue Sky L. Rep. P 74,721, at 79,834 (*Tenn. Crim. App.* 2008).

(n34)Footnote 34. *State v. Casper*, CCH Blue Sky L. Rep. P 74,721, at 79,834 (*Tenn. Crim. App.* 2008).

Casper is currently on appeal to the Tennessee Supreme Court.

(n35)Footnote 35. See *State v. Dumke*, 901 S.W.2d 100 (*Mo. Ct. App.* 1995) (criminal liability for selling unregistered securities requires only that the act in question was intentional and not that the accused realized his conduct violated registration requirements).

(n36)Footnote 36. In *Probst v. State*, [1991-1993 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,559 (*Okla. Crim. App.* 1991), the court observed: "[T]o incarcerate someone in the penitentiary without the showing of a conscious purpose to mislead, deceive or defraud is abhorrent to the orderly administration of justice in this state." The court thus concluded that in order to prove a willful violation of the antifraud provisions of the Oklahoma Blue Sky law, the state must show that the defendant acted with scienter.

(n37)Footnote 37. *People v. Simon*, 9 Cal. 4th 493, 37 Cal. Rptr. 2d 278, 886 P.2d 1271 (1995) ; see also *People v. Corey*, Blue Sky L. Rep. (CCH) P 74,054 (*Cal. Ct. App.* 1995) (legislature must have intended to include an element of scienter in creating substantial criminal penalties for violation of antifraud provisions); *State v. Gunnison*, 127 Ariz. 110, 618 P.2d 604 (1980) .

(n38)Footnote 38. *Simon* significantly predated *People v. Salas*, *above*, in which the California Supreme Court effectively read a guilty knowledge element into the crime of selling unregistered securities by recognizing the right to assert the affirmative defense of "absence of guilty knowledge." The *Salas* court followed the lead of *Simon*, departing only to the extent of reallocating the burden of proof for the "guilty knowledge" requirement in the context of a prosecution for selling unregistered securities rather than committing fraud.

(n39)Footnote 39. *State v. Larsen*, 865 P.2d 1355 (*Utah* 1993) .

(n40)Footnote 40. *See also People v. Rivera*, 56 P.3d 1155 (Colo. App. 2002) (proof of knowledge that an interest is a security is not required to convict for willful securities fraud); *State v. Wolford, Sr.*, [2003-2008 Transfer Binder] Blue Sky L. Rep. (CCH) P 74,671 (Iowa Ct. App. 2007) (Trial court did not err by failing to instruct the jury that there must be specific intent to defraud in order to find a defendant guilty of fraud under the Iowa Securities Act.)

(n41)Footnote 41. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S. Ct. 1375, 47 L. Ed. 2d 668 (1976) .

(n42)Footnote 42. *See Van Antwerp v. State*, 358 So. 2d 782 (Ala. Crim. App.) , *cert. denied*, 358 So. 2d 791 (Ala. 1978) .

But see Ohio Rev. Code § 1707.29, which provides:

In any prosecution brought under [provisions of the Ohio Blue Sky law, with certain limited exceptions], the accused shall be deemed to have had knowledge of any matter of fact, where in the exercise of reasonable diligence, he should, prior to the alleged commission of the offense in question, have secured such knowledge.

This provision in Ohio has the general effect of defining "knowingly" more in terms of "negligently." Thus, for the purpose of fraudulent acts in selling securities in Ohio, a person is criminally liable if he or she represents facts to be different than he or she should have known them to be if he or she had exercised reasonable diligence to ascertain the facts. *State v. Walsh*, 66 Ohio App. 2d 85, 420 N.E.2d 1013 (1979) .

(n43)Footnote 43. *Manson v. State*, 349 So. 2d 67, 76 (Ala. Crim. App.) , *cert. denied*, 349 So. 2d 86 (Ala. 1977) .

See also State v. Fairchild, 171 W. Va. 137, 298 S.E.2d 110 (1982) , in which the court concluded that the jury could infer that because the defendant was a former licensed broker-dealer who had once passed the NASD examination, he was familiar with the antifraud and registration provisions of the West Virginia Securities Act and, thus, "willfully" intended to deceive.

(n44)Footnote 44. *Manson v. State*, 349 So. 2d 67, 76 (Ala. Crim. App. 1977) .

(n45)Footnote 45. *State v. Hynds*, 84 Wn.2d 657, 529 P.2d 829 (1974) .

(n46)Footnote 46. *People v. Yanez*, 30 Cal. App. 4th 513, 35 Cal. Rptr. 2d 867 (1994) , *review denied*, not for publication (1995).

(n47)Footnote 47. *People v. Yanez*, 30 Cal. App. 4th 513, 35 Cal. Rptr. 2d 867 (1994) .

(n48)Footnote 48. *People v. Yanez*, 30 Cal. App. 4th 513, 35 Cal. Rptr. 2d 867 (1994) .

(n49)Footnote 49. Ill. Laws § 14 [5/14].

(n50)Footnote 50. *State v. Mehling*, 34 Kan. App. 2d 122, 115 P.3d 771 (2005) .

(n51)Footnote 51. *See* Unif. Sec. Act § 101 ("[i]t is unlawful for any person *in connection with* the offer, sale or purchase of any security" to engage in fraudulent conduct).

(n52)Footnote 52. *State v. Harry*, 873 P.2d 1149 (Utah Ct. App. 1994) .

(n53)Footnote 53. *GNS Partnership v. Fullmer*, 873 P.2d 1157 (Utah Ct. App. 1994) .

See also Buffo v. State, 415 So. 2d 1158 (Ala. 1982) (defendant properly convicted of fraud in connection with the

sale of securities even though the party harmed by the fraud, the state insurance department, did not purchase or sell the security).

(n54)Footnote 54. Unif. Sec. Act § 409.

(n55)Footnote 55.

Massachusetts: Mass. Gen. Laws Ann. ch. 110A, § 409.

Michigan: Mich. Comp. Laws § 451.809.

Nebraska: Neb. Rev. Code § 8-1117.

New Mexico: N.M. Stat. Ann. § 58-13-43(A).

West Virginia: W. Va. Code Ann. § 32-4-409.

Wyoming: Wyo. Stat. Ann. § 17-4-121(a).

(n56)Footnote 56. *See, e.g.:*

Alaska: Alaska Stat. § 45.55.925 (in addition, a one-year term is mandatory for a felony conviction).

See also:

California: A willful violator of a broad antifraud provision or any of the specific antifraud and prohibited practices provisions (*Cal. Corp. Code* §§ 25400, 25401, 25402), including trading on inside information, is subject to both a fine up to \$250,000 and/or imprisonment for two, three, or five years. *Cal. Corp. Code* §§ 25540(b), 25541.

Georgia: Ga. Code Ann. § 10-5-24(a) (up to \$500,000 and/or one to five years imprisonment).

Maryland: Md. Code Ann. § 11-705 (fine up to \$50,000 and/or imprisonment not exceeding three years).

Michigan: Mich. Comp. Laws § 451.809(a) (up to \$25,000 fine and/or up to 10 years imprisonment).

Mississippi: Miss. Code Ann. § 75-71-735 (up to \$25,000 fine and/or up to five years imprisonment).

Montana: Mont. Rev. Code Ann. § 30-10-306 (up to \$5,000 fine and/or 10 years imprisonment).

Nevada: Nev. Rev. Stat. § 90.650 (up to \$20,000 fine and/or one to six years imprisonment in state prison).

New Jersey: N.J. Stat. Ann. § 49:3-70. Willful violation is a third degree crime for which the penalties are a fine up to \$7,500 (*N.J. Stat. Ann. § 2C:43-3*) and imprisonment for three to five years (*N.J. Stat. Ann. § 2C:43-6*). In addition, a civil fine up to \$10,000 for the first violation and up to \$20,000 for each subsequent violation may be imposed in an administrative proceeding or civil suit by the Bureau Chief. *N.J. Stat. Ann. § 49:3-70(b).*

North Carolina: N.C. Gen. Stat. § 78A-57 (up to \$5,000 fine and/or up to five years imprisonment).

Ohio: Ohio Rev. Code Ann. § 1707.99 (up to \$5,000 fine and/or one to five years imprisonment).

Oregon: Or. Rev. Stat. § 59.991 (most severe violations are class B felonies; other violations are class A misdemeanors).

Rhode Island: R.I. Rev. Laws Ann. § 7-11-24 (miscellaneous sanctions with most severe being up to \$5,000 fine and/or up to five years imprisonment).

Tennessee: Tenn. Code Ann. § 48-2-123 (class E felony, punishable by fine up to \$3,000 for any individual and \$50,000 for a corporation; imprisonment may be from one to six years).

Texas: Tex. Rev. Civ. Stat. Ann. § 581-29 (miscellaneous provisions with the most severe being for fraudulent offenses: not less than 2 or more than 10 years imprisonment and a fine of up to \$10,000 if the amount involved is less than \$10,000; 2 to 20 years imprisonment and a fine of up to \$10,000 if the amount involved is between \$10,000 and \$100,000; and life imprisonment or 5 to 99 years imprisonment and a fine of up to \$10,000 if the amount involved is more than \$100,000. Also, there is a provision for aggregating amounts in determining the gravity of the offense (Tex. Rev. Civ. Stat. Ann. § 581-29-2).

Utah: Utah Code Ann. § 16-1-21 (fine not more than \$10,000 or imprisonment not more than three years, or both).

Vermont: 9 Vt. Stat. Ann. § 9-4238 (up to \$10,000 fine and/or up to five years imprisonment).

Virginia: Va. Code Ann. § 13.1-520 (\$100 to \$5,000 and/or 30 days to one year imprisonment).

Washington: Wash. Rev. Code § 21.20.400 (up to \$5,000 fine and/or up to 10 years imprisonment).

(n57)Footnote 57. *Ala. Code § 8-6-18*.

See also *Gaskin v. State*, 244 Ark. 541, 426 S.W.2d 407 (1968) ; *Gaskin v. State*, 248 Ark. 168, 450 S.W.2d 557 (1970) . A conviction was reversed because the defendant, who actually committed a misdemeanor in that he violated a rule or order of the Commissioner, was tried and convicted of a felony, which is the sanction for a rule violation, but not for a statute violation.

(n58)Footnote 58. *Alaska Stat. § 45-55-925*.

(n59)Footnote 59. *Mont. Rev. Code Ann. § 30-10-306(1)*.

(n60)Footnote 60. *N.H. Rev. Stat. Ann. § 421-B:24(I)*.

(n61)Footnote 61. *N.H. Rev. Stat. Ann. § 421-B:24(I), (II)*.

(n62)Footnote 62. *Del. Code Ann. § 7322(a)*.

(n63)Footnote 63. *Del. Code Ann. § 7322(a), (c)*.

(n64)Footnote 64. *N.J. Stat. Ann. § 49:3-70(a)-(b)*.

(n65)Footnote 65. Off. Comment 3, 2002 Uniform Act § 508. Placing the burden on the defendant only at the time of sentencing is necessary to avoid an unconstitutional shifting of the burden of proof as to the elements of the crime itself. *See United States v. Mandel*, 296 F. Supp. 1038, 1040 (S.D.N.Y. 1969) .

(n66)Footnote 66. *Fla. Stat. § 517.302(3)*.

(n67)Footnote 67. Florida also provides for deposit of any amounts assessed as costs of investigation or prosecution in these and other cases into an "Anti-Fraud Trust Fund" to be used for investigation and prosecution of administrative, civil, and criminal actions, and also to improve public awareness and understanding of prudent investing. *See Fla. Stat. § 517.302(3)(a)*.

(n68)Footnote 68. Indiana, for example, simply declares: "A person who knowingly violates this Chapter commits a Class C felony." *Ind. Code § 23-2-1-18.1*.

(n69)Footnote 69. Section 102(20) of the 2002 Uniform Act exemplifies most state definitions in providing:

"Person" means an individual; corporation; business trust; estate; trust; partnership; limited liability company; association; joint venture; government; governmental subdivision, agency, or instrumentality; public corporation; or any other legal or commercial entity.

(n70)Footnote 70. The Illinois Blue Sky law provides:

If any person referred to in this [Penalty] Section is not a natural person, it may upon conviction of a first offense be fined up to \$25,000, and if convicted of a second and subsequent offense, may be fined up to \$50,000, in addition to any other sentence authorized by law. Ill. Laws § 14 [5/14] F.

(n71)Footnote 71. *See, e.g., Mosley v. State*, Blue Sky L. Rep. (CCH) P 74,254 (Ga. App. 2001) (conviction under state RICO law based on predicate acts including securities violations).

(n72)Footnote 72. *See, e.g.:*

Pennsylvania: 70 Pa. Stat. § 1-511.

Wisconsin: Wis. Stat. Ann. § 551.58.

(n73)Footnote 73. *See Hunter v. State*, 330 Ark. 198, 952 S.W.2d 145 (1997) (once the state proves a sale of unregistered securities, the burden shifts to the defendant to prove that the securities were exempt).

(n74)Footnote 74. *See:*

California: People v. Park, 87 Cal. App. 3d 550, 151 Cal. Rptr. 146 (1978) .

Florida: State v. Buchman, 361 So. 2d 692 (Fla. 1978) .

Ohio: State v. Frost, 57 Ohio St. 2d 121, 387 N.E.2d 235 (1979) .

Pennsylvania: Commonwealth v. Hoffman, 263 Pa. Super. 442, 398 A.2d 658 (1979) .

However, shifting the burden of proof to the defendant is not without constitutional implications in some contexts, a point considered further below. Constitutional considerations are discussed in§ 14.08[4].

(n75)Footnote 75. Fullerton v. State, Blue Sky L. Rep. (CCH) P 74,211 (Nev. 2000).

(n76)Footnote 76. *People v. Terranova*, 38 Colo. App. 476, 563 P.2d 363 (1976) .

(n77)Footnote 77. State v. Montgomery, Blue Sky L. Rep. (CCH) P 74,222 (Idaho 2001).

(n78)Footnote 78. *People v. Blair*, 195 Colo. 462, 579 P.2d 1133 (1978) ; see also *United States v. Pomponio*, 429 U.S. 10, 97 S. Ct. 22, 50 L. Ed. 2d 12 (1976) .

But see People v. Yanez, 30 Cal. App. 4th 513, 35 Cal. Rptr. 2d 867 (1994) , in which the court held that an attorney performing services in connection with the offering and sale of unregistered securities would not be held criminally liable unless he or she acts with subjective bad faith.

(n79)Footnote 79. *State v. Dumke*, 901 S.W.2d 100 (Mo. App. 1995) , quoting *State v. Silva*, 130 Mo. 440, 464, 32 S.W. 1007, 1014 (1895) .

(n80)Footnote 80. Unif. Sec. Act § 409(a).

(n81)Footnote 81. Unif. Sec. Act § 409(a); Draftsmen's Commentary. The same provision is contained in the Revised Uniform Act and is continued as a part of the 2002 Uniform Act.

(n82)Footnote 82. See: Arkansas, California, Delaware, and Louisiana; see also Tenn. Code Ann. § 48-16-123(a) ("no actual knowledge").

(n83)Footnote 83. Unif. Sec. Act § 409 ("[n]o indictment or information may be returned under this act more than five years after the alleged violation").

(n84)Footnote 84. See:

Alabama: Ala. Code § 8-6-18(a).

Alaska: Alaska Stat. § 45.55.210(a).

Arkansas: Ark. Stat. Ann. § 67-1255(i).

Connecticut: Conn. Gen. Stat. ch. 662, § 36-497(c).

Delaware: 6 Del. Code Ann. § 7322(a).

Florida: Fla. Stat. Ann. § 517.302.

Kentucky: Ky. Rev. Stat. Ann. § 292.991(1).

Maryland: Md. Code Ann. § 11-705(a)(3).

Mississippi: Miss. Code Ann. § 75-71-735.

Montana: Mont. Rev. Code Ann. § 30-10-106(1).

Nevada: Nev. Rev. Stat. § 90.190(1).

New Jersey: N.J. Stat. Ann. § 49:3-70(a).

Pennsylvania: 70 Pa. Stat. § 1-511.

Utah: Utah Code Ann. § 61-1-21(1).

Washington: Wash. Rev. Code § 21.20.400.

West Virginia: W. Va. Code Ann. § 32-4-409(a).

(n85)Footnote 85. Ill. Ann. Stat. ch. 121-1/2, § 137.14(C).

(n86)Footnote 86. Mich. Comp. Laws § 451.809(d).

See also: Ohio Rev. Code § 1707.28 (three years); Va. Code Ann. § 13.1-520 (three years); Wis. Stat. Ann. § 551.58 (six years).

(n87)Footnote 87. *See, e.g., Cal. Penal Code § 800* and *N.Y. Crim. Proc. Law § 30.10*. Note, however, that under New York law, the statutory period is determined by whether the prosecution is for a felony (five years) or a misdemeanor (two years). In California, the statute of limitations period extends to three years after the discovery of the securities violation.

(n88)Footnote 88. *State v. Burchard*, [1993-1994 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,807 (Idaho App. 1993).

(n89)Footnote 89. Mich. Comp. Laws § 451.809(d).

(n90)Footnote 90. Ill. Comp. Stat. § 14 [5/14] C.

(n91)Footnote 91. *In re an Inquiry by Elliot Spitzer, Attorney General of the State of New York*, Index No. 02/401522 (N.Y. Sup. Ct. 2002).

(n92)Footnote 92. *See Queen v. Commonwealth*, 434 S.W.2d 318 (Ky. App. 1968) .

(n93)Footnote 93. *People v. Rivera*, Blue Sky L. Rep. (CCH) P 74,265, 2002 Colo. App. LEXIS 389 (Mar. 14, 2002) .



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Blue Sky Regulation

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CHAPTER 14 State Enforcement Authority

2-14 Blue Sky Regulation § 14.07

§ 14.07 Constitutional Considerations in State Enforcement Actions

[1] Qualified Immunity and Constitutionally Protected Rights

In the exercise of enforcement authority under Blue Sky laws by state administrators, the *Eleventh Amendment to the U.S. Constitution* assures that absent an abrogation or waiver of immunity, agencies of state governments may not be sued in federal courts by the persons they regulate. However, the *Eleventh Amendment* does not prohibit actions against state employees sued in their official capacity for prospective equitable relief or to end a continuing violation of federal law.ⁿ¹ Persons or entities subject to regulation under Blue Sky laws may thus sue administrators for alleged violations of federal law or constitutional rights.ⁿ² However, governmental officials sued in their individual capacities have the protection of qualified immunity if their conduct does not violate clearly established statutory or constitutional rights.ⁿ³ To claim the protection of qualified immunity, the state official has only the burden of establishing that he or she was acting within the scope of discretionary authority. Once that is established, the burden shifts to the complaining party to prove that qualified immunity is not warranted by showing that the right allegedly violated is clearly established.ⁿ⁴

The issue of qualified immunity of a state securities administrator from attack on federal constitutional grounds was thoroughly explored by a federal district court in *Harris v. Borg*,ⁿ⁵ where the plaintiff challenged an administrative cease-and-desist order issued by the Alabama Securities Commission. The Commission's order, signed by the Director, addressed a fraud in the offer and sale of unregistered investment contracts in various investment clubs promoted and operated by the plaintiff and others. As part of the administrative process, the Commission and the plaintiff entered into an agreement outlining actions to be taken in the liquidation of investor accounts and the pro rata distribution of available funds to investors as partial reimbursement. The plaintiff then commenced an action in federal court alleging that in issuing the cease-and-desist order, the Director violated the Takings, Equal Protection, and Procedural *Due Process Clauses of the Fifth and Fourteenth Amendments to the U.S. Constitution*. There was no issue in the case that the Director had acted within the scope of his discretionary authority under the Alabama Blue Sky Law. The question before the federal court, therefore, was whether the plaintiff's allegations set out a claim for violation of clearly established constitutional rights. Plaintiff in *Borg* alleged that the "forced" liquidation of investor accounts and seizure of funds amounted to a prohibited taking of property of the investors within the ambit of the *Fifth Amendment*.ⁿ⁶

The court rejected the challenge on the ground that the plaintiff did not identify any legally protected interest allegedly violated by the Director. The court observed that the Commission did not "take" investors' funds by returning to them what remained. Any investor losses on their initial investments could not be attributable to the Commission's Order. The

court also dismissed the plaintiff's procedural due process claim on the same grounds. The plaintiff, said the court, was not deprived of any constitutionally-protected liberty or property interest. Plaintiff had no interest in the money of his investors, and any losses to the investor accounts were incurred by the investors, not the plaintiff. Notably as well, the court found that plaintiff had failed to take advantage of the hearing procedure that was made available to him by the Securities Commission. Finally, the court also rejected the asserted equal protection violation, finding that the plaintiff, an African-American, was not singled out by the Commission because of his race. Plaintiff failed to present sufficient evidence that the Director treated him differently from any similarly-situated individual because of his race.

[2] First Amendment and Commercial Expression

A challenge to an administrative enforcement order issued under the Massachusetts Securities Law based on the *First Amendment to the U.S. Constitution* was rejected. In *Bulldog Investors General Partnership v. Galvin*,ⁿ⁷ the plaintiffs, investment advisers to three hedge funds, sued the Secretary of the Commonwealth and the Chief of Enforcement of the Securities Division of the Office of the Secretary of the Commonwealth for a preliminary injunction against enforcement of an order to stop operating a website. Bulldog Investors maintained an interactive website that provided information about investment products offered by Bulldog. The website made certain information available to any visitor, including press articles and a printable brochure describing Bulldog's three investment vehicles. Certain representations were made on the website concerning performance and a visitor seeking more specific information about the funds and their performance could request such information by registering on the website and providing certain personal identifying information.

The enforcement section of the Massachusetts Securities Division filed an administrative complaint seeking a cease-and-desist order, an administrative fine, and other relief. The enforcement section asserted in its complaint that Bulldog had, via the website, offered securities for sale in the Commonwealth that were not registered or exempt under the Massachusetts Uniform Securities Act. While the administrative proceeding was pending, Bulldog commenced litigation in Massachusetts state court, alleging that the enforcement action violated the conduct forming the basis for the action protected by the free speech and free press guarantees of the *First Amendment of the U.S. Constitution*, and that the administrative action chilled the exercise of those rights.ⁿ⁸ The court rejected the assertion and denied Bulldog's request for a preliminary injunction.ⁿ⁹

After concluding that the speech in question was clearly "commercial," the court applied the four-part test established by the U.S. Supreme Court in *Central Hudson Gas & Electric Corp. v. Public Service Comm'n*,ⁿ¹⁰ to determine whether the enforcement action in *Bulldog* infringed upon the constitutionally-protected commercial expression. Applying that test, a court must determine: (1) whether the speech in question provided truthful information about lawful activity; (2) whether the government has a substantial interest to be achieved by restricting the speech; (3) whether the regulatory technique was in proportion to the government's interest; and (4) whether the government's interest could be served as well by a more limited restriction on the speech.

The Massachusetts court rejected the assertion that Bulldog's website communicated untruthful or misleading information about an unlawful activity. However, the court also concluded that the regulation involved serves a substantial governmental interest, namely, the importance of regulation of the offer and sale of securities in protecting the health of the capital markets and of the economy. Thus, the central questions were whether the regulation was in proportion to that interest and whether the interest could be served as well by a more limited restriction. On these criteria, the court concluded that the regulation involved--prohibition of expression that limits solicitation of offers of securities to those who have made full disclosure in connection with registration--directly serves the government interest in issue and that ultimately: "It is certainly reasonable to conclude that indiscriminate advertising to the general public tends to increase the likelihood of sales to ineligible persons, who may be persuaded to invest without the full information that registration would provide."ⁿ¹¹

Whether the government's interest could be achieved in a less restrictive manner presented the more difficult question.

The court was satisfied, however, that the enforcement order at issue "fit directly within the longstanding aim of securities regulation that Courts have consistently accepted as permissible."¹² The court observed that there were no practical means of imposing less burden and that the attempt to do so would likely result in more, rather than less, burden on speech.

On the other hand, in *Lubin v. Agora, Inc.*,¹³ in which an administrative subpoena for production of subscriber lists, marketing lists, and other documents containing information identifying subscribers to investment newsletters could not withstand a *First Amendment* challenge if the Maryland Commissioner failed to show a compelling need for the material and if the demand was overbroad. In an investigation into potential violations of antifraud and investment adviser licensing requirements in Maryland Securities Act, the administrator argued that *First Amendment* interests were not implicated and the information being sought was relevant to the authorized investigation and would allow for a determination whether the Act had been violated. The Commissioner urged that enforcement of the subpoena would not restrict the respondent's publishing activities in any way and that the information constituted unprotected commercial speech. The respondent argued that no compelling need for the information had been shown and that there was no showing that the agency had no other means of obtaining relevant information.

The court agreed, observing that in order to compel production of the subscriber information, the Commissioner must establish a substantial relation between the information sought and an overriding and compelling state interest. Additionally:

To the extent that the Commissioner's subpoenas require Agora, a publisher, to disclose the identities of those who subscribe to or purchase its materials, the subpoenas seek information within the protective umbrella of the *First Amendment*. Enforcement of the subpoenas would intrude upon the *First Amendment* rights of Agora's subscribers and customers because disclosure of their subscriber status and purchase of the Report would destroy the anonymity that the Supreme Court has recognized as important to the unfettered exercise of *First Amendment* freedoms. If the names of Agora's readers were disclosed to the government, they might be subjected to questioning from investigators about their reading habits. Agora's subscribers may be discouraged from reading its materials if they are interviewed by government personnel investigating potential securities violations, even if the readers are told that, individually, they are not under investigation.¹⁴

Administrative subpoenas may raise other constitutional issues, as for example, *Fourth Amendment* privacy rights, discussed further below.

[3] Administrative Subpoena Authority

The broad scope of subpoena authority granted to administrators in state securities laws may impact privacy rights guaranteed by the *Fourth Amendment of the U.S. Constitution*. In *State of Washington v. Miles*,¹⁵ the Washington Supreme Court confronted a challenge under both state and federal constitutions to an administrative subpoena issued by the Securities Commissioner to a bank, requesting certain records pertaining to accounts used by the defendant investment adviser or entities under his control. Miles, who was subsequently charged with securities fraud, witness intimidation and tampering, and theft, had not been given notice of the subpoena and at trial, sought to suppress the evidence obtained. The trial court concluded that the banking records fell within constitutionally-protected privacy interests under the state constitution and further concluded that because no notice had been provided, the subpoena lacked authority of law. However, the trial court denied the motion to suppress based upon a "pervasively regulated industry" exception to the constitutional requirement for a warrant to obtain the information. An immediate appeal was taken directly to the Washington Supreme Court, which held that the administrative subpoena was invalid and that a search of personal banking records without a judicially issued warrant or subpoena to the subject party violated the state constitution.

The *Miles* court specifically concluded that the Washington Securities Law is invalid to the extent that it authorizes the Commissioner to issue administrative subpoenas to third parties for otherwise private information. The court found that just because a person engages in a business that is pervasively regulated would not expose that person's non-business related private matters to public inspection.ⁿ¹⁶ The court rejected the argument that warrantless inspection of the records was necessary to effectuate the regulatory scheme and that everything offered in purported justification of the warrantless search in fact supported resort to judicial issuance of a subpoena or warrant and did not support any exception.ⁿ¹⁷

[4] Due Process--Generally

In *Majors v. South Carolina Securities Commission*,ⁿ¹⁸ the South Carolina Supreme Court considered a constitutional due process challenge to the summary issuance of an initial cease-and-desist order. The South Carolina Attorney General, acting as the Securities Commissioner, issued an order for the plaintiffs to cease and desist selling unregistered securities and engaging in securities fraud. Although issued summarily, the order gave notice of a right to a hearing, which plaintiffs requested and which was held. Based on a report and recommendation issued in connection with that hearing, the Commissioner issued a final order to cease and desist from offering or selling unregistered securities--investment contracts. However, there was no finding that the plaintiff was engaged in securities fraud. Plaintiffs appealed, claiming, among other things, that the Commissioner did not have lawful authority to issue the initial cease-and-desist order and that they were not afforded due process in the underlying administrative proceeding.

The plaintiffs' appeal to the South Carolina Court of Appeals was certified directly to the South Carolina Supreme Court, which affirmed the administrative orders. The Supreme Court first concluded that the Commissioner clearly had authority to issue cease-and-desist order prior to the commencement of a civil case.ⁿ¹⁹ Then, as to due process, the court concluded that the administrative process allowing summary orders was permissible so long as notice and opportunity to be heard was provided. It is not necessary, said the court, that there be notice and an opportunity to be heard at each step of the administrative process. Rather, it mandates notice and opportunity to be heard at some point before the agency makes its final decision.ⁿ²⁰ The court concluded that the respondents had been afforded due process because the initial cease-and-desist order provided them with the right to a hearing, which they requested and were afforded by an independent hearing officer. Thereafter, they were permitted to appeal the Commissioner's final cease-and-desist order and were allowed to post a bond to stay enforcement of that order pending appeal.ⁿ²¹

Due process concerns are always present in state administrative enforcement proceedings. In *Trust & Investment Advisers, Inc. v. Hogsett*,ⁿ²² for example, plaintiff brought an action in federal court seeking declaratory and injunctive relief as well as money damages for the alleged violation of its procedural due process rights in an enforcement proceeding brought by the Indiana Securities Division. Among other things, plaintiff asserted that the Division had an "indirect pecuniary interest" in the adjudication of the case, and that conduct of the Commissioner evidenced that the Division had prejudged the outcome of the proceeding. The U.S. District Court abstained and dismissed the suit. On appeal, however, the Seventh Circuit reversed and remanded the case for further findings on whether the Indiana Commissioner's institutional bias in the proceeding denied plaintiff a procedurally fair hearing in the state forum. The Seventh Circuit called for a realistic appraisal of the effect, if any, that the alleged bias on the part of the Division would have on the adjudicator's capacity for fair and impartial decision-making.ⁿ²³

On balance, however, procedural due process in administrative proceedings under Blue Sky laws requires only that an individual be given adequate notice of the charges and an opportunity to be heard. In *Schwalm v. Pa. Secs. Commission*,ⁿ²⁴ the respondent alleged, among other things, that he had been denied due process in connection with an order to show cause, and a resulting determination that he be permanently barred from selling securities in the state and ordered to pay \$350,000 as an assessment. Respondent claimed that the hearing process was not fair and impartial because he did not know he was allowed to call witnesses. The reviewing court found no due process violation, and in describing the particular process involved in the case, also described what is typical under all state securities laws:

In the present case, Schwalm was afforded all the process to which he was due. The original order to show cause clearly listed all the charges against Schwalm, and he was given adequate time to respond. The hearing notice sent by the Commission explicitly stated that witnesses could be called and that Schwalm could call his own witnesses in his defense. Moreover, counsel represented Schwalm during the hearing; any concerns he had regarding witnesses and evidence should have been discussed with his counsel at that time. There is nothing in the record to suggest that the hearing was not conducted in accordance with administrative rules and procedures, and Schwalm had every opportunity to be heard.ⁿ²⁵

[5] Constitutional Issues with Penal Provisions

The constitutionality of criminal penalties provided in Blue Sky laws has occasionally been tested. For the most part, such challenges are made on arguments that provisions under which a defendant is convicted are void for vagueness. In *State v. Shepherd*,ⁿ²⁶ for example, the defendant sought to overturn his conviction for selling unregistered securities, and without a license, on grounds that the provisions of the Utah Blue Sky law under which he was convicted were unconstitutionally vague. As with all Blue Sky laws, Utah makes it unlawful to offer or sell an unregistered security unless the security or transaction is exempt. Exempt transactions in Utah include transactions not involving a "public offering," which is not specifically defined in the statute. The defendant argued that because the key term is not defined, he was not provided with adequate notice to guide his conduct. The court disagreed, concluding instead that the term provides a "reasonable degree of common understanding" and that terms not defined in the statute are not only assigned a meaning commonly accepted in the business community, but is also a settled term as a matter of long-standing federal securities regulation, which supplies the business community with a common understanding. Thus, said the court, the term is definite enough to provide adequate notice of proscribed conduct:

The business community has had an operable definition of public offering for over forty years. When a businessperson operates in a highly regulated arena such as the sale of securities, he must make certain that he is complying with all technical requirements.ⁿ²⁷

Likewise, in *State v. Woodington*,ⁿ²⁸ the Wisconsin Supreme Court emphasized that given the purpose of Blue Sky laws to protect the public by preventing the sale of worthless or fraudulent securities:

[W]e have no hesitancy in concluding that no average person seeking registration of securities for the purpose of sale to the public could be unaware or confused as to the prohibitions of sec. 189.19(2)(d). The statute, with ample clarity, advises him that he cannot seek registration nor offer securities for sale if he in fact knows of the falsity or misleading nature of a material statement or representation in connection therewith. The statute advises him with equal clarity that he is obligated to use ordinary care to determine the falsity or misleading character of material statements or representations. Because of the legislative concern for the welfare of the public, the burden imposed--to exercise ordinary care--is neither ambiguous, uncertain, nor unfair. Where the substantial protection of the public welfare is concerned the legislature can, in the proper exercise of the police power, constitutionally prohibit, by criminal statute, negligent conduct which would be detrimental to this public interest.ⁿ²⁹

The constitutionality of the penal provisions in Blue Sky laws has thus generally been upheld.ⁿ³⁰

Although most constitutional challenges fail, a successful constitutional attack was mounted against the shifting in burden of proof that is involved in some criminal prosecutions for violation of Blue Sky laws. In *State v. Powdrill III*,ⁿ³¹ the Louisiana Supreme Court held that a provision in the Blue Sky law which effectively shifted the burden of proof in a criminal case to the defendant who was charged with selling securities by means of false or misleading statements was unconstitutional. The Louisiana securities law provided for criminal liability of one who willfully offers or sells a security by means of any false or misleading statement of a material fact. An available defense provided that a

criminal defendant could prove lack of guilty intent by proving that he or she did not know, and in the exercise of reasonable care could not have known, of the untruth or omission. The burden of proof on the defense was squarely upon the defendant, and the court concluded that shifting the burden was impermissible because it negated the state's obligation to prove each of the elements of the crime charged.

The court admonished that proof of willful behavior requires the state to prove that a defendant acted knowingly and deliberately. The burden of proof, said the court, could not be shifted to the defendant via the statutory "defense" because it would actually shift to the defendant the state's burden to prove the willfulness element of the violation. The burden shifting language of the Louisiana law was thus held to be a prohibited reallocation of burden and a violation of due process guarantees under the state and federal constitutions.ⁿ³²

Finally, a criminal prosecution instituted subsequent to an administrative proceeding in which a civil penalty is imposed may impact constitutional protections against double jeopardy. The U.S. Supreme Court has determined that a civil penalty will not be treated as the equal of a criminal penalty for double jeopardy purposes except where it is clear that the legislature intended that treatment. The guidelines established in *Hudson v. United States* ⁿ³³ for equating civil and criminal penalties portend that few administrative penalties under state Blue Sky laws will be deemed to implicate the double jeopardy protection. Nevertheless, the Supreme Court made certain that traditional double jeopardy principles may still be applied to equate civil and criminal penalties if there is clear proof of the legislature's intention, as evidenced by the nature of the administrative sanction authorized, the elements and objective involved in imposing it, and its historical characterization as punishment.

Where double jeopardy is implicated, the impact on parallel proceedings is apparent. In *Hudson*, the Office of the Comptroller of the Currency imposed large civil money penalties on board members of two banks who the agency found had made improper loans. The individuals were subsequently indicted for bank fraud stemming from the same transactions. Had the civil penalties been determined to be "punishment" for *Fifth Amendment* purposes, the criminal prosecution would have been precluded. The Supreme Court rejected the argument because, among other things, equating the administrative sanction with a criminal penalty would undermine the government's ability to engage in effective regulation.ⁿ³⁴

FOOTNOTES:

(n1)Footnote 1. See *Ex parte Young*, 209 U.S. 123, 28 S. Ct. 441, 52 L. Ed. 714 (1908) , superseded by statute as stated in *Presbyterian Church (U.S.A.) v. United States*, 870 F.2d 518 (9th Cir. 1989) (a plaintiff seeking prospective relief from the state must name as a defendant a state official rather than the state or state agency directly, even though in reality the case is against the state).

(n2)Footnote 2. See *Seminole Tribe v. Florida*, 517 U.S. 44, 116 S. Ct. 1114, 134 L. Ed. 2d 252 (1996) .

(n3)Footnote 3. *Harlow v. Fitzgerald*, 457 U.S. 800, 818, 102 S. Ct. 2727, 73 L. Ed. 2d 396 (1982) .

(n4)Footnote 4. *Saucier v. Katz*, 533 U.S. 194, 201, 121 S. Ct. 2151, 150 L. Ed. 2d 272 (2001) , overruled in part as stated in *Barnard v. Las Vegas Metro. Police Dep't*, (9th Cir. Feb. 4, 2009), 310 Fed. Appx. 990 . See also *Karel v. Gee*, CCH Blue Sky L. Rep. P 74,741, at 79,943 (D. Idaho 2008) (although it was ultimately determined that the Department lacked authority to inspect certain documents, the defendant regulators were entitled to qualified immunity because they were carrying out discretionary functions).

(n5)Footnote 5. *Harris v. Borg*, 2007 U.S. Dist. LEXIS 73356 (M.D. Ala. Sept. 28, 2007) .

(n6)Footnote 6. The "Takings" Clause of the *Fifth Amendment* made applicable to the states through the *Fourteenth Amendment* provides that private property shall not "be taken for public use, without just compensation." See also *Lingle v. Chevron U.S.A. Inc.*, 544 U.S. 528, 536, 125 S. Ct. 2074, 161 L. Ed. 2d 876 (2005) .

(n7)Footnote 7. *Bulldog Investors General Partnership v. Galvin*, 23 Mass. L. Rep. 413 (Mass. Super. Ct. 2007) .

(n8)Footnote 8. Bulldog also alleged that the enforcement action violated Article XVI of the Massachusetts Declaration of Rights.

(n9)Footnote 9. The court initially declined to rule on Bulldog's request for the injunction, pending action in the administrative proceeding. A final order in that proceeding that Bulldog had offered unregistered securities via its website was issued, resulting in a cease-and-desist order and fine being imposed. The court thereupon undertook consideration of Bulldog's request for a preliminary injunction against enforcement of the order and any further enforcement proceedings.

(n10)Footnote 10. *Central Hudson Gas & Electric Corp. v. Public Service Comm'n*, 447 U.S. 557, 100 S. Ct. 2343, 65 L. Ed. 2d 341 (1980) .

(n11)Footnote 11. *Bulldog Investors General Partnership v. Galvin*, Blue Sky L. Rep. (CCH) P 74,681, at 79,607 (Mass. Super. Ct. 2007).

(n12)Footnote 12. *Bulldog Investors General Partnership v. Galvin*, Blue Sky L. Rep. (CCH) P 74,681, at 79,607 (Mass. Super. Ct. 2007).

(n13)Footnote 13. *Lubin v. Agora, Inc.*, 389 Md. 1, 882 A.2d 833 (2005) .

(n14)Footnote 14. *Lubin v. Agora, Inc.*, 389 Md. 1, 882 A.2d 833, 846 (2005) (citations omitted).

(n15)Footnote 15. *State v. Miles*, 160 Wn.2d 236, 156 P.3d 864 (2007) .

(n16)Footnote 16. 160 Wn.2d at 250 .

(n17)Footnote 17. The validity of administrative subpoenas in the face of constitutional challenges is largely governed by a three-part test articulated by the U.S. Supreme Court, by which a subpoena will be enforced if the court is satisfied that the inquiry is within the authority of the agency, the demand is not too indefinite, and the information sought is reasonably relevant, *See Oklahoma Press Pub. Co. v. Walling*, 327 U.S. 186, 66 S. Ct. 494, 90 L. Ed. 614 (1946) ; *United States v. Morton Salt Co.*, 338 U.S. 632, 70 S. Ct. 357, 94 L. Ed. 401 (1950) .An administrative subpoena meeting the three-part test does not amount to an unreasonable search in violation of the *Fourth Amendment to the U.S. Constitution*. *Target Oil & Gas Corp. v. Commonwealth*, [2003-2008 Transfer Binder] Blue Sky L. Rep. (CCH) P 74,574, 2006 Ky. App. LEXIS 156 (May 26, 2006) .

(n18)Footnote 18. *Majors v. S.C. Secs. Comm'n*, 373 S.C. 153, 373 S.C. 153, 644 S.E.2d 710 (2007) .

(n19)Footnote 19. Prior to adoption of the 2002 Uniform Act in South Carolina (eff. Jan. 1, 2006), the South Carolina Uniform Securities Act did not directly provide for issuance of cease-and-desist orders, although the power to do so was included under general authority of the Commissioner.

(n20)Footnote 20. *See Majors v. S.C. Secs. Comm'n*, 373 S.C. 153, 161, 373 S.C. 153, 161, 644 S.E.2d 710 (2007) .

(n21)Footnote 21. *See 373 S.C. at 162. See also Baro v. Dep't of Corps.*, [2003-2008 Transfer Binder] Blue Sky L. Rep. (CCH) P 74,675, 2007 Cal. App. Unpub. LEXIS 9493 (Nov. 27, 2007) (Appellant was provided ample notice of the specific charges against him. He did not object to the adequacy of notice of charges at the administrative hearing, and did not show any prejudicial absence of specificity.).

(n22)Footnote 22. *Trust & Inv. Advisers v. Hogsett*, 43 F.3d 290 (7th Cir. 1994) .

(n23)Footnote 23. Practical considerations in the administrative enforcement process are examined in Chapter 16.05[4], *below* .

(n24)Footnote 24. 965 A.2d 326 (*Pa. Commw. Ct.* 2009) .

(n25)Footnote 25. 965 A.2d at 330 .

(n26)Footnote 26. *State v. Shepherd*, 989 P.2d 503, 1999 UT App. 305 .

(n27)Footnote 27. *State v. Shepherd*, 989 P.2d 503, 508, 1999 UT App. 305 .

In the process of criminal adjudications under Blue Sky laws, definitional issues may arise concerning the role of judge and jury. In *People v. Pahl*, 169 P.3d 169 (*Colo. Ct. App.*) , *modified*, 2006 *Colo. App. LEXIS* 1775 (Oct. 26, 2006) , a defendant convicted of selling unregistered securities claimed the trial court erred by submitting to the jury the issue of whether a "security" was involved at all. The defendant maintained that the issue is a question of law for the court. The appellate court disagreed, noting in part that the defendant's motions for judgment of acquittal, which were denied, had been partially based on the contention that no security was present. The court was satisfied that a legal determination of whether the instrument involved in the case was a security was satisfied by the trial court's finding that there was sufficient evidence in that regard to send the case to the jury.

In *Pahl*, the court also upheld the trial court to allow expert testimony by the former Commissioner of Securities that the transaction was a security. Although calling it a close question, the appeals court concluded that it was not an abuse of discretion to permit the testimony and that the expert's opinion did not rise to the level of a pronouncement of law or exceed the role and limits of expert testimony.

(n28)Footnote 28. *State v. Woodington*, 31 Wis. 2d 151, 142 N.W.2d 810 (1966) , *appeal dismissed*, 386 U.S. 9, 87 S. Ct. 854 ; 386 U.S. 9, 87 S. Ct. 854, 17 L. Ed. 2d 699 (1967) .

(n29)Footnote 29. *State v. Woodington*, 31 Wis. 2d 151, 142 N.W.2d 810 (1966) , *appeal dismissed*, 386 U.S. 9, 87 S. Ct. 854 ; 386 U.S. 9, 87 S. Ct. 854, 17 L. Ed. 2d 699 (1967) .

(n30)Footnote 30. *See, e.g.:*

California: People v. Sears, 138 Cal. App. 2d 773, 292 P.2d 663 (1956) .

Kansas: State of Kansas v. Kirshner, Blue Sky L. Rep. (CCH) P 73,340 (Kan. App. 1990).

Kentucky: Queen v. Commonwealth of Kentucky, 434 S.W.2d 318 (Ky. App. 1968) .

New York: Dunham v. Ottinger, 243 N.Y. 423, 154 N.E. 298 (1926) .

North Dakota: State v. Martin, 85 S.D. 587, 187 N.W.2d 576 (1971) .

In *State v. Hornbeck*, 2008-NMCA-39, 178 P.3d 847 , the court rejected a defendant's argument that his convictions for fraud and securities fraud constituted multiple punishments for the same offense, and for that reason, violated the *Double Jeopardy Clause of the Fifth Amendment*. The court held that the New Mexico Securities Act expressly provides that nothing limits the power of the state to punish a person for conduct that constitutes a crime under other law. Each crime with which the defendant was charged requires proof of elements that the other does not and the legislature intended that a prosecutor be afforded discretion in both charging the crimes and seeking separate punishments of such crimes. A defendant may be convicted and sentenced for both general fraud and securities fraud.

(n31)Footnote 31. *State v. Powdrill*, 95-2307 (La. 11/25/96), 684 So. 2d 350 , *reh'g denied*, *In re Cooks*, 96-1447 (La. 05/20/97), 694 So. 2d 892 .

But see *State v. Ribadeneira*, [1991-1993 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,551 (Kan. App. 1991), in which the court held that because securities exemptions constitute affirmative defenses to a criminal charge, the burden of producing facts which might exonerate the defendant does not constitute an impermissible shifting of the burden of proof.

(n32)Footnote 32. *State v. Powdrill*, 95-2307 (La. 11/25/96), 684 So. 2d 350 , *reh'g. denied*, *In re Cooks*, 96-1447 (La. 05/20/97), 694 So. 2d 892 .

(n33)Footnote 33. *Hudson v. United States*, 522 U.S. 93, 118 S. Ct. 488, 139 L. Ed. 2d 450 (1997) .

(n34)Footnote 34. *See also* *New Jersey v. Darby*, [1991-1993 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,523 (N.J. App. 1991) (an order for \$292,000 in civil penalties and disgorgement of \$3.1 million in a civil action brought by the state did not provide grounds for a double jeopardy dismissal on related alleged criminal conduct); *Mullet v. Miller*, 168 Ariz. 594, 816 P.2d 251 (1991) (administrative penalties that are not punitive in nature do not amount to double jeopardy in a subsequent criminal prosecution arising out of the same facts).

In the administration and enforcement of Blue Sky laws, state regulators are clearly state actors for constitutional due process purposes. However, self-regulatory organizations are not state actors for due process purposes, unless a governmental nexus can be established. In *Scher v. NASD, Inc.*, 386 F. Supp. 2d 402 (S.D.N.Y. 2005) , the plaintiff was prosecuted and ultimately convicted of perjury in on-the-record sworn testimony given in an NASD (now FINRA) disciplinary proceeding. In her suit against NASD, the plaintiff alleged that she was not adequately advised that lying in an NASD proceeding could lead to criminal prosecution. The court dismissed the claim, holding that NASD is not a state actor and that without state action, constitutional guarantees of due process do not apply. For due process to apply, said the court, there must be a governmental nexus. The regulatory function of NASD may be viewed as "quasi-governmental." Nevertheless, there is no sufficient tie to government to make it a "state actor."



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CHAPTER 14 State Enforcement Authority

2-14 Blue Sky Regulation § 14.08

§ 14.08 Principal Considerations for Regulatory Actions

Enforcement actions by state securities administrators focus heavily on activities of intermediaries. As outlined in Chapter 11, broker-dealers and investment advisers, along with their agents and representatives, are, in nearly all states, subject not only to qualitative standards in licensing, but also to conduct and business practice standards established by rulemaking under antifraud provisions of Blue Sky laws. In many cases, specific prohibited or fraudulent acts and practices by intermediaries are identified. To that extent, there is at least a degree of certainty in identifying the circumstances in which an enforcement action in the context of intermediary activities and operations could be expected. However, the goal of enforcement is to create a culture of compliance in which those involved in the securities business institute effective, proactive measures to prevent problems from arising and to address them effectively when they do arise.

In an undertaking to encourage firms to self-police, self-report, and to act in a cooperative manner with state securities regulators, in September 2005, the Broker-Dealer Section of NASAA--the North American Securities Administrators Association--issued its "Report on Principal Considerations for Regulatory Actions."¹ The NASAA Report identifies particular considerations that state securities regulators may, in their sole discretion, take into account in determining what enforcement action, if any, should be taken against a broker-dealer when a violation has occurred. The considerations are not intended to provide formal guidance or serve as a basis for a firm to challenge the initiation of any enforcement action or proceeding. Rather, the objective is to encourage proactive steps and cooperation. Although directed specifically at enforcement decisions involving broker-dealers, the considerations presented in the NASAA Report are susceptible to broader application in all areas of enforcement under Blue Sky laws. The principal considerations are outlined below.

(1) Did the firm have adequate written supervisory policies and procedures in place to identify and prevent the misconduct at issue? Elements of this inquiry include whether the firm had qualified supervisory personnel assigned to implement these policies and procedures, and whether there is a "tone at the top" regarding the importance of an effective compliance program. An important consideration here is whether the misconduct at issue was discovered because of internal compliance procedures.

(2) Has the firm taken prompt and adequate measures to avoid future occurrences of the same type of misconduct? The inquiry here focuses on what assurances there are that the particular misconduct is unlikely to recur. This may be a function of new and more effective internal controls and procedures

designed to prevent recurrence of the misconduct. A key consideration here will be the extent to which the firm supplies enforcement agencies with sufficient information to evaluate the measures taken to correct the situation and ensure that the conduct does not recur.

(3) Did the firm conduct a review of all facts involved in the misconduct and make a diligent effort to identify all parties involved? In this analysis, the simple question is whether the firm was committed to learning the truth fully and expeditiously. Regulators will consider whether the firm conducted a thorough review, the extent to which it was properly overseen, and whether it was subject to any scope limitations.

(4) Did the company promptly make available to state regulators the results of its review and provide sufficient documentation reflecting its response to the situation? Production by the firm of a thorough and probing written report may be an important consideration here. One concern is whether in its internal investigation, the company identified possible violative conduct and evidence with sufficient precision to facilitate prompt enforcement action against those who violated the law. The results and completeness of a company review will also be evaluated in terms of whether the company discloses information not directly requested by regulators and which might not have otherwise been uncovered. The overall degree of cooperation between the firm and the regulators is also a factor here.

(5) Was the nature of the misconduct of the employee or agent the result of inadvertence, inadequate training, error, simple negligence, reckless or deliberate indifference to indicia of wrongful conduct, willful misconduct, or unadorned venality? Whether timely and appropriate actions have been taken by the firm against wrongdoers will be considered, as will the extent to which such persons remain associated with the firm and in what capacities.

(6) Where appropriate, did the firm notify the self-regulatory authorities and federal and state regulatory authorities, and/or criminal authorities in a timely and appropriate manner? Part of this process of self-reporting also involves following up with timely notification and disclosure to the CRD and IARD systems, as applicable.

(7) Did the firm act promptly and fully in addressing client complaints and/or losses prior to the intervention by a regulatory agency? Part of a firm's internal review should include steps to identify the extent of damage to investors and other constituencies from the misconduct. The implicit expectation is that the firm will seek out persons or entities harmed by the wrongdoers and offer restitution without state or other regulatory intervention.

Other principal considerations in determining whether enforcement action should be initiated include whether the firm has any history of misconduct, and in particular, of the misconduct at issue, as well as whether the misconduct was a one-time event or lasted for several years. Additionally, what, if any, "red flags" were present that should have warned the firm of potential problems and whether the firm acted on those indications on a timely basis? How did the misconduct arise? Was it the result of pressure placed on employees to achieve specific results, or a tone of lawlessness set by those in control? Along those lines, consideration will also be given to where in the organization the misconduct occurred and to how high up in the chain of command there was knowledge of or participation in the misconduct. The effect of any proposed regulatory action on public policy concerns will also be addressed in deciding whether to commence an action against a firm, as well as how much harm the misconduct inflicted on investors.

The NASAA Report makes clear that a firm's cooperation and proactive steps as outlined will not necessarily absolve firms from responsibility or liability or preclude the initiation of any enforcement action. Moreover, as noted at the outset, NASAA member jurisdictions may choose in the sole discretion whether or not to take the principal considerations into account. However, it is plain that meaningful self-policing and self-reporting is seen as an important

adjunct to Blue Sky regulatory authority and that the desired "culture of compliance" in an organization should be acknowledged and rewarded.

FOOTNOTES:

(n1)Footnote 1. NASAA Reports (CCH) P 8512 (Sept. 2005) (the "NASAA Report").



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CHAPTER 15 Civil Remedies

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CHAPTER 15 Civil Remedies

2-15 Blue Sky Regulation § 15.01

§ 15.01 Introduction

In the preceding chapter the considerable enforcement authority of state securities administrators was considered in detail. Major enforcement initiatives spearheaded by state regulators into such areas as securities analyst conflicts of interest and nationwide promissory note investment scams have demonstrated the vitality of Blue Sky regulation in the post-NSMIA era. Nevertheless, private civil remedies have always been an important part of the Blue Sky regulatory scheme, and the civil liability provisions in state securities laws play a major role in accomplishing investor protection goals by affording remedies for fraud and other misconduct that are more easily achieved than common law actions. The basic rescission and damage remedies that are part of every state securities law are markedly preferable to what is otherwise available as a matter of the common law. This chapter explores the scope and elements of civil liability and remedies available under these provisions.

Only New York has no civil remedy of any kind. New York's Martin Act, with an exception for real estate and theatrical syndications and intrastate issues, provides for liability based almost exclusively on fraud, and empowers only the Attorney General to bring actions.ⁿ¹ There is no private civil remedy unless one could be judicially implied. Although historically several courts recognized an implied private right of action under the Act for purchasers or sellers injured by securities fraud,ⁿ² the New York Court of Appeals held in *CPC International, Inc. v. McKesson Corp.* that "there is no private right of action to enforce the provisions of § 352-c"ⁿ³ and concluded that "an implied private action is not consistent with the legislative scheme underlying the Martin Act."ⁿ⁴ Courts have further recognized the preemptive impact of the Martin Act on various common law claims based upon conduct that falls within the scope of the Martin Act and the Attorney General's exclusive enforcement authority. The extremely broad fraud provisions in the Act may be violated without proof of scienter, or proof of intent to defraud.ⁿ⁵ Causes of action related to an individual plaintiff's securities fraud claim such as negligence or breach of fiduciary duty, which do not include scienter as an essential element, are deemed preempted by the Act in contrast to a claim requiring intent, such as a claim for common law fraud. Claims of negligent misrepresentation, negligence and breach of fiduciary duty have all been held to be preempted by the Martin Act.ⁿ⁶ Given the sole authority of the Attorney General to investigate securities violations, to permit a private plaintiff to go forward on any securities-related claim not involving proof of deceitful intent would in the eyes of these courts effectively permit a private right of action under the Martin Act.ⁿ⁷ Courts will also guard against "backdoor" private causes of action to enforce the Martin Act.ⁿ⁸

However, the Martin Act does not preempt claims of common law fraud resting on the same facts that would support a Martin Act violation as long as they are sufficient to satisfy traditional rules of pleading and proof.ⁿ⁹ In *Kramer v.*

W10Z/515 Real Estate Limited Partnership,ⁿ¹⁰ the court explained:

When a plaintiff pleads all the elements of fraud with particularity, no end run around the Martin Act would be entailed by granting the plaintiff an opportunity to prove the truth of the allegations. But to throw the plaintiff out of court merely because the Attorney General would be entitled to relief under the Martin Act on the strength of the same allegations, or a subset of those allegations, makes no sense. The Martin Act, of course, "was enacted to protect the public from fraudulent exploitation" ... and "has a broad remedial purpose to protect the public interest... ." To construe the Martin Act to have abolished the right of purchasers of condominium and cooperative interests (and purchasers of other securities) to sue sellers for common-law fraud is to give the Martin Act a construction that is antithetical to its remedial purpose. Nor does anything in the text of the Martin Act lend any support to such a construction.ⁿ¹¹

In states other than New York, which have express civil liability provisions in their Blue Sky laws, the question arises whether there may be any further implied causes of action for violations. For that analysis, the focus most often turns to paragraph (h) of Section 410 of the Uniform Act and those states that have adopted it, with or without the final clause: "[b]ut this act does not create any cause of action not specified in this section or section 202(e)." This clause was added to the Uniform Act specifically to exclude implied liability under the Blue Sky law,ⁿ¹² and the provision was carried into the 2002 Uniform Act.ⁿ¹³ The express, statutory rights of action are thus intended to provide the exclusive cause of action.

In states with an express civil liability provision that is silent as to whether the rights and remedies under the Blue Sky law are in addition to those at law or in equity,ⁿ¹⁴ it may be possible to imply a private right of action for violation of particular provisions of the Blue Sky law. However, to do so requires application of principles that have long governed the implication of private rights of action under the federal securities laws, not the least of which today is that there be a manifest intent of the legislature to allow such a remedy where none is expressly provided.ⁿ¹⁵

Civil liability and remedies under Blue Sky laws may be impacted by the National Securities Market Improvements Act, ("NSMIA"),ⁿ¹⁶ which amended section 18 of the Securities Act of 1933 and other federal statutes regulating the securities industry by providing for limited preemption of state Blue Sky laws. The legislation preempts state authority to require registration of "federal covered securities" and limits state regulation of securities disclosure documents and certain intermediaries. However, the states retain their authority to bring enforcement actions with respect to "fraud or deceit" or "unlawful conduct by a broker or dealer."ⁿ¹⁷

Private remedies to redress securities violations are not directly addressed by NSMIA. However, derivative or implied rights of action that are based upon violations of state securities law provisions that are preempted are necessarily also preempted. Accordingly, a civil action derived from a proscribed state regulation of covered securities or intermediaries would be unenforceable for lack of the requisite underlying violation. Against this backdrop, the private remedy provisions of state securities laws are considered further below.

FOOTNOTES:

(n1)Footnote 1. See N.Y. Consol. Laws ch. 20, art. 23-A, §§ 352-e, 359-ff.

(n2)Footnote 2. *Halle & Stieglitz v. Kolen*, 180 N.Y.L.J. 6, 7 (July 31, 1978) ; *Bosee v. Babcock Int'l, Inc.*, 65 A.D.2d 727, 410 N.Y.S.2d 1008 (1978) . See *Condec Corp. v. Farley*, 578 F. Supp. 85 , CCH Blue Sky L. Rep., '82-84 Decisions, at P 71,861 (S.D.N.Y. 1983), in which the court notes by analogy to federal securities law that "private action may be a necessary supplement to public enforcement." See also *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112 (S.D.N.Y. 1974) .

(n3)Footnote 3. *CPC International, Inc. v. McKesson Corp.*, 70 N.Y.2d 268, 519 N.Y.S.2d 804, 514 N.E.2d 116

(1987) ; *Revak v. SEC Realty Corp.*, 18 F.3d 81 (2d Cir. 1994) ; *RTC v. Diamond*, 18 F.3d 111 (2d Cir. 1994) ; *Pahmer v. Greenberg*, 926 F. Supp. 287 (E.D.N.Y. 1996) ; *Perlman v. Salomon Inc.*, 1995 U.S. Dist. LEXIS 3188 (S.D.N.Y. March 10, 1995) ; *Whitehall Tenants Corp. v. Estate of Olnick*, 213 A.D.2d 200, 623 N.Y.S.2d 585 (1st Dep't 1995) ; *Breakwaters Townhomes Ass'n v. Breakwaters of Buffalo*, 207 A.D.2d 963, 616 N.Y.S.2d 829 (4th Dep't 1994) ; *Rego Park Gardens Owners, Inc. v. Rego Park Gardens Assocs.*, 191 A.D.2d 621, 595 N.Y.S.2d 492 (2d Dep't 1993) .

(n4)Footnote 4. *CPC International, Inc. v. McKesson Corp.*, 70 N.Y.2d 268, 519 N.Y.S.2d 804, 514 N.E.2d 116 (1987) . The court invited the New York Legislature to amend the Act to create an express private right of action to provide remedies for defrauded investors. The Legislature has so far declined.

(n5)Footnote 5. *People v. Federated Radio Corp.*, 244 N.Y. 33, 244 N.Y.S. 33, 154 N.E. 655 (1926) . *See also State v. Sonifer Realty Corp.*, 212 A.D.2d 366, 367, 622 N.Y.S.2d 516 (1st Dep't 1995) ("[T]he fraudulent practices targeted by the statute need not constitute fraud in the classic common law sense, and reliance need not be shown in order to obtain relief.") (citing *People v. Royal Sec. Corp.*, 5 Misc. 2d 907, 165 N.Y.S.2d 945, 909 (Sup. Ct. New York County 1955)) ; *People v. Barysh*, 95 Misc. 2d 616, 408 N.Y.S.2d 190, 193 (Sup. Ct. New York County 1978) (holding that the Martin Act does not require reliance or scienter).

(n6)Footnote 6. *See Sedona Corporation v. Ladenburg Thalmann & Co., Inc.*, 2005 U.S. Dist. LEXIS 16382 (S.D.N.Y. Aug. 8, 2005) (dismissing common-law claims sounding in negligence and breach of fiduciary duty); *Dujardin v. Liberty Media Corp.*, 359 F. Supp. 2d 337 (S.D.N.Y. 2005) (dismissing a negligent misrepresentation claim as preempted by the Martin Act); *Marcus v. Frome*, 329 F. Supp. 2d 464, 475-476 (S.D.N.Y. 2004) (same); *Gabriel Capital, L.P. v. NatWest Fin., Inc.*, 137 F. Supp. 2d 251 (S.D.N.Y. 2000) (dismissing a negligence claim); *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171 (2d Cir. 2001) (upholding dismissal of a breach of fiduciary duty claim pursuant to the Martin Act); *Heller v. Goldin Restructuring Fund, L.P.*, 590 F. Supp. 2d 603 (S.D.N.Y. 2008) (same).

(n7)Footnote 7. *Dujardin v. Liberty Media Corp.*, 359 F. Supp. 2d 337, 355 (S.D.N.Y. 2005) . *But see Scalp & Blade, Inc. v. Advest, Inc.*, 281 A.D.2d 882, 722 N.Y.S.2d 639, 640 (4th Dep't 2001) ("Nothing in the Martin Act ... precludes a plaintiff from maintaining common-law causes of action based on such facts as might give the Attorney General a basis for proceeding civilly or criminally against a defendant under the Martin Act."); *Cromer Fin. Ltd. v. Berger*, 2001 U.S. Dist. LEXIS 14744 (S.D.N.Y. Sept. 19, 2001) (Nothing in the Martin Act indicates an intention to abrogate common law causes of action. However, these decisions were characterized in *Nanopierce Techs., Inc. v. Southridge Capital Mgmt. LLC*, 2003 U.S. Dist. LEXIS 15206 (S.D.N.Y. Sept. 2, 2003) , as "solitary islands in a stream of contrary opinion.").

(n8)Footnote 8. *See, e.g., Kerusa Co. LLC v. W10Z/ 515 Real Estate Limited Partnership*, 12 N.Y.3d 236, 879 N.Y.S.2d 17, 906 N.E.2d 1049 (2009) . In *Kerusa*, the New York Court of Appeals concluded that plaintiff's action would expand the already detailed disclosure requirements of the Martin Act, and base fraud claims on alleged omissions from filings required by the Martin Act and the Attorney General's implementing regulations. Merely alleging the elements of common law fraud, said the Court, does not transmute a prohibited private cause of action to enforce Martin Act disclosure requirements into an independent common law tort.

(n9)Footnote 9. *Hamlet on Olde Oyster Bay Home Owners Association, Inc. v. Holiday Organization, Inc.*, 59 A.D.3d 673, 874 N.Y.S.2d 508 (2d Dep't 2009) .

(n10)Footnote 10. 44 A.D.3d 457, 844 N.Y.S.2d 18 (1st Dep't 2007) .

(n11)Footnote 11. *Kramer v. W10Z/ 515 Real Estate Ltd. Partnership*, 44 A.D.3d 457, 459-460, 844 N.Y.S.2d 18 (1st Dep't 2007) (citations omitted). *See also Caboara v. Babylon Cove Development, LLC*, 54 A.D.3d 79, 862 N.Y.S.2d 535 (2d Dep't 2008) (common law fraud and breach of contract claims were not preempted by the Martin Act where the complaint was sufficient to state causes of action, and thus the allegations were not mere "artful pleading" to avoid preemption).

(n12)Footnote 12. See Official Code Comment to Uniform Securities Act § 410(h); see also Note, *Express and Implied Civil Liability Provisions in State Blue Sky Laws*, 17 Case W. Res L. Rev. 1173, 1194 (1966): "It is entirely clear that the draftsmen of the Uniform Act intended that the doctrine of implied liabilities should not be applied under the Act."

(n13)Footnote 13. Unif. Sec. Act § 509(m) (2002).

(n14)Footnote 14. These jurisdictions include: Illinois, Montana, New York, and Washington. See also *Ainsworth v. Skurnick*, 960 F.2d 939, [1991-1992 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,620 (11th Cir. 1992), cert. denied, 507 U.S. 915, 113 S. Ct. 1269, 122 L. Ed. 2d 665 (1993) (punitive damages recoverable in addition to other remedies); *Gochnauer v. A.G. Edwards & Sons, Inc.*, 810 F.2d 1042 (11th Cir. 1987) (Florida Blue Sky law did not "co-opt the existence of separate claims under state fiduciary principles"); *Vogel v. A.G. Edwards & Sons*, 801 S.W.2d 746 (Mo. Ct. App. 1990) (federal claim of "churning" or excessive trading to generate commissions against brokerage firm employee concurrently stated breach of fiduciary duty claim under state law); *Merchant v. Oppenheimer & Co., Inc.*, 568 F. Supp. 639 (E.D. Va. 1983), aff'd, *Dixon v. Oppenheimer*, 739 F.2d 165 (4th Cir. 1984) (contract action maintainable).

(n15)Footnote 15. See *Wade v. Skipper's, Inc.*, 915 F.2d 1324, 1329-1332 (9th Cir. 1990) (language of Washington state securities act indicated that legislature did not intend to impose civil liability beyond bounds of express provision), relying on *Ludwig v. Mutual Real Estate Investors*, 18 Wn. App. 33, 567 P.2d 658 (1977). The Washington court refused to imply a private right of action for damages for violation of an antifraud provision of the Washington Blue Sky law without resort to the civil liability provision of the Blue Sky law. In the absence of the equivalent of Uniform Act § 410(h) from the Washington civil liability provision, the court stated: "While our legislature did not choose to incorporate section 410(h) into the Washington Securities Act, we do not think this omission is of sufficient significance to overcome the comprehensiveness and apparent intended exclusiveness of the remedies that are specified." 18 Wn. App. 33, 567 P.2d 658, 663, n.8 (1977).

(n16)Footnote 16. Pub. L. No. 104-290, 110 Stat. 3416 (codified as amended in scattered sections of 15 U.S.C.).

(n17)Footnote 17. See Chapter 5, *Securities Registration*, above.

See also *Zuri-Invest AG v. Natwest Fin. Inc.*, Fed. Sec. L. Rep. (CCH) 91630, 2001 U.S. Dist. LEXIS 17495 (S.D.N.Y. Oct. 26, 2001). While NSMIA precluded states from regulating any national offering of securities, there was no indication that statute was intended to preempt state fraud actions, since it did not provide any civil liability or enforcement provisions and did not amend statutes providing that the federal remedy was in addition to other remedies. The court concluded that claims for common law fraud did not interfere with regulatory provisions of NSMIA and were consistent with the objective of federal securities law to deter fraud.



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Blue Sky Regulation

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CHAPTER 15 Civil Remedies

2-15 Blue Sky Regulation § 15.02

§ 15.02 Statutory Civil Remedies

With the exception of New York, which provides no private civil remedy, Blue Sky laws universally provide a statutory remedy of rescission, or to recover damages as a rescission equivalent, in a transaction which involves a violation of registration or intermediary licensing provisions, or which involves fraud or deception. This principal statutory remedy in Blue Sky laws may include a particular culpability element. For the most part, however, there is strict liability for a seller (and in several states a purchaser as well) in a transaction which violates the law. The statute of limitations is always a consideration, and there are defenses applicable in regard to non-sellers or others against whom joint and several liability may be imposed. On balance, however, the basic statutory remedy in Blue Sky laws involves no substantial obstacles, and is a much easier remedy to obtain in comparison to alternatives in common law or equity. In this section, the baseline remedy available under Blue Sky laws is discussed, and the scope of that remedy as, for example, to include punitive damages or other elements of loss or expense, is likewise presented.

[1] Purchasers and Sellers

The central statutory right of action in Blue Sky laws is that provided for a purchaser of a security to sue persons who "sell" the security, to obtain rescission of the purchase, or damages as a rescission equivalent, along with interest, costs, and attorneys fees. Based on what is today section 12(a) of the federal Securities Act of 1933,ⁿ¹ the basic right of action in state securities laws is triggered when an offer or sale of a security is made in violation of the law. Although "violation" may be more broadly or specifically defined in some Blue Sky laws, the basic statutory right of action addresses violations of: (1) securities registration requirements; (2) antifraud provisions;ⁿ² and (3) broker-dealer and agent licensing requirements. Thus, as prescribed by section 410(a) of the original Uniform Securities Act:

(a) Any person who

(1) offers or sells a security in violation of section 201(a) [Broker-Dealer and Agent Registration], 301 [Securities Registration], or 405(b) [Unlawful Representation Concerning Registration or Exemption], or of any rule or order under section 403 [Filing Sales Literature] which requires the affirmative approval of sales literature before it is used, or of any condition imposed under section 304(d), 305(g), or 305(h), or

(2) offers or sells a security by means of any untrue statement of a material fact or any omission 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 (the buyer not knowing of the untruth or omission), and who does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission, is liable to the person buying the security from him, who may sue either at law or in equity to recover the consideration paid for the security, together with interest at six percent per year from the date of payment, costs, and reasonable attorneys' fees, less the amount of any income received on the security, upon tender of the security, or for damages if he no longer owns the security.

The same civil remedy is carried into section 509 of the 2002 Uniform Securities Act, except that it has been expanded to also include a statutory right of action for a defrauded *seller* of a security to recover from the purchaser.ⁿ³ While the majority of states still limit the statutory right of action to purchasers,ⁿ⁴ the expanded 2002 Uniform Act provision reflects a more modern and broader view of antifraud remedies that extends protection to both defrauded purchasers and sellers. The broader statutory right of action that is now part of the 2002 Uniform Act is, of course, made a part of the Blue Sky laws of those several states that have adopted the Act.ⁿ⁵ Other states have done so as well.ⁿ⁶ Where a right of action is provided for a seller against a purchaser, the statutes also extend joint and several liability to control persons and others who materially aid or participate in the conduct giving rise to liability.ⁿ⁷

The statutory rights of action for purchasers, or sellers, addressing fraud in Blue Sky laws typically contain specific elements or defenses, not the least of which is a "reasonable care" defense. For other violations, however, subject to the applicable statute of limitations, there is strict liability. There is no defense in Blue Sky laws to a statutory claim based upon the sale of unregistered, non-exempt securities. Likewise, there is strict liability on the face of Blue Sky laws for the sale of a security by an unregistered broker-dealer or agent. Liability under these provisions in connection with the sale of securities must, of course, fall upon one who is held to be a "seller," or who falls within another statutory category of liable persons. The *scope* of strict liability is thus constrained by the requirement for some degree of culpability where a non-seller or secondary actor is involved.

In some states, the basic private civil remedy for purchasers is triggered in a transaction in which the seller violates *any* provision of the state Blue Sky law. These states commonly provide that any sale or contract of sale made "in violation" of the Blue Sky law is voidable at the election of the purchaser, who may then sue to recover from the seller.ⁿ⁸ The breadth of such provisions was criticized by drafters of the original Uniform Securities Act for several reasons. First, the seller has to search every substantive provision of a typically complicated statute before he or she knows whether the contract or sale is voidable. Secondly, there are so many substantive provisions, and they are often so technical, that voiding a substantial contract sometimes seems to be a remedy out of all proportion to the seriousness of the violation. The drafters questioned why, for example, a sophisticated buyer should be able to recover the purchase price from the seller when the market generally has gone down just because the buyer later discovers that the seller filed a required report a day late.ⁿ⁹ In some instances, this concern has been addressed by provisions requiring that the "violation" upon which a claim is based be one that materially affects the protection contemplated by the violated provision.ⁿ¹⁰ However, without such a statutory basis for limiting liability, any sale made "in violation" will make a transaction voidable against the seller, provided the claim is brought within the applicable statute of limitations.

The sale of unregistered, non-exempt securities is a specific ground for private civil action in almost all states.ⁿ¹¹ The vitality of civil remedies under Blue Sky laws in these circumstances is well illustrated by the 2005 Alabama Supreme Court decision in *Buist v. Time Domain Corp.*,ⁿ¹² in which the Court held that civil liability claims made under the Alabama securities law arising out of transactions alleged to be exempt by Rule 506 of Regulation D under the federal Securities Act of 1933, and thus federal "covered securities" were not preempted by NSMIA. Because no evidence had been presented that the subject sales of securities were actually made in compliance with Rule 506 of Regulation D, the transactions could not be deemed to be exempt and preempted from state regulation under NSMIA. They were thus

subject to application of the registration requirements of the Alabama securities law.ⁿ¹³ Likewise, most states provide for civil liability when sales are made by unregistered broker-dealers or agents.ⁿ¹⁴

In sum, although even among Uniform Act states there is some variation, the array of "violations" for which the basic statutory private right of action by purchasers may be brought against "sellers" include the following:

- (1) acting as broker-dealers, agents, or investment advisers without registration;ⁿ¹⁵
- (2) selling unregistered securities for which no exemption is available;ⁿ¹⁶
- (3) representing that registration constitutes approval by the administrator of any person, security, or transaction;
- (4) failing to file with the administrator any advertising or sales literature that may be required;ⁿ¹⁷
- (5) selling securities without submitting a prospectus to purchasers in accordance with rules of the administrator;ⁿ¹⁸
- (6) failing to comply with escrow conditions that the administrator may order in connection with securities sold to promoters at a price less than the public offering price or sold for consideration other than cash;ⁿ¹⁹ and
- (7) failing to comply with the form of sales contract for the sale of securities as required by the administrator.

That a private civil action is not specifically allowed under a state's Blue Sky law does not necessarily mean that an injured party is precluded from bringing suit. As noted earlier, Uniform Securities Act § 410(h) provides: "The rights and remedies provided by this act are in addition to any other rights or remedies that may exist at law or in equity, but this act does not create any cause of action not specified in this section or section 202(e)." This provision continues as section 509(m) of the 2002 Uniform Act, and in one form or another is included in virtually all Blue Sky laws.ⁿ²⁰ Remedies at common law or in equity are specifically discussed further in section 15.03.

A caveat in the application of statutory rights of action in Blue Sky laws is that NSMIA may preempt all or some actions arising out of transactions involving federal covered securities. Certainly to the extent that the Blue Sky law of a state imposes civil liability or allows a right of action for registration-related violations of the law, the NSMIA preemption of state registration requirements for federal covered securities necessarily extinguishes any private remedy under those provisions where federal covered securities are involved.ⁿ²¹ NSMIA does not, however, preempt the operation of antifraud provisions in Blue Sky laws, and to the extent that violations of Blue Sky laws are defined in antifraud terms or arise under antifraud provisions, there is no NSMIA preemption regardless of the character underlying security or transaction. Any such action arising out of a transaction involving a federal covered security is nevertheless likely to be challenged on federal preemption grounds. Moreover, as discussed in Chapter 12, to the extent that any action is brought under Blue Sky antifraud provisions as a class or "mass" action, the Securities Litigation Uniform Standards Act (SLUSA)ⁿ²² will operate to preempt it if federal covered securities are involved and the claims are based on alleged false or misleading disclosures or fraud generally in the offer and sale of the securities.

The scope of civil liability under statutory rights of action in Blue Sky laws is expanding in terms of remedies available. Most often the attention on statutory rights of action is focused on the right to rescission, or to damages as a rescission equivalent, that is the common private right of action in state laws and which is rooted in the Uniform Act. Broader civil liability provisions in some Blue Sky laws today extend in many instances to investment advisers or "financial planners." Remedies may also include rights to obtain private injunctive and other equitable relief.ⁿ²³ Statutory civil

remedies provided in many states for clients of investment advisers are discussed below.

[2] Advisory Clients

All states but one (Wyoming) impose licensing or registration requirements on investment advisers and investment adviser representatives who meet certain business activity threshold criteria. Investment advisers who are registered with the SEC under the federal Investment Advisers Act of 1940 need not be licensed, as such, and make only "notice" filings in states in which they do business. Investment adviser representatives, however, must be registered or licensed in each state in which they meet the threshold business activity criteria, regardless of whether the investment adviser itself is subject to state registration or licensing.ⁿ²⁴ In addition to licensing requirements, states impose particular antifraud and business conduct requirements on investment advisers and representatives. In the enforcement of all elements of state regulation of these intermediaries, many states provide a specific statutory civil remedy for advisory clients. Thus in Ohio, for example, a specific civil remedy is prescribed as follows:

Whoever acts as an investment adviser or investment adviser representative in violation of Chapter 1707 of the Revised Code shall be liable for damages resulting from the violation in an action at law in a court of competent jurisdiction. Damages may include consideration paid for the advice, any loss due to the advice, and all court costs, less the amount of any income received from the advice. No person may bring an action under this division more than five years after the rendering of investment advice or two years after discovery of facts constituting the violation, whichever is the shorter period.ⁿ²⁵

The 2002 Uniform Securities Act likewise expressly imposes civil liability on unregistered investment advisers and investment adviser representatives, as well as liability for investment advice involving fraud.ⁿ²⁶ These specific civil liability provisions applicable to investment advisers and investment adviser representatives are important because the basic civil liability provisions in Blue Sky laws discussed earlier address the right of purchasers of securities to sue sellers, and to obtain rescission of a transaction or damages as a rescission equivalent. Specific investment adviser and investment adviser representative liability is not predicated on a transaction, and no "seller" must be present. While it is true that in some circumstances an investment adviser or investment adviser representative may be deemed to be a "seller" or a person who materially aids or participates with a seller in a sale that violates the Blue Sky law, in many instances the role of the adviser may not be connected to an unlawful sale. Moreover, one who engages in investment advisory activities in violation of licensing or registration requirements in a particular state, but who is not a "seller" of securities in an unlawful transaction will not face liability under the basic civil liability provision simply by reason of being unlicensed. The statutory right of action for advisory clients to sue advisers who violate licensing or antifraud provisions thus provides a civil remedy that in many instances would not exist.

Civil remedies provided expressly for advisory clients broaden the range of protection under Blue Sky laws. However, they also impose certain logical limits on the scope of liability of investment advisers and investment adviser representatives. There is in many provisions, for example, a culpability, or "willfulness," element.ⁿ²⁷ Additionally, damages are generally limited to those resulting from the actual violation by the adviser or representative. Broad recovery of investment losses may or may not be within the scope of liability that permits recovery of actual damages resulting from a violation. These are issues to be addressed on a case-by-case basis. However, it is clear that damage causation plays a greater role in liability assessments under specific advisory client remedy provisions than with the basic purchaser or seller rescission provisions in Blue Sky laws.

[3] Standing

[a] Generally

The common civil liability provisions in Blue Sky laws are derived from section 410 of the Uniform Securities Act, which provides that any person who offers or sells a security in violation of registration or broker-dealer and agent licensing provisions or who offers or sells a security by means of any untrue or materially misleading statement is

liable:

to the person buying the security from him, who may sue either at law or in equity to recover the consideration paid for the security, together with interest at six percent per year from the date of payment, costs, and reasonable attorneys' fees, less the amount of any income received on the security, upon tender of the security, or for damages if he no longer owns the security.ⁿ²⁸

Modern variations of the original Uniform Act civil liability provision, as best illustrated by section 509 of the 2002 Uniform Securities Act, have added a provision for civil remedy of a purchaser to a seller in a transaction involving a false or materially misleading statement. The remedy is the same, namely, rescission of the transaction upon tender of the purchase price back to the seller, or actual damages.ⁿ²⁹ However, the essential predicate in both situations is that there is an actual transaction.ⁿ³⁰ Whether in a particular state Blue Sky law the remedy is available to just purchasers or also to defrauded sellers, the key event is obviously a transaction. Even as extended to unregistered broker-dealers or agents,ⁿ³¹ liability and the civil remedy are predicated on a sale or purchase of a security in which the unlicensed intermediary is involved. And the extension of liability to controlling persons or others who materially aid or participate in conduct giving rise to liabilityⁿ³² is likewise anchored in an actual transaction in which there is a culpable seller or, where addressed, a purchaser.

These provisions do not create a general remedy for conduct that violates a Blue Sky law. They do not, for example, provide a civil remedy against unregistered investment advisers or investment adviser representatives who do not actually sell a security or sufficiently participate with a seller in an actual transaction. To be sure, many states, and the 2002 Uniform Act, now include specific civil liability and remedy provisions for the benefit of clients of unregistered advisers,ⁿ³³ but these are separate remedies with their own elements and specifications as to permitted recovery. They are not predicated on a sale or purchase of a security made in violation of the Blue Sky law.ⁿ³⁴

In some non-Uniform Act states the basic civil liability provision is worded to provide that "any sale or contract of sale made in violation" of the Blue Sky law is voidable, and thus subject to rescission or damages as a rescission equivalent. In Ohio, for example:

[E]very sale or contract of sale made in violation of Chapter 1707 of the Revised Code, is voidable at the election of the purchaser. The person making such sale or contract for sale, and every person that has participated in or aided the seller in any way in making such sale or contract of sale, are jointly and severally liable to the purchaser.ⁿ³⁵

Clearly, however, this does not change the transactional focus of civil liability and the remedy for a *purchaser*. A sale or contract of sale must still be made in violation of the law. Persons who solicit or play a meaningful role in bringing about the sale or contract of sale may fall within the scope of liability, but the essential element is that the resulting transaction violated the Blue Sky law.

While it is manifest on the face of the basic civil liability provisions in Blue Sky laws that standing to assert them must be based on an actual purchase or sale transaction, it is also true that Blue Sky laws do not provide the only remedies under state or common law for aggrieved investors seeking redress for alleged fraud or fraudulent conduct. All states provide for survival of other rights or remedies that may exist at law or in equity.ⁿ³⁶ The phenomenon of "holder" claims in state courts emerged as plaintiff investors sought recovery under common law theories alleging that material misrepresentations or omissions caused them to retain ownership of securities that they acquired prior to the alleged wrongdoing. "Holder" claims are not made under Blue Sky laws for the obvious reason discussed above that there is no transaction connected to the alleged wrongdoing. The antifraud provisions in Blue Sky laws are broad, but civil liability for fraud or fraudulent conduct under them has a transactional predicate. Nevertheless, because "holder" claims are being asserted in state courts under other provisions of state and common law, it is important that they be considered and understood as part of the overall picture of civil liability for conduct addressed in Blue Sky laws. These emergent

claims and the manner in which they have been treated, are discussed below.

[b] "Holder" Claims

As the previous discussion makes clear, with the exception of provisions specifically aimed at intermediaries such as investment advisers, the civil liability provisions of state securities laws all have a transactional focus. They protect actual purchasers of securities, and in some states defrauded sellers. Violations of registration or qualification requirements are addressed by civil remedies for rescission of an unlawful transaction. The transactional focus of Blue Sky civil remedies precludes "holder" actions. A "holder" action is one in which the plaintiff alleges that material misrepresentations or omissions caused him or her to retain ownership of securities that were purchased prior to the alleged wrongdoing. While "holder" claims may not be asserted under Blue Sky statutory civil liability provisions, all Blue Sky laws preserve other state and common law remedies. As noted earlier, section 509 of the 2002 Uniform Securities Act, which tracks section 410 of the original Uniform Act, preserves the "rights and remedies that exist at law or in equity."ⁿ³⁷ Thus, to the extent that "holder" claims may be recognized as a matter of other state or common law remedies, such claims are not precluded by the existence of specific transaction-based remedies in the Blue Sky law.

Under the federal securities laws, the U.S. Supreme Court held over a quarter century ago in *Blue Chip Stamps v. Manor Drug Stores* ⁿ³⁸ that because of the inherent difficulty in proving reliance and damages in such actions, holders of securities are not entitled to sue under section 10(b) of the Securities Exchange Act of 1934, and SEC Rule 10b-5 adopted under it. The Court cited several policy reasons that weighed against a claim that would rely largely on a plaintiff's oral version of the facts, and which is not verifiable by documentation. Allowing such a claim, said the Court, would encourage frivolous and vexatious litigation that would be difficult to resolve on the merits without a trial.ⁿ³⁹

As a matter of state law, although it is settled that purchaser or (where available) seller status is necessary to invoke unlawful transaction civil remedies under Blue Sky laws, state courts have not widely addressed the question whether "holder" claims by investors might be maintained under common law fraud or fiduciary duty theories. Applying Connecticut law, a federal court rejected a common law claim for damages by plaintiffs who alleged that they had failed to sell stock or to hedge their position as a result of misconduct. The claim was rejected as too speculative, with the court further observing that holder claims violate the "established principle that a plaintiff cannot recover profits which might have been realized if he had not been deceived, unless there is evidence by which such profits can be estimated with reasonable certainty."ⁿ⁴⁰ Other courts have relied on principles of loss causation to reject holder claims. These courts concluded that persons who hold securities during an alleged fraud are unable to plead that the misrepresentations caused their loss.ⁿ⁴¹ A Delaware state court dismissed a putative class action brought on behalf of holders of securities alleging violations of Delaware law because of the impossibility of proving reliance.ⁿ⁴²

Where "holder" claims have been permitted to stand, courts have imposed heightened pleading standards, and have required plaintiffs to allege specific reliance on alleged misrepresentations by defendants. In *Small v. Fritz*,ⁿ⁴³ for example, the California Supreme Court found that a class action "holder" claim could be stated under California law, provided that the class could meet a heightened standard for pleading reliance. The Court held:

In a holder's action a plaintiff must allege specific reliance on the defendants' representations: for example, that if the plaintiff had read a truthful account of the corporation's financial status the plaintiff would have sold the stock, how many shares the plaintiff would have sold, and when the sale would have taken place. The plaintiff must allege actions, as distinguished from unspoken and unrecorded thoughts and decisions, that would indicate that the plaintiff actually relied on the misrepresentations. Plaintiffs who cannot plead with sufficient specificity to show a bona fide claim of actual reliance do not stand out from the mass of stockholders who rely on the market... . Such persons cannot bring individual or class actions for fraud or misrepresentation.ⁿ⁴⁴

These issues inherent in "holder" claims are particularly acute for purported class actions, where heightened pleading

requirements for reliance are virtually impossible to meet.ⁿ⁴⁵ They are more easily handled in individual actions, however. In a case applying New York and New Jersey law, for example, common law claims by individual holders were permitted to proceed where there were allegations of direct communications and specific reliance.ⁿ⁴⁶ The court found that an individual plaintiff may state a common law fraud claim against a defendant whose misrepresentations caused the plaintiff to hold securities which plaintiff otherwise would have sold. The plaintiffs alleged repeated, face-to-face contact with the defendants during which the defendants made verbal and written misrepresentations. This was a critical consideration for the court, which explained:

One critical feature of the present case is generally absent from the securities market as described in *Blue Chips Stamps*. Plaintiffs had direct dealings with defendants in which the latter made certain of the representations complained of. This case is, therefore, an "ordinary case of deceit" as characterized by the Supreme Court in that defendants made representations directly to plaintiffs. Such a case could not be brought by anyone who happened to own Howard stock at any time from April to December 1989.ⁿ⁴⁷

A Texas appeals court likewise found that individual holder claims could be brought under Texas common law when the misrepresentations were made in direct face-to-face or telephone conversations, and where the plaintiffs alleged that they had a specific plan to sell their shares on a certain date.ⁿ⁴⁸ The court made clear that there would always be a very narrow pool of plaintiffs who could satisfy requirements for holder claims. One factor of particular note here was that the plaintiff holders were the largest individual shareholders of the defendant company.

Although "holder" claims, to the extent they are recognized, have no transactional barrier to *standing* in the manner that civil remedy provisions in Blue Sky laws are limited, it is also clear that a "holder" claim must effectively be linked to an actual intended transaction that did not occur but for the alleged misconduct. Investor claims based on fraud or deception necessarily spring from an investment decision. A decision to "hold" a security may qualify when it is in fact a decision that is causally connected to the alleged wrongdoing. As seen above, the pleading requirements, and ultimate elements of proof, assure that if a holder claim is permitted, it will be based on a virtual transaction.

[4] Rescission or Damages

[a] Generally

Under the Uniform Act, the plaintiff in a private civil action may sue to rescind the sale of the securities that he or she purchased, or sue for damages if he or she no longer owns the security. In either case, the purchaser is permitted:

[t]o recover the consideration paid for the security, together with interest at six percent per year from the date of payment costs, and reasonable attorneys' fees, less the amount of any income received on the security, upon the tender of the security, or for damages if he no longer owns the security.ⁿ⁴⁹

This provision has been adopted in many states,ⁿ⁵⁰ although there are variations. The most common variation is in the level of recoverable interest,ⁿ⁵¹ but a few statutes are silent on the recoverability of attorneys' fees.ⁿ⁵² Some states do not say whether costs are recoverable. In some states that allow actions for rescission or damages,ⁿ⁵³ as under the Uniform Act, interest is recoverable either upon the amount of interest due on the security, if it is an interest bearing obligation, or upon a statutory amount, if the security is non-interest bearing.ⁿ⁵⁴ These states provide for recovery of costs and reasonable attorneys' fees.

In other states, the only recourse is an action for rescission.ⁿ⁵⁵ In these states, plaintiff must retain possession of the securities so that they can be returned. An action for damages alone is not permitted. However, as illustrated by Illinois, although an action for damages is not permitted, a modified rescission remedy is allowed for purchasers who have disposed of the securities. The remedy is for damages, but only as a rescission equivalent.ⁿ⁵⁶ The equivalent amount recoverable in most of these states is the full amount paid for the securities (less any income received thereon), interest, costs, and reasonable attorneys' fees.ⁿ⁵⁷ The amount of interest recoverable on interest bearing obligations is the

amount specified in the obligation; for all other securities, recoverable interest is at a statutory annual rate.ⁿ⁵⁸ Section 509 of the 2002 Uniform Act, which forms the basis for civil liability provisions in an increasing number of states, more completely sets the parameters of the basic right of action for rescission or damages:

(b) **[Liability of seller to purchaser.]** A person is liable to the purchaser if the person sells a security in violation of Section 301 or, by means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statement made, in light of the circumstances under which it is made, not misleading, the purchaser not knowing the untruth or omission and the seller not sustaining the burden of proof that the seller did not know and, in the exercise of reasonable care, could not have known of the untruth or omission. An action under this subsection is governed by the following:

(1) The purchaser may maintain an action to recover the consideration paid for the security, less the amount of any income received on the security, and interest [at the legal rate of interest] from the date of the purchase, costs, and reasonable attorneys' fees determined by the court, upon the tender of the security, or for actual damages as provided in paragraph (3).

(2) The tender referred to in paragraph (1) may be made any time before entry of judgment. Tender requires only notice in a record of ownership of the security and willingness to exchange the security for the amount specified. A purchaser that no longer owns the security may recover actual damages as provided in paragraph (3).

(3) Actual damages in an action arising under this subsection are the amount that would be recoverable upon a tender less the value of the security when the purchaser disposed of it, and interest [at the legal rate of interest] from the date of the purchase, costs, and reasonable attorneys' fees determined by the court.ⁿ⁵⁹

Unlike the original Uniform Act, the 2002 Act also provides a corresponding right of action for a seller to obtain rescission or damages.ⁿ⁶⁰

Whenever an action for rescission is brought, the purchaser must be prepared to "tender" the securities to the seller,ⁿ⁶¹ and, if the statute allows only rescission, prior disposition of the securities will bar recovery of anything more than a rescission equivalent.ⁿ⁶² Generally, however, tender requirements, while enforced, are not difficult to fulfillⁿ⁶³ because there is rarely a narrow period of time stipulated within which tender must be made. The Uniform Act, for example, permits the tender of securities "at any time before entry of judgment,"ⁿ⁶⁴ and a number of states have adopted this recommended provision.ⁿ⁶⁵ Other states reach the same result by providing that the securities may be tendered directly to the seller or in open court.ⁿ⁶⁶ In a few jurisdictions, notice of willingness to exchange the security may be given by service, as in civil actions, or by certified mail.ⁿ⁶⁷ This latter group does not specify the time period in which tender must be made.

The situation in states not having a statutory provision that specifies the time of tender is unclear.ⁿ⁶⁸ In one state without such a provision, a plaintiff's attorney inadvertently neglected to deposit the securities with the clerk of the court, although the complaint alleged that this had been done. When defendant moved to dismiss on the ground of lack of tender, the trial court denied the motion when the securities were then submitted. It was also shown that a tender of the securities was refused by defendant prior to trial. In these circumstances it was held that sufficient tender had been made.ⁿ⁶⁹

Some states have provisions for notice to the seller by the purchaser of the intention to void the sale.ⁿ⁷⁰ Under these statutes, the purchaser, within six months after having knowledge that the purchase is voidable, must give written notice by registered mail to all persons he seeks to hold liable of his election to rescind the sale. These provisions are not tender requirements, since tender need not be made until after commencement of an action, nor are they statutes of limitations. In one state's interpretation, the provision has been called "an equitable feature built into the statute to

protect against stale claims."ⁿ⁷¹ While this requirement is unusual, the principle behind the notice provision has been widely enacted. Thus, a purchaser receiving a written repurchase offer that promises to return the full price, plus interest, less any income paid on the security, must accept the offer within a given number of days from its receipt or be permanently barred from bringing an action.ⁿ⁷² A comparable provision in the Uniform Securities Act gives the purchaser thirty days to accept the offer or be barred from bringing suit.ⁿ⁷³ But since the Uniform Act also permits a damage action, the buyer, if he or she no longer owns the security, must reject the offer in writing within the thirty day period or lose the judicial remedy. The Uniform Act provision has been substantially enacted in most states.ⁿ⁷⁴ In some states, if the statute allows only a rescission action, there is no reference to rejection of the repurchase offer.ⁿ⁷⁵ It has been held in at least one state that any rescission offer must be made to all the purchasers whose names appear on the securities for the offer to be sufficient to bar suit.ⁿ⁷⁶

[b] Reliance and Causation

The rescission remedy in Blue Sky laws is applied in the most straightforward manner in circumstances involving violations of registration or intermediary licensing provisions. But for the applicable statute of limitations and operation of any tender requirements, there are no substantive conditions or elements to the rescission remedy once the violation is *prima facie* shown. At that point, the burden shifts to the defendant to prove an available exemption. That is not so clear, however, when the rescission claim is based on an alleged misrepresentation or omission in a securities transaction. Most Blue Sky civil liability provisions do not prescribe any element beyond materiality of the representation or omission. Whether reliance or causation is required has been left to consideration by the courts.

In *Green v. Green*,ⁿ⁷⁷ the Tennessee Supreme Court considered the question of whether the right of action for rescission in the Tennessee Blue Sky lawⁿ⁷⁸ requires the plaintiff to prove reliance on representations or omissions of the defendant. In *Green*, the plaintiff was the seller of securities seeking rescission from the defendant purchaser, who asserted that the plaintiff must prove reliance. As with all Blue Sky laws, the Tennessee statutory right of action contained no such requirement. The elements of the statutory claim were clearly stated in the law, and the Tennessee Supreme Court found no basis for engrafting such a requirement where the language is clear and unambiguous. In support of its conclusion, the Court, among other things, observed:

We also note that our interpretation ... is consistent with the prevailing interpretation of similar provisions in other states' blue sky laws. The drafter of the 1956 Uniform Securities Act has explained that "civil liability is an essential adjunct to a blue sky law." He has also pointed out that the civil liabilities provision of the Act requires only that the plaintiff prove that he or she did not know that a representation was untrue and that it does not require proof of reliance. The overwhelming weight of authority in states with statutes similar to *Tenn. Code Ann. § 48-2-121(a)* and *Tenn. Code Ann. § 48-2-122(b)(1)* is that reliance is not an element of a right of action for false or misleading statements in a securities transaction.ⁿ⁷⁹

In *Green*, the Court also cautioned against confusing the "closely related concepts" of materiality and reliance in the application of the Blue Sky rescission remedy. Materiality, said the Court, is the objective test of causation; whereas reliance is directed toward the impact of the allegedly false or misleading information. Materiality is an element of any claim based upon an alleged misstatement or misleading statement.ⁿ⁸⁰ Referring to it as an objective test of causation in the context of a statutory rescission remedy is important in cementing the point that there is an essential causation element built into the statutory remedy. A securities transaction wholly unconnected to a subsequently alleged misrepresentation or misleading statement in support of the rescission remedy is not appropriately brought within the scope of protection of the civil liability provisions. Materiality, however, supplies a causal connection between an information failure and the transaction based upon the substantial likelihood that a reasonable purchaser or seller would consider a misstated or omitted fact important in making the investment decision.ⁿ⁸¹

A federal district court considered the same issue raised under the South Carolina Uniform Securities Act in *Brown v.*

Charles Schwab & Co. n82 In *Brown*, the necessity to prove causation or reliance in an action under that state's version of 2002 Uniform Act section 509n83 was argued as a bar to certification of a purported class of persons asserting claims against a broker-dealer for materially aiding an investment adviser in the commission of a securities fraud. The defendant broker-dealer urged that causation or reliance is an element of proof, and that necessary individual determinations prevented requisite commonality for class action treatment. The district court flatly rejected the proposition.

The broker-dealer defendant in *Brown* maintained that plaintiffs must prove reliance and causation because those elements are required in an action under SEC *Rule 10b-5* under the federal Securities Exchange Act, and that section 501 of the South Carolina law is modeled on *Rule 10b-5*. However, noting that section 501 of the South Carolina law does not contain the words "reliance" or "causation," the *Brown* court rejected the argument that these elements should be imported into the statutory text of the Blue Sky law. A private right of action under SEC *Rule 10b-5* is implied, and federal courts have also implied its elements which include reliance and causation. But the *Brown* court readily acknowledged and embraced relevant case law, making the point that what federal courts have done in regard to a judicially created cause of action is easily distinguishable from what is statutory text.n84

[c] Scope of the Remedy

When a suit is brought, what constitutes appropriate recovery has occasionally been addressed. In a rescission for fraud action, it has been held that the purpose of permitting rescission is "to make the defrauded party whole" and to allow interest as a measure of recovery.n85 In *Hofer v. General Discount Corp.*,n86 the plaintiff bought securities from defendant and, on a subsequent occasion, exchanged them with defendant for other securities. When an action was brought to recover the purchase price, the defendant claimed that all plaintiff was entitled to was return of the securities she had exchanged. The South Dakota court, in examining the statute, which promised the return of "the full amount paid"n87 in a rescission action, held that, in view of the statutory language, plaintiff was entitled to recover her original purchase price. Interestingly, the court compared the state's statute with the Uniform Act provision and said that, if it were the intention of the legislation to allow only the return of the exchanged securities, it should have provided for a refund of the consideration, as under the Uniform Act.n88

Whether this is a correct view of the Uniform Act provision is open to question. In Washington, which has enacted the Uniform Act recovery provision,n89 an appellate courtn90 almost equated the word consideration (recoverable in a rescission action) with the word value (which, under the statute, plays a part only in an action for damages if the security has been disposed of), by saying that a purchaser is limited to recovery of his consideration whether or not she still has the securities.n91 However, unlike *Hofer*,n92 this situation turned on what is recoverable in an action for damages after the purchaser sold the securities at a loss. The answer was that the purchaser was entitled to recover his out-of-pocket or actual loss and that the "value of the security" for determining such loss was the price that the purchaser obtained on resale. Recovery in such an action was held to be the difference between the acquisition price and the resale price.n93

The decision in this case was reached despite an argument by defendants that such a measure of damages could cause gross injustice since the purchasers could increase damages by disposing of the security at an inadequate price. The court's answer was to remind the sellers that they could have made a repurchase offer, as provided by the statuten94 which, if rejected by the buyer while he still had the securities, would have barred the action. This, said the court, "is all the protection to which the seller is entitled under the statute."n95

Another state court similarly held that the purchaser need not mitigate damages.n96 Here, the seller had advised the purchaser to sell at a higher price and the purchaser failed to do so while the market for the securities was up. Again, the court held that it is the seller's responsibility to mitigate his own damages by making a repurchase offer.n97

[5] Punitive Damages

The matter of awarding punitive damages in civil actions under Blue Sky laws has not been fully explored, and no state includes punitive damages within its definition of "damages."ⁿ⁹⁸ However, under the Uniform Securities Actⁿ⁹⁹ and the "savings" provisions in states with a comparable provision, actions are permitted under the Blue Sky law that are in addition to other rights and remedies otherwise allowed by law or equity.ⁿ¹⁰⁰

In two states that have enacted the Uniform Act savings provision, Arkansas and Oregon,ⁿ¹⁰¹ the courts have come to opposite conclusions concerning whether punitive damages are recoverable. In Oregon,ⁿ¹⁰² the court held that the section on the calculation of damages was specific and did not include punitive damages. Thus, the case was decided without reference to Oregon's provision comparable to that in the Uniform Act. In Arkansas,ⁿ¹⁰³ however, the court cited its state's version of the Uniform Act as supporting the premise that there is "no merit in [the] contention that punitive damages cannot be recovered where the Securities Act applies."ⁿ¹⁰⁴ The court proceeded to state that

"[T]he authorities generally recognize that where an action is brought and sustained both under the Securities Act and common law fraud, punitive damages are recoverable."ⁿ¹⁰⁵

Finally, Texas, which has a statute similar to the Uniform Act, specifically addresses punitive or exemplary damages. The Texas savings provision declares: "The rights and remedies provided by this Act are in addition to any other rights (including exemplary or punitive damages) or remedies that may exist at law or equity."ⁿ¹⁰⁶

When punitive damages are recoverable, applicable state laws setting evidentiary standards and caps will operate. Most states require clear and convincing evidence of conduct constituting oppression, fraud wantonness or malice before punitive damages may be imposed generally. These standards are no less applicable to damage claims made under state securities laws.ⁿ¹⁰⁷ State limitations on punitive damage awards generally may also impact the scope of civil liability under Blue Sky laws.ⁿ¹⁰⁸

[6] Attorneys Fees

The recoverability of attorney's fees, generally permitted by statute,ⁿ¹⁰⁹ has been the source of some judicial debate. The Uniform Act provision on the award of attorney's fees as adopted in one stateⁿ¹¹⁰ was deemed permissive rather than mandatory and within the discretion of the court to grant.ⁿ¹¹¹ Similarly, when fees are part of the judgment, the amount is to be determined by the court,ⁿ¹¹² although a stipulation of amount by the parties will be accepted.ⁿ¹¹³ The granting of attorneys' fees has been allowed even where the arrangement between attorney and client is for a contingent fee,ⁿ¹¹⁴ but an award of attorneys' fees without an award of general damages will probably not be allowed.ⁿ¹¹⁵

[7] Taxes

There is little case law on the recoverability of taxes as part of the damages awarded. However, the question of taxes has been used both in an attempt by a plaintiff to increase the award of damages and by a defendant to reduce the plaintiff's recovery by the amount of the tax benefits to be received by the plaintiff. In one case,ⁿ¹¹⁶ the plaintiff sought the recovery of compensatory damages in part based upon lost tax benefits. The court held that "the alleged loss of future profits and tax benefits are not recoverable because they are based upon sheer speculation and guesswork." The court implied that the plaintiff *might* have been able to sustain his claim for lost future profits and tax benefits if evidence were presented showing a basis for measuring the losses with reasonable certainty. The damages sought, said the court, "must be susceptible of ascertainment in some manner other than by mere speculation, conjecture, or surmise." In this case, the court held that plaintiff had not met the burden.

In another case,ⁿ¹¹⁷ the defendant sought to reduce the recovery by the amount of the tax benefits received by the plaintiff, claiming it was plaintiff's object in purchasing the limited partnership interests to obtain tax losses. In denying that the valuation of the plaintiff's investment should depend on the tax benefits that he had received, the court stated

that "[T]ax consequences as a result of the purchase do not enter into the computation of damages under the statute."¹¹⁸

[8] Actions on a Bond

The subject of bonds required to be posted by broker-dealers, investment advisers, and agents as a condition of registration has already been addressed elsewhere in this Treatise.¹¹⁹ These bonds are generally used for purposes of purchaser protection, and purchasers are permitted to recover against the bond if the broker-dealer or agent sells securities contrary to law. Although many of these bonding statutes have separate provisions for a statute of limitations,¹²⁰ the allowable statute of limitations period usually (but not always) coincides with the limitation period generally prescribed.

Similarly, a few states require persons registering securities to post bonds for purchaser protection.¹²¹ In these states, there is typically a two-year statute of limitations for bringing an action on the bond.¹²²

[9] Survival of Actions

Every cause of action under the Uniform Securities Act survives the death of any person who might have been a plaintiff or defendant.¹²³ Most states have a comparable survival provision in their Blue Sky laws.¹²⁴ In those states not following the Uniform Act, the survival statute, if it exists, will most likely be found in that state's laws of more general application (e.g., the code of civil procedure).¹²⁵

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 77l(a). Section 12(a)(1) and (2) establish a private right of action for a purchaser of a security to sue the seller(s) of the security for rescission or damages in transactions in which there is a violation of the securities registration provisions of Act, or in which there is an information failure.

(n2)Footnote 2. The scope of fraud actionable under Blue Sky laws is addressed in detail in Chapter 13, *Fraudulent and Other Prohibited Practices--Proving Fraud Under Blue Sky Laws, above*.

(n3)Footnote 3. See Unif. Sec. Act § 509(c) (2002).

(n4)Footnote 4. See *Space v. E.F. Hutton, Inc.*, 188 Ill. App. 3d 57, 135 Ill. Dec. 710, 544 N.E.2d 67 (1989), appeal denied, 548 N.E.2d 1078, 139 Ill Dec 522 (1990) (call options writer had no standing to sue unregistered sales agent since the court characterized plaintiff as seller and not a purchaser of securities).

(n5)Footnote 5. See, e.g., Missouri: Mo. Rev. Stat. § 5-509(c).

(n6)Footnote 6. See, e.g., California: Cal. Corp. Code §§ 25500, 25501; Florida: Fla. Stat. § 517.211; Texas: Tex. Rev. Civ. Stat. Ann. art. 581-33A(2).

(n7)Footnote 7. See, e.g., Unif. Sec. Act § 509(g) (2002).

(n8)Footnote 8. See, e.g., Ill. Comp. Stat., ch. 815, § 5/13; Ohio Rev. Code § 1707.43.

(n9)Footnote 9. Draftsmen's commentary to the Uniform Securities Act § 410(a), reproduced in Loss & Cowett, Blue Sky Law 390, 391 (1958); see also Note, *Express and Implied Civil Liability Provisions in State Blue Sky Laws*, 17 Case W. Res. L. Rev. 1173, 1174, 1175 (1966).

For an example of how a technical violation under one of these statutes can lead to a rescission of a sale, see *Brown v. Gitlin*, 4 Ill. App. 3d 1040, 283 N.E.2d 115 (1972) (failure to report sale of shares as required by statute).

(n10)Footnote 10. *See, e.g., Ohio Rev. Code § 1707.43(A).*

(n11)Footnote 11. *See, e.g., Cal. Corp. Code § 25503; Fla. Stat. § 517.211; Mass. Gen. Laws Ann., ch. 110A, § 410(a)(1); N.J. Stat. Ann. § 49:3-71; 70 Pa. Cons. Stat. Ann. § 1-501(a); Tex. Rev. Civ. Stat. Ann. art. 581-33(A)(1).*

(n12)Footnote 12. *926 So. 2d 290 (Ala. 2005) .*

See also R. Rapp and F. Berckmueller, "Testing the Limits of NSMIA Preemption: State Authority to Determine the Validity of Covered Securities and to Regulate Disclosure," *63 Bus. Law. 809 (May 2008).*

(n13)Footnote 13. *See also Gordon v. Drews, 358 S.C. 598, 595 S.E.2d 864 (Ct. App. 2004)* (illegal sale of stock because no exemption was available).

(n14)Footnote 14. *See, e.g., Florida, Massachusetts, New Jersey, Pennsylvania, and Texas.*

(n15)Footnote 15. *See, e.g., Ah Moo v. A.G. Becker Paribas, Inc., 857 F.2d 615, 621 (9th Cir. 1988)* (registered securities dealer liable under Hawaiian law for failing to register its salesman and failing to register securities sold to Hawaiian resident); *Darnall Kemna & Co. v. Heppinstall, 851 P.2d 73 (Alaska 1993)* (brokerage and agent's failure to comply with Alaska registration requirements resulted in strict liability to purchase for full amount of sale plus interest, fees, and costs); *Deets v. Hamilton Management Corp., 2 Kan. App. 2d 452, 581 P.2d 826 (1978)* (corporation that employs unregistered agent jointly and severally liable with agent to anyone defrauded by purchase through the agent; relying on *Kan. Stat. § 17-1268*, which in turn incorporates *Kan. Stat. § 17-1254*).

(n16)Footnote 16. *See, e.g., Tex. Rev. Civ. Stat. Ann. art. 581-33(A)(1); see also Ah Moo v. A.G. Becker Paribas, Inc., 857 F.2d 615, 621 (9th Cir. 1988) ; Adams v. Hyannis Harborview, Inc., 838 F. Supp. 676 , Blue Sky L. Rep. (CCH) P 73,884 (D. Mass. 1993), aff'd in part, vacated in part, on other grounds, remanded, Adams v. Zimmerman, 73 F.3d 1164 (1st Cir. 1996)* (sale of non-exempt interests in condominium units violated Massachusetts registration requirements; receiver of bank liable for agents' sale of unregistered securities under doctrine of respondent superior); *Pencheff v. Adams, 5 Ohio St. 3d 153, 449 N.E.2d 1277 (1983)* (as matter of law, violation of registration provisions of Ohio Securities Act materially affects protection investors are entitled to under Act; plaintiff-purchaser entitled to rescission regardless of whether registration violation materially denied him in fact of protection accorded by statute).

(n17)Footnote 17. *See, e.g., Sanchez v. Walls, 59 Ill. App. 3d 75, 16 Ill. Dec. 507, 375 N.E.2d 138 (1978)* (failure to report sale of such securities to Secretary of State allowed purchaser to void transaction at his option).

But see Schuler v. Beers, 157 Ill. App. 3d 97, 109 Ill. Dec. 427, 510 N.E.2d 48, 49 (1987) , which dismissed the purchaser's rescission claim that was based on the sellers' failure to file a report of sale, holding that 1983 and 1985 amendments to the Illinois Blue Sky law eliminated the rescission remedy for failure to file a report pursuant to Illinois' limited offering exemption. *Accord Metzger v. New Century Oil & Gas Supply Corp. Income & Dev. Program-1982, 230 Ill. App. 3d 679, 171 Ill. Dec. 698, 594 N.E.2d 1218 (1992) .*

(n18)Footnote 18. *See, e.g., State v. Tiraco, 92 Misc. 2d 715, 401 N.Y.S.2d 397 (Sup. Ct. New York County 1977)* . Although the case dealt with the issuance of a preliminary injunction sought by the Attorney General, the basis for the injunction was the defendant's failure to use a prospectus or offering circular as required by *N.Y. Gen. Bus. Law § 399-c(3)*.

But see Ackerman, Jablonski, Porterfield & Deture v. Alhadeff, 1986 U.S. Dist. LEXIS 26697 , [1986-1987 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,390 (W.D. Wash. April 16, 1986) (no private right of action against accountant employee of seller, retained for purpose of auditing financial statements to be used in prospectus, for failure to file annual reports on financial condition of issuer).

(n19)Footnote 19. *See McCauley v. Michael, 256 N.W.2d 491 (Minn. 1977)* (agreements to transfer escrowed

stock unenforceable and illegal); *see also* *Minn. Stat. Ann.* §§ 80A.12(5), 80A.23(1).

But see In re Bell & Beckwith, 114 B.R. 475 (Bankr. N.D. Ohio 1989) (director's failure to escrow "cheap stock" as required by Ohio Division of Securities did not permit rescission; director's noncompliance did not establish violation of statute).

(n20)Footnote 20. *See, e.g., Cal. Corp. Code* § 25510; *Fla. Stat.* § 517.241(2); *Mass. Gen. Laws Ann., ch. 110A*, § 410(h); *N.J. Stat. Ann.* § 49:3-71(j); *Ohio Rev. Code Ann.* § 1707.40; *Tex. Rev. Civ. Stat. Ann. art.* 581-33(M).

(n21)Footnote 21. *But see Buist v. Time Domain Corp.*, 926 So. 2d 290 (Ala. 2005) .

(n22)Footnote 22. For a more complete discussion of the impact of federal preemption on Blue Sky fraud provisions, *see* Ch. 13, *above*.

(n23)Footnote 23. *See, e.g., Ill. Comp. Stat.* § 5/11G(1).

(n24)Footnote 24. State registration or licensing of intermediaries generally, and investment advisers and investment adviser representatives particularly, are thoroughly considered in Ch. 11, *above*.

(n25)Footnote 25. *Ohio Rev. Code* § 1707.42(B).

New Jersey likewise prescribes civil liability for one who:

[E]ngages in the business of advising others, for compensation, 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 (i) in willful violation of this act or of any rule or order promulgated pursuant to this act, or (ii) employs any device, scheme or artifice to defraud the other person or engages in any act, practice or course of business or conduct which operates or would operate as a fraud or deceit on the other person, is liable as set forth [in further provisions].

N.J. Stat. § 49:3-71(5).

(n26)Footnote 26. *See Unif. Sec. Act* § 509(e)-(f) (2002).

See also:

Alabama: Ala. Code, ch. 6, § 8-6-19.

Colorado: Colo. Rev. Stat. § 11-51-604.

Connecticut: Conn. Gen. Stat. § 36b-29.

District of Columbia: D.C. Code § 31-5606.05.

Idaho: Idaho Code § 30-14-509.

Iowa: Iowa Code § 502.509(5)-(6).

Maryland: Md. Code § 11-703.

Missouri: Mo. Rev. Stat. § 5-509.

Nebraska: Neb. Rev. Stat. § 8-1118.

Oklahoma: Okla. Stat. § 509(E)-(F).

South Dakota: S.D. Codified Laws § 47-31B-509.

Tennessee: Tenn. Code Ann. § 48-2-122(d).

Texas: Tex. Rev. Civ. Stat. Ann. § 33-1.

U.S. Virgin Islands: V.I. Code § 23-659.

Vermont: Vt. Code Ann. § 4240(e)(2).

Virginia: Va. Code Ann. § 13.1-522(B).

(n27)Footnote 27. *See, e.g.,* New Jersey: *N.J. Stat. § 49:3-71(5), above.*

(n28)Footnote 28. Unif. Sec. Act § 410(a)(2).

(n29)Footnote 29. *See* Unif. Sec. Act § 509(c) (2002).

Under the 2002 Uniform Act provision "actual damages" means the difference between the price at which the security was sold and the value the security would have had at the time of the sale in the absence of the purchaser's conduct causing liability. It also includes interest at the legal rate, costs, and reasonable attorneys' fees as determined by the court.

(n30)Footnote 30. *See Twin Fires Investment LLC v. Morgan Stanley Dean Witter & Co., 2002 Mass. Super. LEXIS 478 (Dec. 16, 2002)* (since the Massachusetts Blue Sky law grants a statutory civil remedy for false representations only to those who have purchased securities, and since the plaintiffs never actually purchased the shares, the plaintiffs have no standing to sue to obtain the statutory remedy).

See also Space v. E.F. Hutton Co., Inc., 188 Ill. App. 3d 57, 135 Ill. Dec. 710, 544 N.E.2d 67 (1989) (remedies under the Illinois Blue Sky law are available only to purchasers of securities).

(n31)Footnote 31. *See, e.g.,* Unif. Sec. Act § 509(d) (2002).

(n32)Footnote 32. The scope of civil liability under Blue Sky laws, and the extension of liability to "nonsellers" in particular, is discussed in detail in § 15.04, *below*.

(n33)Footnote 33. *See, e.g.,* Unif. Sec. Act PP 509(e)-(f) (2002).

(n34)Footnote 34. Civil remedies for fraud or other conduct by investment advisers in violation of the Blue Sky law may nevertheless be imposed in connection with the purchase or sale of securities by an advisory client, but the remedy may be limited to actual damages incurred by reason of the violation, *see, e.g., N.H. Rev. Stat. § 421-B:25(II)*. New Jersey permits recovery of loss "due to the advice" of an investment adviser who has acted in violation of antifraud provisions, *see N.J. Stat. § 49:3-71(c)*. Civil remedy provisions applicable specifically to investment advisers and investment adviser representatives are discussed in § 15.04[3], *below*.

All of the basic civil liability provisions are applicable to persons who "offer" as well as sell securities in violation of registration or antifraud provisions. Civil liability may thus be imposed when an "offer" violates the Blue Sky law even though the sale does not. But, as the drafters of the Uniform Securities Act made clear, the making of a non-exempted offer can create no civil liability to the offeree unless the offer results in a sale. *Official Code Comment*, Unif. Sec. Act § 410.

(n35)Footnote 35. *Ohio Rev. Code* § 1707.43.

(n36)Footnote 36. This has been part of the Uniform Securities Act from the beginning. While making clear that no additional causes of action under the Blue Sky law are intended, section 410(h) of the original Uniform Act provides: "The rights and remedies provided by this act are in addition to any other rights or remedies that may exist at law or in equity."

See also Unif. Sec. Act § 509(m) (2002).

(n37)Footnote 37. Unif. Sec. Act § 509(m) (2002).

(n38)Footnote 38. 421 U.S. 723, 95 S. Ct. 1917, 44 L. Ed. 2d 539 (1975) .

(n39)Footnote 39. 421 U.S. at 742-43 .

(n40)Footnote 40. *Chanoff v. United States Surgical Corp.*, 857 F. Supp. 1011, 1018 (D. Conn. 1994) , *aff'd*, 31 F.3d 66 (2d Cir. 1994) .

(n41)Footnote 41. See *Crocker v. Federal Deposit Ins. Corp.*, 826 F.2d 347 (5th Cir. 1987) (applying Mississippi law); *Sit-Set, A.G. v. Universal Jet Exchange, Inc.*, 747 F.2d 921 (4th Cir. 1984) (applying Virginia law); *Kagan v. Edison Bros. Stores, Inc.*, 907 F.2d 690 (7th Cir. 1990) (applying Illinois law); *Arnlund v. Deloitte & Touche LLP*, 199 F. Supp. 2d 461 (E.D. Va. 2002) (applying Virginia law).

(n42)Footnote 42. *Manzo v. Rite Aid Corp.*, 2002 Del. Ch. LEXIS 147 (Dec. 19, 2002) .

(n43)Footnote 43. 30 Cal. 4th 167, 132 Cal. Rptr. 2d 490, 65 P.3d 1255 (2003) .

(n44)Footnote 44. 65 P.3d at 1265 .

In *Rogers v. Cisco Systems, Inc.*, 268 F. Supp. 2d 1305 (N.D. Fla. 2003) , a federal court applying Florida law concluded that the reliance element was key in assessing a "holder" claim. Plaintiffs alleged that they had refrained from selling their stock after reviewing defendants' reports and financial statements. They claimed if they had known the true state of the company's financial position they would have sold their shares before a collapse in the stock price when the facts became known. The court dismissed the claim, finding that the allegations were too vague to satisfy the reliance requirement applicable under Florida law. Imposing a heightened burden of pleading reliance in "holder claims" is essential, said the court, in order to separate plaintiffs who actually and justifiably relied on misrepresentations from the general investing public who did not so rely, but suffered a loss due to the decline in share value. 268 F. Supp. 2d at 1314, n.18 .

(n45)Footnote 45. In the complex of cases comprising the *In re Worldcom, Inc. Securities Litigation*, the United States District Court for the Southern District of New York, analyzing Georgia law, dismissed claims of a putative "holder" class in *Weinstein v. Ebberts*, 336 F. Supp. 2d 310 (S.D.N.Y. 2004) . Named plaintiffs in the case alleged that material misrepresentations or omissions caused them to retain ownership of the subject securities that they had acquired prior to the alleged wrongdoing. The court found no basis to predict that the Georgia Supreme Court would permit claims of a nationwide "holder" class to go forward. Among other things, the federal court recognized that under

Georgia law, certification of a class action requires that questions of law and fact common to the class members must predominate over any individual questions. The *Weinstein* court concluded that even if Georgia courts were to permit "holder" claims, they would require allegations of specific reliance in the manner addressed by the California Supreme Court in *Manzo*, *above*. This heightened pleading requirement would be virtually impossible to meet in the context of a class action. Thus, after reviewing authority from other states, the *Weinstein* court concluded: "Given the weight of this authority, and the sound policy reasons that underlie these decisions, there is no basis to predict that Georgia would strike out on a different path and countenance this lawsuit." 336 F. Supp. 2d at 323 .

(n46)Footnote 46. *Gutman v. Howard Savings Bank*, 748 F. Supp. 254 (D.N.J. 1990) .

(n47)Footnote 47. 748 F. Supp. at 266 .

(n48)Footnote 48. *Shirvanian v. DeFrates*, 2004 Tex. App. LEXIS 182 (Jan. 8, 2004) .

(n49)Footnote 49. Unif. Sec. Act § 410(a).

(n50)Footnote 50. See, e.g., *Cal. Corp. Code* § 25503 (purchasers or sellers); *Fla. Stat. Ann.* § 517.211(1) (purchasers or sellers). See *Skurnick v. Ainsworth*, 591 So. 2d 904 , [1991-1993 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,561 (Fla. 1991). A broker-dealer registered in New York and Connecticut but not in Florida was deemed to have executed a sale of securities in Florida by receiving in New York an order or check by mail from a Florida resident and acting on that request by purchasing securities on behalf of the investor in New York. Since the broker-dealer was not registered in Florida, the investor could rescind the transaction and recover damages.

See also *Fireman's Ins. Co. v. Vento*, 586 So. 2d 89 (Fla. Dist. Ct. App. 1991) . In an action by a surety to recover for payments it made on an insured promissory note, it was error to award rescission of the note by summary judgment on a counterclaim without joining the original seller of the investment; *Mass. Gen. Laws Ann.*, ch. 110A, § 410(a); *N.J. Stat. Ann.* § 49:3-71(a); 70 Pa. Cons. Stat. §§ 1-501(a), 1-502; *Tex. Rev. Civ. Stat. Ann.* art. 581-33(A) (purchasers or sellers).

(n51)Footnote 51. For example, in California, Florida, and Pennsylvania, interest is recoverable "at the legal rate." See *Kane v. Shearson Lehman Hutton, Inc.*, 916 F.2d 643 (11th Cir. 1990) (plaintiff may recover interest, costs, and attorneys fees). In Massachusetts, the rate is 6%; in New Jersey, it is the rate for judgment interest for the same period.

(n52)Footnote 52. See, e.g., California, New Jersey, and Pennsylvania.

(n53)Footnote 53. See, e.g., *Or. Rev. Stat.* § 59.115(2); see also *Scheurenbrand v. Wood Gundy Corp.*, 8 F.3d 1547 (11th Cir. 1993) (choice of equitable remedies between rescission or damages but no right to jury trial).

(n54)Footnote 54. In Oregon, the rate on non-interest bearing securities is the rate for judgment interest. Note that Oregon will compute the interest at that rate in all cases where the purchaser no longer owns the security and is seeking damages. The amount of recovery for the value of the security, whether in rescission or damage, is computed the same as in Uniform Act states.

See also *Degen v. Bruce*, [1995-1996 Transfer Binder] Blue Sky L. Rep. (CCH) P 74,040 (Pa. 1995).

(n55)Footnote 55. See, e.g., 815 Ill. Comp. Stat. § 5/13A; *Ohio Rev. Code* § 1707.43.

See also *In re Van Dyke*, 731 F.2d 431 (7th Cir. 1984) (Illinois statute does not require tender of security with valid acceptance of repurchase offer); *Renovitch v. Stewardship Concepts, Inc.*, 654 F. Supp. 353, 359 (N.D. Ill. 1987) (only civil remedy provided by Illinois Security Act is rescission of the sales); *Ansbro v. Southeast Energy Group, Ltd.*, 658 F. Supp. 566 (N.D. Ill. 1987) (failure to tender securities and seek rescission within stated period bars remedy under statute); *Shofstall v. Allied Van Lines, Inc.*, 455 F. Supp. 351 (N.D. Ill. 1978) . In discussing the Illinois statute, the

court observed that unlike the federal securities laws, Illinois' Securities Act is wholly statutory. There is no implied remedy for damages equivalent to the rescissory amount, and the only civil remedy provided for is rescission of the sale.

The Ohio Supreme Court has held that where stock was sold in violation of the securities registration provisions of Ohio Blue Sky law, plaintiff's initiation of the sale did not bar his right to rescission under *Ohio Rev. Code § 1707.43*. *Callahan v. Class One, Inc.*, 58 Ohio St. 3d 76, 567 N.E.2d 1036 (Ohio 1991) .

(n56)Footnote 56. Ill. Comp. Stat., ch. 815, § 5/13A(2); *see also Ohio Rev. Code § 1707.43*.

(n57)Footnote 57. The Illinois statute is silent on the recovery of costs, and others make no mention of attorneys' fees.

See also Huggins v. Chapin, 233 Ga. App. 109, 503 S.E.2d 356 , [1997-1998 Transfer Binder] Blue Sky L. Rep. (CCH) P 74,164 (1998) (attorney fee award overturned because no basis shown for fee calculation); *Mashburn v. First Inv. Corp.*, 111 N.C. App. 398, 432 S.E.2d 869 (1993) (attorney's fees not available when plaintiff accepts offer of rescission).

(n58)Footnote 58. *See, e.g., Haw. Rev. Stat. § 485-20(a)* (10%); 815 Ill. Comp. Stat. § 5/13A (10%).

(n59)Footnote 59. Unif. Sec. Act § 509(b) (2002).

(n60)Footnote 60. Section 509(c) of the 2002 Uniform Act provides:

(c) **[Liability of purchaser to seller.]** A person is liable to the seller if the person buys a security by means of an untrue statement of a material fact or omission to state a material fact necessary in order to make the statement made, in light of the circumstances under which it is made, not misleading, the seller not knowing of the untruth or omission, and the purchaser not sustaining the burden of proof that the purchaser did not know, and in the exercise of reasonable care, could not have known of the untruth or omission. An action under this subsection is governed by the following:

(1) The seller may maintain an action to recover the security, and any income received on the security, costs, and reasonable attorneys' fees determined by the court, upon the tender of the purchase price, or for actual damages as provided in paragraph (3).

(2) The tender referred to in paragraph (1) may be made any time before entry of judgment. Tender requires only notice in a record of the present ability to pay the amount tendered and willingness to take delivery of the security for the amount specified. If the purchaser no longer owns the security, the seller may recover actual damages as provided in paragraph (3).

(3) Actual damages in an action arising under this subsection are the difference between the price at which the security was sold and the value the security would have had at the time of the sale in the absence of the purchaser's conduct causing liability, and interest [at the legal rate of interest] from the date of the sale of the security, costs, and reasonable attorneys' fees determined by the court.

(n61)Footnote 61. In at least one jurisdiction, a court has decided that a plaintiff who purchased securities through an unregistered broker-dealer was not required to set aside all the transactions, but could rescind selected transactions at his option, *see Piantes v. Hayden-Stone, Inc.*, 514 P.2d 529 (Utah Sup. Ct. 1973) , *cert. denied*, 415 U.S. 995 , *reh'g. denied*, 416 U.S. 963 (1974) .

But see Cox v. Lemonds, 669 N.E.2d 23, 1995 Ohio App. LEXIS 5045 , [1996-1997 Transfer Binder] Blue Sky L. Rep. (CCH) P 74,138 (Ohio App. 1996) (partnership interest not a security and no rescission permitted); *accord Roddy v. Alexander, Montgomery County App. No. 18503*, 2001 Ohio App. LEXIS 4487 , Blue Sky L. Rep. (CCH) P 74,237 (Ohio Ct. App., Montgomery County Oct. 5, 2001) (*Ohio Rev. Code § 1707.43* provides that sales violating Ch. 1707 are voidable at purchaser's election; however, before § 1707.43 can apply, the transaction must fit within definition of "security.").

(n62)Footnote 62. *See, e.g., Sloane v. Merrill, Lynch, Pierce Fenner & Smith, Inc.*, 221 So. 2d 451 (Fla. Dist. Ct. App. 1969) ; *Ansbro, above*, 658 F. Supp. at 571 ; *Tobey v. NX Corp.*, 323 N.E.2d 30 (Ill. Ct. App. 1974) .

(n63)Footnote 63. However, a tender must satisfy any peculiar statutory requirements of the jurisdiction. *See, e.g., Tex. Rev. Civ. Stat. Ann. §§ 581-33 (D), (I), (J)*. Thus, merely tendering two written assignments did not satisfy the requirement that the securities be properly tendered. *Riggs v. Riggs*, 322 S.W.2d 571 (Tex. Civ. App. 1959) . The offer must also comply with statutory mandates, *see Binder v. Gordian Securities*, 742 F. Supp. 663 (N.D. Ga. 1990) (offer of rescission failed to meet statutory requirements; accordingly plaintiff's cause of action not barred under Georgia law.). Moreover, there must be a complete tender. A buyer who has resold part of the securities purchased in a single transaction may not be permitted to affirm his purchase as to that part while tendering and rescinding as to the remainder, *see Glen v. Dodson*, 180 N.E. 393 (Ill. Sup. Ct. 1932) , cited as a benchmark decision in *Tobey v. NX Corp., above*; *see also Mosler v. S/P Enterprises, Inc.*, 888 F.2d 1138 (7th Cir. 1989) (under Illinois law, plaintiff must tender securities sold); *Windswept Corp. v. Fisher*, 683 F. Supp. 233, 239 (W.D. Wash. 1988) (Washington Securities Act does not allow plaintiff to retain stock and seek damages). Since most states require that any income earned be deducted from the purchase price recoverable during rescission, all jurisdictions basically require the same thing.

But see Roger v. Lehman Bros., 621 F. Supp. 114, 119 (S.D. Ohio 1985) (formal tender of stock not a prerequisite to rescission under Ohio law when broker had already received securities and paid over value of shares and all that was required was to pay purchaser difference between original sale price and repurchase price); *Trimble v. American Sav. Life Ins. Co.*, 733 P.2d 1131 (Ariz. App. 1986) (investors who failed to tender securities back to insurance company after receiving notice of insurance company fraud did not waive their right to rescind when tender and discontinuance of premium payments would completely devalue the original transaction and cut off any chance of return).

(n64)Footnote 64. Unif. Sec. Act § 410(c).

(n65)Footnote 65. *See, e.g., Cal. Corp. Code §§ 25501, 25503; Mass. Gen. L. Ann., ch. 110A, § 410(c); N.J. Stat. Ann. § 49:3-71(e)*.

(n66)Footnote 66. *See, e.g., Ill. Comp. Stat., ch.815, § 5/13(A); Ohio Rev. Code § 1707.43. See also Diversified Prop. Corp. v. Winters Natl. Bank & Trust Co.*, 234 N.E.2d 608 (Ohio Ct. App. 1967) .

(n67)Footnote 67. *See, e.g., 70 Pa. Cons. Stat. § 1-501(a); 9 Vt. Stat. Ann. § 4240(c)*.

(n68)Footnote 68. *See, e.g., Fla. Stat. Ann. § 517.211(3)(a)* ("upon tender of the security"); *Haw. Rev. L. § 485-20(a)* ("upon tender of the securities sold or of the contract made").

(n69)Footnote 69. *Bullard v. Garvin*, 401 P.2d 417 (Ariz. Ct. App. 1965) .

(n70)Footnote 70. *See, e.g., Ill. Comp. Stat., ch. 815, § 5/13(B)*.

(n71)Footnote 71. *Gowdy v. Richter*, 314 N.E.2d 556 (Ill. Ct. App. 1974) .

The six months rule regarding notice is not a statute of limitations. Rather, it is an equitable feature built into the statute to protect against stale claims. The issue of when a purchaser had sufficient knowledge to realize a sale is voidable against a particular defendant is a mixed question of law and fact on which a layman is entitled to acquire his first knowledge from an attorney.

See also Martin v. Orvis Brothers & Co., 323 N.E.2d 73 at 79 (Ill. Ct. App. 1974) : "Its purpose [the six month rule] is to prevent purchasers, who have sufficient knowledge of the remedy available to them, from waiting the entire statute of limitations to decide whether to elect rescission."

In *Norville v. Alton Bigtop Restaurant, Inc.*, 317 N.E.2d 384 (Ill. Ct. App. 1974) , the court held that despite the statutory requirements of notice by registered mail, the service of a complaint alleging that less than six months had passed since knowledge of voidability had been ascertained was sufficient notice under the statute.

See also Renovitch v. Stewardship Concepts, Inc., 654 F. Supp. 353 (N.D. Ill. 1987) , in which the failure to notify defendants within six months of learning that the sale of securities is voidable under Illinois blue sky law as a matter of law required dismissal of a count under the Illinois Securities Act. The fact that defendants acted as counsel for defendant corporations that did receive the notice was insufficient. The statute creates an absolute requirement which was not satisfied by constructive notice.

(n72)Footnote 72. *See, e.g.*, Ill. Comp. Stat., ch. 815, § 5/13(C). The period in Illinois is fifteen days.

(n73)Footnote 73. Unif. Sec. Act § 410(e) provides:

No person may sue under this section (1) if the buyer received a written offer, before suit and at a time when he owned the security, to refund the consideration paid together with interest at six percent per year from the date of payment, less the amount of any income received on the security, and he failed to accept the offer within thirty days of its receipt, or (2) if the buyer received such an offer before suit and at a time when he did not own the security, unless he rejected the offer in writing within thirty days of its receipt.

See also Rev. Unif. Sec. Act § 607.

(n74)Footnote 74. *See, e.g.*, *Colo. Rev. Stat. § 11-51-604(9)(a)*; *Conn. Gen. Stat. § 36b-29(g)*; 32 Me. Rev. Stat. Ann. § 10607 (drawn from Rev. Unif. Sec. Act § 607); *Mass. Gen. L. Ann., ch. 110A, § 410(e)*. For comparable provisions in other states, *see Cal. Corp. Code § 25507(b), (c)*; 70 Pa. Cons. Stat. § 1-504(d); *Wash. Rev. Code § 21.20.430(4)(b)*.

Cf. Interlake Porsche & Audi, Inc. v. Bucholz, 728 P.2d 597, 605 (Wash. Ct. App. 1986) (Washington's Blue Sky law limits private claims for damages to only actual purchasers or sellers and so minority shareholder offerees who did not accept offers to purchase her stock could not maintain a Blue Sky action against the offeror).

(n75)Footnote 75. *See, e.g.*, *Ohio Rev. Code § 1707.43*.

(n76)Footnote 76. *Hummel v. Kranz*, 126 N.W.2d 786 (N.D. Sup. 1964) .

(n77)Footnote 77. 293 S.W.3d 493 (Tenn. 2009) .

(n78)Footnote 78. *See Tenn. Code Ann. § 48-2-122(b)(1)*.

(n79)Footnote 79. 293 S.W.3d at 508 (citations omitted).

The Tennessee Supreme Court noted that only two states, Georgia and Washington, require proof of reliance in such claims, and that the prevailing view is also reflected in the civil remedies provision of the 2002 Uniform Act. *Green v. Green*, 293 S.W.3d 493, 508 (Tenn. 2009) .

(n80)Footnote 80. *Green v. Green*, 293 S.W.3d 493, 508 (Tenn. 2009) .

(n81)Footnote 81. This is the baseline standard of materiality articulated by the U.S. Supreme Court in *TSC Industries Inc. v. Northway*, 426 U.S. 438, 96 S. Ct. 2126, 48 L. Ed. 2d 757 (1976) , in which the Supreme Court more fully articulated it as follows:

An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote... . It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

426 U.S. at 449 .

The *Northway* standard arose out of litigation under the proxy rules of the Securities Exchange Act of 1934. It has since become the standard in all settings in which materiality is an issue as, for example, its application by the Tennessee Supreme Court in *Green*.

(n82)Footnote 82. *Brown v. Charles Schwab & Co.*, No. 2:07-CV-03852, 2009 U.S. Dist. LEXIS 114840 (D.S.C. Dec. 9, 2009) .

(n83)Footnote 83. See S.C. Code Ann. § 35-1-509. Plaintiffs claimed that the broker-dealer materially aided or controlled the investment adviser in his violations of section 501 of the South Carolina Act--the general antifraud provision--for which a private civil remedy is available under section 509.

(n84)Footnote 84. See also *Dunn v. Borta*, 369 F.3d 421, 433 (4th Cir. 2004) ("Because the [Virginia] Act fails to mention reliance or causation, ... it would be inappropriate for a court to imply them").

(n85)Footnote 85. *Kaas v. Privette*, 529 P.2d 23 (Wash. Ct. App. 1974) . See also *Merchant v. Oppenheimer & Co., Inc.*, 568 F. Supp. 639, 1983 U.S. Dist. LEXIS 14947 , [1982-1984 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,860 at 70,141, 70,144 (E.D. Va. 1983), *aff'd*, *Dixon v. Oppenheimer*, 739 F.2d 165 (4th Cir. 1984) . In *Merchant* the court noted that it is difficult to characterize the remedy due a fraud victim as a "windfall," even if it exceeds total out of pocket loss. The court concluded that the legislature intended for a buyer of securities to recover damage for any sale of securities in violation of the statute regardless of whether the buyer happened to profit from other sales of securities in violation of the statute.

See also *McCoy v. Goldberg*, 810 F. Supp.539, 1993 U.S. Dist. LEXIS 58 , [1993-1994 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,801 (S.D.N.Y. 1993).

(n86)Footnote 86. 192 N.W.2d 718 (S.D. Sup. Ct. 1971) (decided under former statute).

(n87)Footnote 87. S.D. Comp. L. § 47-31A-410(g), as amended to "consideration paid."

(n88)Footnote 88. 192 N.W.2d at 725 . The court stated:

We conclude that if our legislature had contemplated only the return of plaintiff's original guaranteed debentures in the circumstances of the instant case it would have used the words "refund the consideration paid" as set forth in the Uniform Securities Act rather than the words "price equal to the full amount paid."

(n89)Footnote 89. Wash. Rev. Code § 21.20.430(1), which is substantially the same provision as under the Uniform Act.

(n90)Footnote 90. Garretson v. Red-Co., Inc., 516 P.2d 1039 (Wash. Ct. App. 1973) .

(n91)Footnote 91. 516 P.2d at 1042 . The court added: "[T]he act limits a seller's liability to a purchaser to the amount of consideration (plus interest) paid by the purchaser when he acquires the stock. This is true whether the purchaser still has the stock and seeks to rescind the sale, or whether he has disposed of the stock."

However, the issue in this case was not the same as the one faced by the South Dakota court in *Hofer*, above. The question under the Uniform Act still remains whether if the purchaser is entitled to return of the property or rescission of its cash equivalent if he or she pays for the securities with consideration other than cash. The problem becomes even more complex if the seller has disposed of the non-cash consideration and this is what the purchaser seeks to recover.

(n92)Footnote 92. 192 N.W.2d 718 (S.D. Sup. Ct. 1971) (decided under former statute).

(n93)Footnote 93. Hofer, 516 P.2d at 1042 , 1043. The statute examined by the court was that portion of the Uniform Act which had been deleted by amendment, but which was adopted in Washington.

(n94)Footnote 94. Wash. Rev. Code § 21.20.430(4)(b).

(n95)Footnote 95. 516 P.2d at 1043 .

(n96)Footnote 96. Merrill Lynch, Pierce, Fenner & Smith v. Byrne, 320 So. 2d 436 (Fla. Dist. Ct. App. 1975) .

(n97)Footnote 97. 320 So. 2d at 441 . While explaining that the burden was on the broker to offer in writing to take back the securities and to refund the purchase price (plus interest), the court stated that:

[T]he broker, therefore, is able to limit its loss in most cases by prompt action so the argument that the broker should not have to bear the loss here when the buyer--by selling at the higher price--could have prevented it, is without substance. Moreover, we feel that the statute is clearly designed for the benefit of the buyer--not the broker who is presumed to have superior knowledge and is in a position to minimize his losses.

See also Rowe, *Rescission Offers Under Federal and State Securities Law*, 12 J. Corp. L. 383 (1987); Lake, *Corporate Rescission Offers Under the Nebraska Securities Act*, 58 Neb. L. Rev. 718 (1979); Bromberg, *Curing Securities Violations: Rescission Offers and Other Techniques*, 1 J. Corp. L. 1 (1975).

(n98)Footnote 98. But see Utah Code Ann. § 61-1-22(2) (In cases of fraud a court may impose damages in an amount equal to three times the consideration paid for the securities.).

(n99)Footnote 99. Unif. Sec. Act § 410(h).

(n100)Footnote 100. See State of Montana v. Montana District Court, 228 Mont. 59, 741 P.2d 412 (Mont. 1987)

(punitive damages not available on counts characterized by relator-plaintiffs as Blue Sky claims for statute of limitations purposes); *Byrley v. Nationwide Life Ins. Co.*, 640 N.E.2d 187, 1994 Ohio App. LEXIS 771, [1995-1996 Transfer Binder] Blue Sky L. Rep. (CCH) P 74,016 (Ohio App. 1994) (punitive damages not authorized by Ohio Blue Sky law).

But see Ainsworth v. Skurnick, 960 F.2d 939, 1992 U.S. App. LEXIS 11005, [1991-1992 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,620 (11th Cir. 1992) (punitive damages recoverable in addition to other remedies); *In the Matter of David Allen Pendleton*, [1991-1993 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,621 (Mich. Order 1992) (civil penalty permitted).

(n101)Footnote 101. Ark. Code Ann. § 23-42-106 (a)(2); Or. Rev. Stat. § 59.115(2)(a).

(n102)Footnote 102. *Fulsaas v. Janitorial Enterprise, Inc.*, 1978 U.S. Dist. LEXIS 20313, 3 Blue Sky L. Rep. (CCH) P 71,453 (D. Or. 1978).

(n103)Footnote 103. *Mitchell v. Beard*, 513 S.W.2d 905 (Ark. Sup. Ct. 1974) .

(n104)Footnote 104. 513 S.W.2d at 908 .

(n105)Footnote 105. 513 S.W.2d at 908 .

See also Bowden v. Robinson, 136 Cal. Rptr. 871, 1977 Cal. App. LEXIS 1268 (Cal. Ct. App. 1977) , although punitive damages were not available under the facts of this case, punitive damages could be sought if premised on common law fraud.); *Ainsworth v. Skurnick*, 960 F.2d 939, 1992 U.S. App. LEXIS 11005 (11th Cir. 1992) *cert. denied* 507 U.S. 915, 113 S. Ct. 1269, 122 L. Ed. 2d 665 (1993) (punitive damages recoverable in addition to other remedies); *Anvil Investment Limited Partnership v. Thornbill Condominiums, Ltd.*, 85 Ill. App. 3d 1108, 407 N.E.2d 645 (Ill. App. Ct. 1980) (where the defendant's conduct was willful, amounted to malice, and surpassed inadvertence or neglect, a remedy above and beyond the statutory provisions was appropriate); *Naranjo v. Paull*, 803 P.2d 254 (N.M. App. 1990) (punitive damages allowable under New Mexico securities act.); *Pelletier v. Stuart James Co., Inc.* 863 F.2d 1550, 1557 (11th Cir. 1989) (punitive damages may be awarded on pendant state law claims even if federal securities statute does not permit them) (Georgia law); *Manufacturers Hanover Trust Co. v. Drysdale Sec. Corp.*, Fed. Sec. L. Rep. (CCH) 92902, 801 F.2d 13, 1986 U.S. App. LEXIS 30205 (2d Cir. N.Y. 1986); *Hall v. Security Planning Services, Inc.*, 462 F. Supp. 1058 (D.C. Ariz. 1978) ; *Faller Group, Inc. v. Jaffe*, 564 F. Supp. 1177 (S.D.N.Y. 1983) (although punitive damages are not generally available under Exchange Act Rule 10b-5, punitive damages are available under New York law upon a showing of willful and wanton misconduct).

But see Peterson v. Baloun, 715 F. Supp. 212 (N.D. Ill. 1989) (punitive damages not recoverable under Illinois Securities laws); *Renovitch v. Stewardship Concepts, Inc.* 654 F. Supp. 353 (N.D. Ill. 1987) (punitive damages not available under New York General Business Law §§ 339-1 and 352-c); *Sprangers v. Interactive Tech. Inc.*, 394 N.W.2d 498 (Minn. App. Ct. 1986) (punitive damages not recoverable for violation of Minnesota securities statute).

Cf. Jordan v. Clayton Brokerage Co., 975 F. 2d 539 (8th Cir. 1992) , *cert. denied*, 507 U.S. 916, 113 S. Ct. 1272, 122 L. Ed. 2d 667, 1993 U.S. LEXIS 1211 (1993) , in which \$400,000 in punitive damages awarded on a state common law breach of fiduciary duty claim survived a motion for judgment n.o.v. or for a new trial. The court found the punitive damages award was not "altogether disproportionate" to the plaintiff's injury, and applied considerations including the character and standing of the parties, the malice with which the act was done and the defendant's financial condition.

(n106)Footnote 106. Tex. Rev. Civ. Stat. Ann. § 581-33(M).

(n107)Footnote 107. *See, e.g., Morgan Keegan & Co., Inc. c. Cunningham*, 2005 Ala. LEXIS 66 (Ala. 2005) (Punitive damage award reversed where conduct amounted only to negligence).

(n108)Footnote 108. *See, e.g., Quay v. Heritage Financial, Inc.*, 274 Ga. App. 358, 617 S.E.2d 618 (2005) (Punitive damages in Georgia are limited to \$250,000 for any tort unless the defendant is found to have acted or failed to act with specific intent to cause harm).

(n109)Footnote 109. The constitutionality of the Uniform Securities Act provision allowing recovery of attorneys' fees by successful plaintiffs, but not by successful defendants, was upheld in *Bradley v. Hullander*, 287 S.E.2d 140 (S.C. 1982) .

(n110)Footnote 110. *Colo. Rev. Stat. § 11-51-604*.

(n111)Footnote 111. *See also Andrews v. Blue*, 489 F.2d 367 (10th Cir. 1973) (applying Colorado law); *Hunt v. Miller*, 908 F.2d 1210 (4th Cir. 1990) (attorney fees allowed against brokerage under N.C. law); *Brockmann Indus. v. Carolina Sec. Corp.*, 861 F.2d 798 (4th Cir. 1988) (attorney's fees not permitted under N.C. law when investor had accepted broker's rescission offer prior to suit); *Bemis v. Fidelity Deposit Co. of Maryland*, Blue Sky L. Rep., 1993-1994 CCH Decisions, P 73,897 (Dist. Ct. Idaho 1993) (attorney fee award denied when recovery limited to surety bond); *Piretti v. Dean Witter Reynolds Inc.*, 578 So.2d 474 (Fla. Ct. App. 1991) (attorney's fees awarded under Florida law); *Newsom v. Dean Witter Reynolds, Inc.*, 558 So. 2d 1076 (Fla. Ct. App. 1990) (attorneys' fees denied when broker found to have violated state securities laws prevailed on statute of limitations defense); *Opatz v. John G. Kinnard & Co.*, 454 N.W. 2d 471 (Minn. Ct. App. 1990) (attorneys fees awarded against broker under vicarious liability/agency principles).

(n112)Footnote 112. *See McPherson v. Hewitt*, 335 N.E.2d 606 (Ill. Ct. App. 1975) ; *see also Huggins v. Chapin*, 503 S.E.2d 356, 1998 Ga. App. LEXIS 913 , Blue Sky L. Rep., 1997-1998 CCH Decisions, P 74,164 (Ga. App. 1998) (court overturned award when no basis offered for fee calculation); *Hall v. Security Planning Services, Inc.*, 419 F. Supp. 405 (D.C. Ariz. 1976) (in applying Arizona's blue sky law, the court awarded attorneys' fees at the rate of ten percent as a surcharge of actual damages awarded).

(n113)Footnote 113. *Treider v. Doherty & Co.*, 527 P.2d 498 (N.M. Ct. App. 1974) , *cert. denied*, 527 P.2d 493 (N.M. Sup. Ct. 1974) ; *see also Plunkett v. Francisco*, 430 F. Supp. 235 (N.D. Ga. 1977) (applying Georgia law, the court instructed the attorneys for both sides to the litigation to negotiate a settlement of the amount of attorneys' fees. In the absence of agreement, a hearing on the question of fees was available to plaintiff's attorney).

(n114)Footnote 114. *Gowdy v. Richter*, 314 N.E.2d 549 (Ill. Ct. App. 1974) .

(n115)Footnote 115. *See, e.g., Young v. Taylor*, 466 F.2d 1329 (10th Cir. 1972) (applying Utah law); *see also Brockmann Indus.*, n. 55, *above*, 861 F.2d at 801 , in which the court observed: "[W]here a plaintiff prevails, he may recover the consideration 'together with' interest, costs and fees. The term 'together with' indicates that the statute provides attorneys' fees as an ancillary remedy where a plaintiff obtains rescission through litigation. It does not suggest a cause of action for recovery of fees alone ..." (Emphasis in original).

(n116)Footnote 116. *Shamburger v. McCann*, 1979 U.S. Dist. LEXIS 13493 , [1978-1980 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,496 (E.D. Ark. 1979).

(n117)Footnote 117. *Borovoy v. Bursar Realty Corp.*, 273 N.W.2d 545 (Mich. Ct. App. 1978) .

(n118)Footnote 118. 273 N.W.2d at 548 ; *see also Boettcher & Co., Inc. v. Munson*, 854 P.2d 199, 1993 Colo. LEXIS 471 , Blue Sky L. Rep., 1993-1994 CCH Decisions, P 73,844 (Colo. 1993) (same result under Colorado law); *Hayden v. McDonald*, 742 F.2d 423 (8th Cir. 1984) (same result under Minnesota law).

(n119)Footnote 119. *See Ch. 11, Regulation of Intermediaries: Broker-Dealers, Investment Advisers and Associated Persons, above*.

(n120)Footnote 120. *See, e.g., Alaska Stat. § 45.55.040(f)* (three years); *Cal. Corp. Code § 25216(e)* (two years); *N.J. Stat. Ann. § 49:3-57(e)* (two years).

(n121)Footnote 121. *See, e.g., Ga. Code Ann. § 10-5-6(b)*.

(n122)Footnote 122. *See, e.g., Ga. Code Ann. § 10-5-6(b)*.

(n123)Footnote 123. *Unif. Sec. Act § 410(d); see also Rev. Unif. Sec. Act § 609(c)*.

(n124)Footnote 124. *See, e.g., Cal. Corp. Code § 25509; Mass. Gen. L. Ann. ch. 110A, § 410(d); N.J. Stat. Ann. § 49:3-71(f); Tex. Rev. Civ. Stat. Ann. § 581-33(G)*.

(n125)Footnote 125. *See, e.g., Fla. Civ. Prac. and Pro. § 46.021*.



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Blue Sky Regulation

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CHAPTER 15 Civil Remedies

2-15 Blue Sky Regulation § 15.03

§ 15.03 Remedies at Common Law or in Equity

With the greatest focus here on statutory remedies, it is important to keep in mind that Blue Sky laws do not foreclose any other available remedies. Section 410 of the Uniform Securities Act and now section 509 of the 2002 Uniform Act form the core of any discussion of civil liabilities and statutory remedies under Blue Sky laws. However, any actions at common law or in equity, and any remedies and defenses that exist in addition to those expressly provided by statute, may be available by virtue of the savings clause found in paragraph (h) of section 410, and its equivalent in the various jurisdictions, which provides that the rights and remedies provided by the Act are in addition to any other rights or remedies that may exist at law or in equity. However, the same provision also makes clear that the Act does not *create* any cause of action not specified in the Act.

Because the Uniform Act and most states permit remedies available at common law and in equity in addition to those available under the Blue Sky laws, as an alternative to bringing an action for damages or rescission under the Blue Sky law, a defrauded purchaser, for example, may seek more complete relief in a common law suit for damages, alleging either fraud or negligent misrepresentation. Thus, for example, a plaintiff who may have suffered significant consequential damages as a result of a fraudulent transaction may wish to retain the securities and sue for damages rather than settle for rescission.ⁿ¹ In these circumstances, the plaintiff is allowed to affirm the transaction, retain the security (or consideration paid, if the seller is bringing suit), and sue instead for monetary damages.

The elements of common law fraud are discussed elsewhere in this Treatise.ⁿ² However, the measure of damages in a common law action for fraud is often based on the "benefit of the bargain" rule.ⁿ³ The "benefit of the bargain" is computed as the difference between the value of the security as represented and its actual value at the time of sale.ⁿ⁴ In addition, the injured party may recover consequential damages for losses proximately caused by the defendant's acts.ⁿ⁵ Thus, a comparison of type of suit (at common law or under the Blue Sky law) resulting in the greatest monetary recovery is possible.ⁿ⁶ Alternative pleading is permitted, and a plaintiff will not be required to elect remedies as between a Blue Sky statutory recovery and an available common law or equitable remedy.ⁿ⁷

An action for negligent misrepresentation is based upon negligence and not upon fraud. It arises when the defendant breaches a duty to exercise reasonable care in disclosing material facts relevant to the securities transaction.ⁿ⁸ Although actions for negligent misrepresentation in at least one state have arisen mainly in connection with sales of real property, the analysis of the elements of the action appears to be equally applicable to securities transactions.ⁿ⁹

The significance of preserving all forms of action available to a purchaser is illustrated by the decision of a New York trial court in *Berman v. 283 Washington Avenue LLC*,ⁿ¹⁰ in which a breach of contract action brought by the plaintiff purchaser was permitted to go forward despite the preclusion of any private remedy under New York's Blue Sky law--the Martin Act. There is no statutory private right of action under the Martin Act, and only the Attorney General can pursue and enforce its provisions. In *Berman*, the court concluded, however, that a plaintiff is not precluded from bringing a common law cause of action for breach of contract or fraud which is distinct from a claim under the Martin Act. The court stated:

[T]he Attorney General cannot adjudicate the plaintiff's breach of contract dispute which is not subject to Martin Act regulations, but pertain to a private dispute. Whether plaintiff's claims will survive a dispositive motion after issue has been joined remains to be decided. However, at this time, accepting plaintiff's facts, they support a common law action for breach of contract.

The significance of other remedies at common law or in equity is lessened overall by the fact that there are specific statutory causes of action which are generally easier to prove, it is well to keep the following remedies in mind: breach of warranty, tort action for deceit, reformation, specific performance, and declaration of a constructive trust.ⁿ¹¹

Although in Uniform Act states this manifest intent of the drafters, and legislatures adopting the Uniform Act, not to create any additional remedies likely precludes any judicially *implied* remedies, in states with an express civil liability provision that is silent as to whether the rights and remedies under the Blue Sky law are in addition to those at law or in equity, it may be possible to imply a private right of action for violation of particular provisions of the Blue Sky law. However, to do so requires application of principles that have long governed the implication of private rights of action under the federal securities laws, not the least of which today is that there be a manifest intent of the legislature to allow such a remedy where none is expressly provided.ⁿ¹²

FOOTNOTES:

(n1)Footnote 1. *See, e.g., Knoell v. Huff*, 224 Neb. 90, 395 N.W.2d 749 (1986) . In a 4-3 decision, the Supreme Court of Nebraska held that individuals who sustain damages in the purchase of securities are not restricted to suit under Nebraska's Blue Sky law, but may also pursue common law remedies; accordingly, the action was not time barred by the two-year statute of limitations in the Nebraska Securities Act; the common law causes of action were negligence, breach of fiduciary duty, and misrepresentation to which longer limitations periods arguably applied; *see also McCowan v. Sears, Roebuck & Co.*, 1990 U.S. Dist. LEXIS 347 , Blue Sky L. Rep., 1990-1991 CCH Decisions, P 73,261 (S.D.N.Y. Jan. 16, 1990).

But see Arst v. Stifel, Nicolaus & Co., Inc., 86 F.3d 973 , Blue Sky L. Rep., 1995-1996 CCH Decisions, P 74,100 (10th Cir. 1996) (defendant must have duty to disclose); *Butz v. Bliss*, 1987 U.S. Dist. LEXIS 6343 , Blue Sky L. Rep., 1997-1998 CCH Decisions, P 72,635 (S.D.N.Y. July 14, 1987) (scienter required).

(n2)Footnote 2. *See* Ch. 13, *Fraudulent and Other Prohibited Practices*, above.

See also Turner v. Enders, 15 Wn. App. 875, 552 P.2d 694 (1976) , in which the nine generally accepted elements of common law fraud or misrepresentation are presented; *Crazy Eddie Sec. Litig.*, 802 F. Supp. 804 (E.D.N.Y. 1992) .

(n3)Footnote 3. *See Turner*, above, 552 P.2d at 697 .

(n4)Footnote 4. *Sigman v. Stevens-Norton, Inc.*, 70 Wn.2d 915, 425 P.2d 891 (1967) .

(n5)Footnote 5. *See Stamp v. Rippe*, 29 Colo. App. 185, 483 P.2d 420 (1971) ; *see also Arst v. Stifel, Nicolaus & Co., Inc.*, 86 F.3d 973 , Blue Sky L. Rep., 1995-1996 CCH Decisions, P 74,100 (10th Cir. 1996).

(n6)Footnote 6. It should be noted, however, that attorneys' fees are not usually recoverable in a common law

action. *But see Badger v. Paulson Inv. Co.*, 311 Or. 14, 803 P.2d 1178 (1991) ; *see also* 9 Loss & Seligman, Securities Regulation 4128-4131 (Aspen Law & Business, 3d ed.).

(n7)Footnote 7. Courts will not require a plaintiff to elect remedies as between a Blue Sky statutory recovery and an available common law or equitable remedy. That being said, however, the fact that two remedies are mutually exclusive does not change the historical double recovery and one satisfaction rule. In *Aegis Ins. Holding Co. v. Gaiser*, No. 04-05-00938, 2007 Tex. App. LEXIS 2364 (March 28, 2007) , the court rejected the contention that investors may be forced to make an election of remedies, as for example, between rescission of their investment under the state securities law and damages for breach of contract. The court concluded, however, while a party may assert alternative theories of recovery, there cannot be recovery on both theories because that is considered a double recovery. In *Aegis*, the plaintiff investors sued for rescission of their investment based on misrepresentation under the Texas Securities Act and also sued for damages equaling the amount of their investment alleging breach of an agreement. The court concluded that even though the investors sued on different claims, there was only one injury as a result of the defendant's actions. Awarding either rescission under the Texas Securities Act or damages for breach of contract makes the investors whole, and that accordingly, the investors are entitled to one recovery through either claim.

(n8)Footnote 8. *See* Prosser & Keeton, Law of Torts § 107 (5th ed.); *see also* *Trust Co. of La. v. N.N.P., Inc.*, 104 F.3d 1478 (5th Cir. 1997) (Louisiana law); *Bear Stearns & Co. v. Daisy Sys. Corp.* (In re Daisy Sys. Corp.), 97 F.3d 1171 (9th Cir. 1996) (federal statute).

(n9)Footnote 9. *See* Comment, *Securities Fraud Under the Blue Sky Law of Washington*, 53 Wash. L. Rev. 279 (1978).

(n10)Footnote 10. Blue Sky L. Rep. (CCH) P 74,780 (Sup. Ct. New York County 2009).

(n11)Footnote 11. *See Baker, Watts & Co. v. Miles & Stockbridge*, 876 F.2d 1101 , [1988-1990 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,987 (4th Cir. 1989) (In a securities fraud case, Maryland claims to the extent they allow a right of action for indemnification are preempted by the federal securities laws, but Maryland common law and statutory actions for contribution are not preempted.). For general discussions of these remedies, *see* Loss & Seligman, Securities Regulation 1124-1128 (Aspen Law & Business, 3d ed.); Restatement (Second) of Torts (1965); Pomeroy, Equity Jurisprudence (1941).

See also Mashburn v. First Inv. Corp., 111 N.C. App. 398, 432 S.E.2d 869 (1993) (money had and received).

(n12)Footnote 12. *See Wade v. Skipper's, Inc.*, 915 F.2d 1324, 1329-1332 (9th Cir. 1990) (language of Washington state Securities Act indicated that legislature did not intend to impose civil liability beyond bounds of express provision), relying on *Ludwig v. Mutual Real Estate Investors*, 18 Wn. App. 33, 567 P.2d 658 (1977) . The Washington court refused to imply a private right of action for damages for violation of an antifraud provision of the Washington Blue Sky law without resort to the civil liability provision of the Blue Sky law. In the absence of the equivalent of Uniform Act § 410(h) from the Washington civil liability provision, the court stated: "While our legislature did not choose to incorporate § 410(h) into the Washington Securities Act, we do not think this omission is of sufficient significance to overcome the comprehensiveness and apparent intended exclusiveness of the remedies that are specified." 567 P.2d 663, n.8 .



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CHAPTER 15 Civil Remedies

2-15 Blue Sky Regulation § 15.04

§ 15.04 The Scope of Civil Liability

[1] Primary Liability

Primary, or direct, civil liability in private actions under Blue Sky laws is imposed on those persons who engage in or are directly involved in conduct that violates the law. In most states this encompasses persons who "participate" in the unlawful conduct, although participation is not a defined term. In Arizona, for example, section 44-2003(A) of the Arizona Securities Act provides that a private civil action:

[m]ay be brought against any person, including any dealer, salesman or agent, who made, participated in or induced the unlawful sale or purchase, and such persons shall be jointly and severally liable to the person who is entitled to maintain such action.ⁿ¹

Arizona courts have held that "participated in" for purposes of direct civil liability under the Act means "to take part in something" or "have a part or share in something."ⁿ² In *Grand v. Nacchio*,ⁿ³ the court examined the sufficiency of "participated in" allegations against defendants who were officers and directors of an issuer. Plaintiff trustees alleged that during the time the trust was purchasing shares in the public aftermarket of an initial public offering, the issuer was fraudulently inflating its earnings with fictitious revenue--a practice or course of business which operated as a fraud or deceit in connection with the trust's purchases. Plaintiffs claimed that the defendants participated in the trust's purchases of the stock by, among other things, sending reassuring written communications concerning market conditions and other favorable information, as well as favorable analysts' reports and misleading press releases. Plaintiffs alleged that the defendants were "information gatekeepers" who controlled disclosures that were made to the public.

Affirming dismissal of claims under the Act, the Arizona Court of Appeals concluded that these allegations fell short of demonstrating that the defendants had participated in the trust's purchases of stock in the aftermarket for purposes of section 44-2003(A). It would stretch the statutory language too far, said the court, to impose liability on persons as to aftermarket sales because to hold otherwise would be to impose liability on all publicly traded companies and their management without any showing of *inducement*, and only upon the showing that by creating an open market, they later necessarily participate in each and every sale conducted in that market. This is something far different from the direct involvement in a transaction which participation connotes.

Primary liability under the civil remedy provisions of Blue Sky laws is aimed at persons who actually offer or sell securities, or are directly involved in offers or sales in violation of the law. More often than not the scope of direct

liability is considered under the heading of "seller" liability, which is imposed for all violations. The scope of "seller" liability under Blue Sky laws extends to *any person* who offers or sells a security.ⁿ⁴ "Offer" and "offer to sell" and "sale" are defined terms in Blue Sky laws, and broadly include every attempt or offer to dispose of, or solicitation of an offer to buy a security for value.ⁿ⁵ Given the breadth of the definitions, "seller" status for purposes of civil liability under Blue Sky laws may be attached to all persons who solicit or directly participate in the process leading to a completed sale. The Court of Appeals of South Carolina illustrated this point in *Cowburn v. Leventis*,ⁿ⁶ in which summary judgment granted in favor of a lawyer against whom civil liability under the Blue Sky law was asserted for the sale of unregistered securities was reversed. The Court of Appeals found that the defendant lawyer had played an integral role in the program involving the sale of the securities. He had introduced investors to the program, and received a referral fee for doing so. The court further recounted the lawyer's activity as follows:

Leventis told potential investors about the Program and provided written information to them regarding the Program. Leventis persuaded potential investors to contribute to the program by telling them about other investors, including him and his mother, and their contributions. He also arranged trips for potential investors to meet with Gause and other principals of the Program. After individuals decided to invest in the Program, Leventis assisted them in making their investment by providing them with forms and information about how to set up a SDIRA. He even went further in some cases by filling out the forms for investors and assisting them with transactions.ⁿ⁷

To be sure, civil liability asserted against one in the position of the attorney in *Leventis* could also be based upon participation as that notion is described in *Grand v. Nacchio* above. As will be seen, it may also be seen as "aiding," and thus serve as the basis for liability when the particular statute contains such a broader provision for *secondary* liability. It is not necessary to do so, however, when the actions of a defendant constitute an attempt to dispose such that actual "seller" status may be found, and primary liability thus imposed. Perhaps the most useful standard for setting the scope of "seller" status is whether a defendant's acts were a substantial contributing factor in the sale transaction. In making that assessment, the Washington State Supreme Court identified three factors for a court to consider:

(1) The number of other factors which contribute to the sale and the extent of the effect which they have in producing it; (2) Whether the defendant's conduct has created a force or series of forces which are in continuous and active operation up to the time of sale, or has created a situation harmless unless acted upon by other forces for which the actor is not responsible; and (3) Lapse of time.ⁿ⁸

Other courts, influenced by the U.S. Supreme Court analysis of the scope of seller liability under section 12 of the Securities Act of 1933 in *Pinter v. Dahl*,ⁿ⁹ embrace a "financial benefit" test to determine seller status. Under that approach a seller is defined as one who is motivated by pecuniary gain. The definition extends to a person who solicits the purchase, motivated by desire to serve his or her own financial interests or those of the securities owner. The Supreme Court of Idaho endorsed this test as offering courts a clear line in deciding whether an individual meets the definition of "seller," while at the same time offering adequate protection to investors.ⁿ¹⁰

Against this judicial backdrop it is certain that in most cases the question of "seller" status for purposes of the civil liability provisions in Blue Sky laws will be one of fact. Indeed, in most cases, the issue has been considered in reviewing, and reversing, summary judgments granted in favor of defendants alleged to be sellers. It would be difficult under any of the common approaches to conclude that no material fact issue is presented in the necessary determination of the scope of "seller" status. However, it may be that boundaries based on clearly tangential and insignificant conduct of an actor can be discerned, and the three factors identified by the Washington Supreme Court discussed above may also provide a useful roadmap. More insight into the entire question of the scope of liability is available by considering approaches that have been taken in regard to non-seller or non-participant liability, that is, secondary liability of persons who do not actually sell a security in violation of or in a transaction that violates the Blue Sky law. That analysis follows below.

[2] Purchaser Civil Liability

Although the Uniform Securities Act does not provide for a suit against a buyer who by fraudulent means induces a sale by the seller, a few states permit civil actions by anyone, whether buyer or seller, defrauded in a securities transaction.ⁿ¹¹ The 2002 Uniform Act includes an express provision for antifraud liability of purchasers to sellers.ⁿ¹² Under this provision, a defrauded seller is entitled to recover the security sold, together with any income received on the security by the purchaser, along with costs and attorneys' fees. Alternatively, actual damages may be awarded, representing the price at which the security was sold and the value the security would have had at the time of the sale in the absence of the purchaser's conduct causing liability, plus interest, costs, and fees. This provision in the 2002 Act clearly reflects the modern trend in defining the scope of antifraud protections under state Blue Sky laws.

[3] Secondary Liability

[a] Statutory Joint and Several Liability

Statutory civil liability for sales of securities in violation of Blue Sky laws extends to certain categories of persons who do not actually sell (or purchase) the securities. Under section 410 of the original Uniform Securities Act, control persons, partners, officers, and directors of an actual seller who is liable, and employees, broker-dealers, and agents who materially aid in the sale are jointly and severally liable with the seller. However, non-seller liability under provisions based on section 410 is subject to the defense that the non-seller did not know and in the exercise of reasonable care could not have known of the existence of the facts by reason of which the liability is alleged to exist. Section 410(b) provides in pertinent part:

Every person who directly or indirectly controls a seller liable under subsection (a) [of Section 410], every partner, officer, or director of such seller, every person occupying a similar status or performing functions, every employee of such a seller who materially aids in the sale, and every broker-dealer or agent who materially aids in the sale are also liable jointly and severally with and to the same extent as the seller, unless the non-seller who is so liable sustains the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist.ⁿ¹³

Although the 2002 Uniform Act more precisely spells out the persons who may be held jointly and severally liable, it encompasses the same non-seller classifications and includes the same defense.ⁿ¹⁴ Both Acts provide for contribution among jointly and severally liable parties.

Section 410 of the original Uniform Act has been interpreted to divide non-sellers into two groups for liability purposes. If the non-seller is in control of the seller or if the non-seller is an officer, director, or partner (or similar person) of the seller, liability automatically attaches unless he or she can prove lack of knowledge within the meaning of the provision.ⁿ¹⁵ On the other hand, if the non-seller is an employee, broker-dealer, or agent, the purchaser must bear the additional burden of proof that such person materially aided in the sale.ⁿ¹⁶ Again, lack of knowledge proved by the non-seller is a defense. Although this defense has been accepted by states adopting the Uniform Act provision, as well as by courts in states not having a comparable statute,ⁿ¹⁷ it seems to be established that lack of knowledge means that the non-seller, after the exercise of reasonable care, did not know of the facts that might lead to personal liability.ⁿ¹⁸

Most states have substantially adopted the original Uniform Act provision.ⁿ¹⁹ Section 509(g) of the 2002 Uniform Securities makes the secondary liability construct clear in applying the "materially aids" qualifier to employees, broker-dealers, agents, investment advisers, or investment adviser representatives. Thus, in Idaho, for example, which has adopted the 2002 Uniform Act, the following persons are liable jointly and severally with and to the same extent as persons who are primary violators:

- (1) A person that directly or indirectly controls a person liable under subsections (b) through (f) of

this section, unless the controlling person sustains the burden of proof that the person did not know, and in the exercise of reasonable care could not have known, of the existence of conduct by reason of which the liability is alleged to exist;

(2) An individual who is a managing partner, executive officer, or director of a person liable under subsections (b) through (f) of this section, including an individual having a similar status or performing similar functions, unless the individual sustains the burden of proof that the individual did not know and, in the exercise of reasonable care could not have known, of the existence of conduct by reason of which the liability is alleged to exist;

(3) An individual who is an employee of or associated with a person liable under subsections (b) through (f) of this section and who materially aids the conduct giving rise to the liability, unless the individual sustains the burden of proof that the individual did not know and, in the exercise of reasonable care could not have known, of the existence of conduct by reason of which the liability is alleged to exist; and

(4) A person that is a broker-dealer, agent, investment adviser, or investment adviser representative that materially aids the conduct giving rise to the liability under subsections (b) through (f) of this section, unless the person sustains the burden of proof that the person did not know and, in the exercise of reasonable care could not have known, of the existence of conduct by reason of which liability is alleged to exist.ⁿ²⁰

There are variations on the Uniform Act provisions. In Virginia, for example, liability extends only to persons in control of the seller.ⁿ²¹ For others to be held liable, the purchaser must prove that the non-seller "materially participates or aids" in the sale. In Oregon, partners, officers, directors, and similar persons are liable as under the Uniform Act, but the statute makes any other person liable who "participates or materially aids" in the sale.ⁿ²² There is no specific reference to employees, broker-dealers, or agents. Iowa, which has substantially adopted the 2002 Uniform Securities Act, includes a variant on the 2002 Act employee joint liability provision to extend liability to any person--whether an employee of the seller *or otherwise*--who materially aids in the act or transaction constituting the violation, and who materially aids the conduct giving rise to the liability, who cannot meet the burden of the statutory defense.ⁿ²³

Some Non-Uniform Act state laws extend civil liability to any person that participates with or aids the seller in any way in making the sale. In Ohio, for example:

[T]he person making such sale or contract for sale, and every person that has participated in or aided the seller in any way in making such sale or contract of sale, are jointly and severally liable to the purchaser.ⁿ²⁴

The Texas Securities Act extends civil liability to "aiders"--any person who, directly or indirectly, with intent to deceive or defraud or with reckless disregard for the truth or the law materially aids a seller, buyer, or issuer of a security that is liable.ⁿ²⁵

Illinois makes persons liable strictly by virtue of their relationship to the seller. The Illinois statute imposes liability *per se* on the issuer, controlling person, underwriter, dealer, or other person by or on behalf of whom the sale is made.ⁿ²⁶ Other underwriters, dealers, or salesman who participated or aided in any way in making the sale may be held liable as may officers, directors, and similar persons of the issuer, controlling person, underwriter, dealer, or other organization by or on whose behalf the sale was made, but only if such persons participated or aided in making the sale.ⁿ²⁷

Civil liability in other states is imposed on directors, officers, agents or persons who personally participated or aided in any way in making the sale.ⁿ²⁸ Some statutes provide for liability of "any person" who "participated in or induced" the saleⁿ²⁹ or who has "participated or aided the seller in any way" in making the sale,ⁿ³⁰ but even where a statute names

only specific persons who are liable, such provisions have been stretched to reach persons not otherwise covered by the statute.ⁿ³¹

Even when a statute does not provide for personal liability of a partner, director, or officer of a seller, the level of activity needed to make such persons participants or aiders in a sale is not great. Officers and directors of a selling corporation are charged with the duty of knowing the existence of facts with respect to corporate operations, or, at the very least, of exercising that degree of care toward their responsibilities required of prudent persons.ⁿ³² Consequently, officers and directors of the seller have often been held personally liable when securities were sold by the corporation in violation of Blue Sky laws.ⁿ³³ Accordingly, it has been held that ignorance on the part of corporate directors and officers does not relieve them from liability.ⁿ³⁴ It has also been held that state securities laws are "designed to protect the public not only from fraud and dishonesty, but also from incompetency [sic], ignorance and irresponsibility of persons engaged in the business of disposing of securities to the public."ⁿ³⁵ Thus, the scope of liability is always defined broadly.ⁿ³⁶

In addition to the types of non-seller liability already discussed under the Uniform Act, California has two provisions modeled after two sections found in the Securities Exchange Act of 1934. The first is patterned after rarely used section 9(e) of that statute, with respect to liability for violation of the manipulation provisions, and provides:

Any person who willfully participates in any act or transaction in violation of Section 25400 shall be liable to any other person who purchases or sells any security at a price which was affected by such act or transaction for the damages sustained by the latter as a result of such act or transaction. Such damages shall be the difference between the price at which such other person purchased or sold securities and the market value which such securities would have had at the time of his purchase or sale in the absence of such act or transaction, plus interest at the legal rate.ⁿ³⁷

Basically, liability is predicated on willful participation in any act or transaction that contravenes the general liability provisionⁿ³⁸ and that accordingly affects the price paid for the purchase, or received during the sale, of a security.

The other California provision declares:

It is unlawful for an issuer or any person who is an officer, director or controlling person of an issuer or any other person whose relationship to the issuer gives him access, directly or indirectly, to material information about the issuer not generally available to the public, to purchase or sell any security of the issuer in this state at a time when he knows material information about the issuer gained from such relationship which would significantly affect the market price of that security and which is not generally available to the public, and which he knows is not intended to be so available, unless he has reason to believe that the person selling to or buying from him is also in possession of information.ⁿ³⁹

This represents an attempt at codification of the doctrine of implied liability under federal *Rule 10b-5* as applied to insider trading. In effect, the issuer and anyone in a control relationship with the issuer who is privy "to material information about the issuer not generally available to the public," and who uses such information to buy or to sell a security whose price would be affected by the general dissemination of such information, is liable to the purchaser or seller of that security.ⁿ⁴⁰ However, unlike under *Rule 10b-5*, the issuer or anyone in a control relationship with the issuer privy to inside information is not liable to a purchaser or seller of that security who is also in possession of the information. Damages would be "equal to the difference between the price at which such security was purchased or sold and the market value which such security would have had at the time of the purchase or sale if the information known to the defendant had been publicly disseminated prior to that time."ⁿ⁴¹ The statute of limitations in both instances is four years after the violation and one year after the plaintiff's discovery.ⁿ⁴²

Although what constitutes aid or participation is a question of fact, some cases have indicated general rules that may be

applied.ⁿ⁴³ Thus, actual participation of officers or directors in a sale is not necessary for the imposition of liability if they aided in any way in making the sale.ⁿ⁴⁴ Applying this principle, it would seem that knowledge of sales in violation of the law, such as a director's knowledge of unlawful sales in general, would be sufficient for the imposition of personal liability although a director had no knowledge of a sale to a particular purchaser.ⁿ⁴⁵ Even a totally inactive director has been charged with the responsibility of knowing about the affairs of his corporation and has been held personally liable.ⁿ⁴⁶ Nevertheless, one court held that an officer-director who knew that sales in violation of the Blue Sky law were being made may escape liability if he had not known of a particular purchaser.ⁿ⁴⁷ In another case, it was held that even though the seller's officers were not liable under the statute, a corporate officer's signature appearing on an unregistered promissory note was sufficient to hold the officer personally liable even though there was no other participation in any sale of the notes.ⁿ⁴⁸ However, another jurisdiction reached the opposite conclusion under a similar statute. The court held that liability attached only when the purchaser was induced to invest by some act or acts of the defendant. In the latter case, the defendant was an attorney who assisted in organizing the corporation in which the plaintiff invested.ⁿ⁴⁹ The only knowledge plaintiff had of defendant's connection with the company was that his signature appeared as attesting witness on the securities that were purchased. Plaintiff testified that she knew defendant personally, that she had trusted his judgment, and that she was swayed by the defendant's signature on the securities. It was established, however, that defendant had no further contact with plaintiff with respect to the securities, and that the appearance of his signature on the securities was not sufficient to impose liability.

In addition, before a person can be held liable as materially aiding a sale, it must be established that there was a seller who would also be liable. In an Oklahoma case,ⁿ⁵⁰ where persons were held liable as participants who materially aided in the sale, the only persons involved who could possibly be the actual sellers were held not to be liable. On appeal, the judgment against the "participants" was reversed. The court stated: "as the prerequisite for liability by a participant or aider in a sale ... the person making the sale must be liable."ⁿ⁵¹

In assessing the scope of secondary liability under the civil remedy provisions of Blue Sky laws, questions relating to a particular type of actor sometimes arise. Attorneys, for example, may play a meaningful role in the structuring and execution of transactions for an issuer or other seller, and in that capacity may be open to secondary liability assertions. In other settings, specialized issues may arise as to promoters and agents. Civil liability approaches to these particular non-sellers are discussed further below.

Attorneys. Personal liability of attorneys as non-sellers in securities transactions has been the subject of a variety of cases. In an early case,ⁿ⁵² the attorneys represented the seller of securities and assisted the seller in issuing the securities by drafting and filing documents and performing other services normally performed by lawyers for their clients in similar circumstances. There was no allegation that the attorneys knew that sales were made in violation of the Blue Sky laws. The court held that the attorneys could not be held personally liable. The Oregon statute in effect at the time required the purchaser to plead and prove that the non-seller participant had knowledge of the violation of the Blue Sky law. However, the Oregon statute as amended is now based on the Uniform Securities Act, and the burden is on the defendant to raise the defense of lack of knowledge to avoid liability.ⁿ⁵³

In a subsequent case decided by a federal court applying then current Oregon law,ⁿ⁵⁴ the court recognized that a person may participate in a sale without communication with the purchaser and held that the sale could not have been made without the attorney who prepared the legal documents. It was then up to the attorney as a participant to prove that he had no knowledge that the sales were made in violation of the statute. When the Oregon Supreme Court examined this federal decision, it held that the statements therein "may be overly broad, if literally applied," and refused to be bound by the federal interpretation.ⁿ⁵⁵ In this case, it was held that an attorney who prepared, attended to the execution of, and personally delivered and filed documents to register securities was personally liable when he had knowledge that solicitation and sales had already been made.ⁿ⁵⁶

Promoters. On occasion, persons who are not direct participants in the activities of the seller will be held liable although they are not partners, officers, or directors. In one case,ⁿ⁵⁷ a promoter was permitted to register the securities

with the state on the condition that all proceeds were to be placed in escrow until \$25,000 was accumulated. If such amount was not obtained by a fixed date, the entire collected sum was to be returned to the subscribers. When it appeared that the required amount would not be raised, the promoter personally borrowed the amount needed from the defendant. Upon release of the escrow funds, the promoter began to repay the defendant from this money. When the corporation failed, the subscribers brought suit against the promoter and defendant. In holding defendant liable, the court found that there was sufficient evidence to believe that the loan was made for the purpose of obtaining defendant's assistance to circumvent the Securities Act.ⁿ⁵⁸

Agents. Personal liability has been found against an agent licensed to sell securities whose only participation was to mention to the purchasers that he had invested his own money in the securities, believing it was a good investment.ⁿ⁵⁹ The court found that the purchasers substantially relied on the agent's statements and such statements were decisive factors in inducing the sales. The fact that the agent did not know the securities were unregistered was deemed immaterial.ⁿ⁶⁰

[b] Civil Aiding and Abetting

The availability of private claims against aiders and abettors of violations of Blue Sky laws is extremely significant for aggrieved purchasers and sellers of securities today in the wake of the 1994 United States Supreme Court decision which eliminated such secondary liability claims under the antifraud provisions of the federal securities laws.ⁿ⁶¹ As discussed above, under the civil liability provisions of Blue Sky laws, purchasers (and in some states sellers) of securities may seek rescission or damages from persons who "materially aid" or who "participate" with parties who commit primary violations of state registration and antifraud provisions. This is statutory secondary liability. Civil aiding and abetting may be available as a separate basis for imposing secondary liability for violations of Blue Sky laws.

Not all states recognize civil aiding and abetting as an independent cause of action in any context. Where allowed, however, the claim is premised on some degree of knowledge of facts and assistance in commission of the violation committed by another. The difference between aiding and abetting and statutory joint and several liability under Blue Sky laws was explained in *State ex rel. Goettsch v. Diacide Distributors, Inc.*,ⁿ⁶² in which the Iowa Supreme Court held the plaintiff to the burden of proving knowledge of a securities law violation by the alleged aider and abettor. In an action under the Blue Sky law for materially aiding in the conduct giving rise to the liability, the burden is on the defendant to prove that he or she did not know and in the exercise of reasonable diligence could not have known, of the existence of conduct by reason of which the liability is alleged to exist.

The availability of civil aiding and abetting as an independent cause of action in a state in which the Blue Sky statutory secondary liability provision is limited is an important consideration. There is a certain universal approach, however, that will focus attention on the knowledge, or scienter, of an alleged aider and abettor. Culpability standards in assessing civil liability generally are discussed further below. It is certain though that a common assessment, whether an aiding and abetting claim is statutory or common law based, was expressed by an Iowa Court of Appeals in *Pender State Bank v. Remington*,ⁿ⁶³ in which the court affirmed summary judgment granted in favor of an alleged aider and abettor of violations of the Iowa Blue Sky law which had been presented in an administrative cease-and-desist order against the primary actor:

While Koerselman knew Harriett intended to invest in Columbia, a start-up company, we find no evidence in the record to show Koerselman knew, or should have known, the parties named in the cease and desist order were violating the Iowa securities laws. There was no evidence Koerselman had any contact with any of the parties named in the cease and desist order. The letter signed by Harriett at the time she signed the loan documents provides that the Bank 'has not studied nor have we endorsed in any way any investments.'ⁿ⁶⁴

[4] Culpability Standards

On the face of basic civil remedy provisions of Blue Sky laws, the liability of one who actually offers or sells a security in violation of the law is virtually absolute, subject only to the applicable statute of limitations. There is, for example, no requirement that a seller "knowingly" or "intentionally" sell unregistered securities in order to be held liable for rescission or damages as a rescission equivalent. Similarly, as a federal district court applying Wisconsin law held, an issuer may be held liable for rescission and other statutory recovery to a purchaser when its agent is not properly licensed. The fact that the issuer did not know that its agent was required to be licensed as a broker was deemed irrelevant by the court, which ruled: "[A]n issuer violates [the Wisconsin Blue Sky licensing provision] if it employs an unlicensed agent who is not exempt from the licensing requirement, whether the issuer knew of the agent's unlicensed status or not."⁶⁵

On the other hand, an Ohio appellate court declined to impose civil liability under that state's Blue Sky civil remedy provision on an individual who unquestionably sold unregistered securities, but did so with a mistaken belief, after making a reasonably diligent inquiry into the issue, that the instrument involved was not a security. In *Williams v. Guarnieri*,⁶⁶ the plaintiffs purchased promissory notes, as investments, from the defendants. The notes were not registered under the Ohio Blue Sky law, and when the issuer defaulted, plaintiffs sued the defendant seller for rescission. The appeals court affirmed a lower court decision denying rescission. Although it was undisputed that the promissory notes were securities subject to registration requirements, the court concluded that plaintiffs should not automatically recover their investment. According to the appeals court, plaintiffs must show that the defendant knowingly sold unregistered securities. The defendant had testified that he had been advised by several individuals, including his broker-dealer, that the notes were merely debt obligations and not securities. The court found that despite this wrong conclusion, the defendant had exercised reasonable diligence in seeking to determine whether the notes were securities.⁶⁷

This approach in Ohio, which injects a culpability element into civil liability determinations that on the face of the statute would appear to be absolute, underscores an important consideration in assessing the scope of civil liability. The result in *Guarnieri* turned on the court's assessment of the "violation" involved. In the Ohio Blue Sky law, "violations" are defined.⁶⁸ The applicable "violation" provided that no person shall "knowingly" sell or cause to be sold unregistered or non-exempt securities. The "knowingly" element of the violation was read by the court in conjunction with another provision in the Blue Sky law so as to conclude that a reasonable inquiry was required and that, by extension, one who fulfills the obligation would not act knowingly when it turns out that the securities should have been registered. Civil liability, and thus the civil remedy, is dependent on there being a "violation," which in *Guarnieri* the court found wanting. In this, the court illustrated how a culpability element may be added to what by conventional wisdom is considered strict liability of a seller.⁶⁹

Civil liability provisions based on section 410 of the Uniform Securities Act separate violations of securities registration and intermediary licensing requirements from antifraud liability. These statutes do not impose strict liability on a seller for untrue statements or omissions. Instead, they provide a reasonable care defense, by which the seller may meet the burden of proof "that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission."⁷⁰ The seller's burden may be high, but the available defense establishes a baseline element of culpability in civil liability determinations. This is equally apparent in the manner in which secondary or aiding and abetting liability has been handled under Blue Sky civil liability provisions.

To the extent secondary, or aiding and abetting, liability is permitted under the civil remedy provisions of Blue Sky laws, it is predicated on a general awareness of the role of the secondary actor in commission of a primary violation in addition to substantially assisting the primary violator. In a 2005 decision, the Texas Supreme Court, for example, opined that in order to impose aiding and abetting liability under the Texas Securities Act, a plaintiff must show that the alleged aider "possessed a general awareness that his role was part of an overall activity that is improper."⁷¹ This, said the court, means that an aider can only be held liable if it rendered substantial assistance in the face of a perceived risk

that its assistance would facilitate untruthful or illegal activity by the primary wrongdoer. Although several state Blue Sky laws extend civil liability under the basic remedy provision generally to aiders and abettors, or to persons who materially participate in an unlawful transaction, secondary liability extending beyond control persons, employees, and agents of a seller who aid in a sale is not the norm. Moreover, for those secondary actors who are expressly exposed to liability there is commonly a "reasonable care" defense provided, thus underscoring the element of culpability necessary to the imposition of civil liability.ⁿ⁷²

Where the focus is on secondary liability, or the violation alleged is fraud, a culpability standard clearly makes sense. When the violation is the offer or sale of unregistered, non-exempt securities, or the failure to be licensed as a broker-dealer or agent, the logic of a culpability element is far less certain. The mission of Blue Sky laws to protect investors through securities registration and intermediary licensing weighs heavily against denying recovery for innocent or "technical" violations of these provisions by any primary ("seller") violator. Still, as *Guarnieri* illustrates, courts may be unwilling to impose strict liability when a seller has in fact acted in good faith to assess the need for compliance and been misguided into a failure to comply.

FOOTNOTES:

(n1)Footnote 1. *Ariz. Rev. Stat. § 44-2003(A)*.

(n2)Footnote 2. *Standard Chartered PLC v. Price Waterhouse*, 190 Ariz. 6, 21, 945 P.2d 317, 332 (Ct. App. 1996) .

(n3)Footnote 3. 217 P.3d 1203 , Blue Sky L. Rep. (CCH) P 74,792 (Ct. App. 2009).

(n4)Footnote 4. *See, e.g.*, Unif. Sec. Act § 410; Unif. Sec. Act § 509 (2002).

(n5)Footnote 5. Section 102(26) of the 2002 Uniform Securities Act, for example, provides in pertinent part:

'Sale' includes every contract of sale, contract to sell, or disposition of, a security or interest in a security for value, and 'offer to sell' includes every attempt or offer to dispose of, or solicitation of an offer to purchase a security or interest in a security for value.

(n6)Footnote 6. 366 S.C. 20, 619 S.E.2d 437 (2005) .

(n7)Footnote 7. 366 S.C. 20, 32 .

(n8)Footnote 8. *Haberman v. Washington Public Power Supply System*, 109 Wn.2d 107, 131-132, 744 P.2d 1032 (1987) .

See also *Herrington v. Hawthorne*, 111 Wn. App. 824, 47 P.3d 567 (2002) , *petition for review denied*, 148 Wn.2d 1025, 66 P.3d 638 (2003) (defendant was provided a general power of attorney and financial statements, and attempted to convince plaintiffs to invest); *Kirchoff v. Selby*, 703 N.E.2d 644 (Ind. 1998) . The "substantial factor" test has also been utilized by courts in Texas and Kansas, *see Lutheran Brotherhood v. Kidder Peabody & Co., Inc.*, 829 S.W.2d 300, 306 (Tex. App. 1992) ; *State ex rel. Mays v. Ridenhour*, 248 Kan. 919, 811 P.2d 1220 (1991) .

But see *Standard Chartered PLC v. Price Waterhouse*, 190 Ariz. 6, 945 P.2d 317 (Ct. App. 1996) (independent auditing firm's activities were only tangentially related to the sale, and the firm did not participate in or induce the subject securities transaction).

(n9)Footnote 9. 486 U.S. 622, 108 S. Ct. 2063, 100 L. Ed. 2d 658 (1988) .

The definitions of "sale" and "offer to sell" in the Securities Act of 1933, and those in the Uniform Act are nearly

identical. In *Pinter v. Dahl*, the U.S. Supreme Court resolved a longstanding conflict among the lower federal courts regarding the standard for determining whether a particular person has "offered" or "sold" securities for purposes of liability under the 1933 Act. The Court held that liability extended to a "person who successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner." The Court concluded, however, that being merely a "substantial factor" in causing the sale was not sufficient in itself for liability.

(n10)Footnote 10. *Meyers v. Lott*, 133 Idaho 846, 993 P.2d 609 (2000) .

(n11)Footnote 11. *See, e.g., N.J. Stat. Ann. § 49:3-71(a); Vt. Stat. Ann. tit. 9, § 4240(c).*

See also American General Ins. Co. v. Equitable General Corp., 493 F. Supp. 721, 750 (E.D. Va. 1980) (conduct of corporate buyer satisfied necessary elements of liability under Texas Blue Sky law for an insurance holding company which fraudulently repurchased blocks of its own stock from sophisticated financial investor); *Baker v. Pfeifer*, 940 F. Supp. 1168 , [1995-1996 Transfer Binder] Blue Sky L. Rep. (CCH) P 74,155 (S.D. Ohio 1996) (statute of limitations not applicable to defrauded sellers).

(n12)Footnote 12. Unif. Sec. Act § 509(c) (2002).

(n13)Footnote 13. Unif. Sec. Act § 410(b).

(n14)Footnote 14. *See* Unif. Sec. Act § 509(g)(1)-(4) (2002).

(n15)Footnote 15. *See, e.g., Molecular Technology Corp. v. Valentine*, 925 F.2d 910, 920 (6th Cir. 1991) (plain reading of statute imposes liability on directors who knew or reasonably should have known the information was false or misleading); *Hines v. Data Line Systems, Inc.*, 114 Wn.2d 127, 787 P.2d 8, 14 (1990) (under plain language of statute, investors need only show defendant "directly or indirectly" controlled the seller; plaintiff not required to prove culpable participation but burden shifts to defendant to prove lack of knowledge); *Taylor v. Perdition Minerals Group, Ltd.*, 244 Kan. 126, 766 P.2d 805, 811 (1988) (Kansas statute imposes strict liability on directors as non-selling parties unless statutory defense of lack of knowledge proven).

See also Kirchoff v. Selby, 688 N.E.2d 1284 (Ind. Ct. App. 1997) , *aff'd in part and vacated in part, on other grounds*, 703 N.E.2d 644 (Ind. 1998) (Under the former Blue Sky law, the Indiana statute imposed derivative liability on five groups: (1) each person who directly or indirectly controls a person liable under the relevant provisions; (2) each partner, officer, or director of the person; (3) each person occupying a similar status or performing similar functions; (4) each employee of a person who materially aids in the conduct creating liability; and (5) each broker-dealer or agent who materially aids in the conduct; only fourth and fifth categories require personal participation in transaction and statute does not require partner, officer, director, or controlling person to materially aid violation to be liable.); *Badger v. Paulson Inv. Co.*, 311 Or. 14, 803 P.2d 1178 (1991) (Oregon statute provides for derivative liability of every non-selling person who (a) directly or indirectly controls seller and (b) every person who participates or materially aids in sale but controlling non-seller can escape liability if the non-seller sustains burden of proof that the non-seller did not know, and, in exercise of reasonable care, could not have known, of existence of the facts on which liability is based); *Castle v. Ritacco*, 142 Or. App. 89, 919 P.2d 1196 , [1995-1996 Transfer Binder] Blue Sky L. Rep., (CCH) P 74,115 (1996).

(n16)Footnote 16. *See, e.g., Quick v. Woody*, 295 Ark. 168, 747 S.W.2d 108, 111-112 (1988) (agent who convinced investor to buy securities, gave out prospectuses and advice regarding securities and solicited sales materially aided sales).

But see Metal Tech Corp. v. Metal Techniques Co., 74 Or. App. 297, 703 P.2d 237, 245-246 (1985) (more than mere preparation and execution of documents required to find liability for materially aiding sale under Oregon statute).

See also *Quincy Co-Operative Bank v. A.G. Edwards & Sons, Inc.*, 655 F. Supp. 78 (D. Mass. 1986) (broker-dealer was subject to liability as seller or person controlling seller under Massachusetts Blue Sky law for alleged material omissions by its representative in recommending bond purchase; firm's claim that it acted only as broker and not seller was rejected since its participation in sale was substantial factor in inducing purchase); *In re Paine Webber, Inc.*, [1995-1996 Transfer Binder] Blue Sky L. Rep. (CCH) P 74,089 (Tex. Sec. Bd. 1996); but see *Connecticut National Bank v. Giacomini*, 242 Conn. 17, 699 A.2d 101 (1997) ("agent" limited to natural persons); *Tatum v. Legg Mason Wood Walker, Inc.*, 83 F.3d 121, [1995-1996 Transfer Binder] Blue Sky L. Rep. (CCH) P 74,094 (5th Cir. 1996) (no showing that defendant acted as agent or salesperson).

(n17)Footnote 17. See *Connecticut National Bank v. Giacomini*, 242 Conn. 17, 699 A.2d 101 (1997); *Huryta v. White*, 184 Neb. 24, 165 N.W.2d 354 (1969).

But see *Hines v. Data Line Systems, Inc.*, 114 Wn.2d 127, 787 P.2d 8, 17-19 n.23 (1990) (defense only available if such person "did not know" and "could not have known of" existence of liability producing facts); *Heilbron v. ARC Energy Corp.*, 757 S.W.2d 294, 296 (Mo. Ct. App. 1988) ("Whether or not [the defendant] exercised reasonable care in conducting the affairs of his business is not relevant under [the statute]. The statute would exempt him from liability only if he could prove that, in the exercise of reasonable care, he could not have known of the existence of the facts which have given rise to his liability."); *Huryta v. White*, 184 Neb. 24, 165 N.W.2d 354 (1969); see also *Steenblik v. Lichfield*, 906 P.2d 872, Blue Sky L. Rep. (CCH) P 74,074 (Utah 1995); *Gilbert v. Meason*, 137 Ga. App. 1, 222 S.E.2d 835 (1975), *aff'd*, 236 Ga. 862, 226 S.E.2d 49 (1976); *Boddy v. Theiling*, 129 Ga. App. 273, 199 S.E.2d 379 (1973).

(n18)Footnote 18. See *Hines*, 787 P.2d 8, at 19 (reliance on counsel regarding materiality of facts does not sustain officer's burden of proof that he did not know of existence of facts by reason of which liability is alleged to exist); *Taylor v. Perdition Minerals Group, Ltd.*, 244 Kan. 126, 766 P.2d 805, 811, n.23 (1988).

But see *Badger v. Paulson Inv. Co.*, 311 Or. 14, 803 P.2d 1178 (1991) (two registered representatives had apparent authority of their employing broker-dealer firm in conducting fraudulent sales of securities, and firm secondarily liable to investors).

(n19)Footnote 19. See, e.g., *Ala. Code* § 8-6-19(b); *Cal. Corp. Code* §§ 25504, 25504.1, 25505.

See also *Foster v. Jesup & Lamont Securities Co.*, 482 So. 2d 1201 (Ala. 1986); *Durham v. Kelly*, 810 F.2d 1500 (9th Cir. 1987) (allegations in an action against a corporate secretary and director based on the controlling person provision of *Cal. Corp. Code* § 25504, in connection with alleged misrepresentation by her husband, the corporation president, dismissed for failure to present facts demonstrating that defendant knew that her husband made misrepresentations or concealed material facts in violation of California's Blue Sky law); *In re Victor Technologies Sec. Lit.*, 1987 U.S. Dist. LEXIS 13584 (N.D. Cal. Jan. 8, 1987) (dismissing claims under the general antifraud provisions of California's Blue Sky law against an accounting firm possible for auditing financials in a company's registration statement and prospectus, for lack of strict privity between the firm and plaintiff investors); *ZZZZ Best Sec. Litig.*, 1990 U.S. Dist. LEXIS 20867 (C.D. Cal. Jan. 8, 1990).

See also *Mass. Gen. Laws Ann.*, ch. 110A, § 410(b); *N.J. Stat. Ann.* § 49:3-71(d); 70 *Pa. Cons. Stat. Ann.* § 1-503. Pennsylvania attaches liability to affiliates of the seller instead of persons in control. When officers are to be held liable, they are to be principal executive officers.

(n20)Footnote 20. *Idaho Code* § 30-14-509(g).

(n21)Footnote 21. *Va. Code Ann.* § 13.1-522(c).

(n22)Footnote 22. *Or. Rev. Stat.* § 59.115(3).

(n23)Footnote 23. *Iowa Code § 502.509(7)(c)* imposes joint and several liability for:

An individual who is an employee of or associated with a person liable under subsections 2 through 6 or a person, whether an employee of such person or otherwise, who materially aids in the act or transaction constituting the violation, and who materially aids the conduct giving rise to the liability, unless the individual sustains the burden of proof that the individual did not know and, in the exercise of reasonable care could not have known, of the existence of conduct by reason of which the liability is alleged to exist.

(n24)Footnote 24. *Ohio Rev. Code § 1707.43*.

(n25)Footnote 25. *Tex. Stat. § 33.F*.

In California, any person who "materially assists" in certain violations with intent to deceive or defraud is jointly and severally liable with every other person liable under the Act. *See Cal. Corp. Code § 25504.1*. California courts have explained that "intent to defraud" under this provision equates with intent "to induce reliance" on a knowing misrepresentation or omissions. *See Lazar v. Superior Court*, 12 Cal. 4th 631, 638, 49 Cal. Rptr. 2d 377, 909 P.2d 981 (1996) ; *see also Apollo Capital Fund LLC v. Roth Capital Partners, LLC*, 158 Cal. App. 4th 226, 257, 70 Cal. Rptr. 3d 199 (2007) .

(n26)Footnote 26. 815 Ill. Comp. Stat., § 5/13.

(n27)Footnote 27. In *Jacobs v. James*, 215 Ill. App. 3d 499, 158 Ill. Dec. 899, 574 N.E.2d 1292 (1991) , the chairman of the board of a bank holding company was held liable for the unregistered issuance of debentures on a controlling person theory for voting to authorize the issuance while owning more than 25% of the company's shares and "act[ing] in concert with" the company's president "who did personally solicit the sales."

(n28)Footnote 28. *See, e.g., Fla. Stat. Ann. § 517.211*; *see also Fireman's Ins. Co. v. Vento*, 586 So. 2d 89 (Fla. Dist. Ct. App. 1991) (error to award rescission of note by summary judgment on counterclaim since question of fact remained as to whether plaintiff-surety that paid off note and now sought to recoup was "seller" of the note); *Whigham v. Muehl*, 500 So. 2d 1374 , Blue Sky L. Rep. (CCH) P 72,471 (Fla. Dist. Ct. App. 1987) in which a defendant who was equal partner in a family business when it was first organized, and who became a director, vice-president, and stockholder in the business when it was incorporated, was found to have aided the sale of securities sufficiently to be liable under Florida's Blue Sky antifraud provision due to her active participation in the organization of the business and its ongoing affairs, although she did not request funds from plaintiff.

(n29)Footnote 29. *See, e.g., Ariz. Rev. Stat. Ann. § 44-2003*; *see also Kirchoff v. Selby*, 686 N.E.2d 121 (Ind. Ct. App. 1997) , *aff'd in part and vacated in part, on other grounds*, 703 N.E.2d 644 (Ind. 1998) .

(n30)Footnote 30. *See, e.g., Ohio Rev. Code § 1707.43*; *see also Baker v. Conlan*, 66 Ohio App. 3d 454, 585 N.E.2d 543 (1990) . In addition, Ohio has an anti-touting provision:

[W]homever, with intent to secure financial gain to himself, advises and procures any person to purchase any security, and receives any commission or reward for such advice or services without disclosing to the purchaser the fact of his agency or his interest in such sales, shall be liable to such purchaser for the amount of such purchaser's damage thereby, upon tender of such security to, and suit brought against, such adviser, by such purchaser. No such suit shall be brought more than one year subsequent to such purchase.

Ohio Rev. Code § 1707.42.

See also *Perkowski v. Megas Corp.*, 55 Ohio App. 3d 234, 563 N.E.2d 378 (1990) (radio talk show host who received compensation from issuer for promoting its unregistered securities on show was liable to investor in the securities).

(n31)Footnote 31. See, e.g., *Adamson v. Lang*, 236 Or. 511, 389 P.2d 39 (1964) . Although this case was decided under prior Oregon law, the statutory provision in effect at the time is similar to those cited in nn. 17, 20 and 30, above; see also *Perkowski*, 55 Ohio App. 3d 234, 563 N.E.2d 378 .

(n32)Footnote 32. *Connecticut National Bank v. Giacomini*, 242 Conn. 17, 699 A.2d 101 (1997) ; *Huryta v. White*, 184 Neb. 24, 165 N.W.2d 354 (1969) .

But see *Hines v. Data Line Systems, Inc.*, 114 Wn.2d 127, 787 P.2d 8, 17-19 n.23 (1990) (defense only available if such person "did not know" and "could not have known of" existence of liability producing facts); *Heilbron v. ARC Energy Corp.*, 757 S.W.2d 294, 296 (Mo. Ct. App. 1988) ("Whether or not [the defendant] exercised reasonable care in conducting the affairs of his business is not relevant under [the statute]. The statute would exempt him from liability only if he could prove that, in the exercise of reasonable care, he could not have known of the existence of the facts which have given rise to his liability.").

(n33)Footnote 33. See *Huryta v. White*, 184 Neb. 24, 165 N.W.2d 354 (1969) ; see also *Steenblik v. Lichfield*, 906 P.2d 872 , Blue Sky L. Rep. (CCH) P 74,074 (Utah 1995); *Gilbert v. Meason*, 137 Ga. App. 1, 222 S.E.2d 835 (1975) , *aff'd*, 236 Ga. 862, 226 S.E.2d 49 (1976) ; *Boddy v. Theiling*, 129 Ga. App. 273, 199 S.E.2d 379 (1973) .

(n34)Footnote 34. See *Karnes v. McDowell*, 87 B.R. 554, 559 (Bankr. S.D. Ill. 1988) (under Wisconsin Blue Sky law, liability for sale of unregistered and nonexempt securities absolute; seller's intent and knowledge of violation irrelevant); *Trimble v. American Sav. Life Ins. Co.*, 152 Ariz. 548, 733 P.2d 1131, 1136 (Ct. App. 1986) (company selling securities has affirmative duty not to mislead potential investors); see also *McGonigle v. Combs*, 968 F.2d 810 (9th Cir. 1992) .

(n35)Footnote 35. *Jenkins v. Dearborn Securities Corp.*, 42 Ill. App. 3d 20, 355 N.E.2d 341, 344 (1976) .

(n36)Footnote 36. See also *Marshall v. Harris*, 276 Or. 447, 555 P.2d 756, 760 (1976) , in which the court targeted: "a certain class of gentlemen ... [who] toil not neither do they spin,' but who 'lie awake nights endeavoring to conceive some devious and shadowy way of evading the law.'" (quoting *Sperry & Hutchinson Co. v. Hudson*, 190 Or. 458, 226 P.2d 501 (1951)) .

(n37)Footnote 37. *Cal. Corp. Code* § 25500.

See also *Diamond Multimedia Systems, Inc. v. Superior Court*, 19 Cal. 4th 1036, 80 Cal. Rptr. 2d 828 , 968 P.2d 539 (1999) (far from restricting market manipulation actions to those brought under federal securities law, Congress left individual actions unrestricted; except to extent SLUSA limits class actions, there is no preemption and federal law in this arena supplements, but does not displace, state regulation and remedies).

(n38)Footnote 38. *Cal. Corp. Code* § 25400.

(n39)Footnote 39. *Cal. Corp. Code* § 25402.

See also *Cal. Corp. Code* § 25502.5, providing that any person trading on inside information in securities of an issuer with total assets exceeding \$1 million and a class of equity securities held of record by 500 or more persons is liable to the issuer for damages up to three times the difference between the price at which the security was purchased or sold and the putative market value at the time had the information been publicly disseminated and a market absorption period elapsed. Costs and attorney's fees are available for an issuer or person suing derivatively. The damages are

reduced, however, by any amount recovered by the SEC on account of the insider transaction(s) and the state action will be delayed if a proceeding by the SEC has been commenced but not finally resolved. *See also* Berger, *Issuer Recovery for Insider Trading Profits Under Section 25502.5 of the California Corporations Code*, 21 Pac. L.J. 221 (1990).

(n40)Footnote 40. *Cal. Corp. Code* § 25502 provides:

Any person who violates Section 25402 shall be liable to the person who purchases a security from him or sells a security to him, for damages equal to the difference between the price at which such security was purchased or sold and the market value which such security would have had at the time of the purchase or sale if the information known to the defendant had been publicly disseminated prior to that time and a reasonable time had elapsed for the market to absorb the information, plus interest at the legal rate, unless the defendant proves that the plaintiff knew the information or that the plaintiff would have purchased or sold at the same price even if the information had been revealed to him.

(n41)Footnote 41. *Cal. Corp. Code* § 25402.

(n42)Footnote 42. *Cal. Corp. Code* § 25506.

(n43)Footnote 43. *Quick v. Woody*, 295 Ark. 168, 747 S.W.2d 108, 111-112 (1988) ; *Weidner v. Engelhart*, 176 N.W.2d 509 (N.D. 1970) .

The Supreme Court of Alabama rejected the position that a best efforts underwriter was not liable under the state's Blue Sky law unless it was a 'substantial factor' in plaintiff's purchase and instead upheld liability where the firm 'materially aided' the disputed sale. *Foster v. Jesup & Lamont Securities Co.*, 482 So. 2d 1201, 1206-1208 (Ala. 1986) . The evidence supported findings that: (1) the offering material prominently identified the underwriter firm as the primary best efforts underwriter; (2) although the firm had withdrawn as underwriter prior to plaintiff's purchase, the firm's president told plaintiff's accountant after the withdrawal that the firm was 'involved' in the offering; and (3) plaintiff relied on the firm's participation in part in reaching his decision to purchase. The court considered it irrelevant that plaintiff did not directly communicate with the underwriter firm, instead discussed his prospective investment with the issue's promoter, and then delivered his check to the promoter.

(n44)Footnote 44. *Weidner v. Engelhart*, 176 N.W.2d 509, 518 (N.D. 1970) .

(n45)Footnote 45. *See Huryta v. White*, 184 Neb. 24, 165 N.W.2d 354 (1969) , *Hines v. Data Line Systems, Inc.*, 114 Wn.2d 127, 787 P.2d 8, 17-19 (1990) ; *Heilbron v. ARC Energy Corp.*, 757 S.W.2d 294, 296 (Mo. Ct. App. 1988) , *Steenblik v. Lichfield*, 906 P.2d 872 , Blue Sky L. Rep. (CCH) P 74074 (Utah 1995); *Gilbert v. Meason*, 137 Ga. App. 1, 222 S.E.2d 835 (1975) , *aff'd*, 236 Ga. 862, 226 S.E.2d 49 (1976) ; *Boddy v. Theiling*, 129 Ga. App. 273, 199 S.E.2d 379 (1973) .

See also Connecticut National Bank v. Giacomi, 242 Conn. 17, 699 A.2d 101 (1997) (Bank liable on aiding and abetting theory because it influenced investors to proceed with investment through ease of loan approval and apparent endorsement of venture).

(n46)Footnote 46. *See Boddy v. Theiling*, 129 Ga. App. 273, 199 S.E.2d 379 (1973) .

But see Hamilton Bank and Trust Company v. Holliday, 469 F. Supp. 1229 (N.D. Ga. 1979) , in which outside directors were not chargeable with knowledge of the wrongdoing or liable under the 'control' theory. The Georgia court found the Georgia 'do-nothing director' rule inapplicable to the directors in this case, and distinguished *Boddy*, in which an outside director was liable as a controlling person because he failed to establish that he exercised reasonable care as a director.

(n47)Footnote 47. *Ruffinilli v. Jordan*, 216 Cal. App. 2d 59, 30 Cal. Rptr. 780 (1963) ; see also *Gowdy v. Richter*, 20 Ill. App. 3d 514, 314 N.E.2d 549 (1974) , but in this case, there was no allegation that any other sales were authorized or made.

(n48)Footnote 48. *Young v. Kwock*, 52 Haw. 273, 474 P.2d 285 (1970) ; see also *Heilbron v. ARC Energy Corp.*, 757 S.W.2d 294, 296 n.38 (Mo. Ct. App. 1988) .

(n49)Footnote 49. *Ruden v. Medalie*, 294 So. 2d 403 (Fla. Dist. Ct. App. 1974) ; see also *Gerhard W. Gohler IRA v. Wood*, 919 P.2d 561 (Utah 1996) (reliance not an element under Utah statute).

(n50)Footnote 50. *Nikkel v. Stifel, Nicolaus & Co., Inc.*, 542 P.2d 1305 (Okla. 1975) .

(n51)Footnote 51. 542 P.2d at 1309 ; see also *Klein v. Opp*, 944 F. Supp. 396 , [1995-1996 Transfer Binder] Blue Sky L. Rep., (CCH) P 74,132 (E.D. Pa. 1996), *aff'd without opinion*, 118 F.3d 1576 (3d Cir. 1997) (sale required); *Ludwig v. Mutual Real Estate Investors*, 18 Wn. App. 33, 567 P.2d 658 (1977) , in which the president and principal owner of the corporate general partner of the defendant-seller was not personally liable under *Wash. Rev. Code § 21.20.430(3)* (the "derivative" liability provision) because the plaintiff-buyer failed to prove liability on the part of the defendant-seller.

(n52)Footnote 52. *Gonia v. Estep*, 251 Or. 431, 446 P.2d 114 (1968) (decided under earlier law).

(n53)Footnote 53. *Or. Rev. Stat. § 59.115(3)*.

(n54)Footnote 54. *Black & Company v. Nova-Tech, Inc.*, 333 F. Supp. 468 (D. Or. 1971) .

(n55)Footnote 55. *Adams v. American Western Securities, Inc.*, 265 Or. 514, 510 P.2d 838, 843 (1973) ; followed by *Goodyear Tire & Rubber Co. v. Tualatin Tire & Auto*, 322 Or. 406, 908 P.2d 300 (1995) .

(n56)Footnote 56. See also *Moore v. Fenex, Inc.*, 809 F.2d 297 (6th Cir. 1987) , *cert. denied*, 483 U.S. 1006, 107 S. Ct. 3231, 97 L. Ed. 2d 737 (1987) . The case involved a class action brought under Ohio Securities Act and the Securities Exchange Act of 1934. The investors were unable to establish that the attorney aided a securities fraud where evidence indicated that he had been kept in the dark by clients about their financial dealing and did not learn until much later that funds collected were not segregated and used as stated in the offering circular. In addition, the attorney was under no duty to correct offering circular upon learning that it contained misrepresentations; rather than advising clients to correct the circular, the attorney had insisted that they comply with its representations. See also *Ahern v. Gaussoin*, 611 F. Supp. 1465 (D. Or. 1985) (corporate attorneys and accountants who performed services in connection with registration and sale of securities with knowledge of sellers' fraudulent activities may be liable for the sales).

Cf. Austin v. Baer, Marks & Upham, 1986 U.S. Dist. LEXIS 22522 , [1986-1987 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,437, at 72,041 (D. Or. July 21, 1986) (summary judgment granted for defendant attorneys who allegedly participated in or materially aided an allegedly fraudulent securities registration and sale, for failure to produce evidence that the attorneys knew of the fraudulent scheme).

See also *Hines v. Data Line Systems, Inc.*, 114 Wn.2d 127, 787 P.2d 8, 20 (1990) (advice by counsel to issuing company about materiality of facts is rendering of routine legal services in connection with an offer and does not give rise to seller or control person liability; dismissal on summary judgment proper); *Rendler v. Markos*, 154 Wis. 2d 420, 453 N.W.2d 202, 207 (Ct. App. 1990) (complaint must allege that attorneys sold or offered securities: "only that, not the provision of legal services, leads to attorney liability as an agent under [Wisconsin law]"); *Prince v. Brydon*, 307 Or. 146, 764 P.2d 1370, 1372 (1988) , in which a summary judgment that was based on the professional role of an attorney who prepared documents, including drafting a major portion of the offering circular, and performed other legal services in connection with the sale of securities by a limited partnership was reversed; court held that typing, reproducing, and delivering the documents not material as tasks could be done by anyone, but: "It is a drafter's knowledge, and assertions

reflected in the contents of the documents that are 'material' to the sale.").

However, an attorney who promoted an issuer's unregistered securities on a radio show and was compensated by the issuer was liable to the purchaser of some of the securities. *Perkowski v. Megas Corp.*, 55 Ohio App. 3d 234, 563 N.E.2d 378 (1990). But see *Zendell v. Newport Oil Corp.*, 226 N.J. Super. 431, 544 A.2d 878 (1988) (attorneys who had no contact with buyers of securities and no managerial position with or financial investment in issuer not sellers or control agents under New Jersey law).

See also *Cal. Corp. Code* § 25504.2, imposing joint and several liability on professional persons, including attorneys, who have consented to and are "named in any prospectus or offering circular distributed in connection with the offer and sale of securities as having prepared or certified in such capacity either any part of such document or any written report or valuation" if the document contains an untrue statement or omission of a material fact relied on by the plaintiff. However, a reasonable investigation and good faith belief in the accuracy of the facts is a defense.

(n57)Footnote 57. *Adamson v. Lang*, 236 Or. 511, 389 P.2d 39 (1964).

(n58)Footnote 58. 389 P.2d at 42.

See also *Winkler v. Trico Fin. Corp.*, 693 F. Supp. 896, [1988-1990 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,949 (W.D. Wash. 1988) (corporate secretary liable); *Hoffer v. State*, 110 Wn.2d 415, 755 P.2d 781 (1988), *adhered to, on reconsideration, en banc*, 113 Wn.2d 148, 776 P.2d 963 (1989) (state liable for defaulted bond obligations).

(n59)Footnote 59. *Gonia v. E. I. Hagen Co.*, 251 Or. 1, 443 P.2d 634 (1968); see also *Excalibur Oil, Inc. v. Sullivan*, 616 F. Supp. 458 (N.D. Ill. 1985); *Norwest Bank Hastings v. Clapp*, 394 N.W.2d 176 (Minn. Ct. App. 1986) (bank was not agent against which secondary liability could attach under Minnesota's Blue Sky law).

(n60)Footnote 60. *Gonia v. E.I. Hagen Co.*, 251 Or. 1, 443 P.2d 634, 637 (1968).

See also *Arst v. Stifel, Nicolaus & Co., Inc.*, 86 F.3d 973, [1995-1996 Transfer Binder] Blue Sky L. Rep. (CCH) P 74,100 (10th Cir. 1996) (agent's duty to disclose self-dealing); *Badger v. Paulson Inv. Co.*, 311 Or. 14, 803 P.2d 1178, 1183-1185 (1991) ("controlling person" liability in statute not intended to preempt common law theory of respondeat superior; broker-dealer and investment advisor liable for illegal sales of securities by registered representative under agency principles even if principal expressly forbade conduct in question); *Opatz v. John G. Kinnard & Co.*, 454 N.W.2d 471, 473-474 (Minn. Ct. App. 1990) (sales agent acting within scope of authority when misrepresentation made to induce sale of securities; brokerage firm liable for fraud under agency principles).

But see *Crim v. E. F. Hutton*, 298 S.C. 448, 381 S.E.2d 492, 493 (1989) (plaintiff's personal loan to sales agent not sale of security and customer's belief that firm would be liable for loans of its sales agent based on employment status not reasonable belief in apparent authority of agent). For liability of clearing brokers, see *Carlson v. Bear, Stearns & Co.*, 906 F.2d 315 (7th Cir. 1990) (no liability under Illinois law as clearing broker performed only ministerial tasks); *Ross v. Bolton*, 904 F.2d 819 (2d Cir. 1990) (no liability imposed under federal and New York law because no scienter proven on part of clearing agent); accord, *McDaniel v. Bear Stearns & Co.*, 196 F. Supp. 2d 343 (S.D.N.Y. 2002).

By statute in Pennsylvania, an investment adviser that violates the registration provisions is liable to the client for all fees paid and an investment adviser that engages in specified prohibited acts including fraud is liable to the client (jointly and severally with the seller of the security) for consideration paid plus legal interest from the date of payment, less income received on the security. 70 Pa. Stat. § 1-501(f). However, in the absence of such a statute, an investment adviser that maintained an investor's discretionary account was not liable to the investor as a "seller" under the Oregon Blue Sky law. See *Poole v. Frank*, 1990 U.S. Dist. LEXIS 18435 (D. Or. Oct. 31, 1990); but see *New Mexico v. Colonial Penn Ins. Co.*, 112 N.M. 123, 812 P.2d 777, [1991-1993 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,553 (1991) (investment adviser to state could be liable by contract to recommend to state Investment Officer only legal

investments for state).

(n61)Footnote 61. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, 511 U.S. 164, 114 S. Ct. 1439, 128 L. Ed. 2d 119 (1994) .

(n62)Footnote 62. *State ex rel. Goettsch v. Diacide Distribs.*, 561 N.W.2d 369 (Iowa 1997) .

(n63)Footnote 63. 2009 Iowa App. LEXIS 1439 (Nov. 12, 2009) .

(n64)Footnote 64. 2009 Iowa App. LEXIS 1439 (Nov. 12, 2009) .

(n65)Footnote 65. *Conway v. Leonard*, 2005 U.S. Dist. LEXIS 3659 (W.D. Wis. March 7, 2005) .

(n66)Footnote 66. 2005-Ohio-4044, 2005 Ohio App. LEXIS 3690 (Aug. 5, 2005) .

(n67)Footnote 67. 2005 Ohio App. LEXIS 3690, at *10 .

(n68)Footnote 68. *See Ohio Rev. Code § 1707.44.*

(n69)Footnote 69. Further perspective is added by the complex of state and federal decisions that culminated in *Excel Energy v. Smith*, 394 F.3d 401 (6th Cir. 2005) , which involved summary judgment in favor of an associated person of a bankrupt broker-dealer that executed the sale of unregistered securities in violation of the Kentucky Blue Sky law. Plaintiff sued under the civil liability provision of the Kentucky Act, *see Ky. Rev. Stat. § 292.480*, seeking to recover the purchase price. The defendant broker-dealer had executed the transaction, for which it was paid a commission. Kentucky state courts concluded that a broker who merely executed the trade should not be deemed to be a "seller" for purposes of liability under the Kentucky Blue Sky law. The state court determinations were ultimately affirmed by the federal Bankruptcy Court, U.S. District Court, and finally the Sixth Circuit U.S. Court of Appeals. Although none of the courts involved spoke in terms of a culpability element, a determination that one who merely executes a transaction and has no other interest than a brokerage commission will not be liable as a seller plainly signals that some meaningful degree of culpability must be a predicate to liability.

(n70)Footnote 70. Unif. Sec. Act § 410(a)(2).

(n71)Footnote 71. *Sterling Trust Co. v. Adderley*, 168 S.W.3d 835 (Tex. 2005) .

(n72)Footnote 72. Section 410(b) of the original Uniform Securities Act, on which the majority of civil liability provisions are based, limits the extent of secondary liability as follows:

Every person who directly or indirectly controls a seller liable under subsection (a), every partner, officer, or director of such a seller, every person occupying a similar status or performing similar functions, every employee of such seller who materially aids in the sale, and every broker-dealer or agent who materially aids in the sale are also liable jointly and severally with and to the same extent as the seller, unless the non-seller who is so liable sustains the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist. There is contribution as in cases of contract among the several persons so liable.



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Blue Sky Regulation

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CHAPTER 15 Civil Remedies

2-15 Blue Sky Regulation § 15.05

§ 15.05 Defenses Against Civil Liability Claims

[1] Statutory Defenses

Several subsections of Uniform Act section 410 provide defenses to actions for civil liability. The first of these defenses is available to a seller who is alleged to have offered or sold "a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading (the buyer not knowing of the untruth or omission)...".ⁿ¹ If the seller sustains the burden of proof that he or she did not know, and in the exercise of reasonable care could not have known, of the untruth or omission, he or she will not be liable to the buyer. Many states have adopted a comparable provision,ⁿ² and it has been carried into the 2002 Uniform Act, applicable to actions by either a buyer or a seller.ⁿ³ However, in New Jersey, the buyer must sustain the burden of proof that the seller knew of the untruth or omission and intended to deceive the buyer.ⁿ⁴ In addition, the buyer must prove that she suffered a financial detriment. In Ohio, the "person who receives the profits must establish that "he had no knowledge of the publication [containing the untruth or omission] thereof prior to the transaction complained of, or had just and reasonable ground to believe such statement to be true or the omitted facts to be not material."ⁿ⁵ Finally, in some states that allow the seller to bring an action against a buyer who purchased a security by means of a false statement of, or the omission of, a material fact necessary to make the buyer's statements not misleading, the buyer has the same defenses and burden of proof as the seller in the converse situation.ⁿ⁶

Another available statutory defense is that the purchaser (and in those states that allow suit against the purchaser, the seller) knew of the untruth or omission. However, in those jurisdictions that allow this defense, regardless of whether it refers to the buyer or seller, two states specify who has the burden of proof.ⁿ⁷ It would seem, though, that even where not specified, the burden of proof that the plaintiff knew of the untruth or omission would be on the defendant.ⁿ⁸

Section 410(b) of the Uniform Act also provides a defense for the non-seller, who would under certain circumstances be jointly and severally liable with the seller. Thus, the Uniform Act provides that the non-seller will avoid the seller's liability if she "sustains the burden of proof that she did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist."ⁿ⁹

Another defense provided by Section 410 operates to bar a plaintiff (buyer or seller) from taking advantage of a fraud or known illegality in the contract of purchase or sale. This subsection states that:

No person who has made or engaged in the performance of any contract in violation of any provision of this act or any rule or order hereunder, or who has acquired any purported right under any such contract with knowledge of the facts by reason of which its making or performance was in violation, may base any suit on the contract.ⁿ¹⁰

This provision or one comparable to it has been adopted in most jurisdictions.ⁿ¹¹

As a caveat in the application of statutory defenses, the Uniform Act contains a statutory prohibition relating to the defense of waiver. Section 410(g) provides:

Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this act or any rule or order hereunder is void.ⁿ¹²

This provision has been adopted in most states.ⁿ¹³ Likewise, this principle has been followed by the courts on the theory that agreements contrary to declared public policy, like contracts in violation of Blue Sky laws, will not be enforced.ⁿ¹⁴ This appears to be true regardless of whether the state has a statutory provision disallowing waiver.ⁿ¹⁵

As an equitable defense, waiver, or estoppel, will always be available to defeat claims when facts and circumstances support the defense. The anti-waiver provision in Blue Sky laws is not directed at the assertion of an equitable defense to civil liability claims. It does, however, limit the assertion of waiver, such that a plaintiff may not be barred from asserting a claim by reason of an alleged agreement or undertaking to waive statutory rights and remedies. A Washington appellate court illustrated the point in holding that so-called "non-reliance" clauses in subscription agreements are enforceable under the Washington Blue Sky law.ⁿ¹⁶ By the "non-reliance clause in the subscription agreement the purchaser warranted that he relied solely on the written offering documents and not on any oral representations of others in making his investment decision. Subsequently asserting civil liability for fraud under the state securities law the purchaser sought to avoid enforcement of the "no-reliance" provision on the argument that it amounted to a waiver of the securities law. The court rejected the argument. The subscription agreement did not contain any express or implied waiver of compliance with the securities law, and did not require the investor to waive any right under the law.

"Integration" clauses in subscription or transaction contract documents operate in the same manner as "no-reliance" provisions and are subjected to the same scrutiny. Typical integration clauses provide that the subject document contains the entire agreement between the parties, and that no other party or agent of a party has made any promise, representation or warranty not contained in the contract, and that there have been no inducements or understandings outside the contract. Such a clause may be offered to preclude a fraud claim under Blue Sky laws. However, as the Delaware Chancery Court concluded in such circumstances:

Stated summarily, for a contract to bar a fraud in the inducement claim, the contract must contain language that, when read together, can be said to add up to a clear anti-reliance clause by which the plaintiff has contractually promised that it did not rely upon statements outside the contract's four corners in deciding to sign the contract. The presence of a standard integration clause alone, which does not contain explicit anti-reliance representations and which is not accompanied by other contractual provisions demonstrating with clarity that the plaintiff had agreed that it was not relying on facts outside the contract, will not suffice to bar fraud claims. Rather, in that circumstance, the defendant will remain at risk if the plaintiff can meet the difficult burden of demonstrating fraud.ⁿ¹⁷

The application of equitable defenses to actions brought under civil liability provisions of Blue Sky laws is considered in more detail elsewhere.ⁿ¹⁸ The assertion of waiver or estoppel generally to bar civil claims under Blue Sky laws may be problematic in the face of broadly construed remedial statutes. However, it is at least clear that anti-waiver provisions in Blue Sky laws will not prevent the operation of integration or similar contract clauses when the contract

provisions make unmistakably clear that a purchaser is not relying on any outside facts. The defense, if it applies, must be based on evidence of conduct or other traditional grounds for waiver arising out of facts and circumstances.

As a further statutory defense, section 412 of Uniform Act, pertaining to the rulemaking authority of the Administrator, provides a defense against liability for:

[a]ny act done or omitted in good faith in conformity with any rule, form, or order of the [Administrator], notwithstanding that the rule, form, or order may later be amended or rescinded or be determined by judicial or other authority to be invalid for any reason.ⁿ¹⁹

This subsection or one comparable to it has been enacted in most states.ⁿ²⁰ In context it is clear that this provision is a defense against an enforcement action, but there is no reason to limit it to such settings. Indeed, the provision is a clear statement that good faith actions taken in conformity with a rule or order should not be the basis for any liability. The context also indicates, however, that the principal concern is for actions taken (or not taken) in conformity with rules or orders that subsequently change or which are invalidated, and thus it is unclear how broadly the defense would be applied in more conventional liability settings.

[2] Statute of Limitations

[a] Generally

Blue Sky laws impose statutes of limitations for both criminal and civil actions. With respect to civil actions, the Uniform Act provides that a private civil actionⁿ²¹ may not be instituted "more than two years after the contract of sale."ⁿ²² There are variations, however, applicable to actions based on fraud. The 2002 Uniform Act provision reflects the trend toward liberalization of time limitations on these claims by providing that an action based on fraud must be brought within two years after discovery of the facts constituting the violation, but no more than five years after the violation.ⁿ²³

The principle that the time be measured from the date of contract (or in some states, date of sale) has been enacted in most statesⁿ²⁴ although in a few states the maximum period is other than two years.ⁿ²⁵ Measuring the time from the date of contract precludes measuring the time from the date the violation was discovered or should have been discovered in the exercise of due diligence. However, most states look to discovery or reasonable notice of the violation for purposes of the limitations period.

The statutes are diverse, and the date on which a cause of action is deemed to accrue may depend on the nature of the violation. In Arizona, for example, suit brought because either the securities or the seller was not appropriately registered must be instituted within one year after the violation occurs.ⁿ²⁶ If, however, the cause of action is for breach of the antifraud provisions, action must be commenced within two years after the fraud is discovered, or should have been discovered through the exercise of reasonable diligence.ⁿ²⁷

Similarly, California will permit a fraud action to be brought within four years from the date of the act or transaction constituting the violation or within one year after the violation is discovered, whichever occurs first.ⁿ²⁸ An action based on any other violation, however, must be commenced within two years of the violation or one year after its discovery, whichever occurs first.ⁿ²⁹ Pennsylvania's provision is comparable to California's, except that in Pennsylvania the maximum four-year period applicable to fraud actions is also applicable to suits against unregistered broker-dealers, agents, and investment advisers.ⁿ³⁰ Again, the period is reduced to one year if there is, or should have been, knowledge of the violation. The period of limitations in other suits under the Pennsylvania Blue Sky law is the same as in California.ⁿ³¹

Florida requires an action based upon a violation of the Florida Securities Act to be brought within two years of the date

the facts giving rise to the cause of action either were, or should have been, discovered with the exercise of due diligence.ⁿ³² However, no action may be brought more than five years after the violation occurred. Minnesota requires action for fraud to be commenced within three years of the act or transaction constituting the violation, or within three years from the date of sale if suit is brought on any other statutory ground.ⁿ³³ Iowa has one of the longest limitations periods for fraud actions. Claims there must be instituted within five years after the act of transaction constituting the violation or two years after knowledge of the violation is received or should have been received through the exercise of reasonable diligence, whichever occurs first.ⁿ³⁴ All other actions must be started within two years after the violation.ⁿ³⁵

Other variations include Maryland, which has a general provision allowing suits within three years after contract of sale, but with two limitations. If the suit is based in fraud, it is to be commenced within one year of the discovery of the untrue statement or omission or one year after it should have been discovered by exercising reasonable diligence. If the suit is based on any other violation for which a civil action is permitted, it is to be brought within one year of the violation.ⁿ³⁶ And in Montana, the limitations periods are two years from the date of the violation to enforce a liability on a registered securities claim, and two years after discovery of a misrepresentation or other securities fraud liability or after such liability should have been discovered exercising reasonable diligence, but not later than five years after the transaction on which the action is based.ⁿ³⁷

North Dakota requires the institution of suit within five years from the date of sale.ⁿ³⁸ Mississippi requires that actions for fraud be brought within two years after discovery of the untrue statement or omission or after the discovery should have been made by the exercise of reasonable diligence.ⁿ³⁹ Suits for other actions must be brought within two years after the occurrence of the violation upon which the action is based. New Hampshire's statute is oddly worded, providing that "a person may not recover under this section in actions commenced more than 6 years after his first payment of money to the broker-dealer or issuer in the contested transaction."ⁿ⁴⁰

In the other states, the appropriate statute of limitations is not found in the Blue Sky law, but in statutes of more general application.ⁿ⁴¹ The limitations period is thus dependent upon whether the action is founded in contract or tort.

In all cases the criteria vary for determining when the limitations period begins to run, and this question has also been dealt with by the courts as a central issue.ⁿ⁴² When the statute of limitations period begins on discovery of fraud, much also depends on what constitutes fraud in a particular state. In a California case for example, selling unregistered securities was held to be a fraudulent act and the statute did not begin to run until the discovery by the purchaser that the securities were unregistered.ⁿ⁴³ When the period of limitations begins at the date of contract or date of sale, the time at which the contract or sale became complete is pertinent. In such a case, it was held that it is not the time at which a purchaser signs a subscription agreement that controls, but the time at which the agreement is accepted by the seller.ⁿ⁴⁴ In another case involving an investor who agreed to purchase stock on a "when, as and if issued" basis, the court held that, in an action for rescission for failure of the seller to register the securities, the statute of limitations period began on the date of the agreement, not on the later date when the stock was actually issued. The "when, as and if issued" condition relates to contract liability, not contract formation.ⁿ⁴⁵

Besides determining when the limitations period has begun, it is just as important to know when the limitation period has ended, thereby foreclosing further liability. *Schumacher v. Superior Court of Santa Clara County* ⁿ⁴⁶ involved an action under the California Corporation Code based upon sellers' material misrepresentations in the sale of unregistered securities. The court held that "an amended complaint will be deemed filed as of the date of the original complaint provided recovery is sought in both pleadings on the same general set of facts."ⁿ⁴⁷ Since both the originally alleged federal securities law violations and the action based upon the California Corporation Code were based on the same set of facts, the amended complaint related back to the original, timely filed complaint.

[b] Repurchase Offer and Notice

For the most part, the limitation periods are not absolute. Under many statutes, for example, the seller can reduce the limitation period by making a repurchase offer on which the purchaser must act within thirty days of receipt.ⁿ⁴⁸ In Illinois, which requires that actions must be instituted within three years from the date of sale,ⁿ⁴⁹ there is an additional requirement that the purchaser give those persons he seeks to hold liable notice that he elects to rescind the sale. The notice must be given within six months of the time the purchaser learned that the sale is voidable under the Blue Sky law.ⁿ⁵⁰ This, too, has the effect of reducing the limitation period, even though the six month notice rule has been held not to be a statute of limitations.ⁿ⁵¹

[c] Installment Payments

Installment payments for securities present interesting questions in the application of statutes of limitations. In one case,ⁿ⁵² the purchasers had paid for the securities in three installments, but did not receive the securities until after the final payment. The court held that each payment could be considered an individual sale and that the purchaser could have sued after any interim payment. The final transaction, at which time the rights of the parties became fixed, was a sale in itself and it was from this point that the statute began to run.ⁿ⁵³ However, when the purchaser obtains rights under a purchase agreement from the date of such agreement, it is from that date that the statute begins to run, although payments are to be made in subsequent installments.ⁿ⁵⁴

[d] Tolling

If the statute is clear that the date of contract or date of sale is controlling, the limitation period cannot be tolled by the subsequent discovery of fraud.ⁿ⁵⁵ Other events, however, may have the effect of halting the running of the statute. The bankruptcy of the seller, for example, has been held to toll the statute of limitations.ⁿ⁵⁶ Bringing a class action has also been said to have the effect of tolling the statute in favor of all potential plaintiffs who are members of the class.ⁿ⁵⁷ However, where suit was commenced in a court without jurisdiction, and the statute ran before action could be brought in the proper court, an Arkansas court has held that suit in the proper court was barred.ⁿ⁵⁸

In another case, the purchaser obtained a default judgment against an agent who unlawfully sold securities. When the judgment proved uncollectible, the purchaser brought suit on the bond posted by the agent's broker-dealer employer as a condition of registration. It was held that although the first action was timely, it did not stop the statute of limitations from running against any suit on the bond. Accordingly, the action was barred.ⁿ⁵⁹ Further, various state courts have held that equitable doctrines such as estoppel and fraudulent concealment of material facts can also serve to toll the limitations period.ⁿ⁶⁰

[3] Failure to Exercise Reasonable Diligence

Earlier, in considering culpability standards as part of the scope of civil liability under Blue Sky laws,ⁿ⁶¹ application of a reasonable diligence defense against a claim of "seller" liability was first addressed. In *Williams v. Guarniere* ⁿ⁶² an Ohio appellate court reasoned from the relevant definition of "violation" in the Ohio Blue Sky law that a defendant seller of unregistered securities would not be liable because he had made a reasonably diligent inquiry and as a result did not believe the instrument involved was a security. The court concluded that the defendant had exercise reasonable diligence in seeking to determine whether the instruments he sold were securities. Where fraud liability is asserted, Blue Sky laws provide a "reasonable care" defense, such that liability may be avoided when a seller sustains the burden of proof that he or she did not know, and in the exercise of reasonable care could not have known, of the untruth or omission. There is nothing on the face of any civil liability provision, however, that suggests liability for the sale of unregistered, non-exempt securities could, or should, be subject to a reasonable diligence defense. That is clearly so as well for intermediary licensing requirements. Likewise, in all of this reliance on the advice of counsel has never been a valid defense to a violation of Blue Sky laws.ⁿ⁶³

Recognition of reasonable diligence as a defense against what has historically been viewed as strict liability under Blue

Sky laws for the offer and sale of unregistered, non-exempt securities was made easier in *Guarnieri* because of the Ohio statutory construct. The definition of "violation" involved in the case included a "knowingly" element, and when carried into the civil liability provision the court opined, in effect, that action ultimately determined to be in violation of the securities law, but which was the product of a diligent inquiry to determine otherwise could not be a knowing violation. This statutory construct is not involved in the vast majority of other Blue Sky laws. Nevertheless, *Guarnieri* evidences a willingness of a court to look more closely at good faith undertakings to inquire into and comply with Blue Sky requirements. In any case, "reasonable diligence" would necessarily involve a high burden to be satisfied, but at least as one court has thoughtfully considered it, it is a viable defense.

[4] Equitable Defenses

The civil liability provisions of Blue Sky laws are silent as to the availability of equitable defenses, and their status is uncertain. A Washington Court of Appeals flatly stated in 2005 that the equitable defenses of estoppel and waiver will not be permitted in actions under state's Blue Sky law, which is based directly on the Uniform Securities Act.ⁿ⁶⁴ Rejecting their application to claims under the Blue Sky law, the Court reasoned:

The flexibility of such defenses is inconsistent with our Act's foremost objective of protecting investors. The statute provides the clean and surgical remedy of rescission as the sole recourse for an investor who proves a violation. It would upset the balance struck by the statute to allow fact finders to evaluate the investor's conduct on a case-by-case basis to determine whether it excuses the violation.ⁿ⁶⁵

Other courts have permitted equitable defenses, particularly if a state statute makes a transaction voidable, rather than void, at the election of the plaintiff.ⁿ⁶⁶ If a statute contains no express void or voidable provision, some courts have held transactions in violation of the statute voidable and have permitted equitable defenses.ⁿ⁶⁷ The significance of the void/voidable distinction, however, is in doubt,ⁿ⁶⁸ and it will not prevent courts from acting "fairly."ⁿ⁶⁹

Under the federal securities laws, equitable defenses have been recognized as barring claims when circumstances make it unjust to permit investors to foist their losses upon defendants. In *Royal Air Properties, Inc. v. Smith*,ⁿ⁷⁰ the Ninth Circuit U.S. Court of Appeals long ago opined that: "The purpose of the Securities Exchange Act is to protect the innocent investor, not one who loses his innocence and then waits to see how his investment turns out before he decides to invoke the provisions of the Act."ⁿ⁷¹ In *Royal Air*, the purchaser, after finding out the transaction violated the law, did not immediately move to rescind it, but instead became involved in management of the investment and then asserted the illegality only after the investment turned out to be unprofitable.ⁿ⁷² The scenario could just as easily play out under state securities laws, and those state courts that have specifically recognized the availability of equitable defenses also make clear that the civil liability provisions and remedies must not be misused to protect against errors of business judgment and other things not related to the investor protection mission of Blue Sky laws. The availability of equitable defenses in those circumstances makes sense from a policy as much as a legal perspective. It is quite a different thing, however, to deny a statutory remedy for purchasers by allowing violators to freely assert equitable defenses without regard to the investor protection mission of Blue Sky laws.

Against this backdrop, the most commonly asserted equitable defenses in actions brought under the civil liability provisions of state securities laws are considered in more detail below.

[a] Estoppel and *In Pari Delicto*

Sellers of securities who are defendants in civil actions for violation of Blue Sky laws may raise the defenses of estoppel or *in pari delicto*. While there is a difference between these two doctrines, some courts have referred to them interchangeably. A Florida case, for example, held that the defense of estoppel would defeat a claim by a securities purchaser who was also an officer and director of the selling corporation.ⁿ⁷³ When a similar fact pattern reached a Georgia court, the Florida case was cited for the proposition that *in pari delicto* was a proper defense.ⁿ⁷⁴

Estoppel as an equitable defense refers to barring a party from pleading or proving facts inconsistent with his or her own actions. *In pari delicto*, also an equitable defense, refers to the equal culpability of parties in violating the law.ⁿ⁷⁵ However, it does not matter what label is imposed by the courts.ⁿ⁷⁶ The issue concerns the conduct by a purchaser of securities that will bar him or her from bringing an otherwise valid suit under the Blue Sky laws.

Generally speaking, innocent purchasers of stock issued or sold in violation of the blue sky laws may recover by rescission or damages. On the other hand, a purchaser who is equally culpable will be denied equitable relief. In a Texas case, for example, where the plaintiff-buyers actively sought to buy securities they knew to be speculative, unregistered, subject to transfer restrictions, and not in the seller's name, the court observed:

[I]f the transactions were in fact illegal solely because the stock was not registered, plaintiffs, by knowingly joining with defendants in the illegal scheme, were equally culpable with defendants and, therefore, *in pari delicto*. As such, plaintiffs were precluded from an instructed verdict on the ground alleged by the provisions of [the Act].ⁿ⁷⁷

Total equality of culpability, however, is not always present. Frequently, courts must decide a case in the area between "innocent" and *in pari delicto*. In one such case,ⁿ⁷⁸ the court stated that "where the purchaser is less than innocent but not *in pari delicto*, the law will generally favor the purchaser, since the Blue Sky Laws are intended for his protection."ⁿ⁷⁹ Thus, for example, mere knowledge by the purchaser of the violation without the other elements of estoppel (or *in pari delicto*) is insufficient to preclude recovery.ⁿ⁸⁰

Probably the most common situation in which the defenses arise is when the purchaser participates in the management of a selling corporation as an officer or director. Under such circumstances, defenses of estoppel or *in pari delicto* have generally been held sufficient to defeat the purchaser's claim.ⁿ⁸¹ The courts in these cases do not seem to differentiate between whether the purchaser's participation took place before or after the purchase of the securities, but there is some authority for the proposition that acts of participation committed subsequent to the purchase cannot be considered to place the purchaser *in pari delicto*.ⁿ⁸²

Before a purchaser can be a participant, there must be a modicum of control over or contact with the issuing corporation.ⁿ⁸³ That the purchaser became an officer or director was held insufficient to hold him *in pari delicto* without a showing that he was active in organization or management of the company or took part in illegal securities transactions.ⁿ⁸⁴ Also, gaining employment rights as part of the transaction to purchase the securities will not bar the purchaser's action.ⁿ⁸⁵ In one case where the court found that the purchasers aided in the illegal sale of the same securities they themselves had purchased, the court refused to hold them *in pari delicto* unless it could be established that they were also officers, directors, or selling agents of the seller.ⁿ⁸⁶ However, participation in management by a single member of a group was held to bar recovery by any person so represented by the participant.ⁿ⁸⁷ In this instance, a group of buyers, as part of the purchase agreement, was permitted to designate one of their number as a director of the selling corporation.ⁿ⁸⁸ The person so designated was an active participant in management, and the whole group was estopped from bringing the suit.ⁿ⁸⁹

Because estoppel and *in pari delicto* are equitable defenses, one state has refused to recognize them as valid defenses in Blue Sky actions on the ground that only defenses specifically permitted by statute may be raised.ⁿ⁹⁰ However, in a subsequent case, another appellate court in the same state, without mentioning either defense, barred an officer-director from rescinding his purchase. In this case, the securities would have been exempt from registration except that a required report was not filed. It was the court's opinion that plaintiff's position in the company accorded him the responsibility to see that the securities laws were complied with.ⁿ⁹¹

Estoppel and *in pari delicto* have been raised in non-managerial cases with varying results. A California court decided that knowledge on the part of the purchaser that the securities should have been registered, but were not, was enough to

place the purchaser *in pari delicto* with the seller.ⁿ⁹² In a Florida case,ⁿ⁹³ the securities involved were interests in an oil lease. The sellers were not the issuers and neither the seller nor the purchaser ever had any control over the enterprise. Nevertheless, the court allowed the defense of estoppel because the purchaser and seller had close relationships in various businesses. To allow the purchaser to recover would wrongfully injure the seller since the purchaser's own acts, conduct, knowledge, and business relationships at the time of sale were inconsistent with his acts, conduct, and knowledge in bringing suit.ⁿ⁹⁴ A dissenting opinion proffered that estoppel should be a defense only, "in those cases wherein the purchaser was on equal status with the seller insofar as control over the issuer of the security is concerned... ." ⁿ⁹⁵

[b] Laches

Laches is an affirmative defense. The applicability of the doctrine is dependent upon whether: there is a delay in asserting a right or claim; the delay is excusable; and there is undue prejudice by the delay to the party asserting the defense.ⁿ⁹⁶ In an action to rescind a contract for the purchase of stock, for example, the purchaser must act promptly to repudiate the contract within a reasonable time after discovery of the facts entitling him rescission.ⁿ⁹⁷ However, in applying the doctrine of laches, the delay is measured from the date of constructive knowledge of the facts entitling the plaintiff to bring the suit. Thus, the plaintiff is charged with "such knowledge as he might have obtained upon inquiry, provided the facts already known to him were such as to put the duty of inquiry upon a man of ordinary intelligence."ⁿ⁹⁸

Generally, in the absence of extraordinary circumstances that would render inequitable the enforcement of petitioner's right after a delay, the laches doctrine will not bar a suit short of the statute of limitations period.ⁿ⁹⁹ One commentator takes the position, however, that when a state statute of limitations applies to equitable as well as legal actions it is clear that laches may still bar a plaintiff in equity before expiration of the statutory period, at last when the state statute does not provide otherwise and perhaps even when it does.ⁿ¹⁰⁰

[c] Unclean Hands

Often, unclean hands is a companion defense to *in pari delicto*. The defense of unclean hands is designed to deny equitable relief to a plaintiff who is guilty of unlawful or inequitable conduct arising out of the matter for which he or she seeks relief.ⁿ¹⁰¹ However, for the doctrine of unclean hands to bar an equitable claim, the misconduct alleged must be serious enough to justify a court's denial of relief on an otherwise valid claim.ⁿ¹⁰²

[d] Ratification

Ratification, the validation of a prior act and the relinquishment of a known right, may also be a valid defense to civil liability claims under Blue Sky laws.

FOOTNOTES:

(n1)Footnote 1. Unif. Sec. Act § 410(a)(2); *see also* Rev. Unif. Sec. Act § 605(b).

(n2)Footnote 2. *See, e.g., Cal. Corp. Code* § 25501; *Mass. Gen. L. Ann, ch. 110A, § 410(a)(2)*; 70 Pa. Cons. Stat. § 501(a); *Tex. Rev. Civ. Stat. Ann.* § 581-33(A)(2).

(n3)Footnote 3. 2002 Unif. Sec. Act §§ 509(b),(c).

(n4)Footnote 4. *N.J. Stat. Ann.* § 49:3-71(b)(2).

(n5)Footnote 5. *Ohio Rev. Code* § 1707.41.

(n6)Footnote 6. *See Tex. Rev. Civ. Stat. Ann.* § 581.33(B); *Vt. Stat. Ann.* § 4240(d).

(n7)Footnote 7. In California and Texas, the defendant (buyer or seller) must prove that either the plaintiff knew the facts concerning the untruth or omission or that he, the defendant, did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.

(n8)Footnote 8. *See, e.g.* Rausch v. Jones, 509 N.E. 2d 236-238 (Ind. Ct. App. 1987) (statute places burden of showing that investor knew of all material facts on seller/defendant).

(n9)Footnote 9. Unif. Sec. Act § 410(b); *see also* Rev. Unif. Sec. Act § 605(d). This section adds a defense to control person liability that "the controlling person acted in good faith and did not, directly or indirectly, induce the act, omission or transaction constituting the violation." *See* the discussion of this defense in connection with non-seller liability in *section 14.03, above* .

(n10)Footnote 10. Unif. Sec. Act § 410(f); *see also* Rev. Unif. Sec. Act § 802(a). The result dictated by § 410(f) (prohibition of suit based on an illegal contract) has generally been reached by courts even in the absence of such a provision. *See* Official Code Comment to Uniform Act § 410(f); *see also* *Connecticut National Bank v. Giacomi*, 699 A.2d 101 (Conn. 1997) (bank's securities violations precluded its suit on promissory notes).

(n11)Footnote 11. *See, e.g.*, Conn. Gen. Stat., ch. 662, § 36b-29(h); 32 Me. Rev. Stat. Ann. § 10608(1); *Mass. Gen. L. Ann., ch. 110A, § 410(f)*; *N.J. Stat. Ann. § 49:3-71(h)*.

See also *Criticare Sys., Inc. v. Sentek, Inc.* 465 N.W. 2d 216 (Wis. Ct. App. 1990) (contract need not be found illegal *per se* before statute, which prohibits person who makes or engages in performance of contract in violation of securities law from suing upon contract, can operate); *Murlas Brothers Commodities, Inc. v. Krause*, [1971-1978 Transfer Binder] Blue Sky L. Rep. (CCH) P 71,346 (Wis. Cir. Ct. 1977), in which plaintiff, an unlicensed broker-dealer, was precluded from bringing a lawsuit for breach of the sales contract by defendant-purchaser because he, the plaintiff, was in violation of Wis. Stat. Ann. § 551.31(1), (2) requiring the registration of broker-dealers and agents.

In *Dunn. v. Bemor Petroleum, Inc.*, 680 S.W.2d 304 (Mo. Ct. App. 1984) , a buyer in an action to rescind the sale of unregistered oil and gas securities, was not entitled to summary judgment where the seller properly raised the defense that the buyer knew the securities had to be registered and were not registered.

(n12)Footnote 12. Unif. Sec. Act § 410(g); *see also* Rev. Unif. Sec. Act § 802(b).

(n13)Footnote 13. *See, e.g.*, Conn. Gen. Stat., ch. 662, § 36b-29(i); *Mass. Gen. L. Ann., ch. 110A, § 410(g)*; *Me. Rev. Stat. Ann. § 10608(2)*; *N.J. Stat. Ann. § 49:3-71(i)*.

(n14)Footnote 14. *See* *Fierer v. Ashe*, 235 S.E.2d 598 (Ga. Ct. App. 1977) .

In *Getter v. R. G. Dickinson & Co.*, 366 F. Supp. 559 (S.D. Iowa 1973) one of the issues was whether a choice of law provision in a contract of sale selecting New York law as governing the transaction could be the basis for a defense of waiver of rights and remedies under the Iowa Securities Act. The court concluded that "the plaintiffs did not waive the protections of the Iowa Securities Act" 366 F.Supp. at 575 ; *see also* *Larson v. JRC Resources Corp.*, 1988 U.S. Dist. LEXIS 10713 [1986-1987 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,467 (N.D. Iowa 1986) (In a case of first impression in Iowa, the court held that the state's statutory anti-waiver provision precluded waiver of the right to sue by purchasers of a non-registered non-exempt limited partnership interests who at the time of purchase acknowledged that the interests were not registered and agreed not to revoke their investments); *see also* *Criticare, above*, 465 N.W.2d at 220 .

(n15)Footnote 15. Although the states involved in the following cases did not at the time decided have a statutory provision against waiver, the courts held that where the waiver would be contrary to public policy or the protection of the public, waiver would not be enforced. *See* *Foreman v. Holsman*, 10 Ill. 2d 551, 141 N.E.2d 31 (1957) ; *Bianco v.*

Superior Court, 265 Cal. App. 2d 126, 71 Cal. Rptr. 322 (1968) ; *Boehner v. Walston & Co., Inc.*, 358 F. Supp. 537 (S.D.S.D. 1973) (enforcement of choice of law provision in contract for the sale of securities against public policy of the State of South Dakota; no mention of defense of waiver); *see also Getter*, 366 F. Supp. 559 , *above*.

(n16)Footnote 16. *Stewart v. Steiner*, 93 P.3d 919 (Wash. App. 2004) .

(n17)Footnote 17. *Kronenberg v. Katz*, 872 A.2d 568, 593, 2002 Del. Ch. LEXIS 77 (Del. Ch. 2004) .

See also Marram v. Kobrick Offshore Fund, Ltd., 442 Mass. 43, 809 N.E.2d 1017 (2004) . In *Marram* the Supreme Judicial Court concluded that an integration clause amounts to a waiver of compliance with the Uniform Securities Law and to allow it would thwart the objective of the statute.

(n18)Footnote 18. *See § 15.05[4], below*.

(n19)Footnote 19. Unif. Sec. Act § 412(e); *see also* Rev. Unif. Sec. Act § 707.

(n20)Footnote 20. *See, e.g., Cal. Corp. Code § 25700; Fla. Stat. Ann. § 517.03(2); Ill. Comp. Stat., ch. 815, § 5/11(A); Mass. Gen. L. Ann., ch. 110A, § 412(e); N.J. Stat. Ann. § 49:3-72; Ohio Rev. Code § 1707.20(E); Tex. Rev. Civ. Stat. Ann. § 581-(28-1)(E).*

(n21)Footnote 21. *See Trimble v. American Savings Life Ins. Co.*, 733 P.2d 1131 (Ariz. Ct. App. 1986) (statute of limitations does not apply in a public civil action under the antifraud provision of Arizona's Blue Sky Law).

(n22)Footnote 22. Unif. Sec. Act § 410(e); *see also* Rev. Unif. Sec. Act § 606, which provides:

A person may not obtain relief under Section 605 unless suit is brought within the earliest of one year after the discovery of the violation, one year after discovery should have been made by the exercise of reasonable care, or three years after the act, omission, or transaction constituting the violation.

(n23)Footnote 23. 2002 Unif. Sec. Act § 509(j).

(n24)Footnote 24. *See, e.g., Alaska Stat. § 45.55.930(f); Colo. Rev. Stat. § 11-51-604(8); Conn. Gen. Stat., § 6b-29(f).*

However, note that for actions arising out of intentional misrepresentation or fraud involving exempt limited partnership interests, the period is one year from the date of discovery of the misconduct, but no more than five years from the actual date of the misrepresentation or fraud. With respect to actions arising out of intentional misconduct involving securities other than exempt limited partnership interests, the time period is one year after the misconduct was discovered or, with due diligence, should have been discovered, but no more than three years from the date of the occurrence.

See also Frantsve v. Joseph, 502 N.E.2d 396 (Ill. App. Ct. 1986) (Illinois Blue Sky statute of limitations, precluding claims made more than three years after the date of sale, began to run against plaintiff's partners in a joint venture, at the time when the joint venture agreement was executed and the purchase price was paid, for that was when the plaintiffs acquired a legal interest in the alleged securities and the right of the parties to the transactions were fixed); *but see* Ill. Comp. Stat. ch. 815, § 5/13B, which requires a purchaser electing rescission under the statute to give notice to seller within six months of knowledge of voidability. Illinois courts have construed such notice as a condition precedent to suit; *see also Bouldon v. Chiappa*, 489 N.E.2d 6 (Ill. Ct. App. 1986) .

(n25)Footnote 25. *See, e.g., Alaska Stat. § 45.55.930(f)* (three years); Ill. Comp. Stat. ch. 815, § 5/13D (three years).

(n26)Footnote 26. *Ariz. Rev. Stat. Ann. § 44-2004(A)*.

(n27)Footnote 27. *Ariz. Rev. Stat. Ann. § 44-2004(B)*.

(n28)Footnote 28. *Cal. Corp. Code § 25506*; see also *Bowden v. Robinson*, 67 Cal. App. 3d 705 (Cal. Ct. App. 1977) ; *In re National Mortgage Equity Corp. Mortgage Pool Certificates Sec.Lit.*, 682 F. Supp. 1073 (C.D. Cal. 1987) (*Cal. Corp. Code § 25506* contains the same due diligence standard as Section 12(2) of the federal Securities Act of 1933 (15 U.S.C. § 77l(2), i.e., claims are time-barred one year after plaintiff should have discovered the fraud exercising reasonable diligence).

But see Eisenbaum v. Western Energy Resources, Inc., 218 Cal. App. 3d 314, 324 (Ct. App. 1990) (purchaser entitled to rely on advice of fiduciary/seller of limited partnership interest regarding validity of exemption; existence of trust relationship limited duty of inquiry and thus limitations period did not begin to run until plaintiff actually discovered facts constituting claim).

(n29)Footnote 29. *Cal. Corp. Code § 25507(a)*; cf. *People v. Martinson*, 188 Cal. App. 2d 894 (Cal. Ct. App. 1987) (California Corporations Commissioner was not bound by shorter securities private action limitations periods but could sue for an injunction and disgorgement of sales commissions earned from allegedly violative unregistered sales of securities by unregistered sellers within the four-year period of the catchall provision of the Code of Civil Procedure); see also *Cal. Corp. Code § 25506.1* regarding the time limits on actions involving professional persons named in the prospectus.

(n30)Footnote 30. *70 Pa. Cons. Stat. § 1-504(a)*.

(n31)Footnote 31. *70 Pa. Cons. Stat. § 1-504(b)*.

(n32)Footnote 32. *Fla. Stat. Ann. § 95.11(4)(e)*; see also *Puchner v. Bache Halsey Stuart, Inc.*, 553 So. 2d 216 (Fla. Ct. App. 1989) .

(n33)Footnote 33. *Minn. Stat. Ann. § 80A.23(7)*.

(n34)Footnote 34. *Iowa Code § 502.504(2)*; see also *Mass. Gen. L. Ann. ch. 110A, § 410(e)*.

(n35)Footnote 35. *Iowa Code § 502.504(1)*.

(n36)Footnote 36. *Md. Corp. & Assoc. Code Ann. §§ 11-703(f)(1), (2)*.

(n37)Footnote 37. *Mont. Code Ann. § 30-10-307(5)*. These limitations periods also apply to transactions occurring prior to their effective date of March 27, 1987, if no action has been commenced within one year of that date.

(n38)Footnote 38. *N.D. Cent. Code § 10-04-17(1)*.

(n39)Footnote 39. *Miss. Code Ann. § 75-71-725*.

(n40)Footnote 40. *N.H. Rev. Stat. Ann. § 421-B:25(VII)*.

(n41)Footnote 41. See, e.g., *New York Civ. Prac. L. & R. Art. 2*; see also *State of New York v. 7040 Colonial Road Assoc.*, 671 N.Y.S.2d 938, 1998 N.Y. Misc. LEXIS 78 , Blue Sky L. Rep., 1997-1998 CCH Decisions, P 74,165 (N.Y. Sup. Ct. 1998) (statute of limitations accrues on each violation of securities laws); *Algrant v. Evergreen Valley Nurseries, Ltd. Partnership*, 941 F. Supp. 495, 1996 U.S. Dist. LEXIS 14320 , Blue Sky L. Rep., 1995-1996 CCH Decisions, P 74,126 (E.D. Pa. 1996) *aff'd*, 126 F.3d 178, 1997 U.S. App. LEXIS 24916 (3d Cir. Pa. 1997) (applicable statute of limitations for declaratory judgment is that of underlying substantive claim).

(n42)Footnote 42. See *Fuller v. Dreischarf*, 517 S.E.2d 89, 1999 Ga. App. LEXIS 658, Blue Sky L. Rep., 1999 CCH Decisions, P 74,183 (Ga. App. 1999) (recovery barred); *Ainslie v. Spolyar*, 926 P.2d 822, 1996 Ore. App. LEXIS 1476, Blue Sky L. Rep., 1996-1997 CCH Decisions, P 74,135 (Oregon App. 1996) (statute of limitations runs from date of final payment); *Gygi v. Guest*, 344 N.W.2d 214, 216 (Wis. Ct. App. 1984) (statute starts to run when "reasonable person, aware of the need for an exemption would have been put on notice that something might be wrong").

In *Morton v. Tullgren*, 263 Ark. 69, 563 S.W.2d 422 (Ark. Sup. Ct. 1978), the court discussed the treatment to be given to any enlarging statute of limitations that calls for a longer period for suit than the existing statute. Stating that a split of authority exists, the court expressed the view that depending upon legislative intent, the new statutory period, rather than the old, may be applied to any cause of action that had not been barred at the time the new statute became effective. Although the majority view was stated to be that legislative amendments extend the period of the statute of limitations to causes of action accrued, but not yet barred, Arkansas follows the minority view and will not retroactively apply an amendment unless there is clear legislative intent to the contrary.

In a different situation, a court was asked to determine the constitutionality of a shorter statute of limitations based on securities fraud versus fraud in general. The court held that legislatures are free to make reasonable classifications, i.e., the classification has a reasonable relationship to the purposes of the legislation. In this case, the three year securities fraud statute of limitations was held to be constitutional even though other actions based on fraud were permitted five year statutory periods. *Hutto v. Bockweg*, 579 S.W.2d 382 (Ky. Ct. App. 1979). The court explained that "the lot of the seller is made more onerous by the Blue Sky statute in misrepresentation cases... . Some of the inhibiting strictures of the law of misrepresentation are relaxed and the price exacted is the shortened limitations period." 579 S.W.2d at 385. Based on this *quid pro quo*, the court held the classification reasonable and therefore constitutional.

(n43)Footnote 43. *Ruffinilli v. Jordan*, 30 Cal. Rptr. 780 (Cal. Ct. App. 1963); but see *TCF Banking & Sav., F.A. v. Arthur Young & Co.*, 706 F. Supp. 1408, 1415 (D. Minn. 1988) (language in relevant Minnesota statute of limitations referred to date of occurrence of misrepresentation, not date of sale).

See also *Kelly v. Primeline Advisory, Inc.*, 889 P.2d 130, 1995 Kan. LEXIS 20, Blue Sky L. Rep., 1995-1996 CCH Decisions, P 75,050 (Kan. 1995); *Hess v. IRE Real Estate Fund, Ltd.*, 629 N.E.2d 520, 1993 Ill. App. LEXIS 263, Blue Sky L. Rep., 1993-1994 CCH Decisions, P 73,908 (Ill. App. 1994).

(n44)Footnote 44. *Moerman v. Zipco, Inc.*, 302 F. Supp. 439 (E.D.N.Y. 1969), *aff'd*, 422 F.2d 871 (2d Cir. 1970), *reh'g. denied*, 430 F.2d 362 (2d Cir. 1970).

(n45)Footnote 45. *Eastman Dillon v. Lintz*, 582 S.W.2d 394 (Tex. Sup. Ct. 1979), *rev'ing* 568 S.W.2d 147 (Tex. Ct. Civ. App. 1978).

(n46)Footnote 46. 94 Cal. App. 3d 187, 156 Cal. Rptr. 286 (Cal. Ct. App. 1979).

(n47)Footnote 47. See also *Geisenberger v. John Hancock Distrib., Inc.*, 774 F. Supp. 1045, 1991 U.S. Dist. LEXIS 14196, [1986-1987 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,590 (S.D. Miss. 1991) (Setting the limitations periods for Mississippi analogue to *Rule 10b-5*, the court chose the provision within Mississippi securities law allowing plaintiff two years from reasonable discovery of misrepresentation or fraud).

But see *Lubin v. Sybedon Corp.*, 688 F. Supp. 1425 (S.D. Cal. 1988) (California's two year statute of limitations relating to registration provisions found to be absolute and not subject to equitable tolling).

(n48)Footnote 48. The 2002 Uniform Act contains a specific provision regarding rescission offers to purchasers, sellers, or recipients of investment advice, see 2002 Unif. Sec. Act § 510, and which bars any action under the civil liability provision when a qualifying rescission offer has been made. This provision in the 2002 Uniform Act reflects similar provisions in various state Blue Sky laws.

(n49)Footnote 49. Ill. Comp. Stat., ch. 815, § 5/13(D). Illinois offers a two year tolling provision which extends the time a plaintiff may bring suit and begins to run on the earlier of the date the plaintiff has actual knowledge of the violation or the date the plaintiff has notice of facts which in the exercise of reasonable diligence would lead to knowledge but in no case more than two years beyond the original three year limit; *see also* § 5/13D(1), (2).

(n50)Footnote 50. Ill. Comp. Stat., ch. 815, § 5/13(B).

(n51)Footnote 51. *Gowdy v. Richter*, 314 N.E.2d 549 (Ill. Ct. App. 1974) ; *but see Renshl Assoc. Inc. v. Long Grove Trading Co.*, 754 F. Supp. 1226,1236 (N.D. Ill. 1990) , in which the court dismissed plaintiff's rescission count for failure to comply with the six month notice requirement.

See also Dowling, Sr. v. Finley Assoc., Inc., 714 A.2d 694, 1998 Conn. App. LEXIS 282 , Blue Sky L. Rep., 1997-1998 CCH Decisions, P 74,163 (Conn. App. 1998) *rev'd, remanded on other grounds*, 248 Conn. 364, 727 A.2d 1245, 1999 Conn. LEXIS 77 (1999) (equitable claim that allowed for legal relief barred by statute of limitations).

But see Carter v. Moody, 511 S.E.2d 520, 1999 Ga. App. LEXIS 140 , Blue Sky L. Rep., 1999 CCH Decisions, P 74,177 (Ga. App. 1999) (buyer not barred despite running of statute of limitations).

(n52)Footnote 52. *Silverman v. Chicago Ramada Inn, Inc.*, 211 N.E.2d 596 (Ill. Ct. App. 1965) .

(n53)Footnote 53. 211 N.E.2d at 599 .

(n54)Footnote 54. *See Levine v. Unruh*, 240 N.E.2d 521 (Ill. Ct. App. 1968) ; *see also* Frantzve, n. 24, *above*, 502 N.E.2d at 398 (operative date is date of agreement, not date final installment payment made); *But see Doll v. Bernard*, 218 Ill. App. 3d 719, 578 N.E.2d 1053 (Ill. App. 1991) (statute of limitations began to run when investors made their first installment payment under a subscription agreement although that agreement granted the seller a security interest in the investment to secure payment of further installments).

But see Ainslie v. Spolyar, Blue Sky L. Rep., 926 P.2d 822, 1996 Ore. App. LEXIS 1476 , 1996-1997 CCH Decisions, P 74,135 (Oregon App. 1996) (statute of limitations runs from date of final payment).

(n55)Footnote 55. *See Wilder v. Meyer*, 779 F. Supp. 164, 1991 U.S. Dist. LEXIS 17796 , Blue Sky L. Rep. (CCH) P 73603 (S.D. Fla. 1991) (latter prong of Florida blue sky limitations period--"not more than five years" from the violation--could not be tolled); *Semrad v. Edina Realty, Inc.*, 470 N.W.2d 135 (Minn. App. 1991) , *aff'd*, 493 N.W.2d 528 (Minn. 1992) ; *Martin v. Pacific Insurance Company of New York*, 431 S.W.2d 239 (Ark. Sup. Ct. 1968) ; *see also McCullough v. Leede Oil & Gas, Inc.*, 617 F. Supp. 384, 390-91 (W.D. Okla. 1985) (applying Alabama law).

(n56)Footnote 56. *See Levine v. Unruh*, 240 N.E.2d 521 (Ill. App. 1968) .

(n57)Footnote 57. *Berquist v. International Realty, Ltd.*, 537 P.2d 553 (Or. Sup. Ct. 1975) .

(n58)Footnote 58. *Central Investments, Inc. v. Polk*, 388 S.W.2d 381 (Ark. Sup. Ct. 1965) .

(n59)Footnote 59. *Wells v. Hill*, 396 S.W.2d 946 (Ark. Sup. Ct. 1965) .

(n60)Footnote 60. *See, e.g., State v. Argo*, 915 P.2d 1103, 1996 Wash. App. LEXIS 164 , Blue Sky L. Rep., 1995-1996 CCH Decisions, P 74,116 (Wash. App. 1996) (acts designed to "lull" investors tolled statute of limitations); *Eisenbaum v. Western Energy Resource Inc.*, 218 Cal. App. 3d 314, 324 (Ct. App. 1990) (purchaser entitled to rely on advice of fiduciary/seller of limited partnership interest regarding validity of exemption; existence of trust relationship limited duty of inquiry and thus limitations period did not begin to run until plaintiff actually discovered facts constituting claim); *Sorenson v. Tenuta*, 62 Ohio App. 696, 577 N.E.2d 408 (Ohio App. 1991) (limitations period based on knowledge or reason to know that securities were unregistered and appellant unlicensed in violation of Ohio blue sky

law began to run upon actual discovery of those facts despite the investor's status as a retired U.S. Air Force officer who had "significant investment experience"); *Richey v. Westinghouse Credit Corp.*, 667 F. Supp. 752 (W.D. Okla. 1986) (applying fraudulent concealment doctrine and also finding that if a confidential relationship existed between the parties at the time of the fraud, the statutes of limitations would be tolled until the investors had actual notice of the fraud).

But see DeSciouse v. Chiles, Heider & Co., 239 Neb. 195, 476 N.W.2d 200 (1991) (investor failed to show fiduciary relationship sufficient to toll statute of limitations; mere existence of broker/client relation does not imply one); *Melko v. Dionisio*, 580 N.E.2d 586, 1991 Ill. App. LEXIS 1736, [1991-1993 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,576 (Ill. App. 1991) (five-year statute of limitations for common law fraud began to run when investor was put on notice of the alleged securities fraud, and barred action; investor's claims that limitations period did not begin until actual discovery of the fraud because of alleged company concealment and defendant's alleged fiduciary relationship to her were rejected); *Lubin v. Sybedon Corp.*, 688 F. Supp. 1425 (S.D. Cal. 1988) (California's two year statute of limitations relating to registration provisions found to be absolute and not subject to equitable tolling); *Platsis v. E.F. Hutton & Co.*, 642 F. Supp. 1277, 1304, (W.D. Mich. 1986), *aff'd per curiam*, 829 F.2d 13 (6th Cir. 1987), *cert. denied*, 485 U.S. 979, 108 S. Ct. 1277, 99 L. Ed. 2d 488 (1988) (plaintiff failed to carry the burden of establishing defendant's alleged fraudulent concealment as a basis for tolling the applicable blue sky limitations period, where plaintiff alleged that defendant hid from him the fact that he was not a suitable investor in an oil and gas program but plaintiff's own proof showed that he was within the applicable suitability requirements).

See also *Narum v. Faxx foods, Inc.*, 590 N.W.2d 454, 1999 N.D. LEXIS 49, Blue Sky L. Rep., 1999 CCH Decisions, P 74,181 (N.D. S. Ct. 1999) (seller's rescission offer did not toll statute of limitations); *Tierney v. Garrard*, 477 S.E.2d 73, 1996 N.C. App. LEXIS 1075, Blue Sky L. Rep., 1995-1996 CCH Decisions, P 74,130 (N.C. App. 1996), *aff'd without opinion*, 490 S.E.2d 237, 1997 N.C. LEXIS 653 (1997) (tolling statute not applicable when defendant subject to service by publication under long arm statute).

(n61)Footnote 61. *See* § 15.04[1], *above*.

(n62)Footnote 62. *2005 Ohio 4044, 2005 Ohio App. LEXIS 3690 (11th Dist. Ohio App. 2005)*.

(n63)Footnote 63. *See Marshall v. Harris*, 555 P.2d 756 (Or. Sup. Ct. 1976); *see also Hines v. Data Line Systems, Inc.*, 114 Wa. 2d 127, 787 P.2d 8, 1990 Wash. LEXIS 16 (1990); *Brennan v. Reed, Smith, Shaw & McClay*, 450 A.2d 740 (Pa. Super. Ct. 1982). For an action to arise under the securities laws based upon inadequate advice from counsel, the attorney's duty to his client must have resulted from the provisions of the applicable securities laws and not merely from the failure to advise in a legal capacity of the obligation to register securities. If counsel isn't liable to an investor under the securities laws themselves he may still be liable to his client under common law professional malpractice principles.

(n64)Footnote 64. *Go2Net, Inc. v. Freeyellow.com, Inc.*, 126 Wn. App. 769, 109 P.3d 875 (Wash. App. 2005).

(n65)Footnote 65. 126 Wn. at 783.

(n66)Footnote 66. *See, e.g., Midwest Management Corp. v. Stephens*, 291 N.W.2d 896 (Iowa 1980) (defense of estoppel available under Iowa Blue Sky law, which renders transactions in violation of registration requirements voidable at the election of the purchaser); *Popper v. Havana Publications, Inc.*, 122 So. 2d 247 (Fla. Dist. Ct. App. 1960) (defense of estoppel may be interposed in an action under Florida Blue Sky civil liabilities provision, which provides that violative transactions are voidable at the election of the purchaser).

(n67)Footnote 67. *See Logan v. Panuska*, 293 N.W.2d 359 (Minn. 1980), which was decided under the Blue Sky provision in effect prior to the adoption of the Uniform Act in Minnesota. Section 410(a) of the Uniform Act does not use the terms void or voidable; *see also Straley v. Universal Uranium & Milling Corp.*, 289 F.2d 370 (9th Cir. 1961), in which the court remanded for consideration of the defenses of waiver and estoppel, since those defenses may be

available in an action brought under Section 12(1) of the Securities Act.

Cf. Pinter v. Dahl, 486 U.S. 622, 108 S. Ct. 2063, 100 L. Ed. 2d 658, 1988 U.S. LEXIS 2725 (1988) (barring investor's recovery under *in pari delicto* doctrine, "at least on the basis solely of the buyer's knowledge of the violation, is so foreign to the purpose of the [Uniform Act] that there is hardly a trace of it in the decisions under 12(1)." *quoting* 3 L. Loss, Securities Regulation 1694 (2d ed. 1961) and finding that *in pari delicto* defense may defeat recovery in 12(1) action only where plaintiff's role in offering or sale of non-exempted, unregistered securities is more as promoter than investor).

(n68)Footnote 68. 9 Loss & Seligman, Securities Regulation 4153-54 (Aspen Law & Business, 3d ed.).

(n69)Footnote 69. *See, e.g., Logan v. Panuska*, n. 74, *above*, at 363; *see also* Loss, n. 75 *above* (courts will ignore "void" language when a purchaser was not imposed upon).

(n70)Footnote 70. 312 F.2d 210 (9th. Cir. 1962) .

(n71)Footnote 71. 312 F.2d at 214 .

(n72)Footnote 72. *But see Lawler v. Gilliam*, 569 F.2d 1283 (4th Cir. 1978) , in which the court rejected an effort by sellers of unregistered securities to assert the defenses of unclean hands and *in pari delicto* in an action under the federal Securities Act of 1933, on the basis that allowing such defenses would seriously undermine the deterrent effect of private suits. The court observed:

A judgment based on the 1933 Act performs a dual function. It redresses a private wrong and enforces public policy. Since one of the essential purposes of the Act is to protect investors by requiring publication of information about a security through its registration, enforcement of the Act by private litigation ordinarily should not be encumbered by defenses for which the statute makes no provision. 596 F.2d at 1291 .

(n73)Footnote 73. *Popper v. Havana Publications, Inc.*, 122 So. 2d 247 (Fla. Dist. Ct. App. 1960) .

(n74)Footnote 74. *Nash v. Jones*, 162 S.E.2d 392 (Ga. Sup. Ct. 1968) .

(n75)Footnote 75. *See Theye v. Bates*, 337 N.E.2d 837 (Ind. Ct. App. 1975) ; *Ladd v. Knowles*, 505 S.W.2d 662 (Tex. Ct. Civ. App. 1974) . *See also* Note, *Estoppel and In Pari Delicto Defenses to Civil Blue Sky Law Actions*, 73 Cornell L. Rev. 448, 453-457 (1988); Annot., "Purchaser's Right to Set Up Invalidity of Contract Because of Violations of State Securities Regulation as Affected by Doctrines of Estoppel or *In Pari Delicto*," 84 A.L.R.2d 479, 491 .

In *Pinter v. Dahl*, 486 U.S. 622, 108 S. Ct. 2063, 100 L. Ed. 2d 658 (1988) , the U.S. Supreme Court held that the defense of *in pari delicto* was available in an action under Section 12(1) of the federal Securities Act of 1933, 15 U.S.C. § 771 (1).

(n76)Footnote 76. In one court, *in pari delicto* was considered grounds for the defense of estoppel, *see Data Lease Financial Corporation v. Barad*, 291 So. 2d 608, (Fla. Ct. 1974) , in which the court opined:

The instant action was not an equitable suit for rescission, but was brought to void the transaction under a statute specifically requiring registration and making sales of unregistered stock voidable where statutory requirements are not met. In such a situation, estoppel is applicable only where the purchaser himself is *in pari delicto*, participates in the management of the issuing corporation, or where some unusual circumstances exist justifying application of the doctrine of estoppel.

291 So. 2d at 612. In *Hayden v. McDonald*, 742 F.2d 423 (8th Cir. 1984), an action alleging violation of the securities registration provisions of the Minnesota Blue Sky Law, the defense of *in pari delicto* was available against investors with full knowledge that the securities were not registered and who actively promoted the securities to prospective new buyers; the defense of equitable estoppel, however, cannot be raised unless the investor has actively participated in the management and control of the fraudulent scheme.

But see *Dunn v. Bemor Petroleum, Inc.*, 680 S.W.2d 304 (Mo. Ct. App. 1984) (neither estoppel nor *in pari delicto* are available to rescind the sale of unregistered securities because that would allow the seller to avoid liability by informing potential purchasers that the securities are unregistered; the state's interest in requiring registration overrides the possibility that a knowing purchaser will receive a windfall).

(n77)Footnote 77. *Ladd v. Knowles*, 505 S.W.2d 662 (Tex. Ct. Civ. App. 1974).

See also *Ross v. Bolton*, 904 F.2d 819 (2d Cir. 1990) (doctrine applied, in an action under New York blue sky law, to exonerate a clearing broker that had no guilty knowledge of introducing broker's wrongful scheme to which plaintiff customer was privy).

(n78)Footnote 78. *McCauley v. Michael*, 256 N.W.2d 491 (Minn. Sup. Ct. 1977).

(n79)Footnote 79. 256 N.W.2d at 495; see also *McAdam v. Dean Witter Reynolds, Inc.*, 896 F.2d 750 (3d Cir. 1990) (N.J. law); *Stell v. Dean Witter Reynolds*, 574 A.2d 468 (N.J. Super. A.D. 1990).

(n80)Footnote 80. See *Fierer v. Ashe*, 235 S.E.2d 598 (Ga. Ct. App. 1977); see also *Comeau v. Rupp*, 810 F. Supp. 1127 (D. Kan. 1992); *Plunkett v. Francisco*, 430 F. Supp. 235 (N.D. Ga. 1977).

(n81)Footnote 81. *Weinstock v. L.A. Carpet, Inc.*, 44 Cal. Rptr. 852 (Cal. Ct. App. 1965); *Krasny v. Richter*, 211 So. 2d 612 (Fla. Dist. Ct. App. 1968).

But see *Krutel v. Stolberg*, 356 So. 2d 1299 (Fla. Dist. Ct. App. 1978). The court held that although the plaintiff, became Secretary-Treasurer of the company and conferred from time to time with the defendants on business decisions, he did not participate to the extent necessary to make the doctrine of estoppel available to the defendants. See also *Logan v. Panuska*, n. 74, above; *Hogg v. Jerry*, 773 S.W.2d 84 (Ark. 1989); *Nicholson v. Harris*, 345 S.E.2d 63 (Ga. 1986).

(n82)Footnote 82. See *Wolken v. Erck*, 421 N.W.2d 63 (S.D.1988); *Trump v. Badet*, 327 P.2d 1001 (Ariz. Sup. Ct. 1958).

(n83)Footnote 83. *Monroe v. Dixon*, 152 So. 2d 744 (Fla. Dist. Ct. App. 1963); see also *Henderson v. Hayden, Stone Inc.*, 461 F.2d 1069 (5th Cir. 1972) (applying Florida law): "Estoppel under Florida law requires that the stock purchaser directly participate in the management of the issuing corporation or otherwise exercise some control over the corporation." 461 F.2d at 1073.

See also *Thiele v. Davidson*, 440 F. Supp. 585 (M.D. Fla. 1977), *aff'd without opinion*, 612 F.2d 578, 1980 U.S. App. LEXIS 20665 (5th Cir. Fla. 1980). The court held that "under Florida law, where a purchaser of securities controls the activities of the corporation or otherwise acts in a manner which is inconsistent with his claim to rescission, the claim may be denied on the theory of estoppel." 612 F.2d at 591.

(n84)Footnote 84. *Loewenstein v. Midwestern Investment Company*, 149 N.W.2d 512 (Neb. Sup. Ct. 1967); see also *Thomas v. Hemmelgarn*, 579 N.E.2d 1333, 1991 Ind. App. LEXIS 1713, [1991-1993 Transfer Binder] Blue Sky L. Rep. (CCH) P 73,573 (Ind. App. 1991) (affirming refusal to apply *in pari delicto* defense in a successful action by

purchasers of unregistered stock and noting that the defense usually does not apply in the context of original issues unless the purchaser participates in the organization or management of the issuer; this does not require that the purchaser have been an officer, director or holder of "voting power" in the issuer, but does require more than service to the corporation as bookkeeper and as electrician as was the case here).

Cf. Investors Equity Group v. Rosenkrantz, Lyon & Ross, Inc., 822 F. Supp. 429, 1993 U.S. Dist. LEXIS 5941, Blue Sky L. Rep., 1993-1994 CCH Decisions, P 73,842 (W.D. Mich. 1993), *rev'd, remanded sub nom, Investors Equity Group v. Universal Symetrics Corp.*, 53 F.3d 159, 1995 U.S. App. LEXIS 10206 (6th Cir. 1995) (Michigan courts have only recognized *in pari delicto defense* to statutory cause of action and court refused to consider other equitable defenses to violation).

(n85)Footnote 85. See *Data Lease Financial Corp. v. Barad*, 291 So. 2d 608 (Fla. Sup. Ct. 1974) .

(n86)Footnote 86. *Young v. Kwock*, 474 P.2d 285 (Hawaii Sup. Ct. 1970) ; see also *In re Bell & Beckwith*, 114 B.R. 475 (B. Ct., N.D. Ohio 1989) .

(n87)Footnote 87. See *Krasny v. Richter*, 211 So. 2d 612 (Fla. Dist. Ct. App. 1968) .

(n88)Footnote 88. 211 So. 2d at 613 . The court observed:

The evidence supports a finding that Mrs. Ladden approached the defendants seeking to participate in their business venture; that she interested some of her friends and relatives in participating with her; that a stockholder's agreement was drawn providing that the investing group would have the right to designate a director, and the group designated Mrs. Ladden; that the investing group employed an attorney who advised that the transaction was exempt from the provisions of ch. 517 F.S.A. Fla. Stat.; that Mrs. Ladden as the representative of the investing group participated in the corporate management from October 1963 to January 1964; and that the corporation retrogressed from good business prospect to failure during this period.

(n89)Footnote 89. The *Krasny* court added:

We know of no reason why the doctrine of estoppel should not be applied where the buyer, rather than participate personally, participates in corporate affairs through an agent. Appellants urge that this application of the doctrine of estoppel would be an extension which should not be made because of public policy. We cannot say that the public policy of Florida is that a purchaser of stock who participates directly in corporate affairs should be estopped to rescind the sale of stock and recover the purchase price but that a purchaser who designates a representative to act for him in corporate affairs should not be so estopped. 211 So.2d at 613 .

(n90)Footnote 90. *Gowdy v. Richter*, 314 N.E.2d 549 (Ill. Ct. App. 1974) . In a Georgia case involving state and federal securities law violations and a claim for punitive damages based on common law fraud, the defense of waiver was not available for violations of state and federal securities law, but was permitted for common law fraud violations under the state's blue sky law that preserves all statutory or common law rights for acts involving the sale of a security. *Jones v. Miles*, 656 F.2d 103 (5th Cir. 1981) .

See also *Dunn v. Bemol Petroleum*, 680 S.W. 2d 304 (Mo. Ct. App. 1984) (use of equitable defense would defeat purpose of Blue Sky laws by allowing seller to inform buyers of irregularities and thus escape liability).

But see *Ainsworth v. Skurnick*, 960 F.2d 939, 1992 U.S. App. LEXIS 11005, Blue Sky L. Rep., 1991-1992 CCH

Decisions, P 73,620 (11th Cir. 1992), *cert. denied*, 507 U.S. 915, 122 L. Ed. 2d 665, 113 S. Ct. 1269 (1993) .

(n91)Footnote 91. *Stevens v. Crystal Lake Transportation Sales, Inc.*, 332 N.E.2d 727 (Ill. Ct. App. 1975) .

(n92)Footnote 92. *Maner v. Mydland*, 58 Cal. Rptr. 740 (Cal. Ct. App. 1967) .

(n93)Footnote 93. *Dokken v. Minnesota-Ohio Oil Corp.*, 232 So. 2d 200 (Fla. Dist. Ct. App. 1970) , *cert. denied*, 240 So. 2d 638 (Fla. Sup. Ct. 1970) .

(n94)Footnote 94. 232 So. 2d at 202 , 203.

(n95)Footnote 95. 232 So.2d at 204-205 ; *see also* *Larson v. JRC Resources Corp.*, 1988 U.S. Dist. LEXIS 10713 , Blue Sky L. Rep. (CCH) P 72,467(N.D. Iowa 1986) (equitable estoppel applied against purchasers who provided false information to investor suitability questionnaires in connection with a limited partnership offering).

(n96)Footnote 96. *See Schmittinger v. Schmittinger*, 404 A.2d 967 (D.C. App. Ct. 1979) ; *see also* *Baker v. Baker*, 951 F.2d 922 (8th Cir. 1991) (Following Missouri precedent, a 1986 action challenging a 1972 agreement between brothers that eliminated plaintiff brother's minority interest in two corporations was barred by laches).

(n97)Footnote 97. *Schultz v. Rector-Phillips-Morse, Inc.*, 552 S.W.2d 4 (Ark. Sup. Ct. 1977) .

But see *Hogg v. Jerry*, 773 S.W.2d 84 (Ark. 1989) (action not barred by laches as seller not disadvantaged by any delay).

(n98)Footnote 98. 552 S.W.2d at 14 .

(n99)Footnote 99. *See Lintz v. Dillon*, 568 S.W.2d 147 (Tex. Ct. Civ. App. 1978) .

(n100)Footnote 100. *See* 9 Loss & Seligman, Securities Regulation 4528, n.147 (Aspen Law & Business, 3d ed.).

(n101)Footnote 101. *Mother Earth, Ltd. v. Strawberry Camel Ltd.*, 390 N.E.2d 393 (Ill. Ct. App. 1979) .

(n102)Footnote 102. *See North Pacific Lumber Co. v. Oliver*, 596 P.2d 931 (Or. Sup. Ct. 1979) .

But see Pomeroy, 2 Equity Jurisprudence, §§ 397-398 (5th ed. 1941). According to this treatise, unclean hands is a broad defense that, if strictly construed, would bar a plaintiff's cause of action no matter how slight plaintiff's moral guilt.



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Blue Sky Regulation

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CHAPTER 15 Civil Remedies

2-15 Blue Sky Regulation § 15.06

§ 15.06 Class Actions After SLUSA

The assertion of civil liability claims under Blue Sky laws as class actions is entirely consistent with the remedial provisions, assuming the prerequisites for any class action are met. Several Blue Sky laws clearly imply the use of class actions.ⁿ¹ In those states, if the Commissioner brings an action for restitution or damages on behalf of parties injured by a violation of the state's securities statute, the court is empowered to award the appropriate relief if it finds that the enforcement of private civil actions, "by class action or otherwise," would be impractical.

As a general matter, the key to whether class action litigation is appropriate under Blue Sky laws will be a function of the applicable state procedural requirements for bringing such actions relative to the elements of particular claims asserted. To the extent individual adjudications are required in the determination of civil liability under any particular Blue Sky law, a class action may not be appropriate. Required individual defense assessments, for example, could predominate over common liability issues. These are matters for determination by courts under applicable procedural rules and case. There is nothing about civil liability provisions in Blue Sky laws generally that would preclude the assertion of class claims. There is, however, the important consideration of federal preemption of certain kinds of claims brought as class actions.

In 1998, to curb the perceived migration of class action securities fraud claims to state court, Congress enacted the Securities Litigation Uniform Standards Act of 1998 ("SLUSA").ⁿ² With a few exceptions, SLUSA provides that no "covered class action"ⁿ³ based upon state statutory or common law, alleging (1) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security or (2) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security, can be maintained by a private plaintiff in state or federal court.

The legislation limits pre-emption to "covered securities" under Section 18(b)(1), (2) of the Act,ⁿ⁴ while retaining state court jurisdiction over class action securities fraud claims arising from the offer or sale of NSMIA sanctioned state regulated securities, as well as certain claims arising from transactions between an issuer and its security holders under the law of the issuer's state of incorporation.ⁿ⁵

Among other restrictions, the Act also extends the discovery stay to state court and allows for removal of covered class actions to federal court, as well as for remand to state court of a removed action if the federal court finds it to be maintainable in the state forum. SLUSA specifically preserves the jurisdiction of state securities commissioners to

investigate and bring fraud enforcement actions.ⁿ⁶

Simply put, SLUSA federalized the law of fraud relative to covered securities in cases brought as class actions. No common law claims of fraud or deceit, or any Blue Sky law claim relating to false or misleading statements, in connection with the offer or sale of covered securities may be brought as class or "mass" actions. To that extent the preemption of Blue Sky law remedies and liabilities is complete, and the assertion of such claims, as "covered class actions" is confined to federal courts under the antifraud provisions of the federal securities laws. SLUSA has no impact, however, on the individual assertion of civil liability claims under state law.

FOOTNOTES:

(n1)Footnote 1. *See, e.g., 70 Pa. Cons. Stat. § 1-509(b)*; Wash. Rev. Code § 1.20.390(4).

(n2)Footnote 2. Pub. L. No. 105-353, 112 Stat. 3234, effective November 3, 1998, adding new 15 U.S.C. §§ 16(b)-(f)

(n3)Footnote 3. *See 15 U.S.C. § 16(f)*; *see also* Chapter 12, *above*.

(n4)Footnote 4. *See* Securities Act of 1933, sections 18(b)(1), (2), National Securities Markets Improvement Act, Pub. L. No. 104-290, 110 Stat. 3416 (1996), effective October 11, 1996; H.R. Rep. No. 104-622, 104th Cong., 2d Sess. (June 17, 1996).

See also Zuri-Invest AG v. Natwest Fin. Inc., Fed. Sec. L. Rep. (CCH) 91630, 2001 U.S. Dist. LEXIS 17495 (S.D.N.Y. Oct. 26, 2001) (while NSMIA precluded states from regulating any national offering of securities, there was no indication that statute was intended to preempt state fraud actions since it did not provide any civil liability or enforcement provisions and did not amend statutes providing that the federal remedy was in addition to other remedies and plaintiff's claims for common law fraud did not interfere with regulatory provisions of NSMIA and were consistent with purpose of federal securities law to deter fraud).

(n5)Footnote 5. SLUSA also permits actions to be brought by states, state political sub-divisions and state pension plans involving covered securities on behalf of a class comprised solely of such entities, as well as allowing certain actions under contractual agreements between issuers and indenture trustees.

(n6)Footnote 6. *See also Lander v. Hartford Life & Annuity Ins. Co., Fed. Sec. L. Rep. (CCH) 91456, 251 F.3d 101, 2001 U.S. App. LEXIS 10991 (2d Cir. 2001)* (variable annuity contracts at issue were "covered securities" as defined by SLUSA, not subject to the anti-preemption rule of the McCarran-Ferguson Act and district court dismissed case pursuant to SLUSA's directive that all such class actions be based exclusively on federal law); *Korsinsky v. Salomon Smith Barney, 2002 U.S. Dist. LEXIS 259 (S.D.N.Y. Jan. 9, 2002)* (in order to defeat a motion to remand an action to state court, defendant must show that: (1) the action is a "covered class action" under SLUSA; (2) the action purports to be based upon state law; (3) the action involves a "covered security" under SLUSA; (4) that the defendant is alleged to have misrepresented or omitted a material fact; and (5) the alleged misrepresentation or omission was made, "in connection with" the purchase or sale of the covered security); *Prager v. Knight/Trimark Group, Inc., Fed. Sec. L. Rep. (CCH) 91281, 124 F. Supp. 2d 229, 2000 U.S. Dist. LEXIS 18101 (D.N.J. 2000)* (removal of case to federal district court proper even though action charged that "market maker" improperly used information about retail customers' intent to trade particular securities in order to execute own trades for profit before executing customer trades; although 15 U.S.C. 77bb(f) often applies to cases involving issuers or their affiliates it does not follow that Congress intended to limit its application to such cases; investor has pleaded what are in essence securities fraud claims, if framed as state law claims).

Cf. Shaw v. Charles Schwab & Co., 128 F. Supp. 2d 1270, 2001 U.S. Dist. LEXIS 3494 (C.D. Cal. 2001) (investors' class action against online broker not preempted by 15 U.S.C. § 78bb(f) where claims relate to commission rate for and efficacy of broker's web-based trading system, and investors' allegations that broker's fraud induced them to select

defendant as their broker, not to invest in particular securities, lay more in realm of consumer protection than securities litigation); *Abada v. Charles Schwab & Co.*, *Fed. Sec. L. Rep. (CCH)* 91294, 127 F. Supp. 2d 1101, 2000 U.S. Dist. LEXIS 18992 (S.D. Cal. 2000) (remand of investor's original action to state court was appropriate because investor's allegations involved relationship between brokerage firm and its customers regarding timely execution of online trades and did not assert misrepresentations "in connection with purchase or sale of covered security" within meaning of 15 U.S.C. § 78bb(f)(1)); *Diamond Multimedia Systems, Inc. v. Superior Court*, 19 Cal. 4th 1036, 968 P.2d 539, 1999 Cal. LEXIS 1, 80 Cal. Rptr. 2d 828, 99 (1999) (far from restricting market manipulation actions to those brought under federal securities law, Congress left individual actions unrestricted; except to extent SLUSA limits class actions, there is no preemption and federal law in this arena supplements, but does not displace state regulation and remedies).



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§ 16.01 Introduction

Although Blue Sky laws have been a part of the securities regulatory landscape since the early days of the Twentieth Century, practice and procedures under individual state securities laws for much of that past largely evolved as a matter of unpublished rules of thumb passed from administrator to administrator and varying considerably from state to state. In a practical sense, the mechanics of Blue Sky "law" actually developed more as "lore," reflecting the parochial approach to localized investor protection that grew out of populist reform initiatives of the times. As discussed elsewhere in this treatise,ⁿ¹ although early constitutional challenges to Blue Sky laws as impediments to interstate commerce were rejected, there was no sense of evolving national financial markets and the need for predictability and uniformity while carrying out the proper police power function of local investor protection. Consequently, there was little structure built into the administration of Blue Sky laws. State securities regulation was largely balkanized. Practice and procedures evolved in the same parochial manner, with meaningful local knowledge but little certainty and even less predictability for those on the outside seeking to access capital markets on a growing regional and national scale.

State administrative procedures acts rationalized rulemaking and adjudicative processes in the enforcement of Blue Sky laws and, eventually, widespread adoption of the Uniform Securities Act brought substantial commonality into the basic workings of state securities regulation. Still, for capital formation the separate administration of state securities laws did not become truly rationalized until the advent of common guidelines for merit review of securities offerings and other uniform procedures, largely resulting from initiatives of the North American Securities Administrators Association (NASAA), that eliminated unnecessary barriers to capital formation while assuring that the historic mission of Blue Sky regulation was not compromised. In earlier chapters, for example, initiatives such as the Uniform Limited Offering Exemption (ULOE) and the Small Corporate Offering Registration (SCOR) have been examined along with such practical approaches to regulation in cyberspace as the NASAA model policy on the advertisement of products and services on the Internet.

In this chapter, practical considerations in Blue Sky practice and procedures are explored. The assessment is grounded throughout in the Uniform Securities Act because what state administrators do, how they do it, and how practitioners effectively function in the process is most easily understood by keying on the provisions that form the basis for practice and procedures in most states. A few states substantially adopted the Revised Uniform Securities Act, and a growing number of states have now adopted the 2002 Uniform Securities Act. Others have not adopted any form of the Uniform Act. In practice, however, there is little distinction between Uniform Act and Non-Uniform Act states in terms of the authority and procedures of the administrator and the empowering provisions of the Blue Sky law under which they act.

Moreover, administrative procedures laws do not vary substantially among the states, and both rulemaking and administrative enforcement procedures are largely uniform, although as discussed in detail elsewhere in this treatise,ⁿ² specific remedial and other enforcement-related powers vary from state to state. There are as well important distinctions to be made in practice and procedures among those states that have abandoned "merit" regulation of securities offerings versus those that continue to require it in one form or another.ⁿ³ Nevertheless, at the baseline, procedures for qualification of securities for offering are in place in all states, and those procedures and the roles of administrators do not vary significantly from what is established in the Uniform Act.

Uniformity in practice and procedures today is perhaps most clearly evident in the manner of licensing or registration of intermediaries--broker-dealers, agents, investment advisers and investment adviser representatives. The Central Registration Depository system--today known as "Web CRD"ⁿ⁴--and the Investment Adviser Registration Depository (IARD) have streamlined these procedures to such an extent that a single gateway application procedure is available in any state.

In the same manner, "guidelines" or policy statements adopted by NASAA--the North American Securities Administrators Association--play an important role in the regulation of securities offerings by publishing available standards against which qualitative assessments are made in the merit regulation process, and in the interpretation and application of Blue Sky laws in particular settings. States have selectively adopted NASAA guidelines,ⁿ⁵ and where adopted, these published guidelines control critical determinations in particular settings, such as real estate or oil and gas-related offerings. NASAA, likewise, facilitates uniformity through the development and promulgation of Model Rules that are available to state administrators who address areas of shared regulatory focus and concern. The NASAA *Model Rule on the Use of Senior-Specific Certifications and Professional Designations*,ⁿ⁶ for example, is representative of initiatives to assure a uniform and effective approach throughout the states.

These processes and procedures are considered below with a view to guiding practitioners in achieving the most efficient and effective results. However, nothing below is a substitute for the detailed analyses of each substantive area of administration under Blue Sky laws that are found in other chapters. A complete understanding of Blue Sky practice and procedure is wholly dependent on a thorough knowledge of the substantive areas and the particular objectives in investor protection that each addresses. Armed with that knowledge, however, the practical points discussed below are particularly useful.

FOOTNOTES:

(n1)Footnote 1. The early development of state Blue Sky laws is considered more fully in Chapter 1, "Introduction to State Blue Sky Regulation," *above*.

(n2)Footnote 2. *See* Chapter 14, "State Enforcement," *above*.

(n3)Footnote 3. Merit review and the entire scope of registration of securities offerings under state Blue Sky laws are considered in depth in Chapters 5 and 6, *above*.

(n4)Footnote 4. In 1999 the former, or "legacy" CRD system, was replaced by NASD Regulation, Inc. (now FINRA) with a new, state-of-the-art registration and licensing system-Web CRDsm. The Internet-based Web CRD supports all functionality of the former system, but is considerably more capable, using a relational database structure, based on uniform registration forms. Web CRD information is more useable and accessible through reporting and data downloads via the Web. It has also eliminated paper filings and duplicative information from amendments that streamline and expedite the licensing process. Throughout this chapter, as indeed throughout this treatise, references to the "CRD" now mean Web CRD.

(n5)Footnote 5. For NASAA policy statements and guidelines published in full, see NASAA Rep. (CCH) P 601 *et seq.*

(n6)Footnote 6. Adopted by NASAA Membership on March 20, 2008, this Model Rule prohibits the misleading use of senior and retiree designations and also provides a means by which a securities administrator may recognize certain designations conferred by an accredited organization.



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§ 16.02 Administration

As in the Uniform Act,ⁿ¹ all state Blue Sky laws provide for administration of the securities law by a state agency, with primary management responsibility delegated to an individual "administrator," "commissioner" or "director" who oversees the work of a professional staff. Some states provide for overall administration of their securities laws by an elected constitutional officer. For example, Georgia,ⁿ² North Carolinaⁿ³ and Massachusetts,ⁿ⁴ among others, designate the Secretary of State as the securities administrator. However, whereas North Carolina and Georgia provide for the Secretary of State to delegate powers under the statute, Massachusetts does not. Delegation of the secretary's authority in Massachusetts is found in the rules of the Securities Division.ⁿ⁵ Similarly, in Indiana administrative authority for the Blue Sky law rests with the Secretary of State, but the law specifically provides for a securities division headed by a commissioner, appointed by the Secretary, and who serves at the will of the Secretary.ⁿ⁶

These examples illustrate the varying grants of authority that exist even within analogous state governmental offices. The state securities agency and its administrator may also be found under or within the authority of the state attorney general's office, as in Maryland, New York, Delaware and New Jersey. It may also fall under cabinet, sub-cabinet or independent agencies within the executive branch,ⁿ⁷ other elected officialsⁿ⁸ or multi-member commissions or boards.ⁿ⁹

The professional staff of a securities administrator's office can be broken down into several job categories: examiner/analyst, attorney and investigator. Examiners or analysts review securities offerings to assure compliance with a state's rules and regulations prior to allowing an offering to be registered. They also review applications for investment advisers, broker-dealers and agents. They may be lawyers, accountants, or otherwise possess financial or business training or experience. Some states have career employees performing this function who are often substantial repositories of knowledge.

The securities examiner has authority to offer comments to issuer's or underwriter's counsel, request and negotiate changes in offering documents and give approval to, or seek withdrawal of, an offering. These tasks are often performed under the supervision of a corporate finance chief, or other senior official, with responsibility for that area. In states with small staff, the administrator may perform that function. As noted earlier, because of changes in federal and state laws in recent years, staffing resources have shifted away from reviewing securities and moved into enforcement efforts.

The bulk of a state securities agency's resources are devoted to its enforcement program. Staff attorneys and investigators comprise an agency's enforcement unit. A substantial portion of the enforcement caseload of an administrator's office is likely to be derived from complaints submitted by investors. The public visibility of the

securities agency may vary from state to state; nevertheless, most investor complaints will end up in the administrator's office. The complaints will range from outright fraud to dissatisfaction with the manner of or delays in processing customer funds and securities. The staff may monitor the frequency of such complaints to identify particular patterns or problems at a specific firm or to discern new types of investment scams.

Investigators review customer complaints, conduct interviews and assist in fact gathering. An enforcement attorney's responsibilities may include the investigative stage of a case, pleadings and brief preparation, prosecuting administrative hearings, court litigation and liaison with federal, state and local prosecutors. Supervision is generally provided by a chief of enforcement. Together with the attorney assigned to the case, the enforcement chief may make such critical decisions as whether or where to institute an enforcement action. To preserve the fact and appearance of impartiality of the administrative hearing process, the administrator, if he or she is also the hearing officer, may have no involvement in the preparation of an enforcement case.

The Securities and Exchange Commission, as a general rule, does not commit its limited enforcement resources to cases where the number of investors or the dollar amounts is not very large, unless the case contains an important issue or has broad national impact. Hence, state securities administrators are the primary resource for individual investor complaints, and are today viewed in very practical terms as the "cops on the beat" in investor protection.

The staff is also responsible for responding to inquiries concerning the application and interpretation of the state's securities law and rules. The inquiries may be of a general nature, specific requests for interpretive opinions or "no-action letters."¹⁰ Larger offices may have a general counsel to supervise these functions. The general counsel may also have responsibility for drafting the agency's rules and any proposed legislation. Securities administrators often become actively involved in state legislative activity. The administrator and senior staff are called upon to submit comments and testify on legislation pertaining to the securities law.

The securities administrator's office is a valuable resource in educating the public about financial fraud. Several states publish regular bulletins or newsletters reporting on their enforcement activities and recent developments in the law or policies of the agency, and also to publish notices of proposed rule-making. Today all states also operate Internet web sites through which a variety of information and investor education material is available in addition to easy access to laws, rules, policy statements and both current and archived enforcement actions.

Many administrators and staff speak frequently before bar and business groups and participate as lecturers and panel members for continuing education programs. Financial reporters regularly utilize the administrator's office for information and articles on recent financial trends, regulatory developments and investment fraud. NASAA likewise generates and actively disseminates information designed to enhance investor education initiatives by the states.¹¹

FOOTNOTES:

(n1)Footnote 1. Unif. Sec. Act § 406.

(n2)Footnote 2. *Ga. Code Ann. § 10-5-10(a)*.

(n3)Footnote 3. *N.C. Gen. Stat. Ann. § 78A-45(a)*.

(n4)Footnote 4. *Mass. Gen. L. Ann., Ch. 110A § 406*.

(n5)Footnote 5. *See 950 Code Mass. Reg. § 14.406*.

(n6)Footnote 6. *Ind. Code Ann. § 23-2-1-15(a)*.

(n7)Footnote 7. *See, e.g.,*

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Alaska: Department of Commerce and Economic Development;

Arizona: Corporation Commission;

California: Department of Corporations;

Connecticut: Department of Banking, Securities and Business Investments;

Hawaii: Department of Commerce and Consumer Affairs;

Michigan: Department of Consumer and Industry Services.

(n8)Footnote 8. *See, e.g.,*

Florida: Office of the Comptroller;

Montana: Office of the State Auditor;

West Virginia: State Auditor's Office.

(n9)Footnote 9. *See, e.g.,*

Virginia: State Corporation Commission;

Texas: State Securities Board;

Pennsylvania: Securities Commission.

(n10)Footnote 10. *See section 16.03[c], "Interpretive Guidance," below.*

(n11)Footnote 11. NASAA resources are accessible through its website--[www. nasaa.org](http://www.nasaa.org).



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§ 16.03 Administrative Authority

[1] Mandated Authority

The scope of administrative authority and responsibilities under Blue Sky laws is characterized in terms of either mandated or discretionary authority. Under the Uniform Act and all state laws there are certain responsibilities of the administrator which must be satisfied and which do not entail the exercise of discretion. While certain subjective determinations may have to be made in carrying out legislatively mandated duties, the administrator must nevertheless act.ⁿ¹ Such mandated responsibility contrasts with the discretionary authority an administrator may exercise in deciding, for example, whether to institute an enforcement action for violation of the state securities law. Mandated authority is provided in the Uniform Act and all state laws in the areas of intermediary registration and licensing, and for registration of securities for distribution.

[a] Intermediary Registration or Licensing

Section 202 of the Uniform Act provides for registration of broker-dealers, agents, investment advisers and investment adviser representatives by filing with the administrator. Today the mechanical application process for these intermediaries is accomplished in almost all instances either through the Web CRD or the IARD. Both Web CRD and the IARD are centralized interactive computer databases, which capture, maintain and update information regarding intermediaries. For securities agents and broker-dealers registered with the NASD and the states all information is submitted through Web CRD. For investment advisers and investment adviser representatives the IARD functions in the same manner.ⁿ² The primary benefit of Web CRD and the IARD is that an applicant need not make a physical "filing with the administrator" as set forth in the statute. Rather, once an eligibility process is completed and a billing account is established, agent, broker-dealer and investment adviser registration forms indicating the desired state of registration are electronically completed and filed. The fees are then distributed to the appropriate states. State administrators maintain the registration records by easily accessing Web CRD and IARD data via a computer terminal located in the administrator's office.

It is important to note that this computerized registration processing system is not an abrogation of the administrator's statutory mandate to register or license intermediaries, and to renew those registrations. The administrator retains complete authority to approve or deny an application for registration. Web CRD and the IARD are only receptacles for the registration filings. Some states have enacted specific legislation directing use of Web CRD and the IARD, while most others have implemented the systems through rules or regulations.

NSMIA--the National Securities Markets Improvement Act of 1996--bifurcated responsibility for registration of investment advisers between the states and the SEC. Generally, investment advisers who manage clients' assets that, in the aggregate, exceed 30 million dollars, must register with the SEC. An investment adviser who does not meet that threshold must register with the state where it maintains its principal office. The Uniform Act provides for investment adviser registration in the same section as that for broker-dealers and agents.ⁿ³ The definition of investment adviser in the Uniform Securities Act and in most state statutes tracks that found in the federal Investment Advisers Act of 1940.ⁿ⁴

After NSMIA, investment advisers registered with the SEC are federal covered advisers, with no substantive registration or licensing requirements at the state level. However, federal covered advisers are subject to notice filing and fee requirements in states, and under NSMIA they remain subject to state antifraud enforcement authority. There is no federal registration of investment adviser representatives, and they remain subject to state licensing or registration requirements without regard to whether the investment adviser with which they are affiliated is a federal covered adviser.ⁿ⁵

[b] Registration of Securities

After the NSMIA realignment of federal and state roles in offerings of securities that are national in character, most public securities offerings are no longer within the purview of state registration and review. The scope of state authority in regard to registration of securities generally is addressed thoroughly in Chapters 5 and 6, and it is beyond the scope of this chapter to discuss the intricacies governing the registration or exemption qualification provisions of state securities law. However, for those securities offerings which must satisfy state laws and regulations, failure to properly register a security or perfect an exemption can lead to enforcement action, civil liability and even criminal prosecution against the issuer and selling agents. Many experienced practitioners thus utilize "Blue Sky memos" or "surveys" that detail the requirements that must be met in each state in order for a security to be lawfully offered and sold. Moreover, even though the states' role in the registration of securities offerings has become limited, states nevertheless require notice filings of securities to be offered to their residents. Such filings usually require the payment of a fee.

[c] Records Maintenance

Section 413(b) of the Uniform Act mandates that the administrator maintain records of applications for registration and registration statements. Considerable statutory and case law has evolved pertaining to public records of government agencies, together with the parallel development of "fair information practices" or privacy laws. Access to a securities administrator's records, therefore, may be governed by laws that are not necessarily consistent with the securities statute. Other non-securities related mandated responsibilities of an administrator may be found in other general laws of a state covering such matters as fiscal affairs, personnel practices, administrative procedure and standards of ethics.

[d] Anti-takeover Laws

In the 1970s and early 1980s, in response to increased activity in the area of corporate takeovers, many state legislatures enacted laws designed to provide some regulatory control over hostile take-over attempts. Some of these laws were clearly designed to protect home-based corporations. Administration of these "tender offer" statutes was given to the securities administrator. The statutes were often aggressively used by target companies to petition the administrator in an effort to prevent or delay the hostile bidder. In response, at the same time it commenced a takeover bid, a bidder would ask a federal district court to enjoin the administrator's exercise of authority under the statute. Obtaining injunctive relief was often critical to the bidder since many administrators had authority to freeze all activity pending a hearing and ultimately prevent a take-over bid from going forward.

In 1982, the United States Supreme Court in *Edgar v. MITE Corp.* ⁿ⁶ ruled on the constitutionality of the Illinois

take-over law. A divided court found the law to be an unconstitutional interference with interstate commerce. Since *MITE*, other federal court decisions have addressed other state take-over laws. While most take-over statutes still remain on the books, there remains little dispute as to their lack of constitutional viability. There are, however, new generations of state laws such as "control share acquisition" laws and others which do operate effectively in the takeover setting. These laws are discussed in more detail in Chapter 4-"State Investor Protection Authority."

[2] Discretionary Authority

[a] Rulemaking

Section 412 of the Uniform Securities Act provides in pertinent part:

(a) The [Administrator] may from time to time make, amend, and rescind such rules, forms, and orders as are necessary to carry out the provisions of this act, including rules and forms governing registration statements, applications, and reports, and defining any terms, whether or not used in this act, insofar as the definitions are not inconsistent with the provisions of this act. For the purpose of rules and forms, the [Administrator] may classify securities, persons, and matters within his jurisdiction, and prescribe different requirements for different classes.

The scope of rulemaking authority is prescribed as follows:

(b) No rule, form or order may be made, amended, or rescinded unless the [Administrator] finds that the action is necessary or appropriate in the public interest or for the protection of investors and consistent with the purposes fairly intended by the policy and provisions of this act. In prescribing rules and forms the [Administrator] may cooperate with the securities administrators of the other states and the Securities and Exchange Commission with a view to effectuating the policy of this statute to achieve maximum uniformity in the form and content of registration statements, applications, and reports wherever practicable.ⁿ⁷

Rulemaking powers granted to an administrator are broad, but not limitless. In *Council for Owner Occupied Housing, Inc. v. Abrams*,ⁿ⁸ for example, regulations under New York's Blue Sky law requiring sponsors to cure building violations and dangerous conditions before converting to condominiums and cooperatives were held invalid as beyond the scope of the Act, which limits the powers of the attorney general to matters of disclosure. Regulations requiring disclosure of such violations and conditions, said the court, were invalid as an attempt to establish improper enforcement guidelines.

In all of this as well, the purpose of administrative rulemaking is to facilitate the agency's placing into effect the policies declared by legislatures through a state's Blue Sky law. The agency may not issue rules that are in clear conflict with the statute.ⁿ⁹ States may also not promulgate rules that are in conflict with federal law and national policy.ⁿ¹⁰

In the exercise of rulemaking authority under the Uniform Act or whatever variant is in place in every state,ⁿ¹¹ administrators' actions are governed as well by administrative law and procedures. The Uniform Act makes no provision for actual rulemaking procedures, but in Official Code Comments recognizes that state administrative procedure acts cut across the area, and may provide specific procedures for the adoption and publication of rules and forms.ⁿ¹² The Blue Sky Laws in several jurisdictions specifically incorporate administrative procedure acts as governing the rulemaking process.ⁿ¹³ Where administrative procedures acts apply,ⁿ¹⁴ there are normally requirements for filing and issuing public notice of proposed rulemaking and for public hearings at which affected or interested persons may appear. Once a rule is adopted in conformity with the requirements, the Uniform Act establishes a safe harbor for actions taken in good faith reliance on it, notwithstanding any subsequent amendment, rescission, or determination of invalidity.ⁿ¹⁵

Rulemaking by securities administrators is limited only to the extent that a rule must bear a reasonable relation to the legislative purposes of the authorizing statute and not be arbitrary, discriminatory, or in conflict with law.ⁿ¹⁶ The scope of rulemaking authority is considered in greater detail in *section 14.02, below*. Administrative proceedings must generally satisfy procedural due process, including reasonable notice of hearing as well as the opportunity to be heard, and administrative decisions imposing sanctions must be based on reliable, probative, and substantial evidence.ⁿ¹⁷

With varying degrees of formality, some states also provide for advisory input in the processes of administration and enforcement. Washington, for example, provides for a seven-member "State Advisory Committee," appointed by the Governor to advise the Commissioner on issues affecting securities regulation in the state.ⁿ¹⁸ The Ohio Division of Securities has established four "advisory committees," comprised of members of the Division staff, the bar, and the securities industry to advise the Division in the areas of registration, licensing, enforcement, and takeovers.ⁿ¹⁹

The rulemaking authority of the administrator must be exercised in accordance with whatever administrative procedure requirements apply in a given state. Most state securities agencies fall within the scope of an administrative procedure act requiring prior notice and publication of proposed rules, followed by a public hearing. The Uniform Act, in section 412(a), requires the administrator to make a finding that the rule "is necessary or appropriate in the public interest or for the protection of investors" and that the rule is consistent with the Act.ⁿ²⁰ As a practical matter, most rules adopted pursuant to this provision will contain a preamble, preliminary statement, or finding by the administrator which addresses the requisite statutory premise. Unlike adjudicatory matters, however, regulatory findings are not required to be supported by specific findings of fact.

[b] Policy Statements and Interpretive Guidance

Less formal than the rule making and interpretive opinion process is the utilization by many jurisdictions of guidelines and policy statements. While no specific authority relative to the adoption of guidelines or policy pronouncements is found in the Uniform Act, the broad authority of the administrator to apply the statute consistent with its intent and purpose is, as a practical matter, sufficient to give import to them. In fact, many Blue Sky practitioners rely on guidelines and policy statements to provide advice to clients, most notably for securities registrations and exempt offerings.

Policy statements are employed by administrators to publicly announce how specific matters of concern will be addressed by the staff. From time to time, the administrator may notice a recurring problem, practice, or pattern that is not addressed by existing standards. Rather than undertake the time consuming process of promulgating a formal rule for what may be a temporary or not overly pervasive practice, the administrator may issue a statement of policy advising as to how a particular issue will be treated by the staff. Policy statements may also be used to signal the bar and industry about specific concerns or disturbing practices that will be given high regulatory or enforcement priority.

Guidelines and policy statements are also helpful to administrators. Less formal and cumbersome than the rule making process, the adoption of guidelines provides the administrator with a useful tool to adjust to creative capital raising techniques and the innovative products and services offered by financial institutions. Guidelines and policy statements also allow for administrative flexibility in addressing unique fact situations or circumstances, without having to worry about the circumvention of formalized rules or creating inappropriate precedents. A practitioner, therefore, may have a better opportunity to persuade an administrator to deviate from a guideline applicable to an offering than if the matter in issue concerned a rule.

In addition to policy statements, guidance is also available through interpretive opinions. Uniform Act section 413(e) provides: "The [Administrator] in [his] discretion may honor requests from interested persons for interpretive opinions." Many states have a provision based on the Uniform Act that grants to the administrator discretionary authority to issue interpretive opinions.ⁿ²¹ The 2002 Uniform Securities Act, now adopted in several states and under active consideration in others, continues the same discretionary approach.ⁿ²² The prescribed authority is in some cases more

formalized, and establishes a Blue Sky analog of SEC "no action" letters.ⁿ²³

Usually, informal opinions that are not in the nature of orders have no force of law, and are not subject to judicial review.ⁿ²⁴ However, that is not universally the case. In Virginia, for example, interpretive opinions are "official interpretations" issued by orders that are considered conclusive in any court, but subject to appeal.ⁿ²⁵ Georgia has a dual system that provides for both informal opinions and for determinations in the form of declaratory rulings. These rulings are available in actual controversies and on a formalized petition process initiated by any person whose legal rights will be interfered with or impaired by the application of the Blue Sky law or any rule or order under it.ⁿ²⁶

Declaratory or administrative "rulings" by administrators may or may not be formally published. However, when issued as formal orders resulting from a hearing process, publication will generally be required as a matter of administrative procedures. The Virginia provision expressly granting "official interpretations" issued by such orders the force of law is not the norm. However, any formally issued and published ruling of an administrator fairly implies such an application. As the Uniform Act itself provides, no act done or omitted in good faith conformity with "any ... order" that is later rescinded or amended may be the basis for liability.

Published rulings or statements of policy issued by an administrator in regard to the administrative process itself, as, for example, in establishing or defining alternative review procedures to be applied to registration statementsⁿ²⁷ are clearly intended to announce regulatory standards and promote general awareness of participants in the process. However, efforts by administrators to make policies generally available have produced certain tensions over what is or is not considered to be "rulemaking." The promulgation of rules is normally governed by state administrative procedures acts, whereas authority to issue administrative rulings or statements of policy operates independently of that process. Nevertheless, the promulgation of regulatory standards through policy statements or administrative rulings may amount to rulemaking and administrators must assess whether published interpretations or policy statements amount to a standard intended to have general application, and if so, whether its promulgation is subject to the state's administrative procedures' requirements.

On the issue of when a statement of policy by an administrative agency amounts to a rule or regulation subject to the administrative procedures act, the Pennsylvania Supreme Court provided guidance in *Pennsylvania Human Relations Comm. v. Norristown Area School District*,ⁿ²⁸ in which the "binding norm" test was adopted. The court explained:

The critical distinction between a substantive rule and a general statement of policy is the different practical effect that these two types of pronouncements have in subsequent administrative proceedings... . A properly adopted substantive rule establishes a standard of conduct which has the force of law... . The underlying policy embodied in the rule is not generally subject to challenge before the agency.

A general statement of policy, on the other hand, does not establish a "binding norm"... . A policy statement announces the agency's tentative intentions for the future. When the agency applies the policy in a particular situation, it must be prepared to support the policy just as if the policy statement had never been issued.

"Binding norm" means that the agency is bound by the statement until the agency repeals it, and if the statement is binding on the agency, it is a regulation. Additionally, in determining whether an agency action is a regulation or a statement of policy, one must look to the extent to which the challenged pronouncement leaves the agency free to exercise discretion to follow or not follow the announced policy in an individual case.ⁿ²⁹

The process of creating informal procedures must itself be consistent with the Blue Sky law of the state and informal

procedures cannot be used to circumvent statutorily-imposed requirements for notice or opportunity for hearing, which are otherwise a part of a particular administrative function.ⁿ³⁰

In those states which do not follow the Uniform Act, and in which there is no express authority for issuing individualized interpretive or administrative opinions, administrators simply base their authority on the broad grant of regulatory and enforcement powers within their statutes.ⁿ³¹ States commonly condition the issuance of such opinions on there being an actual issue or controversy. Hypothetical questions or requests for advisory opinions are generally not entertained. Also, states commonly provide for a fee to be paid before an opinion will be issued.

Some states prescribe specific procedures to follow when requesting an interpretive opinion or no-action letter. States require specific factual information, not hypothetical situations, and appropriate statutory references. The request should also include the writer's interpretation and some discussion of the opposite side of the issue. Careful consideration should be given to addressing broad based policy implications, showing the administrator why the opinion sought is in the public interest and not likely to be harmful to investors. Finally, some states require that a fee be paid with a request for an opinion.

The rules governing interpretive opinions and no-action letter may provide specific disclaimers as to the precedential value of the opinion. For example, an interpretive opinion rendered by the administrator's office in the State of Washington is applicable only to the transaction identified in the request.ⁿ³² While interpretive opinions will not bind the administrator or serve as legal precedent, as a general rule, most administrators will take the opportunity to establish agency policy when rendering an opinion. The request may involve an issue that needs to be addressed because of the frequency in which it is raised or the important policy issue posed. More important opinions may be sent for publication to various legal and trade periodicals. Some administrators also produce monthly or quarterly newsletters where opinions may be published.

[c] Enforcement

Broad investigative authority is conferred upon the administrator so that there can be effective enforcement of a state's securities laws.ⁿ³³ The administrator is given discretion to conduct private and public investigations,ⁿ³⁴ issue subpoenas to witnesses and for recordsⁿ³⁵ and to publish information concerning violations of the statute or rules.ⁿ³⁶ Presumably, this last item was included so that an administrator can utilize the media to warn the public about pervasive fraudulent securities practices and to deter potential violators. In fact, many administrators routinely issue press releases reporting on actions they have taken to alert and educate investors about fraudulent securities activity. Division or departmental web sites are regularly used for the same purpose. Public exposure of securities law violators and fraudulent practices can have a far greater impact in deterring fraud than the issuance of an administrative order known only to the agency and the offender.

The investigative authority given to the administrator even extends in some states to the ability to provide transactional immunity.ⁿ³⁷ Having claimed the privilege against self-incrimination, a person may still be compelled to testify but may not be subsequently prosecuted, at least at the state level. This particular grant of discretionary authority, needless to say, raises several collateral issues for the practitioner, the prosecutor and the administrator. Any decisions contemplated under this provision of the Uniform Act should be undertaken only after due consideration has been given to applicable law at the federal levelⁿ³⁸ and the affected state.

Once a matter has gone beyond the investigative stage, the administrator or enforcement staff determines whether the issuance of an administrative complaint or order is appropriate. The discretionary authority to issue complaints or orders may be express or implied, depending upon the statute. Massachusetts, for example, gives express authority to the administrator to issue temporary cease and desist orders prior to hearing, as well as final orders after a hearing.ⁿ³⁹

Section 408 of the Uniform Act confers express authority upon the administrator to enjoin violations of and enforce

compliance with the statute and its rules. Equitable remedies accompanying an injunctive order, such as the appointment of a receiver or conservator, are also authorized under some state laws.ⁿ⁴⁰ Although the administrator is authorized to seek injunctive relief, in many instances the action may not be commenced without the approval or representation of a state attorney general or similar government legal officer. This division of legal authority may not always be found within a state's securities law.

Administrators may also make criminal referrals to state prosecutors.ⁿ⁴¹ Some administrators, in fact, can initiate their own prosecutions for violations of their securities law. In the majority of states, however, matters are referred by the securities administrator to the state attorney general or appropriate local prosecutor for criminal action. Generally, criminal referrals are reserved for those cases involving clear cases of fraud, or theft of investor funds.

In enforcement and all matters generally, section 412 of the Uniform Act gives the administrator authority to make such "orders" as are necessary to carry out the provisions of the act.ⁿ⁴² The broker-dealer, agent and investment adviser section of the Uniform Actⁿ⁴³ specifically authorizes the issuance of orders to deny, suspend or revoke a registration. Of course, such orders must be preceded by prior notice, opportunity for a hearing and written findings of fact and conclusions of law.ⁿ⁴⁴ Express authority to issue orders is also found in the securities registration provisions of the Uniform Act. Under section 306, the administrator is empowered to issue stop orders to deny effectiveness to any registration statement in the event that it fails to satisfy certain statutory requirements.ⁿ⁴⁵ Some of the requirements may be specific, such as the security having been the subject of an administrative stop order or injunctive action.ⁿ⁴⁶ Other parts of section 306 contain more broadly stated standards which, arguably at least, confer considerable discretionary authority upon the administrator.ⁿ⁴⁷

Counsel should be mindful of the discretion given to the administrator to issue stop orders. A stop order can be issued prior to a hearing. Accordingly, the issuer could be subject to a "domino effect" whereby other administrators utilize the first stop order as grounds for denying the security effectiveness in their jurisdiction. The discretionary authority to issue stop orders is most apparent when issuers opt to withdraw their registration statement from a state, rather than force the issuance of a stop order. Administrators also typically have authority to suspend exemptions from registration, with the same practical impact as a stop order because in both instances failure to comply will result in immediate enforcement action. The same considerations apply in the process of intermediary licensing and registration. Administrators may act at any time to suspend or revoke a license, and in all states there are provisions permitting summary suspension procedures when necessary.

A final important consideration in regard to administrators' authority to make orders is that although the Uniform Act provides that certain securities transactions may be exempt from registration requirements,ⁿ⁴⁸ the administrator, exercising discretion, may deny or revoke some exemptions.ⁿ⁴⁹ Such a denial is accomplished by the issuance of a summary order, provided there is subsequent due process. The power of an administrator to suspend an exemption is most often exercised as a result of an "audit" of reports required to be filed with certain exempt offerings, or upon receiving investor complaints. The power to act summarily is considerable. However, orders denying or revoking exemptions under these provisions do not operate retroactively. Moreover, no person may be considered to have violated the law by reason of a transaction effected after entry of the order where it is shown that the person did not know, and in the exercise of reasonable care could not have known, of the order denying or revoking the exemption.ⁿ⁵⁰

[3] Legislative Oversight

Blue Sky administrators act in accordance with varying provisions among the states on the method of selection of the administrator, salary, term of office, budget, selection and compensation of personnel, and annual reporting requirements to the legislature or governor. As they typically head departments or divisions within a larger, cabinet level department or office, direct oversight of securities administrators is most often exercised at the cabinet level, with legislative oversight coming indirectly by way of overall department budgetary interactions. Appropriate legislative committees can and do call upon administrators for testimony and, as noted earlier, administrators often advocate

directly with such committees on legislative matters. Oversight, as such, at the state level, however, is far less defined in comparison to congressional oversight of activities of the U.S. Securities and Exchange Commission. Ultimately, of course, the state legislature may question any action or initiative by an administrator and may address legislation as seen necessary or appropriate to define the scope of administrative authority. Historically, however, there have been few significant legislative oversight initiatives. Rather, the greater oversight authority is exercised by the Executive branch, and is manifested more often in regulations and policies rather than statutory changes.

[4] Judicial Review

The Uniform Act and the Blue Sky laws of all states provide for judicial review of orders of an administrator. The process is examined more closely in Chapter 14--*State Enforcement Authority*. The key point for consideration in practice and procedure under these provisions is that deference is accorded to the determinations of administrators and to decisions and orders that are a product of the mandated administrative procedure. Courts consistently recognize the expertise of Blue Sky administrators in the exercise of investor protection authority, and do not overturn administrative actions on "arbitrary and capricious" grounds unless it is plainly shown that the administrative action is inconsistent with fundamental due process and other overriding constitutional concerns, or is clearly contrary to the proper exercise of authority. Thus, for example, intermediary licensing determinations are rarely overturned. This fact bears directly on the management of the application process by prospective licensees. In the securities distribution setting, judicial review of stop orders or denials of registration applications is rarely a practical option for issuers, and is infrequent at best.

On the other hand, judicial review of administrative enforcement orders, which are often based upon significant legal interpretations in the application of Blue Sky laws, and which carry broad consequences or impose civil money penalties or other ancillary relief, are much more often taken to judicial review. In these situations judges are more willing and able to review legal analysis rather than practical assessments and judgments of an administrator. If, for example, a significant administrative order is based upon the conclusion that a respondent offered and sold an unregistered security, the fundamental legal analysis that a "security" is present will easily be reviewed in the courts, and as the many cases illustrate, is perhaps the most often reviewed state securities law issue.

FOOTNOTES:

(n1)Footnote 1. Non-action by an administrator, or allowing a certain amount of time to pass without taking action, will cause some events to happen. For example, under section 202(a) of the Uniform Act the application for registration of a broker-dealer, agent or investment adviser becomes effective if no denial order is in effect and no summary postponement under section 204 is pending. In the securities distribution setting this may also occur, as with securities registrations carried out by "notification" or "description" procedures.

(n2)Footnote 2. All states participate in the Web CRD and the IARD system. Alternative provisions for filing hard-copy application materials directly with a state administrator remain generally available for broker-dealers that are not eligible to use Web CRD, although that universe of broker-dealers, comprised of broker-dealers who are not members of FINRA and whose business is exclusively intrastate, is very small.

(n3)Footnote 3. Unif. Sec. Act § 202(a).

(n4)Footnote 4. Investment Advisers Act of 1940, § 2(a)(11).

(n5)Footnote 5. State authority and procedures in regard to licensing or registration of securities intermediaries generally are covered in depth in Chapter 11, *Regulation of Intermediaries: Broker-Dealers, Investment Advisers and Associated Persons, above*.

(n6)Footnote 6. 457 U.S. 624 (1982) .

(n7)Footnote 7. Unif. Sec. Act § 412(b).

(n8)Footnote 8. *Council for Owner Occupied Housing, Inc. v. Abrams*, 72 N.Y.2d 553, 534 N.Y.S.2d 906, 531 N.E.2d 627 (1988) .

(n9)Footnote 9. *State v. Taubman*, 78 Ohio App. 3d 834, 606 N.E.2d 962 (1992) (rules may not contravene or impermissibly narrow a statutory exemption from the definition of a security). *See also* Tex. Att'y Gen. Op. No. 7JM-707 [1987-1988 Transfer Binder] Blue Sky L. Rep. (CCH) P 72,610 (May 22, 1987) (State Securities Board had no authority to promulgate a rule allowing the Commissioner to waive statutory requirements concerning qualification of securities).

(n10)Footnote 10. *Securities Industry Asso. v. Connolly*, 883 F.2d 1114 (1st Cir. 1989) , *cert. denied*, *Crider v. United States*, 495 U.S. 956, 110 S. Ct. 2561, 109 L. Ed. 2d 743 (1990) .

(n11)Footnote 11. Every jurisdiction has an enabling provision comparable to section 412 of the Uniform Act.

(n12)Footnote 12. Official Code Comment, Unif. Sec. Act § 412.

(n13)Footnote 13. Such states include Arkansas, California, Georgia, Illinois, Nevada, Ohio, Oregon, Pennsylvania, South Dakota, Texas, and Wisconsin.

(n14)Footnote 14. Matters of statutory interpretation carried out by way of policy statements, interpretive opinions, or orders typically do not amount to rulemaking that is subject to administrative procedures Acts. However, issues may arise when such undertakings amount to *de facto* rulemaking which, in order to be valid, must be done in compliance with statutory requirements. *See generally* Mayton, *The Legislative Resolution of the Rulemaking Versus Adjudication Problem In Agency Lawmaking*, 1980 Duke L.J. 103 (1980).

(n15)Footnote 15. Section 412(e) of the Uniform Act provides:

No provision of this act imposing any liability applies to any act done or omitted in good faith in conformity with any rule, for or order of the [Administrator], notwithstanding that the rule, form or order may later be amended or rescinded or be determined by judicial or other authority to be invalid for any reason.

(n16)Footnote 16. *See, e.g., Fehrman v. Ohio DOC*, 141 Ohio App. 3d 503, 2001-Ohio-4225, 751 N.E.2d 1089 (Division of Securities rule defining key terms in licensing provisions of the Blue Sky law was an appropriate exercise of administrative authority).

(n17)Footnote 17. *See Sec'y of State v. Tretiak*, 117 Nev. 299, 22 P.3d 1134 (2001) (en banc) (administrative decision may be set aside if the final decision is clearly erroneous in view of the reliable, probative, and substantial evidence on the whole record).

(n18)Footnote 18. *See Wash. Rev. Code* § 21.20.550.

(n19)Footnote 19. *See* H. Friedman, *Ohio Securities Law and Practice* § 47.01, at 690 (2d ed. 1996).

(n20)Footnote 20. This section also applies to the adoption, rescission or amendment of forms and orders.

(n21)Footnote 21. *See, e.g.:*

Alabama: Ala. Code § 8-6-29.

California: Cal. Corp. Code § 25618.

Colorado: Colo. Rev. Stat. § 11-51-705.

Kentucky: Ky. Rev. Stat. Ann. § 292.500(13).

Maryland: Md. Code Ann. § 11-206(e).

Michigan: Mich. Comp. Laws § 451.813(f).

New Jersey: N.J. Stat. Ann. § 49:3-67.

Pennsylvania: 70 Pa. Stat. § 1-604.

Virginia: Va. Code Ann. § 13.1-525

Washington: Wash. Rev. Code § 21.20.530.

Wisconsin: Wis. Stat. Ann. § 551.64(5).

(n22)Footnote 22. *See* 2002 Uniform Act § 605.

(n23)Footnote 23. *See, e.g., Ind. Code § 23-2-1-15(l):*

The commissioner may honor requests from interested persons for interpretive opinions and from interested persons for determinations that the commissioner will not institute enforcement proceedings against specified persons for specified activities. A determination not to institute enforcement proceedings must be consistent with this chapter. A person may not request an interpretive opinion concerning an activity that:

(1) occurred before; or

(2) is occurring on;

the date that the opinion is requested. The commissioner shall charge a fee of one hundred dollars (\$100) for an interpretative opinion or determination.

In Rhode Island, the Administrator may issue declaratory orders. *R.I. Gen. Laws § 7-11-706.*

(n24)Footnote 24. Draftsmen's commentary to the Unif. Sec. Act § 413(e).

(n25)Footnote 25. *Va. Code § 13.1-525.* The "official" authority in Virginia is limited to determinations of whether or not: (1) a particular security or transaction is exempt from registration requirements; (2) the offer or sale of a particular security would be lawful; or (3) a person is an investment adviser or investment adviser representative.

(n26)Footnote 26. *Ga. R. & Regs. 590-4-1-03(3).* Hypothetical questions or requests for advisory opinions will not be entertained.

(n27)Footnote 27. *See, e.g., Rules of the Delaware Sec. Comm'r, Rule 6(A), Interpretive Ruling 6(A), 1A Blue Sky L. Rep. (CCH) § 15,407, at 11,409.*

(n28)Footnote 28. *Pennsylvania Human Relations Com. v. Norristown Area School Dist., 473 Pa. 334, 374 A.2d*

671 (1977) .

(n29)Footnote 29. *Pennsylvania Human Relations Com. v. Norristown Area School Dist.*, 473 Pa. 334, 350, 374 A.2d 671, 679 (1977) , (quoting *Pacific Gas & Electric Co. v. Federal Power Com.*, 506 F.2d 33, 164 U.S. App. D.C. 371 (D.C. Cir. 1974)) . See also *York Mut. Ins. Co. v. Superintendent of Ins.*, 485 A.2d 239 (Me. 1984) (explanatory statements of policy which are not judicially enforceable and which are intended solely to advise persons in complying with their legal duties are not rules).

(n30)Footnote 30. See, e.g., *Amato v. Office of the La. Comm'r of Sec.*, 94-0082 (La. App. 4 Cir. 10/03/94), 644 So. 2d 412 (informal procedure used to refuse a licensing application was invalid in the face of statutory procedures for notice and hearing).

(n31)Footnote 31. These jurisdictions include Arizona (issues "no action letters"), Delaware, District of Columbia, Florida, Illinois, Indiana, Louisiana, Mississippi, Montana, Nevada, New Hampshire, New York, North Dakota, Ohio, Oregon, Tennessee, and Texas.

(n32)Footnote 32. *Wash. Admin. Code* § 460-16A-020 (2002).

(n33)Footnote 33. The full scope of enforcement authority under state securities laws is addressed in Chapter 14, *State Enforcement Authority*, above.

(n34)Footnote 34. Unif. Sec. Act § 407(a)(1).

(n35)Footnote 35. Unif. Sec. Act § 407(b).

(n36)Footnote 36. Unif. Sec. Act § 407(a)(3).

(n37)Footnote 37. Unif. Sec. Act § 407(d).

(n38)Footnote 38. A person accused of violating state securities law could be under investigation or facing charges for similar federal securities law violations.

(n39)Footnote 39. See, e.g., *Mass. Ann. Laws Ch. 110A* § 407(A)(b) (2003).

(n40)Footnote 40. Unif. Sec. Act § 408.

(n41)Footnote 41. Unif. Sec. Act § 409(b).

(n42)Footnote 42. See also Rev. Unif. Sec. Act § 705. The general authority to issue orders under these provisions is in addition to specific authority otherwise granted to the administrator by other provisions of the Act. The Revised Uniform Act expressly provides that orders by the administrator, as with rules, must be: (1) in the public interest and appropriate for the protection of investors; and (2) consistent with the purposes fairly intended by the policy and provisions of the Act. Rev. Unif. Sec. Act § 705(c).

(n43)Footnote 43. Unif. Sec. Act § 204(a).

(n44)Footnote 44. Unif. Sec. Act § 204(f).

(n45)Footnote 45. The reasons set forth in section 306 of the Uniform Act should be seen as merely a starting point for denying effectiveness to registration statements. As fully explored in Chapters 5 and 6, the substantive standards which must be met in order for a registration statement to be deemed effective can vary substantially from state to state.

(n46)Footnote 46. Unif. Sec. Act § 306(a)(2)(C).

(n47)Footnote 47. Under section 306(a)(2)(E), the administrator may issue a stop order if it is determined that the offering has worked or tended to work a fraud upon purchasers, or would so operate.

(n48)Footnote 48. Unif. Sec. Act § 402. For other important practical considerations is regard to securities or transaction exemptions, see § 16.05[1], *below*, in which requirements for prior approval for some exemptions in some states is discussed.

(n49)Footnote 49. Unif. Sec. Act § 402(c).

(n50)Footnote 50. Unif. Sec. Act § 402(c).



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Blue Sky Regulation

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CHAPTER 16 Blue Sky Practice and Procedure

1-16 Blue Sky Regulation § 16.04

§ 16.04 Federal Preemption

The scope of federal preemption of administrative authority under Blue Sky laws in the wake of NSMIA is examined extensively in other chapters, which focus on the distribution of securities, intermediary regulation and enforcement generally.ⁿ¹ As a practical matter, the NSMIA redefinition of federal and state roles in securities regulation to accommodate truly national markets has energized state administrators in refocusing attention to those things most consistent with the historical mission of Blue Sky laws. In the offering context administrators now address investor protection primarily in the context of small or limited offerings conducted on a localized or regional basis. They devote resources to regulation of the people directly involved in the process, and to protection against fraud.

NSMIA effectively reset national policy to make clear that state securities regulation remains an essential element of investor protection in the evolution of national and global securities markets. Blue Sky administrators have responded to NSMIA preemption with a renewed sense of purpose and commitment to the protection of "main street" investors.

FOOTNOTES:

(n1)Footnote 1. *See also* Chapter 4, "State Investor Protection Authority," *above*.



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Blue Sky Regulation

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CHAPTER 16 Blue Sky Practice and Procedure

1-16 Blue Sky Regulation § 16.05

§ 16.05 Administrative Process and Procedures

No security may be offered and sold in any state unless it is first qualified by a registration procedure, or it is exempt from qualification by reason of the type security or the transaction in which it is involved. Likewise, no person may engage in activities as broker-dealer, agent, investment adviser, or investment adviser representative without being appropriately licensed,ⁿ¹ unless that individual or the particular activities are excluded or exempted from licensing requirements. The process and procedures associated with qualification of a securities offering in a state, and regulation of the people who directly facilitate those offerings, and intermediaries bring about securities transactions generally, differ in subtle ways in some cases and more significantly in others. In the offering context, for example, even "uniform" forms may be modified to require additional or different information in different states. Filing requirements associated with exempt transactions, or applicable to particular limited offerings, also vary from state to state. Uniformity in these processes and procedures is not mandated, and despite great progress through widespread adoption of such uniform procedures as the Small Corporate Offering Registration (SCOR) and the Coordinated Equity Review (CER) program, there remain meaningful hurdles in qualifying an offering. For exempt transactions or limited offerings there is no lesser challenge in navigating through variances in both the availability of an exemption and in procedures in a number of instances to "claim" an exemption.

In the discussion below, practical considerations for participating in all of these administrative processes and procedures, as well as intermediary licensing and general enforcement procedures, are examined further.ⁿ²

[1] Exemptions

In Chapters 7 and 8 the considerable array of available exemptions for securities or transactions from full qualification or registration requirements under Blue Sky laws is presented. A critical consideration in regard to exemptions under state securities laws is that some of them require advance approval in some states. In California, for example, an exemption is available for an offer of securities and the execution and delivery of an agreement for the sale of securities pursuant to that offer, but only when a "negotiating permit" is first obtained.ⁿ³ In some states the exemption for offers and sales of securities by eleemosynary institutions is conditioned upon first filing a written proof of exemption with the administrator within a prescribed time for review.ⁿ⁴ "Limited" and "special" offerings are subject to various filing and notice requirements, in some cases amounting to prequalification or approval in addition to follow-up reporting requirements. Thus, it is essential to examine exemption requirements closely in each state in which an offer or sale is expected to occur, as subtle differences in common exemptions and the administration of those exemptions may have

significant consequences.

It is also essential to understand the distinction between exemptions and exceptions from definitions, and distinctions between exemptions themselves, as to the application of antifraud provisions and remedies. Uniform Act section 402, for example, makes clear that enumerated securities and transactions are exempt from registration and advertising restrictions only. Exempt securities are nevertheless securities for all other purposes, and in particular the offer and sale of them, and any other securities in exempt transactions, remains fully subject to antifraud provisions. Purportedly exempt securities and transactions come under close enforcement scrutiny in response to investor complaints and in areas particularly ripe for abuse. As an example, offers and sales of promissory notes under the exemption for commercial paper arising out of a current transaction and which evidence an obligation to pay within nine months that is found in all Blue Sky laws⁵ have prompted aggressive enforcement action by state administrators across the country. Administrators attack both the validity of the claimed exemption and fraud that often pervades offers and sales of such securities.

In those situations in which an exemption must be claimed or noticed in advance administrators will look closely at the offering to be certain that it is consistent with the intent and operation of the exemption involved. All exemptions, whether for securities or transactions, are premised on the belief that particular characteristics of a security or the circumstances of a transaction are such that the protection of the Blue Sky law is not needed. Administrators do not hesitate to move quickly with temporary cease and desist orders or other provisional remedies when it appears that the premise is invalid in any situation. Unlike the administrative process and procedures involved in qualification of securities, with a few exceptions only notice filings and limited follow-up reporting may be involved in exempt transactions. Thus, *ex post* scrutiny is in most instances the only means of policing such offerings, and the consequences of non-compliance at that stage may prove devastating to an issuer or intermediary faced with making rescission offers, or worse. It is important, therefore, to seek out advance guidance from the office of the administrator in any state when there is any question concerning the interpretation or application of an exemption. It is in this area as well that policy statements and other published interpretations play a critical role and must be closely reviewed.

[2] Securities Qualification

The range of securities offerings subject to qualification procedures under Blue Sky laws today is substantially diminished in the wake of NSMIA. Blue Sky practice has changed significantly in this regard. Whereas in the past issuers and intermediaries were faced with the task of managing registration and qualification procedures in multiple jurisdictions, the process today is meaningful only in connection with much smaller offerings carried out on a local or regional basis. State authority to impose substantive qualification requirements on large scale, national, offerings is preempted by NSMIA, as nearly all such offerings involve NSMIA "covered" securities. On the other hand, state authority in regard to qualification of smaller scale offerings such as those conducted under Rule 504 of SEC Regulation D, or pursuant to the Small Corporate Offering Registration (SCOR) procedure, remains in place. These offerings, often by small start-up or entrepreneurial issuers and involving significant risk factors and potential for abuse, that are most appropriately subjected to traditional Blue Sky review and qualification procedures, and which justify that continued role as a matter of investor protection. Without regard to the size of an offering, "intrastate" offerings carried out pursuant to the exemption from federal registration provided by section 3(a)(1) of the Securities Act of 1933⁶ remain fully subject to state qualification procedures. For the offerings that remain subject to Blue Sky qualification procedures practical considerations in the process are discussed further below.

[a] The Review Process

As a general rule, securities offerings must either be registered with the administrator's office, or qualify as being exempt from registration, prior to being offered or sold within or from the state. Once the practitioner has assumed responsibility for obtaining registration or exempt status for a securities offering, organized and thorough files must be kept. During the course of registration, counsel may engage in discussions and negotiations with literally dozens of state

securities agency staff. Notes of all conversations should be made, if only because of the possibility of confusion and error that exists in trying to manage a registration, particularly in multiple jurisdictions.

The first step is the filing of the offering materials, together with appropriate fees and forms. A checklist of the filing requirements for each state should be prepared in advance, reviewed and updated at least quarterly to monitor changes in state requirements. Counsel should determine the proper fee for the filing, the necessary forms, documents and number of prospectuses which must be filed.ⁿ⁷ Some states charge a flat filing fee, while others set the fee as a percentage of the amount of the offering to be registered in the state. Filing fees are generally not refundable. Many practitioners include a copy of the cover letter and a stamped, self-addressed envelope to be date stamped by the agency and returned so a record of receipt can be maintained. Since the number of days a securities offering has been on file with the agency often dictates when offers or sales commence, the date of receipt is critical. Counsel, however, should determine the method used by the agency to count the number of days.ⁿ⁸ Generally, filings are not treated as complete, and hence the counting does not begin, until all required materials have been received.

As a first step in the registration process, most states will review the offering to determine compliance with their filing requirements. Larger state securities offices may have this preliminary review performed by clerical staff, before the file is assigned to an examiner. If the filing is incomplete, it is likely to be put on hold and not substantively reviewed until all filing requirements have been met. The person who submitted the filing will be advised of the filing deficiency by phone or mail.

Once the filing is complete and passes preliminary review, the substantive review process begins. The depth of substantive review performed depends on such factors as whether a state engages in merit or disclosure review, staff size and expertise, regulatory philosophy, and priority allocation as to types of filings. Experienced Blue Sky attorneys usually have a good understanding of the intensity of review in a given state and the critical elements looked for by corporate finance staff. The novice may have to learn by trial and error or devote substantial time to surveying state securities examination staff to get a sense of the issues they are likely to focus on in their review.

There will be substantive standards applied by the examiner who is assigned to review the offering. Formal standards will be found in the statute and the rules or regulations. Less formal than rules, but often applied with equal force, are guidelines, policy statements and interpretive opinions. The guidelines most often utilized are those adopted by the North American Securities Administrators Association (NASAA). NASAA guidelines cover securities such as real estate, oil and gas, equipment leasing, commodity pools and several types of not-for-profit offerings. The guidelines are used primarily by merit review states. Some states promulgate the NASAA guidelines as rules, occasionally with modification. Other jurisdictions may issue formal statements indicating that they will apply the guidelines, while others may informally apply the guidelines without public statement to that effect. After surveying the published requirements of the states, counsel may still have to make further inquiry to determine a state's actual practice with respect to the guidelines.

The scope of review of a securities offering varies greatly from state to state. As a general rule, counsel can expect that merit review states with adequate staff will perform a more thorough analysis of an offering than non-merit review states or those states with small staff. However, the close relationships that exist among state regulators frequently result in a sharing of information. This network of state securities examiners even extends to a recognition that some state examiners are more expert and tend to focus on certain key issues, while leaving other elements of an offering to colleagues in other states. The Coordinated Equity Review (CER) procedure is a product of this multi-jurisdictional deference. Here again, however, the process is meaningful only to the extent that an offering is made on at least a regional basis and review is not otherwise preempted by NSMIA.ⁿ⁹

The assignment of offerings to specific examiners for review may be based upon experience, subject matter, expertise or random distribution. States with larger staff will often have examiner specialists in real estate, oil and gas and equipment leasing securities. Other specialist categories may be equity securities, debt securities, mutual funds, or

public and private limited partnership investments. An administrator's office will usually have a senior person, often an attorney, in charge of its corporate finance section.ⁿ¹⁰ The title may be chief counsel, general counsel, assistant or deputy commissioner for securities registration or corporate finance. This person will assign files for review and may, in fact, screen some offerings that, in his opinion, do not necessitate review. This screening process enables the staff to devote their resources to potentially troublesome offerings.

Once a file is under review by corporate finance staff, any number of scenarios can develop. The staff may "clear" the offering without further comment. Some states will send out notices to that effect, although because of backlogs, not always in a timely fashion. In some states, counsel will have to telephone to learn the disposition of a filing. Since some filings are time sensitive, counsel should submit the filing to the state as soon as possible and expeditiously respond to requests for additional information. Under the Uniform Act, registrations by coordination,ⁿ¹¹ *i.e.*, those which become effective within the state upon SEC registration, must be on file with the securities administrator for at least ten days. Some coordinated offerings may receive expedited treatment and obtain SEC registration with limited or no review. Being mindful of the ten day state requirement, counsel should file with the state at the same time as the SEC. Some states do not react favorably to requests for expedited review and registration if they receive a filing after the SEC and are then asked to move a file to the top of the pile at the expense of more timely submitted offerings.

Perhaps the cardinal rule that should be observed in dealing with securities registration staff is absolute candor at all times. Credibility, both individual and institutional, is an unwritten but very important part of the securities registration process. Securities examiners promptly develop a keen sense as to whether they are being dealt with candidly. Law firms and underwriting or other intermediary firms with solid reputations for fair dealing with state securities staff will generally find it easier to accomplish their objectives than those which do not meet the highest standards of integrity. Word spreads rapidly from state to state and reputations are quickly established. A good example might involve a common inquiry by an examiner to Blue Sky counsel asking about the status of the offering in another state. An inaccurate or obfuscatory response can permanently harm counsel's credibility since such answers are easily verified. Just as practitioners share their experiences in dealing with the state securities staff, so do state securities examiners swap anecdotes about counsel they encounter.

The first stage of review may be a request from the state for additional information or an explanation justifying representations made in an offering. Some requests are easily answered while others necessitate consultation with issuer's or underwriter's counsel or the client. If the examiner is seeking proprietary information which may be placed in a public file, be certain that the availability of that information is understood by the client. Some state public records laws exempt proprietary data from public access. Simply submitting the data with a cover letter requesting confidential treatment may not be enough to protect the information. Another approach is to suggest submission of information and having it returned after review, with a representation from the agency that no copies will be made or retained in any publicly accessible file.

Some states will provide formal comment letters indicating those elements of an offering which do not comply with registration standards or prevent qualification as an exempt offering. Some comments may refer to seemingly objective standards such as compensation, *i.e.* commission to be paid to underwriters or dealers. However, the issue of compensation or profits to promoters or underwriters might also be subjective. For example, the receipt of a particular fee might be treated as compensation and an appropriate comment will be made. The fee, in fact, may represent reimbursement for services or expenses and upon sufficient explanation will not be considered as excessive compensation.

Since comments about an offering may involve subjective judgments by the staff or interpretations of a rule or guideline, there is an opportunity for negotiation. If a promoter is a previously convicted securities swindler, the chance of getting the security registered in a merit state is probably small. However, for many other issues, a flexible and creative approach by counsel and client can often address state concerns. Some comments can be satisfied by volunteering additional disclosure, either by amending the prospectus or perhaps providing a "sticker" to offerees in the

particular state. Corporate governance issues, such as loans to officers or shareholder voting rights, can also be resolved by satisfying state requirements if the client is willing. Often, such matters which are important to the regulator may not be critical to the issuer, who is primarily interested in raising capital.

The attorney should avoid the temptation to debate and try to win every issue. The client may be quite willing to make the necessary amendments to the offering in order to satisfy state regulatory concerns so sales can be made in the state.

[b] The Coordinated Equity Review Program

Notwithstanding the individual states' authority to review, comment upon and approve or reject a securities offering, in an effort to provide uniformity with respect to review of securities offerings, NASAA established the Coordinated Equity Review Program ("CER"). The stated purpose of CER is to "coordinate the blue-sky registration process in all of the states in which the issuer seeks to sell its equity securities." Basically, CER attempts to achieve simplification of the state registration process by designating a lead full disclosure review state and a lead merit regulation state for purposes of reviewing an offering. The lead states are responsible for coordinating full disclosure and merit review comments on behalf of all jurisdictions in which registration is sought. The two lead states then generate a comment letter on behalf of all of the jurisdictions and then proceed to negotiate such comments with the issuer. By participating in the program, the states agree that once an agreement is reached between the lead disclosure state and the issuer with respect to the offering, those states agree to clear the offering simultaneously.

There are specific procedures and forms to be followed for an issuer who wishes to avail itself of the CER. Accordingly, prior to commencing an offering in which the CES might be utilized, counsel should make inquiry of NASAA or a state jurisdiction as to the specifics of the program.

[c] Responding to Adverse Determinations

In the registration process an impasse may be reached, and the offering must either be amended, withdrawn or an appeal must be made to the examiner's superior. At this point, another important practical rule is worth noting. Until it is clear that negotiations with the examiner can go no further, higher review should not be initiated. Furthermore, always advise the examiner that an appeal to a superior will be sought and inquire as to the steps that must be followed.

Depending upon the internal structure and size of the securities agency, the appeal may be directed to the administrator or to a mid-level supervisor. Some states insist on a written appeal which sets forth and discusses the unresolved issues and may require a similar internal memorandum from the examiner. This more formal approach is most likely to occur in the larger states and when the administrator is hearing the appeal. The format used to appeal is usually a letter.

The appeal process can afford a real opportunity to resolve areas of disagreement which surfaced at the initial review state. The practitioner should focus upon the most critical issues from the regulator's viewpoint. If they can be resolved, accommodations are likely to be reached on the other matters. Some states give examiners little room for deviating from applicable standards and they may be instructed to adhere strictly to rules and guidelines unless otherwise advised by a supervisor. This internal approach, while perhaps frustrating to the practitioner, affords the administrator the opportunity to consistently apply agency standards and minimizes disparate treatment of offerings at the staff level.

Counsel should approach the appeal process prepared to respond to the concerns raised by the staff and to have in mind a flexible or creative resolution that may address those concerns. Always be mindful that the supervisor or administrator will not be quick to override the staff. The administrator deciding appealed offerings must take into account staff morale and motivation, as well as the precedential impact and policy ramifications of his decision. Too frequent reversals of staff positions can create a sense of futility among the examiners and undermine the standards upon which the offerings are reviewed. For these reasons, counsel who deal regularly with the administrator's office should carefully consider when to appeal a staff determination. Appealing, or threatening to appeal, staff decisions without a good faith effort

toward resolution will only work against a client's interest.

An appeal may be heard by the administrator via telephone conference, a meeting of the parties, or simply a review of the file. Since the nature of the securities review procedure is usually informal, there is no due process at this point. The right to a hearing is triggered when a stop order is issued, or the effectiveness of the registration statement is postponed or suspended,ⁿ¹² or an order denying or revoking an exemption is issued.ⁿ¹³ Thus, the administrator or supervisor may meet or talk *ex parte* with staff or counsel for the issuer. He or she may decide the matter by reviewing the offering materials on his or her own, or may suggest a meeting with staff and counsel and seek to mediate the dispute.

As an offering moves through the appeal process of the agency, the time in which the administrator must act before the security is deemed registered may not always be met. The administrator or staff, to prevent the offering from being registered or effective and having to issue a stop order or order denying exemption, will ask counsel to waive the applicable time period and to do so in writing. There is little choice in the matter, since by law the administrator in most cases is compelled to issue an order.

If it appears at any point during the securities registration process that clearance is not likely, counsel may offer or be requested to withdraw the filing. This is invariably the end result of an unsuccessful attempt to obtain registration or exempt status for a security. The other alternative, forcing the issuance of an order, offers no real benefit to the issuer. Once a stop order or summary postponement of registration order issues, sales cannot be made without subjecting the issuer and selling agents to injunctive and prosecutorial action. Additionally, the issuance of the order is probably a material fact which should be disclosed to potential investors by amending the prospectus. By the time a hearing is held and a final decision rendered on the summary order, there is usually little left to sell of the offering and considerable money has been spent on the administrative litigation.

Since the issuance of a summary stop order also consumes the resources of the administrator's office, it is in the interest of both sides to permit withdrawal of the offering. For these reasons, stop orders are rare. Most administrators will issue them only in instances where offerings are believed to be truly fraudulent. The reason for issuing an order will be to alert other regulators and attract public attention to a serious threat of securities fraud. Under these circumstances the summary order may be accompanied by other enforcement action, such as a temporary cease and desist order or request for injunctive relief.

[3] Intermediary Licensing and Regulation

[a] Broker-dealers and Agents

In order to effect transactions in securities for the account of others, registration, or licensing, as a broker-dealer or agent must be accomplished at the state level. While there are some exclusions or exemptions from registration as a broker-dealer, their applicability is limited to rather specific types of activity.ⁿ¹⁴ Counsel must therefore review the laws and regulations of each state before advising a client as to whether registration as a broker-dealer or agent is required in connection with a particular transaction. All aspects of intermediary registration and licensing are considered more thoroughly in Chapter 8.

Most administrators have a specific person or unit assigned to broker-dealer and agent matters. Their responsibilities include responding to inquiries, reviewing initial applications, amendments and withdrawals for broker-dealers and agents, examination of broker-dealer operations, investment adviser registration and examinations and enforcement matters. Broker-dealer registration is one of the most critical regulatory responsibilities of the agency. By permitting a broker-dealer to transact securities business within the state, the administrator is, in effect, telling the public that the firm and its registered agents meet the agency's requirements. For this reason, a substantial number of states are quite rigorous in their review of initial broker-dealer applications.

The Application and Review Process--The first step in the initial registration process is a check to see that all appropriate materials and forms have been filed, completed and properly executed. Incomplete applications may be returned or the broker-dealer examiner will write or call the applicant advising of the deficiency. Since there is a thirty-day time limit in which the administrator must act before the application is deemed approved,ⁿ¹⁵ most states will not consider an application complete until all required submissions have been properly filed. For broker-dealers and agents the submission process today has been greatly simplified by Web-CRD and the ability to make "one-stop" electronic filings.

Though all states use uniform forms and participate for the most part in Web-CRD, there are some unique filing requirements from state to state, and so a checklist is a helpful tool. For example, some states have a surety bond requirement; government securities dealers may be exempt or excluded from registration in some states but not others; likewise for exchange floor brokers. If the statute or rules of a given state do not clearly address a given fact situation, inquiry of the staff should be made.

Broker-dealer and agent application review and monitoring constitute a major resource allocation within an administrator's office. As noted, most procedural aspects of broker-dealer and agent registration are managed today by Web-CRD, a national centralized computer system.ⁿ¹⁶ Each state accesses the system through its own computers. Every office, therefore, has at least one person assigned responsibility for reviewing applications and information updates filed with Web-CRD. Larger offices may have several people overseeing broker-dealer and agent operations, including professional and clerical staff.

Review of new Web-CRD data, responding to requests for information and assistance, registration status checks and ministerial matters may be handled by clerical staff in some states. Questions about whether an applicant with a disciplinary history qualifies for registration, statute and rule interpretations, routine or "for cause" broker-dealer branch office examinations and enforcement related matters will usually involve professional staff. A few states also monitor compliance with their net capital requirements and may assign accounting personnel to this task.ⁿ¹⁷

Since providing misleading or incomplete information can be grounds for denial of a registration application,ⁿ¹⁸ counsel must insist that the client be totally candid in completing the necessary forms. The Web-CRD data base is extensive and the likelihood of a prior disciplinary problem escaping a broker-dealer examiner's review is small. Failure to disclose a disciplinary event can have ramifications far greater than the disclosure itself. The disciplinary questions on broker-dealer and agent applications are usually the most important elements of an examiner's review. An affirmative response to a disciplinary question may trigger additional inquiry. The less information volunteered by the applicant in responding affirmatively to those questions, the greater the chance that the application will be delayed while the examiner obtains more details about the incident. Submitting pleadings, complaints, orders and decisions or other explanatory documents in anticipation of follow-up review may expedite the review process and create a positive impression.

In addition to disciplinary matters, an applicant's employment history may be carefully scrutinized. An applicant with a history of transferring from one troublesome firm to another may be subject to rather intense review. Administrators try to screen out actual or potential violators. An agent with an employment history with frequently disciplined firms may find it difficult to obtain state registration. Keeping such agents out of the state is considered a useful prophylactic enforcement tool.

Once it becomes clear that effecting agent or broker-dealer registration will be less than routine, counsel should endeavor to identify the reason for the examiner's concern. The problem might be just one incident, perhaps a fine or suspension that can be satisfactorily explained. The problem may derive from a series of similar incidents, i.e., investor churning complaints, which may evidence a pattern of less than ethical business practices. If an examiner cannot be persuaded to register the applicant, counsel should try to determine the statutory basis for denial. Certain sections of the law are objective disqualifiersⁿ¹⁹ that leave little room for legal debate. Other provisions are more subjectiveⁿ²⁰ and a

convincing argument could be made to support an applicant's registration effort. Counsel should also review carefully the statutory time limitations which govern the ability of the administrator to assert or rely upon certain facts or events in support of a denial, revocation or suspension of registration.ⁿ²¹

Except in instances where an applicant is a repeat offender or has engaged in particularly egregious misconduct, counsel should be prepared to approach the administrator's office creatively. Some administrators use their broad authority to issue such orders "as are necessary to carry out the provisions ..." of their securities lawsⁿ²² to effect limited or conditional registrations of broker-dealer or agent applicants with whom they may not be totally comfortable in giving full registration. Thus, a registrant may be permitted to engage in only certain types of securities transactions or be required to submit regular reports to the administrator. Special broker-dealer supervision over an agent may be a condition of registration.

In addressing an administrator's concerns about an applicant, counsel should suggest terms that will satisfy the administrator that the investing public will be protected. There should be a time limit to the conditions imposed with a provision for automatic removal or modification upon petition to the administrator. Counsel must also be mindful of the possibility that a conditional registration may, depending upon the conditions imposed, be a reportable event and require an amendment to an agent's Form U-4.ⁿ²³

Some administrators may be more inclined to permit a broker-dealer to register if it has a place of business in the state. The rationale is that the registrant can be easily monitored and inspected to ensure compliance. Administrators are also sensitive to the effect of denying an individual applicant the opportunity to earn a living in his or her state of residence. Such sensitivity may not extend to an out-of-state applicant.

When it is clear that registration is not going to be permitted, counsel should suggest that the application be withdrawn. The staff may also make the suggestion. The alternative is the issuance of an order summarily postponing or suspending registration pending a final decision on the application.ⁿ²⁴ This should be avoided at all costs, unless the applicant believes it can prevail upon a full hearing, since the order could trigger a statutory disqualification in other states.ⁿ²⁵

Applicants and practitioners must be particularly mindful of this potential consequence of a registration denial in the context of subsequent or later applications for registration or licensing in an additional state or states. A broker-dealer or agent previously licensed in one or more state who applies subsequently to become licensed in another will be subjected to scrutiny without regard to prior registration(s), and particular as to intervening disciplinary or business conduct matters. The denial of a licensing application by the new state may adversely impact otherwise longstanding prior licensing and registration in others. The practical risk associated with proceeding to challenge a preliminary notice of denial or intent to deny registration through administrative processes must be evaluated very carefully.

Licensing and Registration Renewals--Broker-dealer and agent registrations must be renewed every calendar year. Renewals are processed through Web-CRD. State renewal fees vary, with some fees being the same as initial registrations, while others may be less. Part of the eligibility requirements for participation in Web-CRD is that broker-dealers maintain accounts, and the system simply debits the account based upon the number of registrations renewed in the various states for the firm and its agents. Fees are remitted to the states through the system.

A registrant that fails to renew its broker-dealer registration may be faced with a series of problems. First, some states may require a new registration application. Second, any securities transactions effected while the registration had lapsed may have to be rescinded. There are also significant civil liabilities which may attach.ⁿ²⁶ Third, an enforcement action could be instituted and disciplinary sanctions imposed. Similar problems could arise for failure to renew an agent's registration. Administrators approach failure to renew cases differently. Some require strict adherence to registration requirements, while others are more accommodating if the failure was not willful and can be reasonably explained. Contrition and candor can be helpful in minimizing the damage for failure to renew.

As previously noted, all states participate in Web-CRD. The system is operated by FINRA. Virtually every aspect of broker-dealer and agent registration is handled through Web-CRD, including initial registrations, amendments, transfers and withdrawals. An agent with no disciplinary history can complete a prompt transfer from one broker-dealer to another through the Web-CRD system's temporary agent transfer program (TAT). A transferring agent who has a disciplinary history may experience delays in effecting a transfer.

Post-Registration Requirements and Procedures--Once the registration or licensing process is complete, the securities administrator has broad authority to require broker-dealers to maintain such records that may be prescribedⁿ²⁷ and to file financial reports.ⁿ²⁸ As a practical matter, the extensive requirements of the SEC and the self-regulatory organizations generally encompass those which may be prescribed by the administrator. Registrants also have an ongoing duty to amend their registrations when the documents previously filed become inaccurate or incomplete. The Uniform Act, for example, requires that the registrant "promptly file a correcting amendment."ⁿ²⁹ While most administrators allow amendments to be filed within a reasonable time, undue and repeated delays may signal to the administrator a lackadaisical attitude toward compliance by the firm. Failure to amend, especially as to disciplinary information, is considered to be a serious violation.

Having been registered with the administrator's office, the broker-dealer's next contact will usually occur because of a problem. Routine and "for cause" examinations, investigations and investor complaints are the primary events which may trigger the administrator's interest in a broker-dealer. Several states perform routine broker-dealer and investment adviser examinations to monitor sales practices and assure compliance with record keeping, registration and other requirements. The administrator is authorized to cooperate with other governmental agencies and self-regulatory bodies in performing such exams.ⁿ³⁰ The examinations may be conducted with or without advance notice.

The examinations may be performed at principal or branch offices of the registrant. Employees of a broker-dealer receiving a surprise visit from state securities officials may be reluctant to cooperate without first consulting the main office or counsel. While the authority to conduct the exam without a subpoena is clear, most state securities investigators will give branch office personnel an opportunity to contact the home office or counsel. Resisting an exam, however, can be deemed a violation of the law subjecting the registrant to disciplinary action, an injunction or criminal prosecution.

States that do not perform routine exams will visit broker-dealer offices for cause. These examinations are likely to be generated by investor complaints, tips and referrals or requests from other regulators or law enforcement agencies for assistance. If the exam is likely to interfere with an office's operations, counsel should attempt to work out an arrangement in which the examination is performed so as to minimize the disruption.

If requested records are in storage or at another location, arrangements for prompt production should be made. Unless a decision is made to resist the investigative effort, a cooperative approach is advised. Counsel should be mindful that the reason for the examination may derive from a suspected and potentially serious violation. Exacerbating an adversarial relationship at such an early stage is not likely to be productive.

Investor Complaints--The administrator's office regularly requests records and information from broker-dealers pertaining to investor complaints.ⁿ³¹ Many complaints involve routine matters occasioned by back office delays or misunderstandings and are easily resolved. The first step in processing an investor complaint is an inquiry to the broker-dealer from the staff asking for an explanation in response to the complaint. More often than not, a response date is given. It is important to determine early on whether the response date can be met. If not, a request to the staff seeking more time should be made promptly. Most states will accommodate reasonable requests. Letting the staff know that the broker-dealer is anxious to cooperate cannot hurt and creates a good impression. Dilatory action may increase the problem and create unwarranted suspicions.

If, upon review by counsel or a firm's compliance officer, it appears that there is merit to the investor's complaint, an

offer to resolve the matter is advised. Of course, satisfying the administrator's office may not necessarily end the matter with the complainant. While the administrator wants the law observed, the investor may want something more tangible.

A determination by the broker-dealer that the complaint has no merit, and so advising the administrator, may cause the agency to determine whether additional investigation is appropriate. If the staff believes serious misconduct occurred, a more formal investigation may commence. The investigation, in turn, could lead to the commencement of an administrative proceeding. The action may be brought only against the agent, or the broker-dealer may be included, either for substantive violations or perhaps a claim of failure to supervise.ⁿ³²

[b] Investment Advisers and Investment Adviser Representatives

Prior to NSMIA, investment advisers were subject to the registration requirements of both the SEC and those state jurisdictions that had provisions for investment adviser regulation. While there were *de minimis* exclusions or exemptions from state registration, the practitioner was required to review the specific statutory provisions for those states in which a client might seek to do investment adviser business.

NSMIA created a two-tiered system of investment adviser registration. Simply put, investment advisers with assets under management in excess of \$25 million are subject to federal registration with the SEC. Investment advisers with less than \$25 million under management are required to register in the state where they maintain their principal office. It is important to note, however, that NSMIA preserves for the states their ability to receive notice filings of all investment advisers doing business in their state and, not unimportantly, to continue to receive registration and renewal fees.

The practitioner must also be aware that associated persons of investment advisers may be required to obtain state registration if they maintain a physical presence in a particular jurisdiction, notwithstanding the fact that the investment adviser itself is a federal "covered" adviser, subject only to SEC registration. There is no exemption from the registration or licensing requirements for investment adviser representatives under state Blue Sky laws based on the federal registration of the investment adviser itself. As fully discussed in Chapter 11, an exclusion from licensing in a particular state may be available based upon the *de minimis* level of a representative's contacts or activities in the state, but such an exclusion is unrelated to the fact that the adviser itself may be registered only under federal law. Smaller SEC registered investment advisers and their representatives often fail to recognize the separate registration or licensing requirement for representatives in the mistaken belief that federal registration of the adviser supplants any need for state compliance beyond notice filings. The consequences of the error can be serious in terms not only of administrative enforcement action, but also private civil liability.ⁿ³³ Prior to embarking on a registration effort on behalf of an investment adviser, the practitioner is thus cautioned to conduct a careful review of any notification and/or registration requirements of applicable states, even if the adviser itself qualifies as an SEC registrant.

As Web-CRD has dramatically streamlined the registration and licensing process for broker-dealers and agents, implementation of IARD--the Investment Adviser Registration Depository--is having the same impact for investment advisers and investment adviser representatives. IARD mirrors the Web-CRD functions. However, an important practical distinction for investment advisers is that many states currently require manual submission, in hard copy, of at least Part II of Form ADV, which is the principal disclosure document utilized by many advisers to comply with disclosure or "brochure" requirements of both state and federal law. Part II is subject to the same updating and amendment requirements applicable to any registration filing. The content of Part II of Form ADV is always subject to scrutiny under antifraud provisions, and states have in large measure also adopted or embraced the federal prohibitions and requirements applicable to SEC registered investment advisers in or under their own regulations.ⁿ³⁴

[4] Enforcement

[a] The Enforcement Function--Generally

The handling of a state securities enforcement case varies somewhat in accordance with the procedures applicable to the administrator's office. Most states have a separate enforcement unit, usually headed by an attorney. Smaller offices may rely on support from the state attorney general's office or other personnel from a larger umbrella agency, of which the securities administrator's office may be a part. However the enforcement function is organized, considerable authority is conferred upon the enforcement staff. It is they who preliminarily determine whether a case should be brought, what allegations are to be made and the nature of relief to be sought. Likewise, counsel must negotiate with enforcement personnel throughout the case over matters such as discovery, subpoena issuance, stipulations and proposed settlements.

There are instances when a potential securities enforcement matter may first come to the attention of a registrant (issuer, broker-dealer or investment adviser) before it is uncovered by the state securities agency. Broker-dealers, for example, frequently uncover wrongdoings of their agents through the complaint of a customer who has not yet contacted a government or self-regulatory agency. The attorney advising the registrant must make some critical decisions at this point. First, is the event "material" within the context of Section 203(c) of the Uniform Act?³⁵ For issuers, the same question must be asked with respect to section 306(a)(2)(A). Precise guidelines are difficult here, but an administrator is not as likely to consider an isolated incident involving one agent as serious as a pattern of abusive or illegal practices occurring in a branch office or throughout the firm. Misappropriation of client assets or other sales practice misconduct by an agent might be viewed differently than a failure to follow a technical operational policy or procedure. For broker-dealers and investment advisers the reportable events categories on Forms U-4 and U-5 provide the most practical assessment of what type of "complaint" requires specialized attention, or action, in regard to reporting to regulatory agencies.

Counsel, at the early stage of the enforcement process, should always analyze the problem from the perspective of the administrator. State securities regulators view their statutes and rules as virtually sacrosanct and expect a higher standard of conduct from their registrants than may be found in regular business relationships. They strongly endorse the concept that the integrity of the nation's securities markets is based upon an ethical system that demands more than almost any other enterprise or profession.

While disclosing a potential enforcement problem to the administrator is no guarantee of absolution, it is bound to have some mitigating impact. For counsel representing a client who is likely to have a continuing relationship with the administrator's office, creating a reputation of integrity and candor for the long term may outweigh short term difficulties raised by initiating disclosure of an enforcement problem.

[b] The Investigative Process

The first stage in an enforcement case emanating from the administrator's office is likely to be a request for documents. Routine complaints may only generate a letter to the registrant enclosing the investor complaint and asking for a response by a certain date. If the staff has previously assembled material from other sources, such as a complaining investor, they may wish to speak to the registrant or others connected with the event.

Whatever the nature of the inquiry, a prompt reply is appropriate. If there is likely to be a delay in producing the sought after information, acknowledgement of the request should be sent asking for additional time, with an explanation as to the reason for delay. Section 407 of the Uniform Act gives the administrator broad authority to conduct investigations, and this power is a key part of all Blue Sky laws.³⁶ Since registrants are subject to sanctions for a willful failure to comply with the act,³⁷ it is unwise to try to impede an investigative effort. Pursuing such a course of action could conceivably generate an administrative enforcement case for that reason alone.

The recipient of an information request may not always be advised as to why the material is being sought. Naturally, counsel should try to determine the agency's interest in the matter. If this is not possible, other potential sources should be pursued. For example, an investigation may involve an agent who has since left the firm. Contact with the compliance personnel of the agent's current employer may prove fruitful. Indeed, the new employer may be unaware of

the agent's potential regulatory difficulties.

When a client receives a subpoena from the administrator's office, counsel can comfortably assume that the enforcement staff regards the case seriously. The grant of subpoena authority is not taken lightly by most administrators and they will ordinarily be issued only for more important enforcement cases. Some administrators may, in fact, utilize an internal "probable cause" standard requiring staff to submit a motion or request justifying the issuance of a subpoena.

Subpoenas may seek documents, testimony or both. Unless compelling reasons exist to the contrary, such as a parallel criminal investigation or proceeding, counsel should offer to cooperate. Accommodations as to return dates for documents or taking of testimony can usually be reached with the staff. Since the subpoena authority is statutorily bestowed upon the administrator, the subpoena is likely to compel appearance before him or her. In practice, however, testimony will ordinarily be taken by the enforcement staff.

Subpoenas issued by the administrator may be very broad, often reflecting boilerplate previously used. Attempting to determine what the staff really wants and needs can help in narrowing the scope of the request. Negotiating to limit the amount of information initially subpoenaed can save a client considerable expense in producing records, many of which may not be necessary to the investigation. Counsel should be careful, however, in making clear to the enforcement staff that the objective is to expedite the request and avoid duplication and waste rather than delay or impede the investigation.

[c] The Adjudicative Process

The "adjudicative" process is determined by what type of enforcement proceeding is actually brought by an administrator. As discussed in more detail in Chapter 14, administrators usually have the option of proceeding within the agency itself or in civil injunctive proceedings. Criminal enforcement proceedings are always an option, but are subject to different process considerations and judicial procedures that are beyond the scope of this chapter. The easiest and most direct procedure to address violations is through an administrative procedure, typically focused on the issuance of temporary and final cease-and-desist orders, with other permitted ancillary remedies and money penalties. Civil injunctive actions are the less preferred enforcement proceedings under Blue Sky laws because they are far more cumbersome, time consuming and expensive. On the other hand, the extent to which administrators may seek and obtain meaningful remedies and penalties in the context of administrative proceedings varies considerably among the states, and in many situations the administrator may be compelled to proceed in the courts to assure a wider array of equitable and ancillary remedies such as receivers, conservators, and the like.

The investigative process leading up to an enforcement action will be largely the same whether the administrator proceeds within the agency or in a court action. The adjudicative process, however, will be much different.ⁿ³⁸ Practical considerations in the administrative context are discussed further below.

Once an order has issued from the securities administrator's office, the proceeding that follows will be governed by whatever adjudicatory rules are applicable within the jurisdiction. Some states may have rules applicable to all state administrative agency hearings, while others may have adjudicatory rules promulgated by the specific agency. The complexity of the adjudicatory rules varies state-to-state, as do the procedures employed during the hearing process. The rules may not always reflect the nature of the hearings ordinarily conducted by the agency. For example, some adjudicatory rules may contain little or no reference to discovery and motion practice. In reality, however, an agency may conduct hearings that allow for reasonable discovery and pre-hearing pleading. To determine the scope of a hearing, counsel should consider asking the hearing officer for a conference early on in the process. If held, a conference can help to acquaint counsel with the agency's hearing practice, set schedules for pleadings, simplify discovery and narrow the issues.

The initial pleading prepared by the enforcement staff will usually allege specific violations of the securities law, but

not necessarily be replete with facts supporting the alleged violations. If the pleading does not contain sufficient facts, counsel should consider filing appropriate motions to compel greater specificity.

Because an enforcement case can easily turn into a protracted and expensive proceeding, particularly if counsel needs to create a thorough record in anticipation of a subsequent appeal, preliminary settlement efforts should be considered. The agency, too, has concerns about using limited resources to litigate a case and serious approaches to pre-hearing settlement will be considered. However, once the staff has committed time and energy to hearing preparation, one can expect they will be less inclined to settle.

Proposed settlements are generally submitted to the hearing officer (and perhaps the administrator if he is not the hearing officer) for acceptance and entry of a final order. In considering settlement, the reportability and disclosure implications of the final order should be taken into account. For issuers, the materiality of the order with respect to disclosure in subsequent securities offerings may be important. Similarly, an exemption from securities registration may be lost as a result of an enforcement order.ⁿ³⁹ Broker-dealers, agents and investment advisers may have to report the order to other regulatory authorities with whom they are registered.

If settlement is not reached and the case goes to a hearing, maintaining an adequate record in the event of an appeal is important. Determine in advance the manner in which the agency maintains the hearing record. Most jurisdictions do not have stenographic transcription available due to the expense. Instead, tape recordings are made. Since the quality of a tape recorded proceeding may not be very good and may be difficult to transcribe, counsel may prefer to provide a stenographer.

A review of a state securities agency's regulations and adjudicatory rules should reveal how the hearing officer is designated. Some jurisdictions have staff hired specifically for that task. Others utilize state-designated hearing officers to conduct administrative hearings. Still others employ independent hearing officers either on a contract or full time basis.

In many jurisdictions, the administrator or a senior staff member will serve as hearing officer in cases brought by the staff. Since maintaining the appearance of impartiality can be as important to due process as *de facto* impartiality, many states are careful to isolate the administrator from the specifics of an enforcement case. Accordingly, the administrator may know virtually nothing other than that the staff may be working on a particular case. While this procedure may enhance the prospect of a fair hearing, it can be a two-edged sword for the practitioner. For example, with the administrator isolated, except for the role as hearing officer, it may be difficult to complain about the staff's handling of the case. The only recourse may be through the formalities of the hearing process, i.e., the filing of motions and legal memoranda.

If counsel has reason to believe that the impartiality of the person hearing the case has been compromised, a motion to recuse may be appropriate.ⁿ⁴⁰ Consideration should also be given to requesting the appointment of an impartial hearing officer or seeking judicial relief. As noted above a number of states may designate, or be provided with, administrative law judges or hearing officers to hear the agency's cases. Counsel should find out how a given state provides adjudicators to the agency and whether the hearing officer is familiar with securities law.

A securities enforcement case is likely to be replete with documentary evidence, the introduction of which during the course of a hearing can be quite time consuming. Submitting stipulations with enforcement staff for the admission of documents and uncontested facts will expedite the hearing, perhaps clarify and narrow issues, simplify the record and save time and money.

At the conclusion of an adjudicatory hearing, consideration should be given to the submission of briefs and proposed findings of fact and rulings of law. The longer and more complicated the case, the more useful post-submissions can be to the hearing officer. If the subject is not raised by the hearing officer, counsel might suggest and request the

opportunity to make such filings.

Some administrators make good use of the press in publicizing their office and the cases brought by the agency.ⁿ⁴¹ Since many work for elected officials, the opportunity for press coverage of an enforcement case is very tempting.ⁿ⁴² The ability of counsel to minimize adverse publicity will depend on the administrator's willingness to negotiate the contents of a press release. It is rare when the issuance of the release itself will be subject to negotiation. Nevertheless, it does no harm to try to control damage on behalf of the client. While it may be difficult to have any say in the language of the release, it might be possible to persuade the administrator to emphasize or include information favorable to the client: for example, reference to the fact that no customers were harmed by an infraction, or that the firm made whole all customers harmed by one of its agents.

The press is generally viewed as an ally by the administrator. Publicity about a specific securities fraud case or an endemic problem is probably the best method government can use to educate the public investor. Press coverage of the activities of the administrator's office also serves as a reminder to potential violators that they run the risk not only of being caught, but also being publicly exposed and embarrassed.

[d] Interagency Enforcement Coordination

A significant part of an administrator's job is developing and maintaining cooperation with other financial regulators and law enforcement agencies at the state and federal level. The growth of the financial marketplace, the loosening of interdisciplinary regulatory barriers in financial services, and increased public awareness of investments compel the administrator to look well beyond the confines of his or her own statute.

The importance of federal-state cooperation in securities regulation was recognized by Congress in the early 1980's when it promulgated Section 19(c) of the Securities Act of 1933.ⁿ⁴³ This new law stated that "there should be greater federal and state cooperation in securities matters, including (A) maximum effectiveness of regulation, (B) maximum uniformity in federal and state regulatory standards, (C) minimum interference with the business of capital formation." Today, section 608 of the 2002 Uniform Securities Act reflects a continuing commitment to federal and state cooperation by setting an express objective of uniformity among state, federal, self-regulatory organizations, and foreign governments. The 2002 Uniform Act further makes clear its underlying policy objectives:

(b) [Policies to consider.] In cooperating, coordinating, consulting, and sharing records and information under this section and in acting by rule, order, or waiver under this [Act], the administrator shall, in its discretion, take into consideration in carrying out the public interest the following general policies:

- (1) Maximizing effectiveness of regulation for the protection of investors;
- (2) Maximizing uniformity in federal and state regulatory standards; and
- (3) Minimizing burdens on the business of capital formation, without adversely affecting essentials of investor protection.ⁿ⁴⁴

Today multi-state and multi-agency task forces aimed at particular enforcement initiatives are increasingly common, with the states playing major roles in regard to such things as the widespread abuse associated with offers and sales of promissory notes, and the high-profile investigation into research practices of major broker-dealer and investment banking firms. NASAA is itself an Associate Member of IOSCO-the International Organization of Securities Commissions--and a key participant in evolution and development of investor protection measures and effective regulation across borders in global securities markets.

Investment scams, as well as traditional securities fraud, may bring the administrator into regular contact with the

Securities and Exchange Commission, the Commodity Futures Trading Commission, Federal Bureau of Investigation, United States Postal Inspectors, the Department of Justice, and the Internal Revenue Service. There is also close cooperation between state agencies and the self-regulatory organizations, particularly the Financial Industry Regulatory Authority (FINRA). Referrals of investor complaints are routinely made between state and FINRA district office staff. States with active broker-dealer office examination programs may also coordinate these exams with FINRA, which also examines FINRA member firms. There are relatively few broker-dealers registered or licensed in a state that are not also FINRA members firms.

Coordination with the Securities and Exchange Commission is accomplished through that agency's regional and district offices and Washington, D.C. Many state administrators participate in regular meetings with regional SEC officials to exchange information, refer complaints and coordinate investigations. Some enforcement cases may involve cooperation with the SEC Division of Enforcement. The passage of NSMIA, which gave the states exclusive regulatory authority over small investment advisers, provided the opportunity for the SEC's Division of Investment Management to work with a number of states to provide training in the area of investment adviser examinations. Periodically, the states and the SEC will conduct joint enforcement training conferences. These programs are well attended by state securities enforcement staff and assist in developing working relationships among state and federal regulators.

While the various securities exchanges have enforcement authority over their members, there does not appear to be much specific case coordination with state securities officials. However, as industry-wide issues arise from time to time, NASAA's leadership and relevant committees will exchange information and consult with their counterparts at the exchanges. Not surprisingly, the New York Stock Exchange is the most active in this regard.

At the state level, the administrator's office often works with state and local police and prosecutors. Having developed an enforcement case warranting criminal action, the administrator will seek a prosecution. The ability to interest a prosecutor in a securities fraud case varies from state to state and may depend on the prosecutor's resources. The lack of familiarity with securities matters may inhibit a prosecutor from taking a referral.

Securities administrators and staff are in constant communication with their colleagues in other states. While geographic proximity may result in frequent joint efforts by neighboring states, the mobility of securities law violators and the advent of the Internet transcends distance and hence, widespread investigations are not infrequent. It is now commonplace to have cooperative enforcement actions among several states, sometimes using the staff and financial resources of NASAA to coordinate the investigation in order to address pervasive securities fraud.

Web-CRD has also facilitated interstate communication. The states use their computer terminals to communicate with one another on a daily basis. Almost all states use the CRD to report enforcement actions they have taken, to elicit information and to survey other jurisdictions on particular practices or problems.

Administrators in those states with active securities registration programs regularly talk to one another and provide assistance in understanding and identifying troublesome issues which may be contained in a prospectus or offering memorandum. In response, in part, to industry complaints about lack of uniformity among the states in the standards applied to the review of securities offerings, the states, through NASAA, established the Coordinated Equity Review Program discussed earlier.ⁿ⁴⁵ The practitioner should be aware that inconsistent representations made to state securities examiners in different states are likely to surface eventually. When that occurs, the credibility of the attorney and law firm may be irreparably damaged.

[e] Judicial Review

As discussed earlier,ⁿ⁴⁶ the Uniform Act and all state securities laws provide for judicial review of administrative orders. Enforcement orders are most prominent among the orders taken to courts for review, and the subject is explored in more detail in Chapter 14--"Administration and Enforcement." Some, for example, provide for review by the

administrator of decisions rendered by hearing officers, and permit the administrator specifically to affirm or reject the officer's determination, thus allowing a further opportunity in the process for advocacy. Administrators do not necessarily accord great deference to hearing officers who have no special expertise, and while fact findings are rarely disturbed, administrators with the authority to review such decisions are willing to exercise that authority to correct or modify legal and interpretive errors. States differ on the availability and procedure for internal administrative review as a prelude to judicial review, and thus as a matter of practice and procedure it is essential to evaluate, and to implement, all procedures for review within the agency itself prior to undertaking judicial review.

FOOTNOTES:

(n1)Footnote 1. Only Wyoming does not currently require licensing of investment advisers and investment adviser representatives.

(n2)Footnote 2. The operation of Blue Sky laws and the full scope of administrative authority in regard to these areas are presented in detail in Chapters 5, 7, 8, 11, and 14, *above*. The discussion here addresses them only from a practical, procedural perspective.

(n3)Footnote 3. *Cal. Corp. Code § 25102(c)*. A "negotiating permit" under this provision is conditioned on the fact that none of the securities may actually be issued, and none of the consideration for the transaction may be received or accepted until the sale of the securities is otherwise qualified under the law.

(n4)Footnote 4. *See, e.g., Arkansas: Ark. Code Ann. § 23-42-503(d)(1)*.

(n5)Footnote 5. *See Unif. Sec. Act § 402(a)(10)*.

(n6)Footnote 6. *15 U.S.C. § 77c(a)(10)*.

(n7)Footnote 7. For example, all states use form U-1, the Uniform Application to Register Securities and U-2, the Uniform Consent to Service of Process.

(n8)Footnote 8. In Massachusetts, for example, "full business days" on file are counted. Thus, the date of receipt does not count.

(n9)Footnote 9. CER is discussed in greater detail in *section 16.04[2][b] below*.

(n10)Footnote 10. Sometimes called the securities registration section or division. Some jurisdictions divide their internal operations between registered and exempt offerings.

(n11)Footnote 11. *Unif. Sec. Act § 303*.

(n12)Footnote 12. *Unif. Sec. Act §§ 306(b) and (c)*.

(n13)Footnote 13. *Unif. Sec. Act § 402(c)*.

(n14)Footnote 14. *See, e.g., Unif. Sec. Act § 401(c)*.

(n15)Footnote 15. *Unif. Sec. Act § 202(a)*.

(n16)Footnote 16. Web-CRD[SM.] is operated by the North American Securities Administrators Association (NASAA) and FINRA. With the implementation of Web-CRD, new electronic uniform forms were also introduced. New Forms U-4, U-5, BD and BDW were reformatted and made consistent with the Web-based approach of Web-CRD. The uniform forms are available for review and printing on state web sites as well as the FINRA and NASAA web sites.

(n17)Footnote 17. While several states have net capital requirements for broker-dealers, most rely on NIFRA and

stock exchange surveillance.

(n18)Footnote 18. Unif. Sec. Act §§ 204(a)(2)(A) and (G).

(n19)Footnote 19. Unif. Sec. Act §§ 204(a)(2)(C)(D), (E) and (F).

(n20)Footnote 20. *See* Unif. Sec. Act §§ 204(a)(2)(G)(H)(I) and (J).

(n21)Footnote 21. *See* Unif. Sec. Act §§ 204(a)(2)(F), and the last sentence of § 204.

(n22)Footnote 22. *See* Unif. Sec. Act § 412.

(n23)Footnote 23. Form U-4 is the agent registration form. It must be amended when existing information becomes dated or new information must be reported. The instructions to the form should be read carefully to determine whether an amendment must be filed.

(n24)Footnote 24. Unif. Sec. Act § 204(c).

(n25)Footnote 25. *See* Unif. Sec. Act § 204(a)(2)(F).

(n26)Footnote 26. Unif. Sec. Act § 410.

(n27)Footnote 27. Unif. Sec. Act § 203(a).

(n28)Footnote 28. Unif. Sec. Act § 203(b).

(n29)Footnote 29. Unif. Sec. Act § 203(c).

(n30)Footnote 30. Unif. Sec. Act § 203(d).

(n31)Footnote 31. Most Blue Sky administrators' web sites facilitate the direct electronic submission of investor complaints through on-line forms. At the very least, complete information on how and where to submit a complaint is provided. This information is also made a part of investor education and awareness initiatives by administrators.

(n32)Footnote 32. *See* Unif. Sec. Act § 204(a)(2)(J).

(n33)Footnote 33. Ohio, for example, creates the following express private right of action that is typical of provisions in other state Blue Sky laws:

Whoever acts as an investment adviser or investment adviser representative in violation of [the Blue Sky law] shall be liable for damages resulting from the violation in an action at law in a court of competent jurisdiction. Damages may include consideration paid for the advice, any loss due to the advice, and all court costs, less the amount of any income received from the advice... . *Ohio Rev. Code* § 1704.42(B).

(n34)Footnote 34. *South Carolina: See, e.g.,* S.C. Sec. Comm. Order 97010 (Sept. 2, 1997); proposed Rule 13-224.

(n35)Footnote 35. Section 203(c) provides in regard to post-registration requirements:

If the information contained in any document filed with the [Administrator] is or becomes inaccurate or incomplete in any material respect, the registrant shall promptly file a correcting amendment unless notification of the correction has been given under section 201(b).

(n36)Footnote 36. In Pennsylvania, for example, the breadth of investigative authority is illustrated by the provision that the administrator:

[M]ay, for a reasonable time not exceeding thirty days, take possession of the books, papers, accounts and other records, however created, produced or stored, pertaining to the business of any broker-dealer or investment adviser or pertaining to the activities of any issuer in connection with any transaction in a security, whether or not exempted under section 202 or 203 and the use of any proceeds therefrom, and place a keeper in exclusive charge of them in the place where they are usually kept... . 70 *Pa. Stat. Ann. § 1-510(ii)*.

(n37)Footnote 37. See Unif. Sec. Act § 204(a)(2)(B).

(n38)Footnote 38. Although beyond the scope of this chapter, practical considerations for the litigation process, whether an enforcement or private action, include the availability of such resources as the annotated *Jury Instructions Under Securities Laws* [©] published by the Enforcement Publications Committee of NASAA, and available on the NASAA web site (www.nasaa.org).

(n39)Footnote 39. For example, Most jurisdictions have adopted the Uniform Limited Offering Exemption (ULOE). Under the ULOE, what is commonly referred to as the "bad boy" provision bars use of the exemption for certain categories of persons found to be the subject of specified enforcement orders. Counsel should carefully review the ULOE of each jurisdiction in which a client, who is to be the subject of an enforcement order, anticipates doing business.

(n40)Footnote 40. Due process concerns are always present in state administrative enforcement proceedings. In *Trust & Investment Advisers v. Hogsett*, 43 F.3d 290 (7th Cir. 1994) , for example, plaintiff brought an action in federal court seeking declaratory and injunctive relief as well as money damages for the alleged violation of its procedural due process rights in an enforcement proceeding brought by the Indiana Securities Division. Among other things, plaintiff asserted that the Division had an "indirect pecuniary interest" in the adjudication of the case, and that conduct of the Commissioner evidenced that the Division had prejudged the outcome of the proceeding. The U.S. District Court abstained and dismissed the suit. On appeal, however, the Seventh Circuit reversed and remanded the case for further findings on whether the Indiana Commissioner's institutional bias in the proceeding denied plaintiff a procedurally fair hearing in the state forum. The Seventh Circuit called for a realistic appraisal of the effect, if any, that the alleged bias on the part of the Division would have on the adjudicator's capacity for fair and impartial decision-making.

(n41)Footnote 41. In some states it is a matter of statutory authority. Pennsylvania, for example, provides specifically that as part of investigative authority the administrator:

[M]ay publish information concerning any violation of this act or any rule or order hereunder or concerning securities or practices in the sale thereof, which appear or tend to be unfair, inequitable or fraudulent, but only where it deems such publication to be in the public interest and for the protection of investors. 70 *Pa. Stat. Ann. § 1-510(iv)*.

(n42)Footnote 42. Note, however, that in *Hogsett*, above, one of the asserted constitutional infirmities in the state enforcement proceeding was the fact that the Commissioner had issued a public statement of her belief that the evidence in the case "established" liability. In remanding the case for further consideration, the Seventh Circuit concluded that an inquiry was necessary to determine whether the Commissioner had prejudged the outcome of the proceeding. The Court stated: "Depending on the degree of her involvement in the underlying investigation and the nature of her public statements about the case, it may be that Dant [the Commissioner] has prejudged this case." *Trust & Investment Advisers v. Hogsett*, 43 F.3d 290, 297 (7th Cir. 1994) .

(n43)Footnote 43. *15 U.S.C. § 77s(c).*

(n44)Footnote 44. *Unif. Sec. Act of 2002 § 608(b) (amended 2005).*

(n45)Footnote 45. *See section 16.04[2][b], above.*

(n46)Footnote 46. *See section 16.03[4], above.*



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CHAPTER 16 Blue Sky Practice and Procedure

1-16 Blue Sky Regulation § 16.06

§ 16.06 Resources for Practitioners

The primary resource in Blue Sky practice and procedure is the Internet. Today, every state securities administrative agency (as well as those for the territories of Guam and Puerto Rico) has an Internet web site providing direct access to statutes, rules and regulations, forms and, in many instances, available written interpretations, policy statements, no-action letters, administrative and enforcement orders. These web sites also typically include an agency directory, various investor education and fraud prevention materials, news releases, and access to newsletters or other materials published by the agency. Most web sites also provide a mechanism for submission of complaint to the agency on-line, and also have direct links to other web sites helpful to investors and practitioners. Through their web sites, administrators and staff may be contacted by e-mail.

Agency web sites have become a principal means of disseminating information to the investment and practitioner communities, although traditional hard copy media such as newsletters or periodic bulletins continue to be used, and remain available on a subscription basis. The *Financial Regulators Gateway*, sponsored by the Cybersecurities Law Institute of the University of Toledo College of Law¹ is a premiere site providing direct access to securities and other financial regulatory agencies throughout the United States and around the world. The web site accesses information on securities, futures, banking and insurance regulators, with links to the name, address, telephone and FAX numbers, e-mail and Internet web site addresses. Links to statutes and rules administered by the agency are also provided when available. The *Financial Regulators Gateway* is updated on a regular basis.

The North American Securities Administrators Association (NASAA) a highly visible and active organization of state securities regulators that is also an excellent resource in the administration of and practice under state Blue Sky laws. The expansion of NASAA's activities has involved almost all states in a variety of areas, and many staff members participate in committee work. State securities staff who serve on NASAA committees can often be a valuable resource for information as to the practices and policies of other jurisdictions. The NASAA web site itself² contains useful and important information concerning the administration of state Blue Sky laws, and in particular combined initiatives of states in enforcement and the areas. Like many state agency web sites, the NASAA web site also contains useful links to other financial regulators and useful Internet web sites.

With the goals of greater uniformity among the states and coordination with related federal regulation, state securities regulators are making greater use of information technology systems that may in the future produce a one-stop paperless filing of all state and federal forms. In Ohio, for example, the "OASIS" electronic securities filing system is available

for investment company notice filings, with the goal in the future for the system to be used for all types of filings with the Division of Securities in a manner that will interface at the federal level with the Electronic Data Gathering Analysis and Retrieval System (EDGAR). Similar systems or initiatives are in place or underway in several other states, and administrative processes and procedures will be dramatically affected by these innovations as they are expanded into full-fledged electronic filing systems for the complete range of filings and reports required by Blue Sky laws.

Several states have also implemented or are developing electronic registration, exemption and notice databases to provide easy access to information concerning securities offered and sold in the state.

FOOTNOTES:

(n1)Footnote 1. law.utoledo.edu/financialregulators/pages/finanreg.htm

(n2)Footnote 2. www.nasaa.org



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CHAPTER 16 Blue Sky Practice and Procedure

1-16 Blue Sky Regulation § 16.07

§ 16.07 Challenges in Blue Sky Practice and Procedure

Although significant progress has been made in bringing uniformity to state securities regulation, the principal challenge in Blue Sky practice and procedures remains the gaps in uniformity not only among state regulators, but also among the states, the federal government, self-regulatory organizations, and, to an increasing extent, foreign governments and regulatory agencies. Federal preemption under NSM IA has, for example, exposed the need for developing and maintaining a uniform exemption from Blue Sky registration for small issuers, and for other procedures designed to reduce the burden of raising investment capital by small businesses. Because state registration and securities qualification procedures today are limited to NSMIA non-covered securities, the process impacts almost exclusively on smaller local and regional financings. It is thus not surprising that the 2002 Uniform Securities Act expressly directs cooperation, coordination, consultation and sharing of records and information by administrators in order to accomplish, among other things:

- (1) Coordinating registrations and exemptions;
- (2) Formulating rules, statements of policy, guidelines, forms, and interpretive opinions and releases;
- (3) Formulating common systems and procedures;
- (4) Notifying the public of proposed rules, forms, statements of policy, and guidelines; and
- (5) Developing and maintaining a uniform exemption from registration for small issuers.ⁿ¹

These are some of the most significant practical challenges in Blue Sky practice and procedure affecting capital formation. There are others. In chapters 5 and 6 the merit review and non-merit review dichotomy among the states is discussed at length, and the differences in approach even among the merit review states, presents a continuing challenge. The absence of uniformity in "testing the waters" provisions and requirements, or the fact that some states make no such provision at all, is another factor directly affecting Blue Sky practice and the access to capital. All of these differences and many other individual state provisions, regulations, and forms that make for variations among even the Uniform Act states must be confronted, and managed.

It is also a simple truth that states historically have differed in degrees of "toughness" in the administration of Blue Sky

laws. This has mostly affected the securities registration and qualification process, but it also impacts intermediary registration or licensing matters. As also discussed in chapters 5 and 6, the historical evolution of such differences is manifested today in formalized procedures by which some states defer to others in the merit review process on a regional basis. State by state, however, it is essential to learn and understand any differences in historical approach, and to undertake proactively to address them at the earliest stage. Fortunately, Blue Sky administrators and their staffs are more accessible than ever before, and they are willing to share insights and to offer guidance with a view to achieving mutual goals of investor protection and capital formation.

For intermediaries, while the mechanical process of registration and licensing has been dramatically simplified through implementation of Web-CRD and the IARD, every state applies fitness and qualification criteria independently. Testing requirements, for example, are not uniform. Most states require broker-dealers agents or representatives to pass the Uniform Securities Agent State Law examination (Series 63). However, certain others provide for acceptable alternatives. In the application of fitness criteria, or determinations of "good business repute," states are free to evaluate such things as prior disciplinary history or customer complaints and proceedings, subject only to hearing and deferential review procedures, in making licensing determinations. Because an adverse licensing in one state generally constitutes a reviewing, and in some cases disqualifying, criterion in other states, careful management of the application process is essential, with due regard for the importance of withdrawing an application if it appears from preliminary consultation and procedures that an adverse determination is more likely than not. The considerable mobility among investment intermediaries and their clients makes the subsequent or continuing licensing or registration process today more significant in many instances than the initial process, as administrators have multiple opportunities to review licensing and fitness criteria simply by virtue of renewal procedures as well as new applications in additional states by a currently licensed intermediary in another state.

State licensing or registration requirements are particularly significant for investment adviser representatives. *Representatives* of investment advisers who are subject only to notice filing requirements in the states by reason of registration with the Securities and Exchange Commission are, unless excluded by the limited nature of their activities, nevertheless fully subject to licensing or registration in the states in which they perform advisory activities. Although there is today considerable uniformity in the application of qualification, or "minimum competency" criteria for investment adviser representatives, administrators in this area as well have full authority in evaluating applicants under general fitness requirements, and have the same continuing opportunity to make determinations in the renewal or subsequent registration process as the business of an adviser or representative expands. Prior disciplinary history, for example, plays no lesser role in evaluating the fitness of an investment adviser representative for licensing or continued licensing than it does for broker-dealer agents or representatives.

All intermediaries must further understand that nothing in the dual system of federal and state regulation operating today after NSMIA alters the antifraud provisions of Blue Sky laws and the authority of state administrators to act under them. High profile enforcement initiatives directed against intermediaries have shown the potency of this ultimate authority of state administrators to act in decidedly national market settings where the fundamental investor protection goals of Blue Sky laws are involved. Blue Sky practice and procedures will, going forward, be a part of national and indeed global capital and trading markets, with the emphasis heavily on regulation of the intermediaries who continue to have "main street" impact in making them work.

FOOTNOTES:

(n1)Footnote 1. Unif. Sec. Act (2002) § 608(c).

In its resolution endorsing the Uniform Securities Act (2002), NASAA encouraged its members to seek uniformity of state securities laws, but also recognized that members "may have local provisions important to investor protection in their jurisdiction." *Uniform Securities Act Resolution*, NASAA (Jan. 4, 2003). As amplified in a follow-up news release: "NASAA recognizes there are several paths to achieve uniformity, and as a membership organization, NASAA will respect those members with current strong statutes containing unique tools for investor protection." "State Securities

Regulators Endorse Uniform Securities Act (2002)", NASAA Top Stories, available at www.nasaa.org.



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CHAPTER 17 Franchising and Business Opportunities

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CHAPTER 17 Franchising and Business Opportunities

2-17 Blue Sky Regulation § 17.01

§ 17.01 Introduction

The marketing of franchises and business opportunities to the general public has historically produced the same concerns for protection against fraudulent schemes and information failures that are the foundation for state Blue Sky laws. It is not surprising that through investment contract and "risk capital" analyses, state securities regulators took initiatives to apply Blue Sky law protections to the offer and sale of franchises and business opportunities that manifested the characteristics of investment risk that have defined the existence of a security under both state and federal securities laws.ⁿ¹ Investment contract and risk capital analyses have allowed the application of federal and state securities law protections, particularly antifraud provisions and remedies, to address selling abuses and information failures in situations in which ostensible business opportunities in reality masked passive investment schemes.

The proliferation of mass marketing of franchises or business opportunities ultimately led to widespread enactment of state laws specifically aimed at business franchises, several patterned after provisions of the original Federal Trade Commission Franchise Rule,ⁿ² to address unfair and deceptive practices or to set certain standards in the marketing of franchises and the relationships involved in them. Some of these state laws evolved directly out of state Blue Sky laws and are today administered as franchise "investment" laws under the same administrative authority as the state securities law. In California, for example, the California Franchise Investment Law,ⁿ³ is administered by the Department of Corporations under the same authority as is applicable to regulation of the offer and sale of securities and off-exchange commodities. State franchise investment laws in many ways parallel Blue Sky laws in terms of disclosure of information and protection against fraud, so much so that in 1993 the North American Securities Administrators Association (NASAA) adopted specific Guidelines for a Uniform Franchise Offering Circular (UFOC). Several states adopted the UFOC Guidelines to directly regulate franchise offerings. Others have undertaken specific regulation of business opportunities, which involves a hybridized approach melding elements of securities regulation into a more targeted regulatory provision.ⁿ⁴

In 2007, after a twelve year regulatory review, the Federal Trade Commission adopted an amended Franchise Rule, together with a "Statement of Basis and Purpose and Regulatory Analysis."ⁿ⁵ The FTC 2007 Franchise Rule includes new requirements for franchisor disclosure documents. That rule is now the basis for updated NASAA Guidelines that substantially adopt the disclosure requirements of the FTC 2007 Franchise Rule as a successor to NASAA's previous UFOC Guidelines, and which include new instructions for filing a Uniform Franchise Registration Application in states.ⁿ⁶ The new FTC Franchise Rule and its incorporation into state regulation through the NASAA UFOC Guidelines is specifically discussed in more detail below.ⁿ⁷ It is clear, however, that fundamental concerns and objectives of Blue Sky regulation are generally present in regard to franchise or business opportunity offerings.

Although the emergence of specific state franchise or franchise "investment" laws has sharpened the focus of regulation and added a significant degree of predictability in the scope and application of regulation for those engaged in franchising, these laws have not supplanted state Blue Sky laws. Franchises and business opportunities may still be scrutinized under Blue Sky laws where they in fact create investment contracts or constitute securities under "risk capital" or any other analyses available under the definition of "security" that is a part of every state securities law.

This chapter examines the role of Blue Sky regulation in the areas of franchising and business opportunities. Although § 17.02 below discusses state regulation in the area generally, it is not intended to be an exposition of state franchise law. Rather, the essential point for practitioners is to understand both the interrelationship and the differences between targeted state regulation of franchise or business opportunity offerings and state securities regulation. As explained below, the critical consideration is the application of Blue Sky laws in these settings without regard to specific franchise or business opportunity laws, and to be aware of the elements of a "security" transaction as they continue to apply.

As a prelude to assessment of the role of state securities laws in the offer and sale of franchises or business opportunities it is also important to understand their application in the sale of a "business" generally. In that context the basic notion of investor protection that drives applications of Blue Sky laws today is best understood. Accordingly, in § 17.03 Blue Sky laws in the circumstances of a sale of a "business" generally are discussed, followed in § 17.04 by specific consideration of investment contract and risk capital approaches to the creation and offering of franchises and business opportunities.

FOOTNOTES:

(n1)Footnote 1. The definition of "security" is thoroughly considered in Chapter 2, *supra*. The treatment of unconventional forms of securities under the broad notion of "investment contract" that is found in all federal and state definition provisions was spawned by the U.S. Supreme Court decision in *SEC v. W.J. Howey Co.*, 320 U.S. 344, 64 S.Ct. 120, 88 L.Ed. 88 (1943), which became the benchmark for evaluation of many forms of business opportunities that in reality were passive investment programs that evoked concern for basic securities law protections. *Howey* and its "risk capital" state law progeny as applied specifically to franchises and business opportunities are discussed in more detail in § 17.03. *infra*.

(n2)Footnote 2. *Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures*, 16 C.F.R. Part 436 (Rev. 1981). The original FTC Franchise Rule has since been amended to streamline the Rule, minimize compliance costs, and to respond to changes in new technology and market conditions in the offer and sale of franchises. This amendment, referred to throughout this chapter as the "FTC 2007 Franchise Rule," is discussed specifically in § 17.03[1], *infra*.

See also NASAA Model Franchise Investment Act, *CCH NASAA Reports* P 4303 (Aug. 30, 1990).

(n3)Footnote 3. Cal. Codes §§ 31000-31516.

(n4)Footnote 4. *See, e.g.*, Florida: *Fla. Stat. §§ 559.80, et seq.* (Sale of Business Opportunities Act).

(n5)Footnote 5. 16 C.F.R. Part 436, as amended, 72 FR 15444 (Mar. 20, 2007).

(n6)Footnote 6. *Instructions for Filing a Uniform Franchise Registration Application Using the "New FTC Franchise Rule" after July 1, 2007*, *CCH NASAA Reports* P 3947 (2007).

(n7)Footnote 7. *See* § 17.03, *infra*.



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Blue Sky Regulation

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CHAPTER 17 Franchising and Business Opportunities

2-17 Blue Sky Regulation § 17.02

§ 17.02 State Regulation

As discussed throughout this treatise, the mission of state Blue Sky laws has always been to protect the public against "unsubstantial, unlawful and fraudulent stock and investment schemes."⁸ Myriad scams and schemes for separating people from their money have constantly mixed with legitimate undertakings in capital formation for the pursuit of worthy and desirable business ventures and the promotion of serious entrepreneurship. State and federal securities regulators have closely scrutinized "business" opportunities in which would-be entrepreneurs are lured to pay significant sums over to a promoter on the promise of high returns for little or no work. In chapter 2 many of the business schemes or programs that in reality create *investment* rather than entrepreneurial risk are examined under the catch-all categories of "investment contract" or "certificate of interest or participation in any profit-sharing agreement" found in all statutory definitions of a "security" are examined. In carrying out the mission of Blue Sky laws, states have been especially cognizant of the difference between an entrepreneurial undertaking in which success or failure of an enterprise is a function of actual managerial control of the conduct of the business and what is, in contrast, a passive investment scheme in which the invested capital is subjected to risks over which the provider has no meaningful control. Indeed, the notion is written directly into some state Blue Sky laws. In the State of Washington, for example, the definition of "security" in the Blue Sky law specifically includes an:

[i]nvestment of money or other consideration in the risk capital of a venture with the expectation of some valuable benefit to the investor where the investor does not receive the right to exercise practical and actual control over the managerial decisions of the venture.⁹

This "risk capital" approach to defining the existence of a security is a mainstay along with investment contract analysis in state securities regulation.¹⁰

Franchises or business opportunities offered through mass marketing to the general public have in many instances demonstrated these characteristics that evoke concern for investor protection. As discussed below, although the greater focus today is on protection of purchasers through "Business Opportunity" laws, these schemes may still remain subject to Blue Sky protections under traditional investment contract and risk capital analysis when only a passive investment is evidenced. On the other hand, state courts were unwilling to extend securities law protections to franchise and business opportunity settings that involved some meaningful opportunity, or burden, upon the purchaser to be responsible in the operation of the business or enterprise and to devote time, energy and effort in making it a success. Thus, for example, in *Burke v. State* ¹¹ an Alabama appellate court reversed the criminal conviction of a defendant under the state Blue Sky law in connection with the offer and sale of satellite laboratory testing franchises in which it was claimed that the inexperienced purchaser/franchisees were dependent upon the managerial and technical expertise of the franchisor who

would actually conduct testing. The court concluded that although responsibility and expertise in technical testing aspects of the business rested elsewhere, the franchisee was required to exercise effort in sales, marketing and operation of the collection station for tests to be submitted to the franchisor laboratory. While the operation of the business was dependent upon the ability of the franchisor laboratory to meet its obligations and essential functions, the success of the individual enterprise was a function of the marketing and selling initiatives of the franchisee.ⁿ¹²

Burke illustrates an evolving limitation in defining the scope of state securities law protections. Franchise and business opportunities may involve a clear community of interest between the franchisee/purchaser and the franchisor that is central to the success of the business, but the essential notion of risk capital or investment risk that is a function of the separation of the "investor" from the essential determinants of risk of the enterprise is missing. A dilemma follows, because the offer and sale of franchises and business opportunities often involved all other characteristics such as the absence of information, abusive selling practices and terms, and outright fraud that are addressed by securities laws. Thus today the state regulatory landscape includes a more targeted response to the potential for fraud and abuse in the franchise and business opportunity offering setting. The states' response with specific "franchise" or "franchise investment" laws recognizes that despite the community of interest that may be a central part of the relationship between a franchisee and franchisor, the concern for the type of protections afforded by securities laws are not substantially lessened.ⁿ¹³ State franchise or franchise-related laws thus extend the scope of protection through definitions such as in Minnesota, as follows:

"Franchise" means (1) a contract or agreement, either express or implied, whether oral or written, for a definite or indefinite period, between two or more persons:

(i) by which a franchisee is granted the right to engage in the business of offering or distributing goods or services using the franchisor's trade name, trademark, service mark, logotype, advertising, or other commercial symbol or related characteristics;

(ii) in which the franchisor and franchisee have a community of interest in the marketing of goods or services at wholesale, retail, by lease, agreement, or otherwise; and

(iii) for which the franchisee pays, directly or indirectly, a franchise fee.ⁿ¹⁴

"Community of interest" for purposes of applying state franchise protection laws is broadly defined. In *Martin Investors, Inc. v. Vander Bie*,ⁿ¹⁵ the Minnesota Supreme Court concluded that a contract entered into by a "consultant" with a company engaged in the sale of a computer service matching the needs of potential borrowers to potential lenders throughout the country was an unregistered franchise. Under the contract the consultant acted as an intermediary who sold the computer matching service to potential borrowers by gathering information and who, upon payment of a fee, submitted the information to the company for matching with lenders through the company's database. Holding that the contract between the intermediary and the company was a franchise, and thus affirming application of franchise law remedies, the Court concluded that there was a community of interest between the plaintiff and the company in the on-going relationship that was contemplated and from which each would share in fees from a common source. The computer databank was the common source of the service provided by the franchisor and franchisee. The fact that the franchisor company was entitled to receive only one per cent of the proceeds of any loan placed by the "consultant" did not defeat the community of interest, as no substantiality requirement is part of the statutory definition.ⁿ¹⁶

Some state level guidance in determining whether a particular arrangement constitutes a franchise is available, see, e.g., "When Does an Agreement Constitute a Franchise?," Cal. Dept. of Corporations Rel. No. 3-F (Revised) (June 22, 1994).

Although a majority of states have not adopted laws regulating franchising itself, several have adopted franchise registration and disclosure laws which in operation are not unlike Blue Sky laws applicable to the offer and sale of securities.ⁿ¹⁷ Other states have adopted legislation regulating aspects of the franchise relationship, including

termination. Twenty-two states have adopted legislation regulating the offer and sale of a business opportunity and as discussed below these laws may also be applicable also to franchise agreements when there is no specific state franchise law. It should be noted that in addition to the above laws there is legislation in some states that is industry specific, such as that applicable to gasoline retail and distribution franchises. Where franchise laws exist, they have closed the regulatory gap by a registration and mandated disclosure process, by establishing antifraud protections, and by imposing civil and criminal liabilities. Registration or application procedures closely parallel state procedures under Blue Sky laws, and, absent exemption, involve the same kind of administrative review and authority.ⁿ¹⁸ State "business opportunity laws" evolved separately from earlier franchise laws, and more recently. Many states have enacted them to expand the scope of protection even more broadly in those areas in which Blue Sky laws would not be available.

"Business opportunity" is typically defined in state laws in accordance with the North American Securities Administrators Association (NASAA) Model Business Opportunities Sales Act as:

[A] contract or agreement, between a seller and a purchaser, express or implied, orally or in writing, wherein it is agreed that the seller or a person recommended by the seller shall provide to the purchaser any product, equipment, supplies or services enabling the purchaser to start a business when the purchaser is required to make a payment to the seller or a person recommended by the seller of more than \$500 and the seller represents directly or indirectly, orally or in writing, that:

- (1) The seller or a person recommended by the seller will provide or assist the purchaser in finding locations for the use or operation of vending machines, racks, display cases or other similar devices, on premises neither owned nor leased by the purchaser or seller;
- (2) The seller or a person recommended by the seller will provide or assist the purchaser in finding outlets or accounts for the purchaser's products or services;
- (3) The seller or a person specified by the seller will purchase any or all products made, produced, fabricated, grown, bred or modified by the purchaser;
- (4) The seller guarantees that the purchaser will derive income from the business which exceeds the price paid to the seller;
- (5) The seller will refund all or part of the price paid to the seller, or repurchase any of the products, equipment or supplies provided by the seller or a person recommended by the seller, if the purchaser is dissatisfied with the business; or
- (6) The seller will provide a marketing plan, provided that this Law shall not apply to the sale of a marketing plan made in conjunction with the licensing of a federally registered trademark or federally registered service mark.ⁿ¹⁹

The offer and sale of "business opportunities" has most often involved the sale of seller assisted marketing plans associated with vending machines or work-at-home programs. Often the purchasers of seller assisted marketing plans are individuals who are inexperienced in business matters, and who use savings to purchase the plans in the hope of earning money in addition to retirement income or salary to become self-sufficient. Purchasers include the elderly who are seeking to supplement fixed incomes. Typical mechanics of a business opportunity involve purchasing equipment or products, often overpriced, in circumstances in which the purchaser has not received full and fair information regarding the seller assisted plan, the amount of money the purchaser could reasonably expect to earn, and the previous experience of the marketing plan seller.

Much the same as with franchises, state regulation of the offer and sale of business opportunities is aimed at providing prospective marketing plan purchasers with the information needed to make intelligent decisions regarding the seller

assisted plans being offered. State laws thus require adequate disclosure, prohibit representations that tend to mislead, and prohibit or restrict unfair contract terms.

The central feature of state business opportunity laws is a mandated structured disclosure document. The disclosure document, clearly akin to a prospectus, must present various categories of information about the seller, people responsible for the seller's business activities, the business history of the seller and its financial condition. There must be a full and detailed description of the actual services that the business opportunity seller undertakes to perform for the purchaser. If representations are made concerning sales or earnings, or a range of sales or earnings that may be made through the business opportunity, information must also be included regarding the number of purchasers who have actually achieved such results relative to the total number of purchasers within three years prior to the date of the disclosure statement.ⁿ²⁰

State business opportunity laws also impose requirements for the contracts or agreements utilized in the programs. Requirements go to both content and form.ⁿ²¹ Contracts and agreements are a key part of the registration materials that are filed in connection with business opportunities, and there is overarching the process in many states the ultimate authority of the administrator to deny, suspend or revoke a registration on numerous grounds, not the least of which is a finding that the business opportunity or the offering of the business opportunity has worked or tended to work a fraud upon purchasers or would operate to work such a fraud.ⁿ²²

Administration of state business opportunity laws, as well as franchise laws, is often delegated to the securities administrator of the state, or to the cabinet level department in which securities regulation is also a part. Alternatively, some states assign administrative responsibility to the insurance regulatory authority, or to a consumer protection division of the state Attorney General's office. The common thread of regulatory mission and mechanics as between state securities regulation and regulation of the offer and sale of franchises or business opportunities is apparent. However, unlike the restrictions now imposed on merit regulatory authority of state securities administrators in the wake of NSMIA, state regulatory authority in regard to franchises and business opportunities is largely unfettered, and where registration requirements are imposed, state administrators approach them in much the same fashion as traditional Blue Sky law review of securities offerings.

In many states enforcement powers under state business opportunity laws also parallel those available under Blue Sky laws. Upon a determination that a person has engaged, is engaging, or is about to engage in any act or practice constituting a violation of the law (or any rule or order issued under it) administrators may summarily issue cease and desist orders, or orders requiring other affirmative remedial action. Administrators have public and private investigative authority, and may also pursue injunctive actions in which ancillary relief such as the appointment of a receiver or conservator is specifically available.ⁿ²³

Private remedies under business opportunity laws are equally meaningful and, again, in most instances track the remedies available to purchasers of securities in transactions violating Blue Sky laws. Rescission of contracts or agreements is available, as well as actual damages, plus interest and attorneys fees. Controlling person liability is often imposed, and some statutes permit a direct action against the surety of a seller's bond to recover up to the amount of the bond.ⁿ²⁴

The advent of state franchise and business opportunity sales laws has shifted attention away from application of Blue Sky laws in those settings. The offer and sale of franchises and business opportunities are significantly regulated, and in a manner much akin to securities regulation.ⁿ²⁵ However, Blue Sky laws continue to play a role in the area. First, the sale of a "business" that may be excluded from coverage of business opportunity laws may nevertheless be subject to state securities laws simply because it is effectuated with a sale of stock. Secondly, franchise and business opportunity laws operate to expand protections available to purchasers. They do not exclude coverage of Blue Sky laws where an application of "investment contract" or "risk capital" analysis independently dictates the presence of a security and the need for securities law protections. Each of these points is considered further in § 17.05.

FOOTNOTES:

(n1)Footnote 8. *People v. Figueroa*, 41 Cal.3d 714, 736 (1986) .

(n2)Footnote 9. *R.C.W. § 21.20.005(12)*.

(n3)Footnote 10. For closer consideration of "risk capital" analysis in the franchise and business opportunity setting, see Chapter 14, *infra*.

(n4)Footnote 11. 385 So.2d 643, 1979 Ala. Crim. App. LEXIS 1461 (Ala. Crim. App. 1979) .

(n5)Footnote 12. See also *Brown v. Computer Credit System, Inc.*, 128 Ga. App. 429, 197 S.E.2d 165, 1973 Ga. App. LEXIS 1503 (Ga. App. 1973) . In *Brown*, the franchise agreement provided that the only way for the franchisee to realize profits was to sell services. There was no right to participate in profits or losses outside of sales by the franchisee and, as a result, no investment contract was created for purposes of applying protections of the Georgia Blue Sky law.

(n6)Footnote 13. As part of the California Franchise Investment Law, the legislature included this specific statement of the need for regulation:

The Legislature hereby finds and declares that the widespread sale of franchises is a relatively new form of business which has created numerous problems both from an investment and a business point of view in the State of California. Prior to the enactment of this division, the sale of franchises was regulated only to the limited extent to which the Corporate Securities Law of 1968 applied to such transactions. California franchisees have suffered substantial losses where the franchisor or his representative has not provided full and complete information regarding the franchisor-franchisee relationship, the details of the contract between franchisor and franchisee, and the prior business experience of the franchisor.

It is the intent of this law to provide each prospective franchisee with the information necessary to make an intelligent decision regarding franchises being offered. Further, it is the intent of this law to prohibit the sale of franchises where such sale would lead to fraud or a likelihood that the franchisor's promises would not be fulfilled, and to protect the franchisor by providing a better understanding of the relationship between the franchisor and franchisee with regard to their business relationship. *Cal. Corp. Code § 31001*.

(n7)Footnote 14. *Minn. Stat. § 80C.01, Subd. 4(a)(1)*; see also *Cal. Corp. Code § 31005(a)*.

As defined in the NASAA Model Franchise Investment Act, "Franchise" means:

(i) an oral or written agreement, either express or implied, which:

(A) grants the right to distribute goods or services under a marketing plan prescribed or suggested in substantial part by the franchisor;

(B) requires payment of a franchise fee to a franchisor or its affiliate; and

(C) allows the franchise business to be substantially associated with a trademark, service mark, trade name, logotype, advertising or other commercial symbol of or designating the franchisor or its affiliate;
or

(ii) a master franchise

See NASAA Model Franchise Investment Act § 3(g), CCH NASAA Reports P 3145 (Aug. 30, 1990).

(n8)Footnote 15. 269 N.W.2d 868, 1978 Minn. LEXIS 1287 (1978) .

(n9)Footnote 16. 269 N.W.2d at 874-875 .

(n10)Footnote 17. In some states these are derived from the NASAA Model Franchise Investment Act, adopted in 1990, *see* CCH NASAA Reports P 4303, at 3145 (Aug. 30, 1990).

(n11)Footnote 18. *See, e.g.*, Indiana: Ind. Code §§ 3140.10 (Registration Application Contents); 3140.14 (Registration Stop Order).

(n12)Footnote 19. Illinois Business Opportunity Sales Law of 1995, Ill. Comp. Stat. Ch. 815 § 602/5-5.10(a).

Business opportunity laws exclude certain transactions from the definition. For example, the sale of an on-going business is excluded when the owner of that business sells and intends to sell only that one business opportunity. Employment relationships are also excluded, as are memberships in bona fide cooperative associations. Additionally, offers and sales of a business opportunity by certain large, well-capitalized sellers that are publicly traded companies reporting companies under the federal securities laws are excluded, *see, e.g.*, Georgia: Code Ga. § 10-1-410(2)(B).

The NASAA Model Rule, which forms the basis for many state business opportunity laws, is specifically discussed in § 17.03[3], *infra*.

(n13)Footnote 20. *See, e.g.*, Florida: Fla. Stat. § 559.803.

Making such representations may also trigger bonding or security requirements. In Florida, for example, if the business opportunity seller makes any representation amounting to a guarantee that the purchaser will derive income from the business opportunity which exceeds the price paid or rent charged for the opportunity, or that the purchaser may secure a refund if not satisfied, the seller must have a surety bond, or have established a certificate of deposit or guaranteed letter of credit in the amount of at least \$50,000. *See Fla. Stat. § 559.807*.

(n14)Footnote 21. In Iowa, for example, the required elements of a contract or agreement in connection with the offer and sale of a business opportunity must be set out in at least ten point type or equivalent size, *see* Iowa Code § 523B.2.9.

(n15)Footnote 22. *See, e.g.*, Illinois: Ill. Stat. Ch 815, § 5-45(5).

(n16)Footnote 23. *See, e.g.*, Iowa: Iowa Code § 523B.8. The most broadly stated powers of the administrator are a part of those business opportunity laws derived from the Model Business Opportunity Sales Act, the provisions of which are expressly based on the Uniform Securities Act.

(n17)Footnote 24. The Indiana Business Opportunity Transactions Law creates a right to void the contract and to receive back all consideration paid to the seller within one year of the date of the contract if the seller engages in any fraud or deception, fails to deliver goods or services necessary to begin operation of the business, or violates the contract form and content requirements. Ind. Code, tit. 24, ch. 8 § 16. Indiana further provides:

Notwithstanding any other section of this chapter, a person who is damaged by a seller's failure to comply with this chapter or by a seller's breach of a contract may:

- (1) bring an action for recovery of his actual damages including attorney fees; and
- (2) bring an action against the bond required by section 3 of this chapter;

to recover an amount equal to his actual damages. However, the liability of the seller under this section may not exceed the amount of the bond. Ind. Code, tit. 24, ch.8 § 17.

(n18)Footnote 25. Franchise investment laws are modeled directly on securities laws, and it follows that securities law principles are applied in the assessment of their scope and authority. In *Courtney v. Waring*, 191 Cal. App.3d, 237 Cal. Rptr. 233, 1987 Cal. App. LEXIS (Cal. App. 1987), for example, the court noted that the California Franchise Investment Law was modeled on the Federal Securities Act of 1933, and looked to federal precedent addressing the scope of "offer and sale" of a security under that Act to determine whether a franchise had been offered and sold in violation of the Franchise Investment Law.



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CHAPTER 17 Franchising and Business Opportunities

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§ 17.03 The 2007 Federal Franchise Rule and NASAA Guidelines

[1] The FTC 2007 Franchise Rule

The FTC 2007 Franchise Rule,ⁿ²⁶ which became effective July 1, 2007, amended the Commission's Rule entitled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures. The principal focus of the FTC 2007 Franchise Rule is on disclosure. Based on an extensive regulatory analysis the Commission concluded that misunderstandings about franchise relationships are prevalent, and that more disclosure is warranted to ensure that prospective franchisees are not deceived about the quality of the franchise relationship before they commit to buying a franchise. The original FTC Rule was also aimed at preventing deceptive and unfair practices through pre-sale disclosure of material information necessary to make an informed purchasing decision, and also to prohibit certain misrepresentations. The 2007 Rule expands pre-sale disclosures to address franchise relationship issues more effectively.

Another important goal of the FTC 2007 Rule was to reduce inconsistencies between federal and state pre-sale disclosure requirements. As discussed in § 17.03[2] below, the North American Securities Administrators Association (NASAA) had developed a standard disclosure document the Uniform Franchise Offering Circular ("UFOC") as part of Guidelines adopted in 1993. After NASAA adopted the UFOC Guidelines fifteen states required franchisors to follow the UFOC to comply with state franchise laws. The FTC, as a matter of its own policy, permitted franchisors to comply with the former FTC Rule by furnishing prospective franchisees with a UFOC, including in states that had not adopted the NASAA Guidelines. Use of the UFOC became widespread, and in its regulatory analysis ahead of adopting the 2007 Rule the Commission noted that the UFOC was in fact used by the vast majority of franchisors to comply with the federal rule, and that the UFOC had become a *de facto* national franchise industry standard.ⁿ²⁷ The new FTC Rule was designed to closely track the NASAA UFOC Guidelines, although it omits or streamlines certain UFOC disclosure requirements that the Commission believed to be unnecessary or overly burdensome. The FTC Rule also retained certain elements of the original Franchise Rule that are not contained in the UFOC Guidelines.

Key elements of the FTC 2007 Rule are the obligation to furnish a disclosure document and the content of the disclosure document. As an over-arching consideration, the disclosure requirements of the new Rule apply only to franchises to be located within the United States or its territories. Franchisors are obligated to furnish prospective franchisees with disclosure documents no later than 14 calendar days before the execution of a franchise agreement or the payment of any fee in connection with the franchise sale.ⁿ²⁸ The new rule specifies what actions constitute

furnishing required documents, including the use of electronic media.ⁿ²⁹

The Rule provides specifically what substantive disclosures and attachments franchisors must include in their disclosure documents.ⁿ³⁰ Various items detailed for disclosure include:

- The franchisor and any parents, predecessors and affiliates
- Business experience of the franchisor's directors, trustee, general partnerships and certain executives
- Certain pending and prior litigation, injunctive or restrictive orders
- Prior bankruptcies, including any parent's bankruptcy
- Initial fees
- Other fees
- Estimated initial investment
- Restrictions on sources of products and services
- Franchisee obligations
- Financing
- Franchisor's assistance, advertising, systems and training
- Territory and sales restrictions
- Trademarks, patents, copyrights and proprietary information
- Renewal, termination, transfer and dispute resolution
- Involvement of public figures
- Financial performance representations
- Outlets and franchisee information
- All relevant contracts

The FTC Rule also requires that franchisors disclose three years of audited financial statements prepared in accordance with GAAP, and newly incorporates the UFOC requirement that financial disclosures be in tabular form that compares at least two fiscal years.ⁿ³¹ There is, however an audited financial statement "phase in" period for start-up franchise systems. There are updating requirements applicable to several of these disclosure subjects.

The FTC 2007 Rule also identifies nine prohibited acts and practices. They include four contained in the original Rule. Those are: (1) making statements that contradict the franchisor's disclosures; (2) making financial performance representations without a reasonable basis and written substantiation of the representation at the time the representation is made; (3) failing to make available written substantiation for any financial performance representations; and (4)

failing to make promised refunds. Added to those in 2007 are two new prohibitions relating to furnishing disclosures. The first now prohibits franchise sellers from failing to furnish a copy of the basic disclosure document to prospective franchisees early in the sales process upon reasonable request.ⁿ³² The second addition prohibits franchise sellers from failing to furnish a prospective franchisee who has already received the basic disclosure document with a copy of any updated disclosure document or quarterly update to an existing disclosure document upon reasonable request before the prospective franchisee signs a franchise agreement.ⁿ³³

The Rule also adds two new antifraud provisions designed to preserve the integrity of the disclosure document and franchise agreement. The first prohibits franchise sellers from materially altering the terms and conditions of any franchise agreement presented to a prospective franchisee for signing, unless the seller informs the prospective franchisee of the changes at least seven days before execution of the agreement.ⁿ³⁴ The second prohibits sellers from disclaiming or requiring a franchisee to waive reliance on any representation made in a disclosure document or its exhibits or attachments.ⁿ³⁵ Finally, the 2007 Rule adds a new "anti-shill" prohibition designed to prevent the use of paid testimonials or shill references. The rule prohibits franchise sellers from misrepresenting that any person has purchased or operated a similar franchise from the franchisor, or that any person can provide an independent and reliable report about the franchise or the experiences of any current or former franchisees.ⁿ³⁶

The original FTC Franchise Rule separated the offer and sale of "business opportunities" from the franchise provisions.ⁿ³⁷ The FTC 2007 Rule continues to do so, but makes the separation more precise by including a new definition of "business opportunity" that eliminates all references to franchises. Now, under section 437.2(a) of the 2007 Rule, a "business opportunity" is a commercial relationship created by any arrangement that involves the sale of goods, commodities or services supplied by another person with whom the purchaser is either required to do business or where the third person is affiliated with the seller, and the seller secures outlets, locations, sites for vending machines, rack displays or other product displays. The definition also applies in circumstances in which the seller provides to the purchaser the services of a person able to secure retail outlets, accounts, sites or locations, and the purchaser is obligated to make a payment or commitment to pay the seller or a person affiliated with the seller.ⁿ³⁸ The disclosure requirements and prohibitions of the original Business Opportunity Rule all remain the same.

[2] NASAA UFOC Guidelines

The NASAA Uniform Franchise Offering Circular Guidelines were adopted in April 1993 as a disclosure format for use in states requiring franchise registration statements. These states mandate that franchise registration application include a disclosure document. After adoption of the NASAA Guidelines some 15 states required franchisors to follow the UFOC format, and most franchisors elected to prepare their disclosure documents in conformity the UFOC whether or not specifically required to do so in any state. As noted above, the UFOC became the *de facto* national standard for franchise disclosure documents. Following adoption of the FTC 2007 Franchise Rule, NASAA revisited its UFOC Guidelines with a view to harmonizing them with the new federal rule. In fact, NASAA adopted the disclosure requirements of the FTC 2007 Franchise Rule as a successor to the UFOC Guidelines. It did not, however, adopt an actual replacement for the UFOC Guidelines, and until such time as a replacement is adopted, NASAA issued "Instructions for Filing a Uniform Franchise Registration Application" for use after July 1, 2007.ⁿ³⁹

The NASAA UFOC Guidelines have been supplemented with the adoption of the disclosure requirements of the FTC 2007 Rule, which closely track the UFOC Guidelines that were already in place. However, the FTC 2007 Rule is not identical to the UFOC Guidelines. The FTC Rule is narrower, for example, in not requiring cover page risk factors, disclosures pertaining to brokers, or detailed disclosures to franchisees' computer equipment requirements. Also, the FTC Rule permits a phase-in of audited financial statements in franchise start-up situations. The FTC Rule further addressed a problem identified with the UFOC Guidelines in regard to disclosure of franchise statistics, which the FTC concluded resulted in inflated turnover rates. On the other hand, the new FTC Rule is broader than the UFOC Guidelines in certain respects. The FTC Rule requires greater disclosure of information concerning such things as (1) franchisor-initiated litigation against franchisees; (2) protected territories; (3) the use of confidentiality clauses; and (4)

trademark-specific franchisee associations.ⁿ⁴⁰

NASAA has adopted the FTC 2007 Rule disclosure requirements with certain additional requirements that arise out of these differences. Most notably, the NASAA requirement for a state risk factor cover page to the disclosure document is retained. The state cover page must, in capital letters, disclose risk factors to the extent applicable. These are (1) That the franchise agreement includes a mandatory dispute resolution provision that may require out-of-state proceedings, which may affect costs and force a less favorable settlement; (2) Any other risk factor that is required by a state administrator as, for example, a choice of law provision that could alter protections available under local law; and (3) If one or more risk factors applies, a further statement that there may be other risks concerning the franchise.ⁿ⁴¹ Another additional requirement not contained in the FTC 2007 Rule is that which, if applicable under particular state law, requires a franchisor to provide the disclosure document earlier than the 14 days now provided in the FTC Rule, provided the franchisor adds a statement to the receipt page of the disclosure document to accurately reflect state law requirements to deliver the disclosure document.ⁿ⁴²

Consistent with its adoption of the FTC 2007 Franchise Rule disclosure requirements, NASAA has recommended that all states requiring registration statements or applications regarding franchises permit franchisors to file in those states using disclosure documents prepared in accordance with the FTC 2007 Rule in accordance with the NASAA Instructions. The NASAA UFOC Guidelines will remain available for use until July 1, 2008. Franchisors should note that compliance with the UFOC Guidelines involves more than using the prescribed Uniform Franchise Disclosure Document. Franchisors must continue to file application documents as prescribed by the NASAA Instructions, and which include:

- A Uniform Franchise Registration Application Page;
- Supplemental information page(s);
- A Certification Page;
- A Sales Agent Disclosure Form;
- An authorizing Resolution, as applicable;
- The UFOC;
- An Application Fee;
- Auditor's Consent; and
- Advertising and Promotional Materials (if required in the state).

[3] The NASAA Model Business Opportunities Sales Act

NASAA has specifically addressed state regulation of "business opportunities" through the Model Business Opportunities Sales Act adopted in 1984, and which serves as the basis for a number of state business opportunity laws.ⁿ⁴³ There are several exclusions from the definition of "business opportunity" in the Act as, for example, the exclusion for the sale of an on-going business operated by the seller and to be sold in its entirety.ⁿ⁴⁴ Unless excluded, but subject to certain exemptions,ⁿ⁴⁵ the Model Act requires registration of business opportunities and imposes disclosure requirements. Registration is made using the Uniform Franchise Offering Circular (UFOC) or other disclosure document prepared in accordance with federal or state requirements. Under the Model Act registration may be denied on various grounds including the that the offering would work or tend to work a fraud upon purchasers.

Other criteria for denial of registration (or suspension or revocation of an effective registration) parallel those in Blue Sky laws applicable to securities registration. However, there are no applicable NASAA "guidelines" as such applicable to business opportunity offerings. If no stop order is issued or proceeding is commenced, a business opportunity registration automatically becomes effective ten business days after a complete filing.

The Disclosure requirements of the NASAA Model Rule prescribe the format and content of a mandated written disclosure document that must be used in the offering. The Model Act also includes requirements for providing the contract or agreement, as well as certain format requirements and required provisions.ⁿ⁴⁶ There are minimum net worth and bond requirements applicable to sellers. The Model Act contains a general antifraud provision and prescribes administrative and civil remedies, as well as criminal penalties for violations of it and other provisions of the Act. In one form or another, twenty-two states have adopted legislation regulating the offer and sale of business opportunities, and the NASAA Model Rule provides a common frame of reference.

FOOTNOTES:

(n1)Footnote 26. 16 C.F.R. Part 436, as amended, *72 FR 15444 (Mar. 30, 2007)* .

(n2)Footnote 27. See "Statement of Basis and Purpose" § I(D), *72 FR* at 15448 .

(n3)Footnote 28. FTC 2007 Franchise Rule § 436.2(a).

(n4)Footnote 29. *Id.*, § 436.2(c)

(n5)Footnote 30. *Id.*, §§ 435.3-436.5.

(n6)Footnote 31. *Id.*, § 436.5(u).

(n7)Footnote 32. *Id.*, § 436.9(3).

(n8)Footnote 33. *Id.*, § 436.9(f).

(n9)Footnote 34. *Id.*, § 436.9(g).

(n10)Footnote 35. *Id.*, § 436.9(h).

(n11)Footnote 36. *Id.*, 436.9(b). Based on its enforcement experience the Commission noted that shills are often the "glue" holding together a scam by allaying consumers' concerns about investment risk, see "Statement of Basis and Purpose," *72 FR* at 15531 .

(n12)Footnote 37. Business opportunity provisions comprised 16 C.F.R. Part 437 ("Disclosure Requirements and Prohibitions Concerning Business Opportunities").

(n13)Footnote 38. *16 C.F.R. Part 437.2(a)*, *71 FR* 15444, at 15538.

Part 437 of the 2007 Rule also adds a new exemption to the business opportunity regulatory provisions for business arrangements that comply with the Franchise Rule, or are exempt from compliance with the Franchise Rule, see § 437.2(3)(v). The change was designed to eliminate potential overlap and duplicative compliance burdens between the Franchise Rule and the Business Opportunity Rule as, for example, businesses exempt from the Franchise Rule pursuant to the "fractional franchise" exemption.

(n14)Footnote 39. CCH NASAA Reports P 3947 (July 2007). The complete NASAA "Instructions" are included with all other NASAA Guidelines collected in Volume 2, *infra*.

Franchise registration statements, which generally include substantial financial information regarding the franchisor are subject to review by the designated administrator and a determination, among other things, that the franchisor has the financial ability to fulfill its obligations to franchisees. Coordinated review for multi-state registration of franchise offerings under "CR-FRAN," a protocol established by NASAA. CR-FRAN is available to a franchisor filing an initial application to register its offering in two or more states. To be eligible for CR-FRAN, the franchisor's registration application must include audited financial statements.

(n15)Footnote 40. See 72 FR 15444 ("Supplementary Information").

In adopting the 2007 "Instructions" NASAA highlighted these differences as well:

The FTC's 2007 Franchise Rule adopts disclosure requirements that closely track the UFOC Guidelines. In some instances, however, the 2007 Franchise Rule omits or streamlines UFOC Guideline disclosure requirements, such as broker disclosures, cover page risk factors, and detailed computer requirements. In addition, the 2007 Franchise Rule incorporates new disclosure requirements not found in the UFOC Guidelines, including disclosures related to a franchisor's parent, franchisor initiated litigation, confidentiality clauses and the existence of trademark-specific franchisee associations. The 2007 Franchise Rule also substantially revised the UFOC Guideline disclosure of statistical information on franchisees and outlets (Item 20), adopting the approach suggested by NASAA in its comment to the FTC's Notice of Proposed Rulemaking. *CCH NASAA Reports* P 3947, at 2184 (July 2007).

(n16)Footnote 41. NASAA Instruction III B, *CCH NASAA Reports* P 3947, at 2185-2186 (July 2007). The NASAA Instructions include a sample state cover page.

(n17)Footnote 42. *Id.*, Instruction III C.

(n18)Footnote 43. "Business Opportunity" under the NASAA Model Act means a contract or agreement between a seller and purchaser, whether express or implied, orally or in writing, in which it is agreed that the seller or a person recommended by the seller will provide to the purchaser any products, equipment, supplies or services enabling the purchaser to start a business, and where the seller represents that:

- (a) The seller or a person recommended by the seller will provide or assist the purchaser in finding locations for the use or operation of vending machines, racks, display cases or other similar devices, on premises neither owned nor leased by the purchaser or seller;
- (b) The seller or a person recommended by the seller will provide or assist the purchaser in finding outlets or accounts for the purchaser's products or services;
- (c) The seller or a person specified by the seller will purchase any or all products made, produced, fabricated, grown, bred or modified by the purchaser;
- (d) The seller guarantees that the purchaser will derive income from the business which exceeds the price paid to the seller;
- (e) The seller will refund all or part of the price paid to the seller, or repurchase any of the products, equipment or supplies provided by the seller or a person recommended by the seller, if the purchaser is dissatisfied with the business; or
- (f) The seller will provide a marketing plan. *CCH NASAA Reports* P 4202, at 3101.

The NASAA Model Act does not apply when the business opportunity involved meets the definition of a "franchise" as set out in the Act, provided the seller meets specific disclosure and contract delivery requirements. State regulation of

offers and sales of business opportunities generally, including states with laws derived from the NASAA Model Rule, is discussed in § 17.02, *supra*.

NASAA has separately adopted the Model Franchise Act, CCH NASAA Reports P 4303, at 3145 (Aug. 30, 1990). The Model Franchise Act requires franchisors to provide a disclosure document containing the detailed information indicated above. In addition it requires state administrative agencies to review and approve the disclosed information and other information prior to all franchise offerings

(n19)Footnote 44. Other exclusions include the sale of a business opportunity to an on-going business where the seller is to provide products, equipment, supplies or services sold by the purchaser in connection with the purchaser's on-going business, or the sale of a business opportunity which is registered (or exempt from registration) under the state's franchise law or registered under the securities law. Offers and sales of a business opportunity which involves a marketing plan made in conjunction with the licensing of a federally registered trademark or federally registered service mark are excluded provided the seller meets certain net worth requirements.

(n20)Footnote 45. See Model Act § 200.

Exemptions from the registration and disclosure requirements are provided, for example, for the offer and sale of a business opportunity for which an immediate cash payment of at least \$25,000 is required, and that cash payment does not exceed 20% of the purchaser's liquid net worth. Another exemption applies when there is only a *de minimis* payment required. There are other exemptions based upon the seller's net worth, the purchaser's net worth, and the type of purchaser.

(n21)Footnote 46. The type of information that must be disclosed under state Business Opportunity laws generally is discussed in more detail in § 17.05[2], *infra*.



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Blue Sky Regulation

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CHAPTER 17 Franchising and Business Opportunities

2-17 Blue Sky Regulation § 17.04

§ 17.04 The Sale of a "Business"

The definition of "business opportunity" contained in the NASAA Model Act and all state business opportunity laws makes clear that the focus of intended protection is on marketing-induced expectations and the meaningful, if not essential, involvement of the seller of the business opportunity in supplying and/or supporting it. In this sense, the sale of franchises or business opportunities is different from the pure sale of an established business. Thus, as noted earlier, state business opportunity laws exclude certain transactions from the definition. The sale of an on-going business is typically excluded when the owner of a business sells and intends to sell only that one business opportunity. The sale of all or substantially all of the assets of an on-going business is also generally excluded.ⁿ⁴⁷

Business opportunity laws are clearly aimed at the widespread marketing of seller assisted programs for start-up business ventures, and not the conveyance of ownership of an on-going enterprise. It is important to understand, however, that although a transaction involving the sale of an entire "business" is normally outside the ambit of franchise and business opportunity laws, it may nevertheless be subject to Blue Sky laws if accomplished by means of a sale of the corporate stock of the acquired company.

Applying the literal, or "plain meaning" reading of the definition of security that was articulated by the United States Supreme Court in the companion cases of *Landreth Timber Co. v. Landreth* ⁿ⁴⁸ and *Gould v. Ruefenacht* ⁿ⁴⁹ under the federal securities laws, "stock" possessing all of the traditional characteristics or attributes of corporate stock is a security regardless of the transaction context in which it is involved. Most state courts have embraced *Landreth* and *Gould* as providing guidance in the application of Blue Sky laws to transactions involving the sale of a business. If stock involved in the transaction is "traditional" stock, *i.e.*, it bears the characteristics usually associated with corporate stock, a purchaser justifiably may assume that securities law protections will apply. Following the federal lead, a majority of state courts thus rejected the "sale of business" doctrine under which Blue Sky law protections were denied to purchasers of all or substantially all of a corporation's stock to acquire control of the business.ⁿ⁵⁰ The most immediate and meaningful consequence was the availability of Blue Sky antifraud provisions and private remedies in negotiated, private acquisition transactions.

Businesses are bought and sold, many as a result of intermediary activities and initiatives, in varied structural settings and in all sizes of transactions. Where accomplished by a transaction in corporate stock, the sale of a business may be subject to state securities law protections simply because the instrument of the transaction is a security. This type of offer or sale of a "business" is quite different from the mass marketing of franchises and seller assisted business opportunities more commonly discussed in regard to business opportunity sales laws. However, the sale of a "business" accomplished by a sale of traditional corporate stock falls within the scope of Blue Sky law remedies unless specifically

exempt, excluded or otherwise determined not to involve a security.ⁿ⁵¹

In *section 17.05 below* the basis upon which Blue Sky laws may yet be applied to the offer and franchises and business opportunities using investment contact and "risk capital" analysis is explored. One must be cognizant, however, of the fact that without regard to either analysis the offer and sale of a "business" may fall within the protective cover of state Blue Sky laws simply by reason of the instrument involved and the legitimate expectations for securities law protection it engenders.

FOOTNOTES:

(n1)Footnote 47. States may address the meaning of "ongoing business" for purposes of this exclusion. In South Carolina for example, a business is not considered an on-going business unless it has filed income tax returns with the state for at least one year. Code S.C. § 39-57-20(4).

(n2)Footnote 48. 471 U.S. 681, 105 S.Ct. 2287, 85 L.Ed.2d 692 (1985) .

(n3)Footnote 49. 471 U.S. 701, 105 S.Ct. 2308, 85 L.Ed.2d 708 (1985) .

(n4)Footnote 50. The treatment of traditional corporate stock as a security, and the manner in which state courts have either embraced or rejected the notion that Blue Sky law protections should be available in business acquisitions is discussed in much greater detail in Chapter 2-Definition of Security--*supra*, and specifically § 2.02 therein.

(n5)Footnote 51. As discussed in Chapter 2, some state courts have applied a joint venture or partnership gloss to "corporate" relationships, and have held that corporate stock in a transaction, regardless of its characteristics, is insignificant in relation to the direct contributions to the success of the enterprise by the persons who combine resources in the shared creation and operation of an enterprise. These courts refuse to extend the protection of the antifraud provisions of Blue Sky laws to the sale of corporate stock on a transaction that in reality involves only the creation of a partnership in corporate form.



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CHAPTER 17 Franchising and Business Opportunities

2-17 Blue Sky Regulation § 17.05

§ 17.05 Application of Blue Sky Laws to Franchising and Business Opportunities

In the context of franchises and business opportunities it is essential to identify the characteristics of a transaction and a set of relationships that differentiate "investment" transactions within the coverage of Blue Sky laws from straightforward commercial transactions involving the conveyance of property or the right to undertake an enterprise. This is, of course, the essential inquiry involved in determining the existence of any unconventional form of security using "investment contract" or "risk capital" analysis.ⁿ⁵² It is explored in depth in Chapter 2. However, in this specific context it is necessary more closely to examine subtle aspects of risk that bear directly on the determination whether Blue Sky protection will be available in the offer and sale of franchises or business opportunities.

The importance of isolating the essential element of risk is well illustrated by *Rzepka v. Michael*,ⁿ⁵³ in which a Michigan appellate court found no requisite element of "investment" risk for purposes of applying either the Blue Sky or Franchise Investment laws to transactions involving the sale of accounts receivable at a discount. In *Rzepka* an employment agency advertised high profit investment opportunities available from the purchase of its fee accounts receivable from clients at a discount. Purchasers entered into agreements with the agency under which they paid two thirds of the face value of the receivables in exchange for post dated checks of the agency in the face amount of the receivable plus an agreement by the agency to collect the receivables. By the arrangement the financially troubled employment agency was able to establish a six month payment program by which clients financed their fees. When the agency ceased operations and the receivables went uncollected, the purchaser sued for violations of the Michigan Franchise Investment Law and the Michigan Uniform Securities Law. Franchise claims were based on another aspect of the business relationship between the parties whereby the same persons who operated the employment agency also offered a "purchase option" by which purchasers were granted a first option to buy certain consumer discount books for resale in an assigned territory. Both claims were rejected.

In support of their securities law claims the plaintiff purchasers alleged that the receivables financing arrangement amounted to a security. Purchasers claimed that they provided capital to an enterprise, and were subjected to the risk of the enterprise failing. The court disagreed, and made a fundamental statement about the nature of risk that is essential to the presence of a security:

[T]he agreements at issue clearly set forth that plaintiff purchased, and Personnel sold, accounts receivable, with recourse, at a discount. Plaintiff received the accounts receivable in exchange for his capital. Regardless of what might happen to Personnel, plaintiff had a right to the proceeds of the

receivables. The plaintiff did not subject his capital to the risks of the enterprise. Rather, plaintiff subjected his capital to the risks that the receivables listed in the agreements, or others of equal value, would not eventually be paid.ⁿ⁵⁴

Further assessing the arrangements under "investment contract" principles, the court observed that the purchase of the receivables was more of an investment in those accounts rather than in a common enterprise with the agency.

As to the second aspect of the relationship between the parties, claims under the Michigan Franchise Investment Law were rejected on the conclusion that the "purchase option" conveyed to plaintiffs for resale of the coupon books did not amount to a franchise. The arrangement did not amount to a "marketing plan or system prescribed in substantial part by a franchisor" within the ambit of the statute, and, moreover, nothing about the "purchase option" addressed any right to use the seller's trademark, service mark, trade name, logo, advertising or other commercial symbol that designated by the seller, and the "fee" paid by plaintiff was not paid in exchange for the right to enter into a business under a franchise agreement.ⁿ⁵⁵

In this unified analysis of securities and franchise law principles the Michigan court well illustrated the baseline factor that today determines whether Blue Sky regulation and protections will apply in franchise and business opportunity settings, namely, *the nature and determinants of risk to which capital or value given up is subjected*. To be sure, this is not a new proposition. It is a part of all inquiries into the definition of a security and the identification of one present in any set of circumstances. But where franchises and business opportunities are the focal points, as a practical matter today it is in fact the only determinant. This is easily seen below in further consideration of the investment contract and risk capital "tests" that have been relied upon, either separately or together, to establish the scope of Blue Sky law protections in this setting.

[1] Investment Contract and Risk Capital Analysis

In Chapter 2 the application of both "investment contract" and "risk capital" tests in determining the existence of a security under state Blue Sky laws is considered at length. The risk capital test is the more flexible approach, and evolved almost entirely from state court analyses in the franchise, business opportunity or "membership" settings. The risk capital test, which some states have expressly incorporated into their statutory definitions of "security," ⁿ⁵⁶ involves four specific elements: (1) an investment of money or value; (2) in the risk capital of a venture; (3) with the expectation of some benefit; (4) where the investor has no direct control in the venture. Investment contract analysis, on the other hand, rests on the fact that profits from an enterprise will derive from the seller's or some third party's entrepreneurial or managerial efforts. Where a purchaser is required to make some significant effort toward the success of the operation in such a fashion as to retain meaningful control over realization of an expected return, the requisite separation of the purchaser from the determinants of return is missing. Both risk capital and investment contract tests focus on the extent to which a purchaser has control over success of the enterprise, but the risk capital approach places lesser emphasis on the extent of control of the enterprise itself and more on the fact that the capital invested by the purchaser is essential to financing the *seller's* enterprise, on which the purchaser is then dependent to a meaningful degree.

Analyzed under securities law principles, there are three forms of franchises and business opportunities to be considered:

- (1) The purchaser of the franchise or business opportunity participates only nominally in the enterprise, and receives or expects to receive profits;
- (2) The purchaser or franchisee is an active participant and, in return for his or her investment, receives goods and/or services from the franchisor/seller. In this situation the purchaser or franchisee must rely only on his or her own efforts for a return on the investment. The consideration paid for the

franchise or business opportunity is for the privilege of selling goods or services under the franchise name; and

(3) The circumstances are the same as (2) above, except that a substantial portion of the consideration paid by the franchisee/purchaser is to be used by the seller as capital without which the seller/franchisor could not supply goods or services, or otherwise meet obligations to the purchaser/franchisee.

These three settings form the basis of the discussion below, which explores the basis and extent to which Blue Sky laws afford investor protection in the offer and sale of franchises or business opportunities.

True franchises, which involve conveyance of the right to engage in a particular business enterprise with varying degrees of support and supply as well as intellectual property of the franchisor generally do not meet the investment contract test for the existence of a security because of the focus on the extent to which the franchisee is involved in the operation of the business.ⁿ⁵⁷ On the other hand, franchises in name only have been deemed to be investment contracts where the franchisee is in fact required to rely upon the franchisor or the efforts of others to generate profits.ⁿ⁵⁸

As between investment contract and risk capital analysis applied to franchises, the Oklahoma Securities Commission findings and conclusions in *In re Barter Systems, Inc.* ⁿ⁵⁹ are instructive. *Barter Systems* involved the offer and sale of franchise agreements under which the purchaser/franchisees were entitled to own a "barter trade exchange" in which participants could purchase, sell or exchange merchandise or services for "trade units" instead of money. The franchisor operated a nationwide network of the trade exchanges. The franchisor provided a training program designed to teach the concepts of barter trade to trade exchange franchisees and their respective employees. It also provided continuing consulting services and on-site training; a nationwide computerized trading network linking all of the franchised trade exchanges; a national marketing system to coordinate large-value trades; and a method of acquiring bulk quantities of imported and domestic products at bargain prices. Fees paid by franchisees obligated the franchisor to provide a computer terminal and access to the necessary software program, initial training as described above, advertising materials and a number of other resources. Franchisees were permitted to sell memberships and issue trade units. At the same time, the franchisor derived the vast majority of its income from the sale of franchises.

The Oklahoma Securities Commission concluded that the franchise agreements were securities under the risk capital definition provision contained in the Oklahoma Securities Act. Although the Commission found that it was not certain that a franchisee's initial risk capital, i.e., the franchise fees, was needed as the initial capital of the franchisor, it pointed out that in risk capital analysis attention is paid to *continuing risk capital* as well. The Commission embraced this observation of an Idaho appellate court:

[A] test which is restricted to the obtaining of initial capital only, is not a satisfactory test if the objective of the Securities Act to protect the investing public from unscrupulous promoters is to be served. Therefore, the term "Risk Capital" should not be construed to apply exclusively to "initial capital." The term should also apply to schemes to raise capital for existing but unproven business as well as schemes to raise initial capital.ⁿ⁶⁰

Following this analysis the Oklahoma Securities Commission opined that despite the fact that a franchisor has sufficient capital to furnish goods and services and to meet other obligations without the use of the capital invested by the franchisee, a security is still present if the franchisor would fail but for the continuing payment of money by franchisees from the sale of franchises. If the franchisor must use continuing invested capital to pay for the goods and services it is obligated to provide, or to repay debts incurred in meeting its obligations under the franchise agreements, then the franchisee's expectation of future success through the use of name and affiliation with the franchisor would have no meaning apart from the success of the entire franchise operation and the continued ability of the franchisor to meet its obligations.

Barter Systems illustrates the willingness of state securities regulators to probe more deeply into the notion of "risk capital" as needed to effectuate the protective goals of Blue Sky laws. An equal willingness has been shown in attempts to avoid application of risk capital analysis to franchise programs that do not involve entirely "passive" investments. A franchisee who acquires the right to offer and sell a product or service in an exclusive territory may be entirely in control of her business. However, if the subject of the franchise is dependent on continuing research and development effort of the franchisor, the value of the franchise is tied directly to the franchisor in a manner not at all unlike the fundamental notion first employed by the U.S. Supreme Court to find a security for purposes of the federal securities laws in *SEC. V. C.M. Joiner Leasing Corp.* n61 Thus, if a valuable benefit will accrue to a franchisee from successful research and development or other factors in the control of the franchisor that are critical to serial production of a product, for n62 example, n63 the fact that a franchisee maintains control over the ultimate sale or distribution is not so meaningful. This is particularly true if in exchange for payment of franchise fees the franchisee receives no ownership interest in research or development, or in design, patents or other intellectual property associated with the product or service.

Blue Sky enforcement initiatives today are much more likely to focus on "business opportunities" than franchises, as most franchises are today effectively regulated under specific state franchise laws. Still, what is offered as a franchise "investment" opportunity or program will in all likelihood be scrutinized under both sets of applicable laws and regulations. n64 More commonly today, however, the focus of Blue Sky laws is directed at the offer and sale of more generically defined business opportunities for which investment contract and risk capital analysis remain meaningful.

Although governing principles for application of investment contract or risk capital analysis remain the same, the Arizona enforcement action in *In re Hotel Connect LLC's 100-1100* n65 typifies the setting in which cases more commonly arise. In *Hotel Connect* the respondents offered and sold "business opportunities" consisting of the sale of wireless cash ticket machines n66 together with service agreements. Purchasers were to receive monthly payments resulting from a share of the profits generated from the operation of their equipment. They exercised no managerial or entrepreneurial duties in connection with their purchase, and never saw the equipment they bought. Their profits were dependent upon the services provided by the service company. The Arizona Securities Commission found that the equipment and agreements constituted securities and were offered by means of false or misleading representations and other acts in violation of antifraud provisions of the Arizona Securities Law. Restitution and other administrative penalties were ordered.

"Business opportunities" like those offered in *Hotel Connect*, or pay telephone n67 and other similar programs that are marketed as involving no work and high returns, are in most instances simply new forms of investment contracts in the mold first articulated under federal law in *SEC v. W.J. Howey & Co.* n68 that has brought myriad schemes and programs within the ambit of securities law protections. These programs involve some outright conveyance of a property interest coupled with a service or other agreement to which any expected return on the purchase or acquisition is practically tied.

In other situations, business-related "memberships" may be offered which carry or convey the right to some valuable expected benefit that rests within the control of another. The Idaho Securities Division has, for example, opined that physicians' memberships in a limited liability company formed for the purpose of performing various services for its members, including billing, collections and marketing programs, are securities using either investment contract or risk capital analysis. In *Eastern Idaho Physicians Organization P.L.L.C.* n69 the Division made clear again administrators will broadly define the elements of a security transaction in order to effectuate Blue Sky law protections. In this instance the Idaho Division addressed the meaning of "expectation of profit:"

The primary attraction for physician members seems to be increased efficiency from the group health care approach, reduced costs from having billings conducted by another group, and increased new business from the joint marketing anticipated by EIPO. Each of these, if realized, will increase the

profitability of the members. Thus, with the payment of a \$1,500 initial fee, and annual dues, members can expect to be able to reduce staff, increase efficiency and quality, and benefit from additional patients.

In our opinion, these qualify as expectations of profit. It does not matter that the profit will show up in increased revenue rather than increased value of the ownership interest.ⁿ⁷⁰

Outcome-oriented expectations are most commonly the product of marketing initiatives, and it is not surprising that state securities regulators focus more consistently on business opportunities offered indiscriminately to large audiences. The Internet makes such widespread solicitations simple and cost-effective, and the economic incentives to offer and sell opportunities are substantial. Enforcement actions relating to the offer and sale of customer-owned coin operated telephones with related service agreements, for example, have shown that seller commissions of 10% to 12% are common.ⁿ⁷¹ Most often such opportunities are marketed with emphasis on "investment" and the passive role of the purchaser.

The application of investment contract and risk capital analyses to franchises and business opportunities will always require a fact intensive inquiry. Realities of the situation will control determinations whether there is truly a passive "investment" in which there is a need for Blue Sky law protections and remedies rather than a genuine business undertaking in which the efforts of the purchaser are a meaningful determinant of success. It is safe to say that a typical business franchisee is not presumed to be a passive investor. To be sure, history has demonstrated that true franchisees face the risk of information failure and outright fraud in connection with entering into franchise agreements and undertaking a business enterprise in reliance on the ability of franchisors to satisfy legitimate expectations and meet contractual obligations. Nevertheless, *investor* protection under state Blue Sky laws turns on the fundamental notion that the purchaser of a "security" is positioned differently than a traditional franchisee in regard to the ability to control the enterprise and thus directly manage the risk. Concerns for investor protection may still arise in what is otherwise a traditional franchise setting if it is clear that a franchisee is supplying the risk capital for a venture the success of which depends on factors separate and apart from any efforts of the franchisee. The inquiry as applied more generally to the offer and sale of business opportunities is the same.

To find that a franchise or business opportunity constitutes a security is to subject the offer and sale to the full range of Blue Sky registration, disclosure and intermediary licensing requirements. Aspects of the Blue Sky regulatory process particularly impacting franchise and business opportunity offerings are summarized below.

[2] Registration, Disclosure and Intermediary Issues

Blue Sky laws uniformly prohibit the sale of non-NSMIA covered securities in any state that are not exempt from registration requirements, or that are not the subject of an exempt transaction unless the issuer complies with one of the available forms of registration. Compliance with registration requirements, and indeed compliance with requirements involved with most transactional exemptions that would most likely be utilized to carry out a limited offering of franchises or business opportunities deemed to be securities, entails significant disclosure obligations through the use of a prospectus or other form of offering circular or memorandum.

Blue Sky laws and rules or regulations adopted under them do not address specific disclosure requirements applicable to the offer and sale of franchises or business opportunities. However, with the emergence of parallel business opportunity disclosure laws in many states, ample guidance is available regarding the type of information that must be a part of any such offering. At a minimum these categories include:

(1) *Seller Information*. In addition to all basic identifying information, including information regarding all trademarks and service marks associated with the products, equipment, supplies or services to be offered, the business experience of the seller's current directors, executive officers, general partners, general managers and any other persons charged with responsibility for the seller's business activities is essential. Background information for any these people who have

been convicted of certain types of crimes, or who have been held liable in civil actions for fraud or for violating any state securities, franchise or business opportunity law must be included, as well as information concerning prior bankruptcies or insolvency proceedings. The business experience of the seller itself is required, including specific information regarding the length of time in which the seller has conducted the type of business involved, and the extent to which it has offered any other business opportunity or line of business. Very specific information concerning the seller's history with the specific franchise or business opportunity being offered is required, including such things as:

- The number of specific business opportunities being operated within a set historical period;
- The number of such business opportunities that were voluntarily terminated or not renewed by purchasers within a set historical period;
- The number of the business opportunities that the seller reacquired by purchase or otherwise, or that were cancelled or terminated by the seller during a set historical period, including general information concerning the reasons for reacquisitions, terminations, failures to renew and the numbers falling within certain categories.

Information concerning the seller also includes financial disclosures, such as the amount of revenue or consideration to be received by the seller or its affiliates from suppliers to purchasers in consideration for goods or services which the seller requires or advises the purchaser to obtain.

(2) *The Business Opportunity.* A complete factual description of the franchise or business opportunity must include a full and detailed description of the actual services or equipment that the seller undertakes to perform or supply to the purchaser, and the actual services which the purchaser undertakes to perform, including all that is required to comply with procedures established by the seller regarding the operation of the business. Disclosures in this area must also include material facts concerning any limitations on the goods or services that a purchaser may offer in the operation of the business, or on the customers to whom those goods or services may be sold. There must be clear disclosure of geographical or territorial limits, and the extent to which a purchaser is granted territorial protection and to what extent the seller may establish other franchises or business opportunities within a defined territory. A complete description of the franchise or business opportunity must also include a description of all real estate, services, supplies, products, inventories, signs, fixtures or equipment relating to establishing and operating the business.

Disclosure regarding the business opportunity must also include a full and accurate presentation of the total funds which the seller requires to be paid to start the business, and any recurring funds in connection with carrying on the business that the purchaser is required to pay to any person for any reason, including royalties, leases, advertising, training, signage, equipment or inventory purchases. Risk factors must also be disclosed. Specific risk factors which make the business opportunity one of high risk or of a speculative nature are particularly important, and may include even more information about the seller, its financial position, and its executives.

(3) *The Agreement.* Disclosure regarding the agreement to be entered into by a prospective purchaser/franchisee must fully and accurately describe:

- The term or duration of the agreement and whether and to what extent the term could be affected by any agreement other than the one in which the term is specified;
- The conditions under which the purchaser may renew or extend the agreement;
- The conditions under which the seller may refuse to renew or extend the agreement;
- The conditions under which the purchaser or seller may terminate the agreement;

- The obligations of the purchaser after termination of the agreement before or after the expiration of the term;
- The conditions under which the seller may repurchase and the terms on which any repurchase may occur;
- The ability of the purchaser to sell or assign all or any part of the business or the assets of the business, and on what terms;
- The conditions under which the seller may sell or assign any of its interest or obligations; and
- The provisions of any covenant not to compete that is associated with the business.

Disclosure must also be clearly made regarding the extent to which the seller requires or it is necessary that a purchaser must participate personally in the direct operation of the business.

(4) *Promises or Representations of the Seller Associated With the Business Opportunity.* Particular disclosure requirements associated with promises or statements made by a seller/franchisor that are critical in the assessment of the business opportunity being offered include, for example, if the seller offers an initial training program or informs prospective purchasers that it intends to provide such training: (a) the type and nature of such training; (b) the minimum amount of training that will be provided; and (c) the costs, if any, to be paid by the purchaser for such training. If the seller makes statements regarding estimated or projected business opportunity sales or earnings, full disclosure mandates including an explanation of all bases and assumptions underlying the estimate or projection and any supportive data. Also, statements concerning sales or earnings or a range of sales or earnings that may be achieved through the business opportunity must be accompanied by further disclosures regarding the number of other purchasers actually achieving such results in relation to the total number of purchasers during a set historical period.

If the seller promises specific services related to site selection or business opportunity outlets, particular information to be disclosed includes not only the full nature of those services, but also information concerning the seller's performance including, for example, disclosure of the range of time elapsed between signing an agreement and the commencement of a purchaser's business. As a general matter, where any start-up or initial services are to be provided by the seller, disclosure of time ranges with respect to each service in relation to actual start-up of the business is important.

Blue Sky law compliance would also entail the inclusion of various cautionary statements in regard to particular representations made by a seller as, for example, to make clear that there are no assurances that any purchaser will achieve projected sales or earnings, and that a purchaser must accept the risk of not achieving such results. Whether undertaken as a matter of Blue Sky disclosure compliance or under a state franchise or business opportunity law, this kind of structured disclosure enables a purchaser/investor to make an informed choice in the context in which there is a dependent relationship, to some meaningful degree, between the seller and purchaser/investors. The degree of dependence and the actual role to be played by a purchaser/investor in the operation of the business will ultimately depend whether the application of investment contract or risk capital principles will define the relationship as one involving the offer and sale of a security. As a practical matter, with the widespread adoption of state laws specifically governing the offer and sale franchises and business opportunities, there is, from both seller and purchaser/investor perspectives, little difference in the operation of the two sets of laws and compliance in either area. They are administered and enforced in the same manner, often by the same administrative agency, require registration, provide similar antifraud protections, and allow similar private remedies.ⁿ⁷²

State franchise and business opportunity laws do not involve any licensing requirement for intermediaries. Although for purposes of these laws "seller" is typically defined to include any agent or representative of a person engaged in the

business of selling or offering business opportunities, there is no requirement that any agent or representative be qualified by registration or licensing. For intermediaries, the application of state Blue Sky laws to the offering and sale of franchises or business opportunities is thus more significant, and it is not surprising that enforcement actions by state securities administrators focus not only on the offer and sale of unregistered securities by an issuer, but also the fact that intermediaries in the process are unregistered dealers, agents or salespersons.ⁿ⁷³ Also, private remedies under Blue Sky laws generally allow for recovery from a broad class of persons who aid or materially participate in a transaction that violates the statute in addition to the actual seller of the security. Thus, the range of potential liability for intermediaries is broader under Blue Sky laws than would otherwise be the case if only "seller" liability is the focal point under a franchise or business opportunity statute.

The creation of investment partnerships or entities for the purpose of acquiring a franchise adds a further dimension to consideration of the scope of liability under Blue Sky laws. A limited partnership, for example, formed through the efforts of a sub-franchisor or intermediary, to purchase a franchise would in most instances be deemed to be a security, subjecting the intermediaries involved to the full scope of enforcement and civil remedies under Blue Sky laws. The focal point, however, is not the offer or sale of the franchise. Rather, it is the separate creation of the investment partnership, and the offer and sale of interests in it that triggers the application of Blue Sky laws. Thus, in *Wade v. Skippers, Inc.* ⁿ⁷⁴ a federal court of appeals applying the State of Washington securities law held that a restaurant franchisor would not be liable to purchasers of interests in a limited partnership formed by others for the purpose of acquiring interests in seven restaurant franchises. To be sure, the Blue Sky law applied to the offer and sale of the limited partnership interests, but the court held that purchasers were not entitled to assert claims under it against the restaurant franchisor whose conduct was not a substantial factor in bringing about the sales of limited partnership interests. The court concluded that there was no evidence that the franchisor had any personal contact with investors or had any involvement in the solicitation of investors in the partnership.

A franchisor or business opportunity seller may well become sufficiently involved in the creation of investment partnerships or other entities formed for the purpose of acquiring a franchise or business opportunity in circumstances in which it is in fact the promoter of the investment vehicle. The focus in these circumstances is also on the investment vehicle rather than the particular franchise or business opportunity. However, the intertwining relationship between a franchisor and the promotion or establishment of an intermediary investment entity may bring the entire program within Blue Sky law coverage, and subject all persons involved in the creation and sale of the program to liability coextensive with the persons involved directly in the creation of the investment vehicle itself.

FOOTNOTES:

(n1)Footnote 52. This type of inquiry may also be used in determining whether a particular relationship or transaction amounts to a franchise, or a marketing plan or system, for purposes of applying either franchise or business opportunity laws. As discussed in §17.02 above, franchise and business opportunity laws do not require the formality of an express written agreement to trigger protections under these laws. Much the same as in securities cases based on the allegation that an unconventional form of security is involved, plaintiffs may claim the creation of a "franchise" or "business opportunity" in order to invoke statutory protections. In these circumstances courts must determine whether statutory elements such as "community of interest" are in fact present, so as to convert what is otherwise a contract or quasi-contractual commercial right or transaction into a franchise or business opportunity that is subject to state regulation.

(n2)Footnote 53. 171 Mich. App. 748, 431 N.W.2d 441 (Mich. App. 1988) .

(n3)Footnote 54. 171 Mich. App. at 758 .

(n4)Footnote 55. 171 Mich. App. at 759-760 .

(n5)Footnote 56. See, e.g., Oklahoma Uniform Securities Act of 2004, Art. I, § 1-102(32)(f), which specifically provides that the term "security" includes an:

[I]nvestment of money or money's worth including goods furnished and/or services performed in the risk capital of a venture with the expectation of some benefit to the investor where the investor has no direct control over the investment or policy decision of the venture.

(n6)Footnote 57. See *Goldsmith v. American Food Services, Inc.*, 123 Ga. App. 353, 181 S.E.2d 95 (Ga. App. 1971) (It is clear from the contract itself that the defendant was to be an active independent operator of the franchise and that any profits were to emanate from his own efforts. This is more than a mere token participation).

See also *Meyer v. Dans un Jardin, S.A.*, 816 F.2d 533 (10th Cir. 1987) (The economic success of the franchise depended on factors controlled by the franchisees, not the franchisors); *Gotham Print, Inc. v. American Speedy Printing Centers, Inc.*, 863 F.Supp. 447 (E.D. Mich. 1994) (Managerial efforts essential to success are those of the franchisee).

(n7)Footnote 58. See *Ball v. Volken*, 741 P.2d 958 (Utah 1987) (Franchisee's expected profits derived from others' success in actually selling products).

However, where available, courts may eschew application of investment contract analysis under the Blue Sky law in favor of applying the protections of a Business Opportunity Law, see *Peltier v. Spaghetti Tree, Inc.*, 6 Ohio St. 3d 194, 451 N.E. 2d 1219 (1983) (The legislature enacted the Business Opportunity Purchaser Protection Act to regulate the sale of business opportunity plans, as a distinctly different activity from the sale of securities).

(n8)Footnote 59. 1981 Okla. Sec. LEXIS 4 (Okla. Sec. Comm., Dec. 28, 1981) .

(n9)Footnote 60. State *ex rel* Park v. Glenn Turner Enterprises, Inc. [1971-1978 Transfer Binder] CCH Blue Sky L. Rep. P 71,023 (Ada Co. Dist. Ct. 1978).

(n10)Footnote 61. 320 U.S. 344, 64 S. Ct. 120, 88 L.Ed.2d 88 (1943) . In *Joiner* the Supreme Court held that the sale of assignments in oil leases was the sale of securities because the assignments only had value because of the opportunity to share in discovery values that might follow the drilling of a test well nearby. *Joiner* is more thoroughly discussed in Chapter 2, *supra*.

(n11)Footnote 62. See *In re Electric Auto Corporation*, 1979 Wisc. Sec. LEXIS 34 (Wis. Sec. Comm., Oct. 9, 1979) .

(n12)Footnote 63. See *Peltier v. Spaghetti Tree, Inc.*, note 32, *supra*.

(n13)Footnote 64. In *In re First Realty, Inc. and Meredith Corporation (Better Homes & Gardens)*, No. 239405-75, 1988 Wisc. Sec. LEXIS 245 (Wis. Sec. Comm., Dec. 1, 1988) , the administrator observed that the state franchise law arose as an attempt to fill a "possible gap" in the securities laws. Noting that the efforts to deal with franchise investment programs under securities laws had produced mixed results, he made clear, however, that securities laws continued to play a role, and that a "franchise investment" may still be deemed to be an investment contract, and hence a security, when the essential managerial efforts to be furnished in an enterprise are those of the franchisor. The hybrid approach taken in *First Realty* produced the conclusion that the respondent offered and sold either franchises or undivided, indistinct interests in a franchise, either or which would be regulated under one statute or the other.

(n14)Footnote 65. Dkt. No. S-03444A- 01-0000, 2001 Ariz. Sec. LEXIS 31 (Ariz. Sec. Comm., Sept. 18, 2001) .

(n15)Footnote 66. Cash ticket machines are small stationary machines located at a merchant's place of business, and allow customers to use credit or debit cards to electronically process merchant transactions.

(n16)Footnote 67. See, e.g., *In re William E. Bergh*, Dkt. No. S-03374A-99-0000, 2000 Ariz. Sec. LEXIS (Ariz.

Corp. Comm., Apr. 14, 2000).

(n17)Footnote 68. 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed.2d 1244 (1946) .

(n18)Footnote 69. 1994 Id. Sec. No-Act LEXIS (Dept. Fin. Sec. Div., Nov. 2, 1994).

(n19)Footnote 70. 1994 Id. Sec. No-Act LEXIS at *6-7

But see In re Charterhouse, Inc. Continuing Care Contract as a "Security," 1988 N. Car. Sec. LEXIS 13 (N.C. Sec. St., Mar. 1, 1988) (Continuing care contracts did not involve a contribution of initial value as venture capital, and fees are used exclusively to maintain the facility and provide ongoing services)

(n20)Footnote 71. *See, e.g.* In re William J. Webb, Order No. 03-038 (Ohio Div. Sec., Mar 3, 2003) (Marketing of pay telephone units involved 12% commissions); In re Michael J. Rudolph, Order No. 02-037 (Ohio Div. Sec., Jan. 23, 2002) (Pay telephone marketing program involved seller commissions of 10% to 12%).

(n21)Footnote 72. In Connecticut, for example, the Business Opportunity Investment Act, *Conn. Gen. Stat. § 36b-74(a)* provides in part:

"If a business opportunity seller uses any untrue or misleading statement in the sale of a business opportunity, or fails to give the proper disclosures in the manner required... or fails to deliver the equipment, supplies or products, or render the services necessary to begin substantial operation of the business opportunity within forty-five days of the delivery date stated in the business opportunity contract, or if the contract does not comply with the requirements of [the Act], then, within one year from the date of the contract, upon written notice to such business opportunity seller, the purchaser-investor may void the contract and shall be entitled to receive from such business opportunity seller all sums paid to such business opportunity seller."

The Connecticut law also establishes a private right of action for damages and for recovery of attorneys fees for a purchaser-investor injured by violations of the law, or by a seller's breach of contract.

(n22)Footnote 73. *See, e.g.,* Commonwealth of Virginia *ex rel.* State Corporation Commission v. Major Marketing Corporation Comedy Dating Corporation, *et al.*, No. SEC9400012, 1994 Va. Sec. LEXIS 98 (Va. Corp. Comm., Feb. 16, 1994) (Permanent injunction against offer and sale of investment contracts in the form of Franchise and Licensing Agreements, and against an individual from transacting business in the state as an unregistered securities agent).

(n23)Footnote 74. 915 F.2d 1324 (9th Cir. 1990) .



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CHAPTER 17 Franchising and Business Opportunities

2-17 Blue Sky Regulation § 17.06

§ 17.06 Practical Considerations

The determination that a security is created in any arrangement or set of circumstances using investment contract or risk capital principles is based on the conclusion that there is a need for the special protection afforded by Blue Sky laws. The offer and sale of franchises and business opportunities is today substantially regulated at the state level outside securities laws, in a manner that affords the same kinds of protections that would be available under Blue Sky laws. Indeed, as discussed earlier in this chapter, state franchise "investment" laws, and many business opportunity sales laws, are derived from the NASAA Model Franchise Investment Act⁷⁵ or the NASAA Model Business Opportunities Act, that is specifically discussed earlier in § 17.03.

Franchisors and established promoters of legitimate business opportunity plans or programs are subjected to compliance with specific state laws and, for the most part need not be concerned about possible application of state securities laws.⁷⁶ As a practical matter, franchises and business opportunities that involve real roles and responsibilities of purchasers in the activities critical to success of a business enterprise will not create a security unless the purchaser is in fact committing risk capital to finance necessary start-up and continuing support by the seller of the franchise or business opportunity. Franchise and business opportunity sales laws otherwise provide the desired protection for prospective and actual purchasers.

The continuing role of state securities laws in regard to franchises and business opportunities is shown, however, when franchises in name only are offered, and business opportunities are merely passive arrangements involving an inducement to reap large rewards for little or no work. In these circumstances the investment characteristics of the arrangement, and the investment *risk* are paramount. These are not traditional franchises, and such business opportunities do not contemplate the active and substantial participation of the purchaser. State securities administrators have shown no hesitation to apply risk capital analysis in the broadest manner to extend the reach of Blue Sky law protections to investors, however they be labeled, who are in fact financing the enterprise of promoters and who are dependent on the success of the promoter to realize the success of any business opportunity or franchise undertaken. Blue Sky laws will be applicable to the offer and sale of such opportunities when it is shown that the overall success of plan or program is as much if not more dependent on the stream of payments by purchasers *to the promoter or franchisor* as any efforts undertaken by the purchaser in the direct pursuit of the business.

In these circumstances, applying investment contract or risk capital principles the threshold assessment of whether a security is created must always be undertaken. If the arrangement is such that a security is in fact created, the full range of transactional exemptions from registration requirements under Blue Sky laws is nevertheless available, and ample guidance on the extent and substance of necessary or appropriate disclosure for reliance on such exemptions is also

available. The critical concern is that the assessment be made in the first place. The inquiry is well-suited for consideration through no-action letters or interpretive opinions available in most states.

FOOTNOTES:

(n1)Footnote 75. Model Franchise Investment Act, *CCH NASAA Reports* P 4303 (Aug. 30, 1990).

(n2)Footnote 76. See *Gotham Print, Inc. v. American Speedy Printing Centers, Inc.*, 863 F.Supp. 447 (E.D. Mich. 1994) (Franchise agreement would be governed by traditional franchise law, and the clearly contemplated substantial active participation of the franchisee in the operation of the venture precluded finding an investment contract for purposes of applying federal securities laws).



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CHAPTER 18 Blue Sky Regulation Of Municipal Securities

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CHAPTER 18 Blue Sky Regulation Of Municipal Securities

2-18 Blue Sky Regulation § 18.01

§ 18.01 Introduction

Broadly defined, municipal securities are debt securities--bonds and notes--issued by states, cities, and counties or their agencies to help finance public projects. Distributions of municipal securities involve underwriting, selling through dealers, and, in many cases, secondary market trading upon completion of a distribution. In the distribution process they are distinguished from other securities that are offered and sold to investors primarily by the credit worthiness and particular characteristics associated with the governmental or agency issuer involved. To a significant degree, municipal securities are exempt from registration requirements of federal and state securities laws. Additionally, many are today "covered securities" under the National Securities Markets Improvement Act of 1996 ("NSMIA"), and regulation under state Blue Sky laws is thus federally preempted except to the extent permitted by NSMIA. In this chapter the extent to which municipal securities remain subject to Blue Sky requirements is explored.

The municipal securities market in the United States is substantial. The Flow of Funds Section of the Board of Governors of the Federal Reserve System estimated that at year-end 2000 there were approximately \$ 1.6 trillion in principal amount of municipal securities outstanding.ⁿ¹ According to a joint report by the SEC Office of Economic Analysis and SEC Office of Municipal Securities, other estimates through the same period are as high as \$ 2.0 trillion in principal amount of securities outstanding, involving 1.1 million different municipal securities from about 51,000 issuers.ⁿ² The SEC Report also noted that unlike the U.S. Government and many corporate issues, most municipal securities offerings contain securities with a number of different maturity dates. An offering might include a number of serial bonds maturing annually for a period of years, or several large term bonds with sinking fund requirements. Corporate issuers generally have relatively few types of equity or debt securities and a relatively low number of offerings. Issuers of municipal securities, on the other hand commonly have many offerings, each with a number of different securities.ⁿ³

The types of municipal securities are broadly characterized in terms of whether they are *fixed* or *variable rate* securities. Fixed rate municipal securities include *fixed coupon* securities that pay a specified interest rate over the life of the security. They also include *zero coupon* bonds, which do not pay any interest to holders until maturity. With these securities interest is accrued and compounded until the maturity date, at which time the principal and interest both become due. Most municipal securities are fixed rate, or "fixed coupon," securities. Variable rate securities comprise a small part of the market. They pay an interest rate which changes periodically. The rate may be linked to an index, or it may be reset periodically by the issuer or a third party. Variable rate municipal securities offerings may include the right to "put" the securities back to the issuer at a set price, usually the par value. Different characteristics among different

types of municipal securities determine whether they are taxable or "tax exempt" securities, meaning that income is either includable in or excludable from gross income of the purchaser for federal income tax purposes.

The types of municipal securities are also characterized in terms of "general obligation" bonds, "revenue" bonds, and "conduit" bonds. "General obligation" bonds are those secured by the credit and general taxing power of the issuer. Repayment of a general obligation bond comes from all revenues of the issuer. "Revenue" bonds relate to a particular public project, and are paid out of revenues from that project. "Conduit" bonds are industrial development bonds or commercial enterprise bonds that are issued to finance a particular project used in a business enterprise by a private entity. Payment of interest and principal on conduit bonds is tied to the credit of the private entity and the success of the enterprise.

All state Blue Sky laws contain a general exemption from registration and qualification requirements for securities issued by a U.S. federal or state governmental or public authority. Section 402(a) (1) of the original Uniform Securities Act is representative of these provisions in its exemption for:

[A]ny security (including a revenue obligation) issued or guaranteed by the United States, any state, any political subdivision of a state, or any agency or corporate or other instrumentality of one or more of the foregoing; or any certificate of deposit for any of the foregoing.ⁿ⁴

A significant number of states, however, exclude from the general exemption industrial revenue bonds, industrial development bonds, or commercial enterprise bonds the interest on which is solely payable from revenues received from a non-governmental industrial or commercial enterprise.ⁿ⁵ The general exemption for municipal securities is premised on the credit worthiness of the governmental or public agency issuer that is backed by taxing authority. With industrial development or commercial enterprise bonds, however, there is no degree of protection afforded by the public issuer's credit worthiness. Unless some provision for an unconditional guarantee by a qualifying person or entity is made, the need for investor protection afforded under Blue Sky laws is no different than with any offering of debt securities by any other issuer.

Where applicable, requirements for municipal securities offerings under Blue Sky laws can be substantial. Municipal securities disclosure requirements vary significantly. States requiring registration of municipal securities offerings also impose strict requirements for the use and content of an "official statement" -- the functional equivalent of a prospectus--that communicates information with which to evaluate default risk, and which is subject to review and approval by state administrators. Other states may impose official statement requirements depending on the type of municipal security involved, distinguishing, for example, between a revenue or general obligation bond, and the type of issuer involved. States that exempt all municipal securities issues from registration requirements do not impose any official statement or other disclosure requirements.

With the enactment of NSMIA in 1996, state regulatory authority over municipal securities was significantly impacted by making securities that are exempt from federal registration under section 3(a)(2) of the federal Securities Act of 1933 into "covered securities" for purposes of NSMIA preemption, except to the extent that the otherwise covered security is offered and sold in the state in which the issuer is located.ⁿ⁶ Thus, regardless of any general exemption for municipal securities that is contained in a state Blue Sky law, NSMIA today preempts any state from applying its registration or merit regulatory provisions to the offer and sale of municipal securities that fit the general exemption in the federal statute, and which are offered in states other than that in which the issuer is located. States may continue to regulate municipal offerings by issuers within their own borders and, as with any "covered security" under NSMIA, may also continue to subject multi-state offerings to antifraud enforcement authority in the state without regard to where the issuer is located. States may also impose notice filing and fee requirements. Municipal securities dealers, and intermediaries generally, likewise remain subject to registration or licensing requirements under Blue Sky laws unless a specific exemption is available. The full scope of Blue Sky regulation of municipal securities after NSMIA is specifically considered later in this chapter.ⁿ⁷

Understanding the extent to which municipal securities fall within the regulatory ambit of Blue Sky laws after NSMIA is challenging because of complicated interactions between state and federal laws in a number of states, particularly as they relate to registration requirements for industrial or commercial enterprise bonds or industrial development bonds. State regulation of municipal securities may also be complicated by the notion of "separate security" that can arise when the financing structure in a municipal securities offering includes a lease, sale or loan arrangement in which an obligor agrees to make payments sufficient to pay debt service on the municipal securities. This issue is largely a function of federal law and application of a specific SEC rule that can result in the creation of separate securities in connection with municipal securities offerings that are subject to registration despite the availability of an exemption for the municipal securities themselves.ⁿ⁸ However, states may in fact make their own determinations to exercise regulatory authority when a separate security is created as a matter of federal law, and, as discussed later in this chapter, some have formalized that authority through their own rulemaking. Others that have adopted the municipal securities exemption contained in the 2002 Uniform Securities Act make clear in their municipal securities exemption that a separate security, as defined in SEC Rule 131 is included in the exemption.ⁿ⁹

Despite general exemptions for municipal securities in state Blue Sky laws, and the altered federal/state regulatory landscape after NSMIA, a significant number of states require registration of certain types of municipal securities. These states also impose varying requirements for the use and content of offering documents. In this chapter the scope of Blue Sky regulation of municipal securities today is explored in depth, beginning below with a closer examination of the exemptions in Blue Sky laws applicable to municipal securities generally.

FOOTNOTES:

(n1)Footnote 1. See Federal Reserve Board, Flow of Funds Accounts of the United States, Z.1 Statistical Release, June 2002, Table L.211.

(n2)Footnote 2. *Report on Transactions In Municipal Securities*, SEC Office of Economic Analysis and SEC Office of Municipal Securities, Division of Market Regulation, at 5 (July 1, 2004) (the "SEC Report").

(n3)Footnote 3. SEC Report, at 5.

(n4)Footnote 4. Unif. Sec. Act § 402(a)(1).

Section 3(a)(2) of the Securities Act of 1933, 15 U.S.C. § 77(c)(a)(2), likewise exempts from the registration requirements of the federal securities laws:

Any security issued or guaranteed by the United States or any territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or Territory, or by any public instrumentality of one or more States or Territories, or by any person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit for any of the foregoing... .

(n5)Footnote 5. See, e.g., *Minnesota*: Minn. Stat. 80A.15.1(a). The exemption from registration does not apply to "Registrable Minnesota Industrial or Commercial Enterprise Bonds," which are municipal securities the income from which is payable solely from payments to be received in respect of property or money used under a lease, sale or loan arrangement by or for a non-governmental industrial or commercial enterprise.

See also: New Hampshire: N.H. Rev. Stat. § 421-B:17, I (a);
New Mexico: N.M. Stat. § 58-13B-26.A;
North Dakota: N.D. Cent. Code § 10-04-06;

Rhode Island: G.L. R.I. § 7-11-401(1);

Vermont: Vt. Stat. § 4203a(1);

Washington: Rev. Code Wash. § 21.20.310(1)

Although securities laws continue to make reference to "industrial development bonds," the term has been replaced in the federal Internal Revenue Code with "Private Activity Bond." For purposes of applying securities law exemptions that continue to make reference to industrial development bonds, "private activity bond" can be used interchangeably.

(n6)Footnote 6. As discussed throughout this chapter, NSMIA specifically preserved state authority to regulate municipal securities with respect to offerings in the state in which the issuer of the security is located, even though the securities are federal "covered securities" under NSMIA, *see* Securities Act § 18(b)(4)(C), 15 U.S.C. § 77r(b)(4)(C). Preservation of state authority under Blue Sky laws for offerings by in-state issuers is consistent with the fundamental premise of NSMIA that state regulation of offerings of securities that are national in character is appropriately preempted, but that states should retain the authority to regulate offerings that are localized. In many instances municipal securities are offered by in-state public issuers on an intrastate or localized basis.

(n7)Footnote 7. *See* § 18.05, *infra*.

(n8)Footnote 8. *See* SEC Rule 131 under the Securities Act of 1933, 17 C.F.R. § 230.131. Rule 131 provides that any part of an obligation evidenced by a bond, note, debenture or other evidence of indebtedness issued by any governmental unit that is specified in the exemption provided in section 3(a)(2) of the 1933 Act which is payable from payments to be made in respect of property or money which is or will be used, under a lease, sale, or loan arrangement, by or for industrial or commercial enterprise, shall be considered a separate "security" under the Act unless certain conditions are satisfied. Rule 131 and its implications for state securities regulation of municipal offerings is discussed further in § 18.04, *infra*.

(n9)Footnote 9. *See, e.g.*, Kansas: Kan. Stat. Art. 12, § 6(1) ("A security, including a revenue obligation or a separate security as defined in Rule 131 (17 C.F.R. 230.131) adopted under the Securities Act of 1933... ." is exempt).

See also Iowa: Iowa Unif. Sec. Act 502.201 (1); Maine: Maine Rev. Stat., Ch. 135, § 16201 (1). Iowa, Kansas and Maine have adopted the 2002 Uniform Securities Act.



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Blue Sky Regulation

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CHAPTER 18 Blue Sky Regulation Of Municipal Securities

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§ 18.02 Municipal Securities Exemptions

[1] General Exemptions

As introduced in § 18.01 above, the exemption for municipal securities contained in the 2002 Uniform Securities Act is an example of general exemptions contained in all Blue Sky laws. It differs from the majority of general exemptions by including a "separate security" as defined by SEC Rule 131 under the Securities Act of 1933 in the exemption. Issues relating to "separate securities" that may be created in connection with an offering of municipal securities having certain characteristics are considered later in this chapter.ⁿ¹ The Uniform Act exemption and many state exemptions are modeled directly on the federal exemption in section 3(a)(2) of the Securities Act of 1933, although some states simplify the language. In Illinois, for example, the general exemption is for:

Any security (including a revenue obligation) issued or guaranteed by the United States, any state, any political subdivision of a state, or any agency or corporation or other instrumentality of any one or more of the foregoing, or any certificate of deposit for any such security.ⁿ²

The general exemption in Blue Sky laws provides the exemption from registration for typical, or traditional, government purpose municipal securities such as general obligation bonds and, expressly, revenue bonds. Unless there is an exception, the general exemption from Blue Sky registration requirements also covers industrial development or commercial enterprise bonds and any other municipal security, and is available regardless of any other characteristics of the security as, for example, its taxable or tax-exempt status.

In some states the general exemption for municipal securities is made subject to a "no default" condition. In Florida, for example, the general exemption from registration for municipal securities contains an exception for securities, other than general obligation bonds, if the issuer or guarantor has previously been in default with respect to payment of principal or interest.ⁿ³ If the exception applies, the issuer must offer and sell the securities by means of an offering circular containing full and fair disclosure as prescribed by rule. Ohio likewise includes an exception to the general exemption for municipal securities other than general obligation bonds if the issuer has previously defaulted in the payment of principal or interest on a bond issue, or if a prior adjudication involving the issuer adversely affects the validity of the securities.ⁿ⁴

If the general exemption for municipal securities is unavailable, and no other securities or transaction exemption applies,ⁿ⁵ the offering must be made in compliance with registration requirements and, where applicable, is subject to

merit review. After NSMIA, however, registration and any form of merit regulation of municipal securities that qualify for exemption under section 3(a)(2) of the Securities Act of 1933 is limited only to municipal securities of in-state issuers.ⁿ⁶ Qualifying municipal securities offered and sold by out-of-state issuers are federal "covered securities" under NSMIA, although notice filing and fee requirements may still be imposed.ⁿ⁷ As a practical matter, the general exemption from registration requirements for municipal securities in Blue Sky laws means that unless a state securities law excludes certain municipal securities from the general exemption, the role of state securities regulators is limited to intermediary regulation and antifraud enforcement.

[2] The Bank Guaranty Exemption

In addition to the general exemption for municipal securities found in Blue Sky laws, states also typically include as exempt securities:

Any security issued by and representing an interest in or a debt of, or guaranteed by, any bank, savings institution, or trust company organized and supervised under the laws of any state or under the laws of the United States.ⁿ⁸

Municipal securities may be exempt from registration and qualification requirements in Blue Sky laws as securities guaranteed by a bank or other qualifying depository institution. This may occur in circumstances in which the payment of principal and interest on the municipal securities is secured by a letter of credit issued by a bank. As discussed later in this chapter, the bank guarantee itself may be deemed to be a separate security subject to its own registration requirement.ⁿ⁹ However, section 3(a)(2) of the federal Securities Act of 1933 includes within the federal exemption any security "issued or guaranteed by any bank," thus making these potentially separate securities, as well as the underlying municipal securities that are bank guaranteed, NSMIA covered securities regardless of the location on the guarantor bank. The combination of bank guaranty exemptions in federal and state securities laws means that municipal securities will be exempt from state requirements without regard to the general municipal securities exemption, and the qualifying bank guarantee should be a federal covered security over which state authority is preempted. As discussed later, whether the municipal security and the guarantee can actually be separated for purposes of this analysis is not entirely certain. In any case, the bank guaranty exemption under Blue Sky laws is a viable alternative to the municipal securities general exemption.

[3] Rule 506 Exempt Offerings

All securities offered and sold pursuant to Rule 506 of Regulation D under the Securities Act of 1933 are "covered securities" after NSMIA.ⁿ¹⁰ But unlike the specific covered security definition applicable to municipal securities exempt from federal registration under section 3(a)(2) of the Securities Act, for which NSMIA preemption of state authority extends only to offerings by out-of-state issuers, preemption of registration authority is complete for securities offered and sold in compliance with Rule 506.ⁿ¹¹ For municipal securities that are covered securities because they are offered and sold pursuant to Rule 506, any exceptions from state exemptions for industrial development or commercial enterprise bonds are inconsequential, as the entire bond issue will have complete NSMIA preemption of state registration authority.

Compliance with Rule 506 in the offer and sale of municipal securities does not eliminate all state authority. NSMIA preserved state authority to require notice filings and to assess filing fees.ⁿ¹² Many states do require notice filings, utilizing Form D as prescribed in Regulation D under the federal Securities Act for Rule 506 offerings, and with the notice filing requirement also impose filing fees.ⁿ¹³ With this authority there is also the power to suspend the offer and sale of securities in the state for failure to submit any required filing or fee.ⁿ¹⁴ State regulatory and enforcement powers with respect to fraud likewise remain fully in place,ⁿ¹⁵ provided that the exercise of those powers as to covered securities does not amount to the indirect imposition of merit-based limitations or conditions on the offering.ⁿ¹⁶

FOOTNOTES:

(n1)Footnote 1. The treatment of "separate securities" under Blue Sky municipal securities exemptions, and considerations relating to SEC Rule 131 generally, are discussed further in § 18.04, *infra*.

(n2)Footnote 2. 815 ILCS 5/3.

See also:

Mississippi: Miss. Code § 75-71-201

Nebraska: Rev. Stat. Neb. § 8-1110

Virginia: Code Va. § 13.1-514(1).

These provisions derive directly from section 402(1) of the original Uniform Securities Act.

California is more explicit in its exemption for:

[A]ny security (including a revenue obligation) issued or guaranteed by the United States, any state, any city, county, city and county, public district, public authority, public corporation, public entity, or political subdivision of a state or any agency or corporate or other instrumentality of any one or more of the foregoing; or any certificate of deposit for any of the foregoing. Cal. Corp. Code § 25100(a).

(n3)Footnote 3. Fla. Stat. § 517.051(1).

(n4)Footnote 4. Ohio Rev. Code § 1707.02(B).

(n5)Footnote 5. Municipal securities, as with any security, may be offered and sold without registration in reliance upon an available transaction exemption. Limited offering exemptions, for example, may be utilized, and Rule 506 of Regulation D under the Securities Act of 1933 permits unlimited sales of municipal securities to accredited investors provided other manner of offering conditions of the Rule are satisfied. Moreover, municipal securities offered and sold under Rule 506 become federal "covered securities" under NSMIA. Rule 506 in the context of municipal securities offerings is discussed further in § 18.02[3], *infra*.

(n6)Footnote 6. With certain notable exceptions, section 18(b)(4)(C) of the federal Securities Act attaches "covered security" status to securities offered and sold pursuant to section 3(a) exemptions in the Securities Act. However, as to securities that are exempt under section 3(a)(2) of the Act, such securities are expressly not NSMIA covered securities with respect to the offer and sale of them in the state in which the issuer is located.

(n7)Footnote 7. The full impact of NSMIA on Blue Sky regulation of municipal securities offerings is discussed in § 18.04, *infra*.

(n8)Footnote 8. N.J. Stat. § 49:3-50; *see also* 2002 Unif. Sec. Act § 201(30).

(n9)Footnote 9. The matter of "separate securities" arising in connection with guarantees on municipal securities is discussed further in § 18.04, *infra*.

(n10)Footnote 10. Offerings meeting the requirements of Rule 506 under Regulation D are deemed "transactions not involving any public offering within the meaning of section 4(2) of the [federal securities] Act. 17 C.F.R. § 230.506(a). Under NSMIA, section 18(b) of the Securities Act of 1933 includes within the definition of "covered securities" any security with respect to a transaction that is exempt from registration pursuant to "commission rules or

regulations issued under section 4(2)." 15 U.S.C. § 77r(b)(4)(D).

(n11)Footnote 11. Rule 506, and Regulation D generally, are discussed in Chapter 8.06[2], *supra*.

(n12)Footnote 12. *See* Securities Act § 18(c)(2), 15 U.S.C. § 77r(c) (2).

(n13)Footnote 13. Individual state requirements applicable to Rule 506 offerings are presented in the State Guides, Vols. 3-4, *infra*.

(n14)Footnote 14. *See* Securities Act § 18(c)(3), 15 U.S.C. § 77r(c) (3).

(n15)Footnote 15. *See* Securities Act § 18(c)(1), 15 U.S.C. § 77r(c) (1).

(n16)Footnote 16. *See* Securities Act § 18(a)(3), 15 U.S.C. § 77r(a)(3).



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CHAPTER 18 Blue Sky Regulation Of Municipal Securities

2-18 Blue Sky Regulation § 18.03

§ 18.03 Industrial Development and Commercial Enterprise Bonds

Section 3(a)(2) of the Securities Act of 1933 includes among the securities exempt from federal registration:

[Any] security which is an industrial development bond (as defined in *section 103(c)(2) of the Internal Revenue Code of 1954*) the interest on which is excludable from gross income under section 103(a)(1) of such Code... .n1

The federal exemption for industrial development bonds thus requires that the interest on the bonds be tax-exempt for the securities exemption to apply, and further requires that the tax-exempt status of the income be established by specific provisions of the Internal Revenue Code that limit the type of projects for which the bonds could be used.n2

The scope of the federal exemption for industrial development bonds is significant for Blue Sky regulation because those falling within the coverage of the federal section 3(a)(2) exemption are today federal "covered securities" under NSMIA, and are not subject to state registration authority when issued by an out-of-state issuer. On the other hand, taxable industrial development or commercial enterprise bonds, including those issued by out-of-state issuers, are not covered securities based on the federal section 3(a)(2) exemption, and are thus fully subject to state regulatory authority unless the Blue Sky exemption is available. However, as discussed earlier in this chapter,n3 in many instances Rule 506 of Regulation D under the federal Securities Actn4 would be available to exempt the offer and sale of such securities as a matter of federal law, in which case the municipal securities become "covered securities" under NSMIA, and thus fall entirely outside of state registration requirements.

Regardless of the scope of the federal exemption under section 3(a)(2) of the Securities Act, NSMIA expressly excludes from the definition of "covered security" a municipal security "with respect to the offer or sale of such security in the State in which the issuer of the security is located."n5 Thus, to the extent that the general municipal securities exemption in any state excludes industrial development or commercial enterprise bonds, state authority to regulate is left intact to the extent an in-state issuer is involved.

Several states have made such exceptions from their general exemption for industrial development or commercial enterprise bonds. In Arizona, for example, the general exemption is for securities issued or guaranteed by the United States, by any state, territory or insular possession of the United States, by any political subdivision of such state, territory or insular possession, by the District of Columbia or by any agency or instrumentality of one or more of the

foregoing. However, the exemption further provides: "This exemption shall not apply to securities regulated pursuant to section 44-1843.01." n6

Section 44-1843.01 of the Act provides that notwithstanding the general exemption, registration requirements will be applicable to several types of municipal securities that are issued by a person who is located in the state, including:

Any obligations or securities that are industrial development bonds as defined in section 103 of the United States internal revenue code of 1954, as amended, with no exception for the small issue exemptions contained in section 103(b)(6) or 103(d), except that the provisions of this paragraph shall not apply to any issue where substantially all of the proceeds are to be used to provide residential real property for family units, airports, docks, wharves, mass commuting facilities, parking facilities, sewage or solid waste disposal facilities, air or water pollution control facilities, or facilities for the furnishing of water if available on reasonable demand to members of the general public.n7

Other states exclude from their general exemption securities of an in-state issuer that are payable solely from revenue to be received from a nongovernmental industrial or commercial enterprise.n8

Exclusions from general municipal securities exemptions in Blue Sky laws for industrial development or commercial enterprise bonds may in turn contain their own exceptions to the exclusion, such that where certain qualifying criteria are met, an industrial development or commercial enterprise bond will be exempt from registration requirements. The qualifying criteria vary from state to state, but all suggest that particular circumstances or characteristics associated with the security or the underlying commercial enterprise mitigate the need for investor protection that registration would provide. Examples of the qualifying criteria found in particular provisions include:

- (1) The industrial or commercial enterprise is undertaken by a person whose securities would be exempt from registration under another provision of the Blue Sky law;n9
- (2) The bonds have a specified rating; n10
- (3) Payments are insured or guaranteed by a qualifying entity;n11
- (4) The securities offering qualifies as an exempt *transaction* under the Blue Sky law.n12

In Wisconsin industrial development or commercial enterprise bonds are excluded from the municipal securities exemption, but an exception is provided when the security is subject to a letter of credit of a bank or savings and loan association. The Wisconsin exemption includes the provision:

[A] revenue obligation is exempt from any filing under the rules of the commissioner if it is the subject of an irrevocable letter of credit from a bank or savings and loan association in favor of holders of the revenue obligations providing for payment of all principal of the revenue obligations and all accrued and unpaid interest to the date of an event of default on the revenue obligations, and the letter of credit is accompanied by an opinion of counsel... n13

The use of irrevocable letters of credit to support the payment of principal and interest on industrial development or commercial enterprise bonds, or any municipal security, can be interpreted to be a "guarantee." A guarantee is included in the definition of "security" in all state securities laws, and thus can constitute a separate security that is subject to its own registration requirements if no exemption is available. If the letter of credit is issued by a financial institution whose securities are exempt,n14 the "separate security" associated with a revenue bond offering would thus also be exempt. Some states expressly include any underlying or separate security which secures a security exempt under the general municipal securities exemption within that general exemption, and in so doing eliminate the issue.n15 However, it remains a consideration in other states, and also is implicated directly by Rule 131 under the Securities Act of 1933.

The "separate security" question is considered in more detail later in this chapter.ⁿ¹⁶

In-state issuers of non-exempt industrial development or commercial enterprise bonds for which no exception is either available or provided face compliance with disclosure requirements that vary among the states. The primary offering document used in a municipal securities offering is the "official statement," which is analogous to a prospectus. In those states in which registration is required, and which mandate the use of a prospectus, the official statement is used. Municipal market participants have voluntarily developed and adopted their own disclosure standards for the content of official statements. The Government Finance Officers Association (GFOA) publishes guidelines for official statements.ⁿ¹⁷ In connection with the offering of municipal securities, the GFOA Disclosure Guidelines call for:

- An introduction to serve as the guide to the official statement;
- A description of the securities being offered, including complete information regarding the purposes of the offering, the plan of financing, the security and sources of repayment, and the priority of the securities, as well as structural characteristics, such as call provisions, tender options, original issue or deep discount, variable rates, and lease purchase agreements;
- Information regarding the nature and extent of any credit enhancement and financial and business information about the issuer of the enhancement;
- A description of the government issuer or enterprise, including information about the issuer's range or level of service, capacity and demographic factors and, in the case of revenue supported offerings, information on the enterprise's organization, management, revenue structure, results of operations and operating plan;
- With respect to obligations of private profit making and nonprofit conduit issuers, information regarding the business or other activity, including the enterprise's form of organization and management, rate-making or pricing policies, and historical operations and plan of operation;
- A description of the issuer's outstanding debt, including the authority to incur debt, limitations on debt, and the prospective debt burden and rate of its retirement;
- A description of the basic documentation, such as indentures, trust agreements and resolutions authorizing the issuance and establishing the rights of the parties;
- Financial information, including summary information regarding the issuer's or obligor's financial practices and results of operations; and
- Financial statements prepared in conformity with generally accepted accounting principles and audited in accordance with generally accepted auditing standards.

The GFOA Guidelines also provide for a discussion of legal matters, such as pending judicial, administrative, or regulatory proceedings that may significantly affect the securities offered, legal opinions, and tax considerations, and a discussion of miscellaneous matters, including ratings and their description and meanings, underwriting arrangements, arrangements with financial advisors, interests of named experts, pending legislation, and the availability of additional information and documentation.ⁿ¹⁸

For municipal securities of any type that are not exempt under a state's general exemption, and which are not federal covered securities because they are offered by an in-state issuer, use of an official statement may be required. Use requirements vary among the states. However, the information provided in official statements is substantially uniform

by reason of adherence to the GFOA guidelines. Official statements also may also constitute "sales and advertising literature" subject to state filing requirements regardless of whether their use is mandated in connection with a municipal securities offering.ⁿ¹⁹

As a practical matter, much of municipal securities disclosure is governed by SEC Rule 15c2-12 under the Securities Exchange Act of 1934.ⁿ²⁰ Subject to limited exceptions, the rule is applicable to primary offerings of municipal securities over \$1 million, and imposes disclosure-related requirements on the underwriters who participate in an offering. The rule mandates that participating underwriters: (1) obtain and review a final official statement prior to purchase of the securities; (2) send a preliminary official statement to any potential customer who requests one; (3) contract with the issuer to obtain a final official statement; and (4) send a final official statement to a potential customer who requests one. These requirements assure that an official statement will be available to investors. Rule 15c2-12 also assures ongoing disclosure by municipal security issuers by prohibiting underwriters from participating in an offering unless the issuer has agreed to systematically disclose material information that might affect the value of the securities. Participating underwriters must reasonably determine that the issuer (or an obligated person) has agreed in writing with holders of the securities to provide financial information, operating data and material event disclosure on an annual basis.ⁿ²¹

There are no Rule 15c2-12 analogs in state securities laws. Moreover, the rule does not mandate actual dissemination of the official statement. From the state regulatory perspective, however, the rule assures that an official statement will be available if the state is one that requires dissemination of a disclosure document as part of satisfying registration and qualification requirements for non-exempt municipal securities such as industrial development and commercial enterprise bonds.

For industrial development bonds, commercial enterprise bonds and any municipal securities that are subject to registration requirements in a state, the full array of *transaction* exemptions also remains available. Limited offering exemptions as well as exemptions for offers and sales to institutional or accredited investors, for example, operate without regard to the type of security involved. In-state issuers who structure and carry out industrial development or commercial enterprise bond offerings in compliance with any of these exemptions will not be subject to registration requirements despite the fact that the securities are not federal "covered securities" and do not fall within the state's municipal securities exemption. Likewise, as discussed earlier, these offerings may be undertaken in compliance with Rule 506 of Regulation D under the federal Securities Act of 1933, in which case the securities will be federal "covered securities" without regard to whether they are taxable or non-taxable, and without regard to the location of the issuer.

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 77c(a)(2).

(n2)Footnote 2. Section 3(a)(2) requires that the income from the bonds be excludable from gross income pursuant to *sections 103(c)(4) or 103(c)(6) of the Internal Revenue Code*. Under those limitations the industrial development bond exemption would be available if bonds were used for residential rental property projects or for industrial parks.

(n3)Footnote 3. See § 18.02[3], *supra*.

(n4)Footnote 4. 17 C.F.R. § 230.506.

(n5)Footnote 5. Securities Act § 18(b)(4)(C), 15 U.S.C. 77r(b)(4)(C).

(n6)Footnote 6. See Ariz. Rev. Stat. § 44-1843(A)(1)

(n7)Footnote 7. Ariz. Rev. Stat. § 44-1843.01(A)(1). Other types of municipal securities excluded from the general exemption in Arizona are certain "bond anticipation notes" and "improvement district bonds" issued under particular provisions of state law. The exception to the exemption also applies to bonds of issuers located outside the state that are

secured only by special assessments, and securities of public subdivisions the proceeds of which are used to finance the acquisition, construction, improvement, equipping or furnishing of a number of categories of health care facilities.

See also New Hampshire: N.H. Rev. Code § 421-B:17, I(a) (No exemption from registration for any "industrial development bond" or "industrial revenue bond"); Vermont: Vt. Stat. § 4203a(1) (Same exclusion, except that the exclusion does not apply to any issue for which substantially all of the proceeds are used to finance educational loans or single family residential mortgages).

(n8)Footnote 8. *See*:

Minnesota: Minn. Stat. § 80A.15.1(a)

Montana: Mont. Code § 30-10-104

New Mexico: N.M. Stat. § 58-13B-26.A

North Dakota: N.D. Cent. Code § 10-04-05.1

Rhode Island: G.L. § 7-11-401(1)

Washington: Rev. Code Wash. § 460-42A-020

(n9)Footnote 9. *See* Mont. Code § 10-104(1) (Includes underlying issuers whose own securities would qualify for exemption by reason of being organized and operated exclusively for religious, educational, benevolent, fraternal, social, athletic or reformatory purposes).

(n10)Footnote 10. In Washington, for example, industrial or commercial enterprise bonds that would otherwise be subject to registration are exempt if the security receives a rating of "AA" or better from Standard & Poor's Corporation or an equivalent rating from Moody's Investors Service, Inc., *see* Rev. Code Wash. § 460-42A-030.

(n11)Footnote 11. In Nevada, for example, the municipal securities general exemption is not available for a security payable solely from revenues to be received from an enterprise unless one of three conditions is met, including:

(1) Payments are insured or guaranteed by the United States, an agency or corporate or other instrumentality of the United States, an international agency or corporate or other instrumentality of which the United States and one or more foreign governments are members, a state, a political subdivision of a state, or an agency or corporate or other instrumentality of one or more states or their political subdivisions... . Nev. Rev. Stat. § 90.502(a)(1).

Nevada also includes exceptions for securities issued by a person whose securities are exempt from registration under certain provisions of the law, and also when payments are insured or guaranteed by a person who meets certain Standard & Poor's or Moody's rating criteria.

(n12)Footnote 12. Most commonly, states expressly provide that municipal securities offered and sold in compliance with Rule 506 of Regulation D under the Securities Act of 1933 are exempt without regard to their character as industrial development or commercial enterprise bonds, *see, e.g.*, Arizona: Ariz. Rev. Stat. § 44-1843.02.C. After NSMIA, securities offered under Rule 506 are federal "covered securities" for which state registration requirements are preempted.

(n13)Footnote 13. Wis. Stat. § 551.22(1)(b).

In addition to stating that the enforceability of the letter of credit would not be materially affected if the enterprise files bankruptcy, the required opinion of counsel in Wisconsin must state that: (1) payment of debt service by the private enterprise will not constitute a preference under federal bankruptcy law if the enterprise files bankruptcy; or (2) that the letter of credit will provide for reimbursement to holders if they are required by order of a federal bankruptcy court to disgorge as a preference any payment of debt service. Wis. Stat. § 551.22(1)(b) (1-2).

(n14)Footnote 14. *See, e.g.*, 2002 Unif. Sec. Act § 201(3), which is representative of Blue Sky law exemptions for securities issued by an international banking institution and certain other domestic banking and financial institutions.

(n15)Footnote 15. In Georgia, for example, the general exemption for municipal securities covers:

Any security (including a revenue obligation) issued or guaranteed by the United States, any state, any political subdivision of a state, or any agency, authority, public corporation, or other instrumentality of one or more of the foregoing, *including any underlying or separate security which secures any of the foregoing securities*. Off. Code Ga. § 10-5-8 (emphasis added).

(n16)Footnote 16. *See* § 18.04, *infra*.

(n17)Footnote 17. GFOA, Disclosure Guidelines for State and Local Government Securities (January 1988) (hereinafter "GFOA Disclosure Guidelines").

(n18)Footnote 18. GFOA Guidelines at xv-xix (summary).

Other groups, including the National Federation of Municipal Analysts ("NFMA"), have published voluntary disclosure guidelines covering industry specific sectors, including among others, housing, student loans, transportation and health care. *See* NFMA, *Disclosure Handbook for Municipal Securities*.

(n19)Footnote 19. West Virginia, for example, requires issuers of any non-exempt security to file sales and advertising literature before it is used. "Sales literature" is defined to include official statements. *See* W. Va. Sec. Comm. Admin. Regs. § 15.05.

(n20)Footnote 20. *17 C.F.R. § 240.15c2-12*.

(n21)Footnote 21. There are eleven "material events" identified in the rule as follows:

- (1) Principal and interest payment delinquencies;
- (2) Non-payment related defaults;
- (3) Unscheduled draws on debt service reserves reflecting financial difficulties;
- (4) Unscheduled draws on credit enhancement reflecting financial difficulties;
- (5) Substitution of credit or liquidity providers, or their failure to perform;
- (6) Adverse tax opinions or events affecting tax-exempt status of the security;
- (7) Modifications of rights of security holders;
- (8) Bond calls;

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- (9) Defeasances;
- (10) Release, substitution, or sale of property securing repayment of the securities; and
- (11) Rating changes.

See 17 C.F.R. § 240.15c2-12 (b)(5)(i)(C).

There are exemptions from the disclosure requirements of the rule for private placements, short term municipal bonds and offerings by qualified "small issuers."



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§ 18.04 Separate Securities in Industrial Development and Commercial Enterprise Bonds

Although industrial development and commercial enterprise bonds may be exempt from state registration and qualification requirements by reason of being included in the general exemption in Blue Sky laws, the structure of some financings may result in the creation of a separate security from the bonds. The possibility arises when these types of conduit bonds issued by a governmental unit are payable from payments made pursuant to a lease, sale or loan arrangement under which the underlying enterprise obligor agrees to make payments sufficient to meet debt service on the bonds. This is largely an issue under the federal securities laws by reason of SEC Rule 131 of the Securities Act of 1933, which provides that unless an exception is available:

Any part of an obligation evidenced by any bond, note, debenture or other evidence of indebtedness issued by a governmental unit specified in Section 3(a)(2) of the [Securities] Act which is payable from payments to be made in respect of property or money which is or will be used under a lease, sale, or loan arrangement, by or for industrial or commercial enterprise, shall be deemed to be a separate "security" within the meaning of Section 2(1) of the Act, issued by the lessee or obligor under the lease, sale or loan arrangement.ⁿ¹

States have no SEC Rule 131 analog. However, the SEC rule brought the issue into sharp focus, and has resulted in several states making specific provision in their general municipal securities exemptions for including any separate security as defined by SEC Rule 131 within the exemption. This is the approach taken in the 2002 Uniform Securities Act, which includes within the general municipal securities exemption "a security... as defined in Rule 131 adopted under the Securities Act of 1933."ⁿ²

Oregon has realistically approached the separate security issue by including within its general municipal securities exemption:

Any other security offered in connection with or as part of the security set forth in [the general exemption] if the security cannot be severed and sold separately from the security in [the general exemption] of this subsection.ⁿ³

Blue Sky laws focus on securities in circumstances in which there is no effective means of assuring investor protection other than qualification with registration and qualification requirements. A guaranty or other obligation embedded in an exempt municipal security does not create a separate investment decision by an offeree or purchaser, and the "separate"

element has no independent significance.

In the majority of states, where no special provision is made for including separate securities within the general municipal securities exemption, the question whether lease and other obligations associated with industrial development and commercial enterprise conduit bonds creates a separate security remains open. On the other hand, Pennsylvania has by rule expressly incorporated SEC Rule 131 into its exemption, such that the general municipal securities exemption specifically excludes any part of an obligation that is deemed to be a separate security under Rule 131.ⁿ⁴ However, at the same time rules under the Pennsylvania Securities Act also establish an exemption from registration for a guaranty of a bond that is offered and sold in the state when certain conditions are met.ⁿ⁵ These conditions include: (1) use of an official statement that contains specified financial information; (2) the proceeds from the sale of the underlying bonds must be utilized for the benefit of a facility that is owned or operated by a qualifying entity; (3) the guarantor must comply with certain requirements relating to the trustee for bondholders; and (4) the trustee must meet specific requirements in the performance of its role under the trust indenture, mortgage, deed of trust or other similar agreement that is involved.ⁿ⁶ When these conditions are satisfied, the result is an exemption from registration requirements for the separate security in the form of a guaranty.

Pennsylvania is unique in its specific incorporation of SEC Rule 131 into the Blue Sky law for purposes of identifying a separate security, excluding them from the general municipal securities exemption, and creating a specific exemption from registration for guaranties which meet stated conditions. In states that make no reference in their municipal securities general exemption either way to SEC Rule 131 and separate securities in relation to guaranties or obligations associated with an industrial or commercial enterprise bonds there is uncertainty unless the guaranty or other obligation that may be considered a separate security is itself exempt under another available exemption.

The question whether bond insuranceⁿ⁷ creates a separate security has become a moot point in the wake of NSMIA. Insurance policies meeting the requirements for the securities exemption in section 3(a)(8) of the Securities Act of 1933ⁿ⁸ are now federal "covered securities" under NSMIA. State regulatory authority is thus preempted as to a separate security if the insurance is deemed to be a guaranty without regard to the location of the bond issuer. All bond insurance policies do not necessarily qualify under section 3(a)(8) of the Securities Act. As a practical matter, however, the major bond insurers are all insurance companies regulated under state insurance laws, and a bond insurance policy issued by any of them will be a federal covered security to the extent that it is deemed to be a separate security associated with the issuance of an otherwise exempt municipal security.

As noted above, in determining whether a separate security is created, Oregon looks to whether the "other" security could be severed and sold separately from the exempt municipal security. The notion of a single integrated security comprised of an underlying exempt security and a guaranty or credit enhancement associated with it is supported by SEC No-Action Letters issued in circumstances in which there is a guaranty or credit support given by a corporate parent or other party closely related to the user of a financed facility. These no-action positionsⁿ⁹ are based on the rationale that a guarantor or provider of a credit support has a direct interest in the success of the financed project extending beyond issuance of the guaranty or other credit support. This identity of interest makes the guaranty or other credit support part of the same security as the underlying bonds. These positions relate to whether a separate security is created for purposes of registration requirements under the federal Securities Act, but the baseline notion of an identity between a guaranty and the exempt municipal security is equally compelling in states that make no specific provision relating to "separate" securities.

FOOTNOTES:

(n1)Footnote 1. 17 C.F.R. § 240.131(a).

Rule 131 contains three exceptions, any one of which will prevent an obligation from being deemed to be a separate security. These exceptions are: (1) the obligation is payable from the general revenues of a governmental unit having other resources which may be used for payment of the obligation; or (2) the obligation relates to a public project or

facility owned and operated by or on behalf of and under the control of a governmental unit specified in section 3(2)(2) of the Act; or (3) the obligation relates to a facility which is leased to and under the control of an industrial or commercial enterprise, but which is part of a public project that, as a whole, is owned by and under the general control of a section 3(a)(2) governmental unit or instrumentality. 17 C.F.R. § 240.131(b).

(n2)Footnote 2. 2002 Unif. Sec. Act § 201(1).

The 2002 Uniform Act provision for including Rule 131 separate securities within the general exemption is now in place in Idaho, Iowa, Kansas, Maine, Missouri, Oklahoma, South Carolina, South Dakota, the U.S. Virgin Islands and Vermont, all of which have adopted or substantially adopted the 2002 Act.

See also: Georgia: Off. Code Ga. § 10-5-8

In Wisconsin, revenue obligations payable from payments to be made in respect of property or money used under a lease, sale or loan arrangement by or for a nongovernmental industrial or commercial enterprise is specifically included in the general exemption, but only as further provided that it is subject to an irrevocable letter of credit from a bank or savings institution providing for payment of all principal and unpaid interest to the date of an event of default, and which is accompanied by a legal opinion as prescribed in the statute, *see* Wis. Stat. § 551.22 (b).

(n3)Footnote 3. Ore. Rev. Stat. § 59.025(b).

(n4)Footnote 4. *See* Pa. Code § 202.010. The Pennsylvania rule provides:

The exemption contained in section 202(a) of the act (70 P.S. § 1-202(a)) is available for any security described in that section which is an exempt security under section 3(a)(2) of the Securities Act of 1933... except for any part of an obligation evidenced by a bond, note, debenture or other evidence of indebtedness issued by any governmental unit specified in section 3(a)(2) that is deemed to be a separate security under United States Securities and Exchange Commission Rule 131 (17 CFR 230.131 (relating to definition of security issued under governmental obligations)).

(n5)Footnote 5. For purposes of the Pennsylvania exemption, guaranty is defined as:

A duly executed written agreement wherein a person, not the issuer, in connection with offer and sale of bonds in this Commonwealth, guarantees the prompt payment of principal of, and interest on, the bonds whether at the stated maturity, at redemption prior to maturity or otherwise, and premium, if any, when and as the principal and interest shall become due and the guaranty cannot be bought, sold traded as a security or otherwise realized upon by a bondholder separately from the bondholder's interest in the bonds. Pa. Code § 202.092(d)(2).

(n6)Footnote 6. Pa. Code § 202.092 ("Guaranties of certain debt securities exempt").

(n7)Footnote 7. Municipal bond issuers that meet certain credit criteria can purchase bond insurance policies from private companies. The insurance guarantees the payment of principal and interest on a bond issue if the issuer defaults. Where bond insurance is involved, bond ratings are based upon the credit of the insurer rather than the underlying credit of the issuer. Municipal bond insurance may lead to a higher bond rating, and thus interest cost savings for an issuer.

(n8)Footnote 8. 15 U.S.C. § 77c(8). Section 3(a)(8) exempts:

Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency

or officer performing like functions, of any State or Territory of the United States or the District of Columbia.

(n9)Footnote 9. *See, e.g.*, The County Commission of Kanawha County, SEC No-Action Letter (available Sept. 10, 1984); Garfield County School District, SEC No-Action Letter (available Aug. 7, 1981); Fort Bend County Municipal District No. 49, SEC No-Action Letter (available June 13, 1986).



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CHAPTER 18 Blue Sky Regulation Of Municipal Securities

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§ 18.05 The Scope of Blue Sky Regulation of Municipal Securities after NSMIA

Throughout this chapter, the scope state regulation of municipal securities in the wake of NSMIA is a dominant consideration. Nearly all states have adopted specific amendments to their Blue Sky laws which expressly implement federal preemption as to "covered securities." All municipal securities within the coverage of the exemption in section 3(a)(2) of the Securities Act of 1933 are today federal covered securities, and state authority to impose registration and qualification requirements is largely preempted. However, NSMIA did not preempt all state authority with respect to municipal securities that are federal covered securities. Moreover, even federal covered securities remain subject to unfettered state regulation when the issuer of the securities is located within the state. As discussed in section 18.02[3] above, states also retain the authority to regulate taxable industrial development and commercial enterprise bonds, including those of out-of-state issuers, which do not qualify for federal covered security status, when these securities are not encompassed in the particular Blue Sky law general exemption for municipal securities. The full scope of state regulatory authority remaining intact after NSMIA is discussed below.

[1] General Antifraud Authority

The historical mission of state Blue Sky laws to protect against fraud in the offer and sale of securities is largely unaffected by NSMIA preemption. Section 18(c) of the Securities Act of 1933 expressly provides with respect to fraud authority:

Consistent with this section, the securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker-dealer, in connection with securities or securities transactions.ⁿ¹

The available exemptions for municipal securities contained in Blue Sky laws are from registration requirements only. There is no exemption from antifraud provisions and the enforcement powers of state regulators in regard to them.ⁿ² A central consideration in the NSMIA preservation of state fraud authority, however, is that where federal covered securities are involved that authority must be exercised in a manner consistent with federal preemption of state registration and any merit qualification requirements. As NSMIA is clear in preserving state fraud authority, it makes just as clear that states may not "directly or indirectly prohibit, limit, or impose conditions, based on the merits of such offering or issuer" upon the offer and sale of covered securities.ⁿ³ To be applied in a "consistent" manner therefore, the exercise of state fraud authority must not amount to direct or indirect merit regulation of a municipal securities offering.

Subject only to that condition, state securities administrators may police municipal securities offerings in the state, including the conduct of issuers and intermediaries who offer and sell them. Although states may not impose registration and particular disclosure requirements for offers and sales of municipal securities that are federal covered securities, official statements and any other disclosure material involved in an offering may be subject to scrutiny under antifraud provisions.ⁿ⁴ Administrative antifraud enforcement powers range from cease and desist orders to injunctions and civil money penalties. For antifraud violations administrators may also seek remedies that may include rescission or restitution either administratively or in court actions. Civil remedies for fraud in Blue Sky laws are likewise not affected by NSMIA preemption.

Preservation of state authority to police municipal securities offerings under antifraud provisions of Blue Sky laws is particularly meaningful as increasing numbers of unsophisticated investors are targeted as buyers of unrated and speculative municipal securities. The municipal securities market has changed to the extent that traditional perceptions of municipal bonds as safe investments have been undermined. The continued role of state securities administrators in carrying out the historic mission of Blue Sky laws is important to maintaining the integrity of that market as the universe of investors expands.

[2] Intermediary Regulation

State authority in regard to registration or licensing of securities intermediaries is not affected by NSMIA. Unless there is an available exemption in a particular Blue Sky law, underwriters, broker-dealers, agents or representatives who make or participate in municipal securities offerings all remain subject to licensing requirements in states in which that activity takes place. In some instances Blue Sky laws specifically exempt from licensing requirements persons who deal solely in United States government securities when they are supervised as dealers by certain federal regulatory authorities.ⁿ⁵ However, there is no exemption for intermediaries who, exclusively or otherwise, deal in municipal securities other than U.S. Government securities that are exempt from registration under the general exemption in a Blue Sky law. Other exemptions from licensing requirements in a particular state may be available by reason of the scope of an intermediary's activities, as, for example, that recognized in section 401(b)(1)(C) of the 2002 Uniform Securities Act for broker-dealers having no place of business in the state and who effect transactions only with institutional investors.ⁿ⁶ Nevertheless, in the absence of such an exemption intermediaries engaged in the offer and sale of municipal securities are subject to the same licensing and continuing regulatory authority applicable to any other intermediary engaged in the securities business.

With regard to intermediary regulation it is important to keep in mind as well that NSMIA expressly preserved state enforcement authority with respect to "unlawful conduct by a broker or dealer" in connection with securities or securities transactions. Apart from licensing, many states, either by statute or rule, prescribe conduct requirements that in most cases include a *suitability* obligation of broker-dealers and their agents or representatives in making recommendations to a customer.ⁿ⁷ Suitability requirements directly impact the offer and sale of municipal securities, the variety and particular risk characteristics of which must be matched to the profile of a purchaser. With the power to investigate and to bring enforcement actions with respect to unlawful conduct of broker-dealers expressly preserved after NSMIA, state administrators have substantial means to police municipal securities offerings by direct and unfettered authority over the intermediaries who carry them out.

[3] Registration and Qualification Authority

The authority of states to require registration of municipal securities that are federal covered securities, and to subject municipal securities offerings to any form of merit review, offering document limitationsⁿ⁸ or other conditions is limited to the offer and sale of such securities in the state in which the issuer is located. Municipal securities offerings by out-of-state issuers that qualify for the federal exemption in section 3(a)(2) of the Securities Act of 1933 are today covered securities, and as such fall outside the scope of state authority except as to antifraud enforcement authority and

intermediary regulation. The full scope of state regulatory authority over municipal securities that are not covered securities, or which are covered securities offered and sold by an in-state issuer, will ultimately depend on the scope of the state's general municipal securities exemption. The preservation of state regulatory authority in NSMIA for municipal securities that are federal covered securities offered and sold by an in-state issuer is meaningful only to the extent the securities are not exempt at the state level. As already seen, general municipal exemptions in Blue Sky laws are broad, and there is nothing in the wake of NSMIA that operates to alter the scope or effect of pre-existing state exemptions.

[4] Notice Filing and Fee Requirements

With respect to municipal securities that are federal covered securities, state authority to require notice filings and to assess fees is expressly preserved. States may require the filing of any document filed by or on behalf of the issuer with the U.S. Securities and Exchange Commission, and may also require annual or periodic reports of the value of the securities sold or offered in the state, but "solely for notice purposes and the assessment of any fee."ⁿ⁹ Consent to service of process in the state may also be required. Importantly, state authority in regard to notice filing and the imposition of fees also includes the power to enforce the requirements through suspension of the offer or sale of the securities in the state.ⁿ¹⁰

For municipal securities that are federal covered securities and which are also exempt securities under the state municipal securities exemption, the state exemption is self-executing and no notice filing or fee requirements are imposed.ⁿ¹¹

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 77r(c).

(n2)Footnote 2. *See, e.g.*, 2002 Unif. Sec. Act § 501. The Official Comments to section 501 make certain: "There are no exemptions from Section 501... Section 501 applies to any securities offer, sale or purchase, including offers, sales or purchases involving registered, exempt, or federal covered securities." Off. Comments 2-3, 2002 Unif. Sec. Act.

(n3)Footnote 3. Securities Act of 1933, § 18(a)(3), 15 U.S.C. § 77r(a)(3).

(n4)Footnote 4. Where federal covered securities are involved, section 18(2)(A) of the Securities Act of 1933, 15 U.S.C. § 77r(a)(2)(A), prohibits any direct or indirect state limitation or condition being place upon the use of any offering document that is prepared by or on behalf of the issuer. Scrutiny of offering documents for covered securities under the retained state antifraud authority must, therefore, also be consistent with the NSMIA mandate that no limitations or conditions may be placed upon their use. Logically, the prohibition would seem to address pre-offering scrutiny and approval procedures rather than cease and desist or other enforcement actions that may be undertaken during or after the conclusion of an offering.

(n5)Footnote 5. *See, e.g.*, 2002 Unif. Sec. Act § 401(b)(2), which is representative in providing an exemption from broker-dealer licensing for:

[A] person that deals solely in United States government securities and is supervised as a dealer in government securities by the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, or the Office of Thrift Supervision.

See also Kansas: Kan. Stat., Art. 12, § 18(b)(2); Maine: Me. Rev. Stat., Ch. 135, § 16401 2. B.

(n6)Footnote 6. 2002 Unif. Sec. Act § 401(b)(1)(C).

(n7)Footnote 7. In Michigan, for example, the administrator may deny, suspend or revoke the registration of a

broker-dealer or agent who:

Has recommended to a customer the purchase, sale, or exchange of any security without reasonable grounds to believe that the recommendation is suitable for the customer on the basis of information furnished by the customer after reasonable inquiry as may be necessary under the circumstances concerning the customer's investment objectives, financial situation and needs, and other information known by the person making the recommendation. Mich. Comp. Laws § 451.604(1)(M).

(n8)Footnote 8. Offering document limitations or requirements might, for example, include requiring a particular legend to be placed on the documents (New Hampshire), or imposing content restrictions, such as might apply to the use of financial forecasts (Pennsylvania).

(n9)Footnote 9. Securities Act of 1933, § 18(c)(2), 15 U.S. C. § 77r(c)(2).

See, e.g., Indiana: Ind. Code § 23-2-1-6.1; Maryland: Code Md. § 11-503.1

For municipal securities offerings carried out pursuant to Rule 506 of Regulation D under the Securities Act of 1933, states are authorized under NSMIA to impose notice requirements that are substantially similar to what is required generally for such offerings. This in effect limits state authority to require anything more than Form D, as prescribed in Regulation D. Because either the Uniform Limited Offering Exemption (ULOE) or an analog is in place in most states, Form D is the common state filing in any case.

(n10)Footnote 10. 15 U.S.C. § 77r(c)(3).

(n11)Footnote 11. *See, e.g.*, 2002 Unif. Sec. Act § 302(a) (providing for required filings for federal covered securities when the securities are not otherwise exempt under the Act).



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CHAPTER UA Uniform Securities Act

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§ UA.syn Synopsis to Chapter UA: Uniform Securities Act

Scope



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CHAPTER UA Uniform Securities Act

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UNIFORM SECURITIES ACT (1956)As Amended in 1958

The Uniform Securities Act (1985), approved by the National Conference of Commissioners on Uniform State Laws in 1985, supersedes the Uniform Securities Act of 1956, as amended in 1958. Further information about the Uniform Securities Act can be found in Volume 1, § 1.03. INTRODUCTION

The Uniform Securities Act was drafted at the request of the Conference by Professor Louis Loss of the Harvard Law School together with Mr. Edward M. Cowett as Research Associate. The Act followed a two-year Study of State Securities Regulation made in consultation with an Advisory Committee containing representatives of the Conference. The American Bar Association, the National Association of Securities Administrators, the Securities and Exchange Commission, the Investment Bankers Association of America, and the National Association of Securities Dealers, Inc., as well as several practicing lawyers with experience in "blue sky law."

The comments included here are the official comments of the Conference. The Act together with the unofficial section-by - section comments of the draftsmen will appear as an appendix in Loss and Cowett on "Blue Sky Law," to be published by Little, Brown & Co. in early 1957. The draftsmen's comments are considerably more detailed than the official comments and also describe generally the existing law. No inference of disagreement with the draftsmen's comments is to be drawn from the non- inclusion of all those comments here. The emphasis here is on brevity.

THE UNIFORM SECURITIES ACT

An Act [Relating to securities; prohibiting fraudulent practices in relation thereto; requiring the registration of broker-dealers, agents, investment advisers, and securities; and making uniform the law with reference thereto:]OFFICIAL PREFATORY NOTE

§ 101 Sales and Purchases

It is unlawful for any person, in connection with the offer, sale, or purchase of any security, directly or indirectly

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(1)

to employ any device, scheme, or artifice to defraud,

(2)

to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or

(3)

to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

Official Code Comment

This section is substantially the Securities and Exchange Commission's Rule X-10B-5, *17 Code Fed. Regs. § 240.10b-5*, which in turn was modeled upon § 17(a) of the Securities Act of 1933, *15 U.S.C. § 77q(a)* [*15 U.S.C.A. § 77q(a)*], except that the rule was expanded to cover the purchase as well as the sale of any security. There are no exemptions from § 101.

The sanctions for the conduct which is made "unlawful" by § 101 (or any other section which makes conduct "unlawful") are found in Part II, III and IV of the statute. Those sanctions include administrative proceedings of various sorts under §§ 204 and 306 when a registration of a broker-dealer, agent, investment adviser or security is pending or effective under Part II or III; judicial injunction under § 408; and criminal prosecution under § 409. Section 410(h) provides that "unlawful" conduct does not result in civil liability except as provided in § 410.

§ 102 Advisory Activities

(a)

It is unlawful for any person who receives any consideration from another person primarily for advising the other person as to the value of securities or their purchase or sale, whether through the issuance of analyses or reports or otherwise,

(1)

to employ any device, scheme, or artifice to defraud the other person, or

(2)

to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon the

other person.

(b)

It is unlawful for any investment adviser to enter into, extend, or renew any investment advisory contract unless it provides in writing

(1)

that the investment adviser shall not be compensated on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client;

(2)

that no assignment of the contract may be made by the investment adviser without the consent of the other party to the contract; and

(3)

that the investment adviser, if a partnership, shall notify the other party to the contract of any change in the membership of the partnership within a reasonable time after the change.

Clause (1) does not prohibit an investment advisory contract which provides for compensation based upon the total value of a fund averaged over a definite period, or as of definite dates or taken as of a definite date. "Assignment," as used in clause (2), includes any direct or indirect transfer or hypothecation of an investment advisory contract by the assignor or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor; but, if the investment adviser is a partnership, no assignment of an investment advisory contract is considered to result from the death or withdrawal of a minority of the members of the investment adviser having only a minority interest in the business of the investment adviser, or from the admission to the investment adviser of one or more members who, after admission, will be only a minority of the members and will have only a minority interest in the business.

(c)

It is unlawful for any investment adviser to take or have custody of any securities or funds of any client if

(1)

the [Administrator] by rule prohibits custody; or

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(2)

in the absence of rule, the investment adviser fails to notify the [Administrator] that he has or may have custody.

Official Code Comment Subsec. (a). This provision is modeled on §§ 206(1) and 206(2) of the Investment Advisers Act of 1940, *15 U.S.C. § 80b-6(1)* and (2) [*15 U.S.C.A. § 80b-6(1)(2)*], except that it avoids the use of the term "investment adviser." The definition of "investment adviser" in § 401(f) contains a number of exceptions which look to the registration requirement in Volume II. But, as in § 101, there are no exemptions from fraud. Subsec. (b). Clauses (1)-(3), together with the first sentence thereafter, are modeled on § 205 of the Investment Advisers Act of 1940, *15 U.S.C. § 80b-5* [*15 U.S.C.A. § 80b-5*]. The definition of "assignment" in the last sentence is taken from the definition in § 202(a)(1) of the federal statute, *15 U.S.C. § 80b-2(a)(1)* [*15 U.S.C.A. § 80b-2(a)(1)*]. Section 102(b) does not require that the entire contract be in writing. An informal exchange of letters containing the three specified provisions would be sufficient. Subsec. (c). The Act does not prohibit the same person from being both a broker-dealer and an investment adviser. See the comment under § 201(c). Section 102(c)(1) is sufficiently flexible so that any rules adopted thereunder might be made inapplicable to persons acting in both capacities, or applicable only with respect to those clients who are charged specially for investment advice. Concerning the distinction between broker-dealers and investment advisers, see the comment under § 401(f).

§ 201 Registration Requirements

(a)

It is unlawful for any person to transact business in this state as a broker-dealer or agent unless he is registered under this act.

(b)

It is unlawful for any broker-dealer or issuer to employ an agent unless the agent is registered. The registration of an agent is not effective during any period when he is not associated with a particular broker-dealer registered under this act or a particular issuer. When an agent begins or terminates a connection with a broker-dealer or issuer, or begins or terminates those activities which make him an agent, the agent as well as the broker-dealer or issuer shall promptly notify the [Administrator].

(c)

It is unlawful for any person to transact business in this state as an investment adviser unless (1) he is so registered under this act, (2) he is registered as a broker-dealer without the imposition of a condition under section 204(b)(5), or (3) his only clients in this state are investment companies as defined in the Investment Company Act of 1940 or insurance companies.

(d)

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Every registration expires one year from its effective date unless renewed. [The [Administrator] may by rule or order prepare an initial schedule for registration renewals so that subsequent renewals of registrations effective on the effective date of this Act may be staggered by calendar months. For this purpose the [Administrator] may by rule reduce the registration fee proportionately.]

[As amended August 1958]

Official Code Comment Subsec. (a). "Agent" and "broker-dealer" are defined in §§ 401(b) and 401(c). The scope of § 201(a) with reference to the phrase "to transact business in this state" is specified in §§ 414(a) and 414(b). Subsec. (b). When an agent shifts from one broker-dealer or issuer to another, the last sentence requires all three persons--the agent, the old employer and the new employer--to notify the Administrator. Subsec. (c). Clause (2): The Act permits the same person to exercise both broker-dealer and advisory functions and to do so without dual registration. Clause (2) ties in with § 204(b)(5), which authorizes the Administrator to condition a particular applicant's registration as a broker-dealer upon his not transacting business as an investment adviser if the Administrator finds that he is not qualified as an investment adviser. Clause (3): This clause is based on § 203(b)(2) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-3(b)(2) [15 U.S.C.A. § 80b-3(2)], which exempts an investment adviser from registration if his only clients are investment companies and insurance companies. But even such an investment adviser is subject to § 102. Clause (3) also ties into § 401(f)(6); see paragraph 12 of the comment under § 414(a)-(f).

The scope of § 201(c) with reference to the phrase "to transact business in this state" is specified in § 414(f). Subsec. (d). The bracketed language is intended for those states where every registration today expires on December 31 or some other fixed date of each year. When any such state goes over to the scheme of § 201(d), the bracketed language will prevent its continuing to be deluged with a mass of renewal applications on the first of every year. Section 418(c) will automatically take care of the situation, without the bracketed language, in those states which already provide that every registration expires one year from its effective date unless renewed.

§ 202 Registration Procedure

(a)

A broker-dealer, agent, or investment adviser may obtain an initial or renewal registration by filing with the [Administrator] an application together with a consent to service of process pursuant to section 414(g). The application shall contain whatever information the [Administrator] by rule requires concerning such matters as (1) the applicant's form and place of organization; (2) the applicant's proposed method of doing business; (3) the qualifications and business history of the applicant; in the case of a broker-dealer or investment adviser, the qualifications and business history of any partner, officer, or director, any person occupying a similar status or performing similar functions, or any person directly or indirectly controlling the broker-dealer or investment adviser; and, in the case of an investment adviser, the qualifications and business history of any employee; (4) any injunction or administrative order or conviction of a misdemeanor involving a security or any aspect of the securities business and any conviction of a felony; and (5) the applicant's financial condition and history. The [Administrator] may by rule or order require an applicant for initial registration to publish an announcement of the application in one or more specified newspapers published in this state. If no denial order is in effect and no proceeding is pending under section 204, registration becomes effective at noon of the thirtieth day after an application is filed. The [Administrator] may by rule or order specify an earlier effective date, and [he] may by order defer the effective date until noon of the thirtieth day after the filing of any amendment. Registration of a broker-dealer automatically constitutes registration of any agent who is a partner, officer, or director, or a person occupying a similar status or performing similar functions. [(b) Every applicant for initial or renewal registration shall pay a filing fee of \$.....in the case of a broker-dealer, \$.....in the case of an agent, and \$.....in the case of an investment adviser. When application is denied or withdrawn, the [Administrator] shall retain \$.....of the fee.]

(c)

A registered broker-dealer or investment adviser may file an application for registration of a successor, whether or not the successor is then in existence, for the unexpired portion of the year. There shall be no filing fee.

(d)

The [Administrator] may by rule require a minimum capital for registered broker-dealers and investment advisers.

(e)

The [Administrator] may by rule require registered broker-dealers, agents, and investment advisers to post surety bonds in amounts up to \$10,000, and may determine their conditions. Any appropriate deposit of cash or securities shall be accepted in lieu of any bond so required. No bond may be required of any registrant whose net capital, which may be defined by rule, exceeds \$25,000. Every bond shall provide for suit thereon by any person who has a cause of action under section 410 and, if the [Administrator] by rule or order requires, by any person who has a cause of action not arising under this act. Every bond shall provide that no suit may be maintained to enforce any liability on the bond unless brought within two years after the sale or other act upon which it is based.

Official Code Comment Subsec. (a). Second sentence: This sentence is a conglomerate of a number of the present statutes as well as the comparable provisions of the Securities Exchange Act of 1934 [15 U.S.C.A. § 78a et seq.] and the Investment Advisers Act of 1940 [15 U.S.C.A. § 80a-1 et seq.] together with the SEC's Forms BD and ADV for broker-dealers and investment advisers respectively. The language is sufficiently broad to cover everything required by those statutes and forms, and at the same time is sufficiently specific to facilitate the adoption of a uniform form for each of the three types of registration. Clause (3): The phrase "any person occupying a similar status or performing similar functions," which modifies "partner, officer, or director" here and elsewhere in the Act, contemplates unincorporated, nonpartnership organizations like Massachusetts trusts. Last sentence: Section 401(b), which defines "agent," provides in its last sentence: "A director, officer, or partner of a broker-dealer or issuer, or a person occupying a similar status or performing similar functions, is an agent only if he otherwise comes within this definition." The reasons for that provision are stated in the comment to that section. But, since § 202(a)(3) contemplates that the qualifications and business history of partners, officers and directors will be disclosed in the application for registration of the partnership or corporation, there is no need to have the same information filed twice. Consequently, under the last sentence of § 202(a) the firm's registration automatically constitutes registration of any agent who is a partner, officer, or director; and, by virtue of this sentence in conjunction with the last sentence of § 401(b), the Administrator, if he deems it appropriate, may institute a proceeding to deny or revoke the registration of a particular partner, officer or director without disturbing the status of the firm. At the same time, the disqualification of a director, officer or partner, as distinct from an ordinary agent, is also a basis for proceeding against the firm's registration if the Administrator finds it in the public interest to do so. Subsec. (b). The last sentence does not apply when a registration is suspended, revoked or canceled under § 204. Subsec. (c). This subsection is designed to avoid unnecessary interruptions of business by removing any doubt as to the propriety of a predecessor's filing an application for the registration of the successor--for example, when a contemplated change in the membership of a partnership may be considered to result in a new partnership under the local partnership law, or when a partnership or an individual contemplates incorporation. Particularly if the states which adopt this act adopt uniform registration forms which are coordinated with those of the SEC, they may also wish to coordinate their procedure on successions. See SEC Rule X-15B-4, 17 Code Fed. Regs. §

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240.15b-4. The regular procedure in § 202(a) concerning the time when an application for registration becomes effective applies also under § 202(c). Subsec. (d). A few states have rules which, instead of prescribing a fixed minimum capital, follow the formula of the SEC and some of the stock exchanges in prescribing a ratio of 15-1 or 20-1 between aggregate indebtedness and net capital. Ill. Rule D-1B; Minn. Reg. VI(a); Wis. Adm. Code s. § 1.01(2). Any state which wants to give its Administrator authority to adopt debt-capital ratio rules should add the following language at the end of Section 202(d): "or prescribe a ratio between net capital and aggregate indebtedness." Subsec. (e). Second sentence: The Administrator has no discretion whether to accept a deposit of cash or securities in lieu of a bond, but he does have reasonable discretion to determine whether the amount of the deposit and the type of securities deposited are appropriate. Third sentence: This sentence applies whether or not the Administrator adopts minimum capital rules under § 202(d) or defines "net capital" under § 412(a) for purposes of the third sentence of § 202(e). If he remain silent, the question whether a broker-dealer has a net capital of \$25,000 should be determined in accordance with sound accounting principles. Conditions of the bond: The first and fourth sentences leave the conditions of the bond to the rule-making authority of the Administrator. But the fourth sentence is designed to avoid the frequently ambiguous provisions concerning who may sue on the bond by making those conditions of any required bond coterminous with the liability provisions of § 410 so far as causes of action under the Act are concerned. It is left to the Administrator to determine by rule or order whether suits should be allowed also for defalcations not involving sales of securities--for example, embezzlement of customers' funds or securities. Thus, except for non-statutory causes of action, § 202(e) merely uses the bonding provision to reinforce any recovery which might be obtained under § 410; it creates no new civil liabilities. Since § 410 imposes civil liabilities only upon sellers of securities, any bond required of a person who is solely an investment adviser could apply only to such non-statutory defalcations as the Administrator might prescribe. Statute of limitations: Since § 410(d) provides that every cause of action under this statute survives the death of any person who might have been a plaintiff or defendant, any bond required under § 202(e) must provide that suit may be brought for the specified two-year period even though the person who is bonded dies before the expiration of that period.

§ 203 Post-Registration Provisions

(a)

Every registered broker-dealer and investment adviser shall make and keep such accounts, correspondence, memoranda, papers, books, and other records as the [Administrator] by rule prescribes. All records so required shall be preserved for three years unless the [Administrator] by rule prescribes otherwise for particular types of records.

(b)

Every registered broker-dealer and investment adviser shall file such financial reports as the [Administrator] by rule prescribes.

(c)

If the information contained in any document filed with the [Administrator] is or becomes inaccurate or incomplete in any material respect, the registrant shall promptly file a correcting amendment unless notification of the correction has been given under section 201(b).

(d)

All the records referred to in subsection (a) are subject at any time or from time to time to such reasonable periodic, special, or other examinations by representatives of the [Administrator], within or without this state, as the [Administrator] deems necessary or appropriate in the public interest or for the protection of investors. For the purpose of avoiding unnecessary duplication of examinations, the [Administrator], insofar as [he] deems it practicable in administering this subsection, may cooperate with the securities administrators of other states, the Securities and Exchange Commission, and any national securities exchange or national securities association registered under the Securities Exchange Act of 1934.

Official Code Comment This section is modeled on § 17(a) of the Securities Exchange Act of 1934, *15 U.S.C. § 78q(a)* [*15 U.S.C.A. § 78q(a)*]. It is broad enough to permit a continuation of the practice which exists in several states of requiring registered broker-dealers to keep lists of the securities they are handling. Subsec. (d) is modeled on § 17(a) of the Securities Exchange Act of 1934, *15 U.S.C. § 78q(a)*. This is a visitorial power which is to be distinguished from the power to investigate and issue subpoenas under § 407. No subpoena is necessary under § 203(d). Failure to submit to a reasonable inspection is a violation of the Act, which may result in an action by the Administrator for a mandatory injunction under § 408 or, if willful, a revocation of the broker-dealer's or investment adviser's registration under § 204(a)(2)(B) or a criminal prosecution under § 409. In some states special fees are charged to defray the cost of examinations. The Act specifically provides for fees only in connection with registration under Parts II and III. Any additional fee provision which may be desired should be inserted in § 406(c).

§ 204 Denial, Revocation, Suspension, Cancellation, and Withdrawal of Registration

(a)

The [Administrator] may by order deny, suspend, or revoke any registration if [he] finds (1) that the order is in the public interest and (2) that the applicant or registrant or, in the case of a broker-dealer or investment adviser, any partner, officer, or director, any person occupying a similar status or performing similar functions, or any person directly or indirectly controlling the broker-dealer or investment adviser.

(A)

has filed an application for registration which as of its effective date, or as of any date after filing in the case of an order denying effectiveness, was incomplete in any material respect or contained any statement which was, in light of the circumstances under which it was made, false or misleading with respect to any material fact;

(B)

has willfully violated or willfully failed to comply with any provision of this act or a predecessor act or any rule or order under this act or a predecessor act;

(C)

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has been convicted, within the past ten years, of any misdemeanor involving a security or any aspect of the securities business, or any felony;

(D)

is permanently or temporarily enjoined by any court of competent jurisdiction from engaging in or continuing any conduct or practice involving any aspect of the securities business;

(E)

is the subject of an order of the [Administrator] denying, suspending, or revoking registration as a broker-dealer, agent, or investment adviser;

(F)

is the subject of an order entered within the past five years by the securities administrator of any other state or by the Securities and Exchange Commission denying or revoking registration as a broker-dealer, agent, or investment adviser, or the substantial equivalent of those terms as defined in this act, or is the subject of an order of the Securities and Exchange Commission suspending or expelling him from a national securities exchange or national securities association registered under the Securities Exchange Act of 1934, or is the subject of a United States Post Office fraud order; but (i) the [Administrator] may not institute a revocation or suspension proceeding under clause (F) more than one year from the date of the order relied on, and (ii) [he] may not enter an order under clause (F) on the basis of an order under another state act unless that order was based on facts which would currently constitute a ground for an order under this section;

(G)

has engaged in dishonest or unethical practices in the securities business;

(H)

is insolvent, either in the sense that his liabilities exceed his assets or in the sense that he cannot meet his obligations as they mature; but the [Administrator] may not enter an order against a broker-dealer or investment adviser under this clause without a finding of insolvency as to the broker-dealer or investment adviser; or

(I)

is not qualified on the basis of such factors as training, experience, and knowledge of the securities business, except as otherwise provided in subsection (b). The [Administrator] may by order deny, suspend, or revoke any registration if [he] finds (1) that the order is in the public interest and (2) that the applicant or registrant

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(J)

has failed reasonably to supervise his agents if he is a broker-dealer or his employees if he is an investment adviser; or

(K)

has failed to pay the proper filing fee; but the [Administrator] may enter only a denial order under this clause, and [he] shall vacate any such order when the deficiency has been corrected. The [Administrator] may not institute a suspension or revocation proceeding on the basis of a fact or transaction known to [him] when registration became effective unless the proceeding is instituted within the next thirty days.

(b)

The following provisions govern the application of section 204(a)(2)(I):

(1)

The [Administrator] may not enter an order against a broker-dealer on the basis of the lack of qualification of any person other than (A) the broker-dealer himself if he is an individual or (B) an agent of the broker-dealer.

(2)

The [Administrator] may not enter an order against an investment adviser on the basis of the lack of qualification of any person other than (A) the investment adviser himself if he is an individual or (B) any other person who represents the investment adviser in doing any of the acts which make him an investment adviser.

(3)

The [Administrator] may not enter an order solely on the basis of lack of experience if the applicant or registrant is qualified by training or knowledge or both.

(4)

The [Administrator] shall consider that an agent who will work under the supervision of a registered broker-dealer need not have the same qualifications as a broker-dealer.

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(5)

The [Administrator] shall consider that an investment adviser is not necessarily qualified solely on the basis of experience as a broker-dealer or agent. When [he] finds that an applicant for initial or renewal registration as a broker-dealer is not qualified as an investment adviser, [he] may by order condition the applicant's registration as a broker-dealer upon his not transacting business in this state as an investment adviser.

(6)

The [Administrator] may by rule provide for an examination, which may be written or oral or both, to be taken by any class of or all applicants, as well as persons who represent or will represent an investment adviser in doing any of the acts which make him an investment adviser.

(c)

The [Administrator] may by order summarily postpone or suspend registration pending final determination of any proceeding under this section. Upon the entry of the order, the [Administrator] shall promptly notify the applicant or registrant, as well as the employer or prospective employer if the applicant or registrant is an agent, that it has been entered and of the reasons therefor and that within fifteen days after the receipt of a written request the matter will be set down for hearing. If no hearing is requested and none is ordered by the [Administrator], the order will remain in effect until it is modified or vacated by the [Administrator]. If a hearing is requested or ordered, the [Administrator], after notice of and opportunity for hearing, may modify or vacate the order or extend it until final determination.

(d)

If the [Administrator] finds that any registrant or applicant for registration is no longer in existence or has ceased to do business as a broker-dealer, agent, or investment adviser, or is subject to an adjudication of mental incompetence or to the control of a committee, conservator, or guardian, or cannot be located after reasonable search, the [Administrator] may by order cancel the registration or application.

(e)

Withdrawal from registration as a broker-dealer, agent, or investment adviser becomes effective thirty days after receipt of an application to withdraw or within such shorter period of time as the [Administrator] may determine, unless a revocation or suspension proceeding is pending when the application is filed or a proceeding to revoke or suspend or to impose conditions upon the withdrawal is instituted within thirty days after the application is filed. If a proceeding is pending or instituted, withdrawal becomes effective at such time and upon such conditions as the [Administrator] by order determines. If no proceeding is pending or instituted and withdrawal automatically becomes effective, the [Administrator] may nevertheless institute a revocation or suspension proceeding under section 204(a)(2)(B) within one year after withdrawal became effective and enter a revocation or suspension order as of the last date on which registration was effective.

(f)

No order may be entered under any part of this section except the first sentence of subsection (c) without (1) appropriate prior notice to the applicant or registrant (as well as the employer or prospective employer if the applicant or registrant is an agent), (2) opportunity for hearing, and (3) written findings of fact and conclusions of law.

Official Code Comment Subsec. (a). First Clause (1): This clause authorizes the Administrator to proceed against an entire firm merely because an individual partner, officer, director or controlling person is disqualified under one of the specific clauses, but it requires a finding that such action is in the public interest. The disqualification of any other agent, or of an employee of an investment adviser may not automatically be used against the broker-dealer or the investment adviser. But, when the agent's or employee's disqualification is due to lack of reasonable supervision, the Administrator may proceed against the broker-dealer or the investment adviser under Clause (J). The Administrator's finding on "public interest" will presumably not be judicially reviewable except upon a showing of abuse of discretion. But the requirement that such a finding be made in all cases emphasizes that not every minor or technical infraction is meant to result in a denial, suspension or revocation order. Clause (A): The completeness and accuracy of the application for registration are to be tested as of its effective date in a suspension or revocation proceeding. That is to say, the fact that an application for registration has become misleading by virtue of developments occurring after its effective date is not a ground for action under Clause (A). Action in such a case would have to be predicated under Clause (B) upon violation of § 203(c). On the other hand, in a proceeding to deny effectiveness to a pending application for registration, the completeness and accuracy of the application cannot be tested as of the effective date. This explains the first "or" clause in Clause (A). Clause (B): As the federal courts and the SEC have construed the term "willfully" in § 15(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o (b), all that is required is proof that the person acted intentionally in the sense that he was aware of what he was doing. Proof of evil motive or intent to violate the law, or knowledge that the law was being violated, is not required. The principal function of the word "willfully" is thus to serve as a legislative hint of self-restraint to the Administrator. Clause (D): The present tense of the word "is" means that an injunction which has expired or been vacated is no longer a ground for action under Clause (D). Clause (E): This clause is designed to make it clear that, when a person who has had his registration revoked applies for a new registration after an interval, the Administrator does not have to establish again the ground which led to the earlier denial or revocation order. Clause (F): As in Clause (E), the opening word "is" means that a suspension order which has expired by its terms or an order of any kind which has been vacated is not a ground for action under Clause (F). Clause (H): The "but" clause makes it clear that a broker-dealer's or investment adviser's insolvency may be used against the broker-dealer or investment adviser, and that an agent's insolvency may be used against the agent, but that an order may not be entered against a broker-dealer or investment adviser on the basis of the insolvency of a partner, officer, director or controlling person under Clause (2). Clause (J): This clause represents a codification of the view held by a number of Administrators, as well as the SEC, to the effect that a registrant must be held responsible for violations resulting from inadequate supervision of subordinates. This Act, unlike § 15(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 17o (b), does not authorize the Administrator to proceed against the registration of a broker-dealer merely because one of his agents has violated the statute (unless the agent happens to be a director, officer or partner). But, when an agent's violation is found to be due to a violation of the broker-dealer's duty of reasonable supervision, and when the Administrator finds that it is in the public interest to proceed against the broker-dealer's registration, he may do so under Clause (J). This is not to say that proof of a violation by the agent is essential to an order under Clause (J). Subsec. (b). Clause (1)-(2): These clauses are a limitation upon Clause (2) of § 204(a). Some firms have limited partners or directors who simply supply capital without taking an active role in the firm's business. There is no need for such persons to be qualified. Clause (5): This is essential in order to avoid double registration by people who act both as broker-dealers and as investment advisers. See the comment under § 201(c)(2). Clause (6): Examinations may be required of any reasonably defined class of applicants. For example, the Administrator may want to examine only applicants for registration as investment advisers, in which event he will wish to examine also those applicants for broker-dealer registration who intend to perform advisory services for special compensation, so that he may properly administer § 204(b)(5). Subsec. (d). This provision is modeled on § 15(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o (b) [15 U.S.C.A. § 78o (b)]. It is designed to regularize the procedure for getting rid of "dead-wood" in the files. Subsec. (e). This provision

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is modeled on § 15(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o (b) [15 U.S.C.A. § 78o (b)]. It is Rule X-15B-6, 17 Code Fed.Reg.s. § 240.15b-6, although the last sentence goes somewhat further. This provision does not affect an applicant's privilege of withdrawing his application for registration before it becomes effective. It is simply designed to make it possible to prevent withdrawal of an effective registration under fire. The last sentence is designed to take care of the case where the Administrator does not know of any reason to object to the withdrawal application until after it has become effective; but it is limited to situations where the Administrator can prove a willful violation under § 204(a)(2)(B).Subsec. (f). Here, as in other procedural provisions of the statute, the Administrator will also have to consider the requirements of any local Administrative Procedure Act, and these provisions may have to be varied depending upon the language of any such legislation.

§ 301 Registration Requirement

It is unlawful for any person to offer or sell any security in this state unless (1) it is registered under this act or (2) the security or transaction is exempted under section 402.

Official Code Comment

This section forbids offers as well as sales prior to the effectiveness of a registration statement. "Offer" and "sale" are defined in § 401(j). The 1954 amendment of the Securities Act of 1933 to permit certain types of offers during the waiting period between the filing and the effectiveness of the registration statement is recognized in a special exemption for securities which are in process of registration under both the federal and state statutes. See the comment under § 402(b)(12). "Security" is defined in § 401(1). The scope of § 301 with respect to the phrase "in this state" is specified in § 414(a), (c), (d) and (e).

§ 302 Registration by Notification

(a)

The following securities may be registered by notification, whether or not they are also eligible for registration by coordination under section 303:

(1)

any security whose issuer and any predecessors have been in continuous operation for at least five years if (A) there has been no default during the current fiscal year or within the three preceding fiscal years in the payment of principal, interest, or dividends on any security of the issuer (or any predecessor) with a fixed maturity or a fixed interest or dividend provision, and (B) the issuer and any predecessors during the past three fiscal years have had average net earnings, determined in accordance with generally accepted accounting practices, (i) which are applicable to all securities without a fixed maturity or a fixed interest or dividend provision outstanding at the date the registration statement is filed and equal at least five percent of the amount of such outstanding securities (as measured by the maximum offering price or the market price on a day, selected by the registrant, within thirty days before the date of filing the registration statement, whichever is higher, or book value on a day, selected by the registrant, within ninety days of the date of filing the registration statement to the extent that there is neither a readily determinable market price nor a cash offering price), or (ii) which, if the issuer and any predecessors have not had any security of the type specified in clause (i) outstanding for three full fiscal years, equal at least five percent of the amount (as measured in clause (i)) of all securities which will be outstanding if all the securities being offered or proposed to be offered (whether or not they are proposed to be registered or offered in this state) are issued;

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(2)

any security (other than a certificate of interest or participation in an oil, gas or mining title or lease or in payments out of production under such a title or lease) registered for nonissuer distribution if (A) any security of the same class has ever been registered under this act or a predecessor act, or (B) the security being registered was originally issued pursuant to an exemption under this act or a predecessor act.

(b)

A registration statement under this section shall contain the following information and be accompanied by the following documents in addition to the information specified in section 305(c) and the consent to service of process required by section 414(g):

(1)

a statement demonstrating eligibility for registration by notification;

(2)

with respect to the issuer and any significant subsidiary: its name, address, and form of organization; the state (or foreign jurisdiction) and the date of its organization; and the general character and location of its business;

(3)

with respect to any person on whose behalf any part of the offering is to be made in a non-issuer distribution: his name and address; the amount of securities of the issuer held by him as of the date of the filing of the registration statement; and a statement of his reasons for making the offering;

(4)

a description of the security being registered;

(5)

the information and documents specified in clauses (8), (10), and (12) of section 304(b); and

(6)

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in the case of any registration under section 302(a)(2) which does not also satisfy the conditions of section 302(a)(1), a balance sheet of the issuer as of a date within four months prior to the filing of the registration statement, and a summary of earnings for each of the two fiscal years preceding the date of the balance sheet and for any period between the close of the last fiscal year and the date of the balance sheet, or for the period of the issuer's and any predecessors' existence if less than two years.

(c)

If no stop order is in effect and no proceeding is pending under section 306, a registration statement under this section automatically becomes effective at [three o'clock Eastern Standard Time] in the afternoon of the second full business day after the filing of the registration statement or the last amendment, or at such earlier time as the [Administrator] determines.

Official Code Comment Subsec. (a). In general: The introductory language of § 302(a) makes it clear that, when a particular security is eligible for registration by notification under § 302 as well as registration by coordination under § 303, it is discretionary with the person filing the registration statement to decide which procedure to use. Clause (1): Section 302(a)(1) contains essentially a single earnings test, regardless of the type of security being registered. It applies in substance to any security whose issuer has been in continuous operation for five years if (A) there has been no default during the past three full fiscal years on any senior security and (B) the issuer during the past three fiscal years has had average earnings of five percent on its common stock. If the issuer has no outstanding securities of the types specified in Clause (A), it is necessary to satisfy only Clause (B). Under Clause (i) the five-percent test is applied to all outstanding securities at the date the registration statement is filed, and those securities are measured by the offering price (when additional securities are being offered) or by the market price, whichever is higher. In order to permit the calculation to be made so as to determine whether the notification procedure is available, the parenthetical clause within Clause (i) permits the person filing the registration statement to use the market price on any day within thirty days before the date of filing. The phrase "maximum offering price" means the highest price at which any of the securities are offered when they are offered to different people at different prices, as when they are offered to existing stockholders at a lower price than to the public generally. The phrase does not mean the maximum proposed offering price referred to in § 303(c)(3). See the comment under that section. But as a practical matter, since the market price and hence the offering price may go up while the registration statement is pending, it will not be safe to rely on the notification procedure unless the five-percent test is satisfied on the basis of the maximum proposed offering price. The five-percent test is applied to book value when there is no readily determinable market price for the security being offered and there is no cash offering price either, as when the offering is made in exchange with security holders of another issuer, or with existing security holders of the same issuer under such circumstances that the exemption in § 402(b)(11) is not available. Clause (1)(B)(ii): Clause (ii) is designed to take care of the case where a corporate registrant (or perhaps a business trust or a limited partnership) has succeeded within the past three years to a business previously conducted by a sole proprietor or a general partnership, so that the five-year requirement at the beginning of § 302(a)(1) would be satisfied but it would be impossible to satisfy the three-year earnings test for want of any outstanding securities during all of that period. Under Clause (ii) the five-percent earnings test is applied in such a case to all securities to be outstanding after the conclusion of the offering. Clause (1) as applied to senior securities: Under Clause (B) the five-percent earnings test on common stock must be satisfied even though the security being offered is a preferred stock or a bond. This affords some margin of safety beyond the requirement in Clause (A) that there shall have been no default. Clause (2): Oil, gas and mineral interests are excluded because they have no "issuer" as that term is defined in § 401(g)(2) and hence all distributions of such securities would be eligible for notification if they were not excluded. Subsec. (b). This section is designed to supply enough information to enable the Administrator to apply the stop-order standards which uniformly govern all registration statements, whether by notification, qualification or coordination. In the case of a primary offering being registered under § 302(a)(1), clause (1) requires basic financial information by way of demonstrating eligibility for the notification procedure. Clause (6) assures a modicum of financial information in the case of a

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non-issuer distribution which is eligible for the notification procedure solely because of § 302(a)(2). With respect to non-issuer distributions, see the comment under § 305(i).Subsec. (c). States in other time zones should substitute "two o'clock Central Standard Time" or "one o'clock Mountain Standard Time" or "noon Pacific Standard Time." Flexibility to take care of emergencies or unusual situations is afforded by authorizing the Administrator to accelerate the effective date. He may do this almost routinely as the SEC does, so as not to require a waiting period of two days after the filing of the price amendment.

§ 303 Registration by Coordination

(a)

Any security for which a registration statement has been filed under the Securities Act of 1933 in connection with the same offering may be registered by coordination.

(b)

A registration statement under this section shall contain the following information and be accompanied by the following documents in addition to the information specified in section 305(c) and the consent to service of process required by section 414(g):

(1)

three copies of the latest form of prospectus filed under the Securities Act of 1933;

(2)

if the [Administrator] by rule or otherwise requires, a copy of the articles of incorporation and by-laws (or their substantial equivalents) currently in effect, a copy of any agreements with or among underwriters, a copy of any indenture or other instrument governing the issuance of the security to be registered, and a specimen or copy of the security;

(3)

if the [Administrator] requests, any other information, or copies of any other documents, filed under the Securities Act of 1933; and

(4)

an undertaking to forward all future amendments to the federal prospectus, other than an amendment which merely delays the effective date of the registration statement, promptly and in any event not later than the first business

day after the day they are forwarded to or filed with the Securities and Exchange Commission, whichever first occurs.

(c)

A registration statement under this section automatically becomes effective at the moment the federal registration statement becomes effective if all the following conditions are satisfied: (1) no stop order is in effect and no proceeding is pending under section 306; (2) the registration statement has been on file with the [Administrator] for at least ten days; and (3) a statement of the maximum and minimum proposed offering prices and the maximum underwriting discounts and commissions has been on file for two full business days or such shorter period as the [Administrator] permits by rule or otherwise and the offering is made within those limitations. The registrant shall promptly notify the [Administrator] by telephone or telegram of the date and time when the federal registration statement became effective and the content of the price amendment, if any, and shall promptly file a post-effective amendment containing the information and documents in the price amendment. "Price amendment" means the final federal amendment which includes a statement of the offering price, underwriting and selling discounts or commissions, amount of proceeds, conversion rates, call prices, and other matters dependent upon the offering price. Upon failure to receive the required notification and post-effective amendment with respect to the price amendment, the [Administrator] may enter a stop order, without notice or hearing, retroactively denying effectiveness to the registration statement or suspending its effectiveness until compliance with this subsection, if [he] promptly notifies the registrant by telephone or telegram (and promptly confirms by letter or telegram when [he] notifies by telephone) of the issuance of the order. If the registrant proves compliance with the requirements of this subsection as to notice and post-effective amendment, the stop order is void as of the time of its entry. The [Administrator] may by rule or otherwise waive either or both of the conditions specified in clauses (2) and (3). If the federal registration statement becomes effective before all the conditions in this subsection are satisfied and they are not waived, the registration statement automatically becomes effective as soon as all the conditions are satisfied. If the registrant advises the [Administrator] of the date when the federal registration statement is expected to become effective, the [Administrator] shall promptly advise the registrant by telephone or telegram, at the registrant's expense, whether all the conditions are satisfied and whether [he] then contemplates the institution of a proceeding under section 306; but this advice by the [Administrator] does not preclude the institution of such a proceeding at any time.

[As amended August 1958.]

Official Code Comment Subsec. (a). This section streamlines the content of the registration statement and the procedure by which it becomes effective, but not the substantive standards governing its effectiveness. The same stop-order standards specified in § 306 govern all three types of registration--notification, coordination and qualification. The phrase "in connection with the same offering" does not require that the federal and state registration statements either be filed simultaneously or become effective simultaneously. Thus a registration statement by coordination might be filed in a particular state shortly after the effectiveness of the federal registration statement, although the Administrator would be free to decide that it was not "the same offering" if the interval was too great. In the case of those investment companies which offer their securities continually by filing periodic amendments to their federal registration statements under the special procedure afforded by § 24(e) of the Investment Company Act of 1940 [15 U.S.C.A. § 80a-24(e)] [see the comment under § 305(k)], conceptually each such amendment represents a new "offering." That is to say, every amendment filed with the SEC under § 24(e) is in substance a new registration statement. Hence it is contemplated that securities so registered with the SEC may be registered under this Act by coordination so long as the interval between the filing of the SEC amendment and the filing under this Act is not too great. Any question as to the propriety of this construction may be readily resolved by the adoption of a definitional rule under § 412(a) providing, in substance, that the term "registration statement" as used in § 303(a) includes an amendment filed under § 24(e) of the Investment Company Act of 1940. Subsec. (b). This subsection limits the Administrator to requiring only such information as is filed with the SEC. Concerning § 303(b)(4), see the comment under §

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303(c).Subsec. (c). This subsection is designed to achieve simultaneous effectiveness at the federal and state levels without impinging upon the Administrator's duty to test the registration statement under the substantive standards imposed by § 306. In order for the registration statement to become effective automatically when it becomes effective at the SEC, all the conditions specified in Clauses (1)-(3) must be satisfied unless the Administrator waives one or more of them. Under § 303(b)(4) the registration statement when it is filed must be accompanied by an undertaking to forward all amendments to the federal registration statement. There is an exception for an amendment which merely delays the federal effective date. This refers to the practice whereby, if twenty days have expired since the filing of the last federal amendment and the registration statement has not yet been corrected to the satisfaction of the SEC, the registrant files an amendment merely changing the filing date, thus starting another twenty-day period running and avoiding the necessity of the Commission's instituting a proceeding to prevent automatic effectiveness. Sometimes amendments are mailed to the SEC and sometimes they are filed manually. When they are mailed they are not "filed" under § 413(a) until they are received, and in that event they will have to be forwarded to the Administrator not later than the first business day after they are sent to the SEC. Under § 306(a)(2)(H) failure to comply with the required undertaking is per se a basis for a stop order. Clause (3) and the next three sentences are addressed to the problem of getting to the Administrator the content of the federal price amendment in the short interval (seldom more than twenty-four hours) which usually elapses between its filing and the effectiveness of the federal registrant statement. Clause (3) enables the Administrator to apply the stop-order test in § 306(a)(2)(F) by comparing the maximum underwriting commissions with the minimum offering price, and to apply the test in § 306(a)(2)(E) by reference to the maximum proposed offering price. Section 410(a)(1) imposes an absolute civil liability upon any person who "offers or sells a security in violation of section 301," and § 410(f) makes the contract unenforceable. But under the fourth and fifth sentences the validity of offers and sales in the state is not affected unless the registrant was at fault. The last sentence makes it possible for counsel for the registrant or the underwriter to give a firm opinion to his client that all the conditions of § 303(c) have been satisfied, although it requires nothing further of the registrant.

§ 304 Registration by Qualification

(a)

Any security may be registered by qualification.

(b)

A registration statement under this section shall contain the following information and be accompanied by the following documents in addition to the information specified in section 305(c) and the consent to service of process required by section 414(g):

(1)

with respect to the issuer and any significant subsidiary: its name, address, and form of organization; the state or foreign jurisdiction and date of its organization; the general character and location of its business; a description of its physical properties and equipment; and a statement of the general competitive conditions in the industry or business in which it is or will be engaged;

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(2)

with respect to every director and officer of the issuer, or person occupying a similar status or performing similar functions: his name, address, and principal occupation for the past five years; the amount of securities of the issuer held by him as of a specified date within thirty days of the filing of the registration statement; the amount of the securities covered by the registration statement to which he has indicated his intention to subscribe; and a description of any material interest in any material transaction with the issuer or any significant subsidiary effected within the past three years or proposed to be effected;

(3)

with respect to persons covered by clause (2): the remuneration paid during the past twelve months and estimated to be paid during the next twelve months, directly or indirectly, by the issuer (together with all predecessors, parents, subsidiaries, and affiliates) to all those persons in the aggregate;

(4)

with respect to any person owning of record, or beneficially if known, ten percent or more of the outstanding shares of any class of equity security of the issuer: the information specified in clause (2) other than his occupation;

(5)

with respect to every promoter if the issuer was organized within the past three years: the information specified in clause (2), any amount paid to him within that period or intended to be paid to him, and the consideration for any such payment;

(6)

with respect to any person on whose behalf any part of the offering is to be made in a non-issuer distribution: his name and address; the amount of securities of the issuer held by him as of the date of the filing of the registration statement; a description of any material interest in any material transaction with the issuer or any significant subsidiary effected within the past three years or proposed to be effected; and a statement of his reasons for making the offering;

(7)

the capitalization and long-term debt (on both a current and a pro forma basis) of the issuer and any significant subsidiary, including a description of each security outstanding or being registered or otherwise offered, and a statement of the amount and kind of consideration (whether in the form of cash, physical assets, services, patents, goodwill, or anything else) for which the issuer or any subsidiary has issued any of its securities within the past two years or is obligated to issue any of its securities;

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(8)

the kind and amount of securities to be offered; the proposed offering price or the method by which it is to be computed; any variation therefrom at which any proportion of the offering is to be made to any person or class of persons other than the underwriters, with a specification of any such person or class; the basis upon which the offering is to be made if otherwise than for cash; the estimated aggregate underwriting and selling discounts or commissions and finders' fees (including separately cash, securities, contracts, or anything else of value to accrue to the underwriters or finders in connection with the offering) or, if the selling discounts or commissions are variable, the basis of determining them and their maximum and minimum amounts; the estimated amounts of other selling expenses, including legal, engineering, and accounting charges; the name and address of every underwriter and every recipient of a finder's fee; a copy of any underwriting or selling-group agreement pursuant to which the distribution is to be made, or the proposed form of any such agreement whose terms have not yet been determined, and a description of the plan of distribution of any securities which are to be offered otherwise than through an underwriter;

(9)

the estimated cash proceeds to be received by the issuer from the offering; the purposes for which the proceeds are to be used by the issuer; the amount to be used for each purpose; the order or priority in which the proceeds will be used for the purposes stated; the amounts of any funds to be raised from other sources to achieve the purposes stated; the sources of any such funds; and, if any part of the proceeds is to be used to acquire any property (including goodwill) otherwise than in the ordinary course of business, the names and addresses of the vendors, the purchase price, the names of any persons who have received commissions in connection with the acquisition, and the amounts of any such commissions and other expense in connection with the acquisition (including the cost of borrowing money to finance the acquisition);

(10)

a description of any stock options or other security options outstanding, or to be created in connection with the offering, together with the amount of any such options held or to be held by every person required to be named in clause (2), (4), (5), (6), or (8) and by any person who holds or will hold ten percent or more in the aggregate of any such options;

(11)

the dates of, parties to, and general effect concisely stated of, every management or other material contract made or to be made otherwise than in the ordinary course of business if it is to be performed in whole or in part at or after the filing of the registration statement or was made within the past two years, together with a copy of every such contract; and a description of any pending litigation or proceeding to which the issuer is a party and which materially affects its business or assets (including any such litigation or proceeding known to be contemplated by governmental authorities);

(12)

a copy of any prospectus, pamphlet, circular, form letter, advertisement, or other sales literature intended as of the effective date to be used in connection with the offering;

(13)

a specimen or copy of the security being registered; a copy of the issuer's articles of incorporation and by-laws, or their substantial equivalents, as currently in effect; and a copy of any indenture or other instrument covering the security to be registered;

(14)

a signed or conformed copy of an opinion of counsel as to the legality of the security being registered (with an English translation if it is in a foreign language), which shall state whether the security when sold will be legally issued, fully paid, and non-assessable, and, if a debt security, a binding obligation of the issuer;

(15)

the written consent of any accountant, engineer, appraiser, or other person whose profession gives authority to a statement made by him, if any such person is named as having prepared or certified a report or valuation (other than a public and official document or statement) which is used in connection with the registration statement;

(16)

a balance sheet of the issuer as of a date within four months prior to the filing of the registration statement; a profit and loss statement and analysis of surplus for each of the three fiscal years preceding the date of the balance sheet and for any period between the close of the last fiscal year and the date of the balance sheet, or for the period of the issuer's and any predecessors' existence if less than three years; and, if any part of the proceeds of the offering is to be applied to the purchase of any business, the same financial statements which would be required if that business were the registrant; and

(17)

such additional information as the [Administrator] requires by rule or order.

(c)

A registration statement under this section becomes effective when the [Administrator] so orders.

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(d)

The [Administrator] may by rule or order require as a condition of registration under this section that a prospectus containing any designated part of the information specified in subsection (b) be sent or given to each person to whom an offer is made before or concurrently with (1) the first written offer made to him (otherwise than by means of a public advertisement) by or for the account of the issuer or any other person on whose behalf the offering is being made, or by any underwriter or broker-dealer who is offering part of an unsold allotment or subscription taken by him as a participant in the distribution, (2) the confirmation of any sale made by or for the account of any such person, (3) payment pursuant to any such sale, or (4) delivery of the security pursuant to any such sale, whichever first occurs.

Official Code Comment Subsec. (b). This subsection is modeled on Schedule A of the Securities Act of 1933, 15 U.S.C. § 77aa [15 U.S.C.A. § 77aa], SEC Form S-1, which is the basic registration form under that act, and a number of the state statutes. Section 305 contains a number of provisions applicable to registration generally, including authority in § 305(e) to reduce the content of the registration statement by rule or otherwise. And § 412(a) gives authority to classify, and adopt different forms for different types of, issues and issuers. Subsec. (d). This subsection simply authorizes the Administrator to require the use of a prospectus in those unusual cases where he deems it in the public interest. This Act, unlike the federal statute, is not primarily a disclosure act.

§ 305 Provisions Applicable to Registration Generally

(a)

A registration statement may be filed by the issuer, any other person on whose behalf the offering is to be made, or a registered broker-dealer. [(b) Every person filing a registration statement shall pay a filing fee of percent of the maximum aggregate offering price at which the registered securities are to be offered in this state, but the fee shall in no case be less than \$.....or more than \$.....When a registration statement is withdrawn before the effective date or a pre-effective stop order is entered under section 306, the [Administrator] shall retain \$.....of the fee.]

(c)

Every registration statement shall specify (1) the amount of securities to be offered in this state; (2) the states in which a registration statement or similar document in connection with the offering has been or is to be filed; and (3) any adverse order, judgment, or decree entered in connection with the offering by the regulatory authorities in each state or by any court or the Securities and Exchange Commission.

(d)

Any document filed under this act or a predecessor act [within five years preceding the filing of a registration statement] may be incorporated by reference in the registration statement to the extent that the document is currently accurate.

(e)

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The [Administrator] may by rule or otherwise permit the omission of any item of information or document from any registration document.

(f)

In the case of a non-issuer distribution, information may not be required under section 304 or 305(j) unless it is known to the person filing the registration statement or to the persons on whose behalf the distribution is to be made, or can be furnished by them without unreasonable effort or expense.

(g)

The [Administrator] may by rule or order require as a condition of registration by qualification or coordination (1) that any security issued within the past three years or to be issued to a promoter for a consideration substantially different from the public offering price, or to any person for a consideration other than cash, be deposited in escrow; and (2) that the proceeds from the sale of the registered security in this state be impounded until the issuer receives a specified amount from the sale of the security either in this state or elsewhere.

(h)

The [Administrator] may by rule or order require as a condition of registration that any security registered by qualification or coordination be sold only on a specified form of subscription or sale contract, and that a signed or conformed copy of each contract be filed with the [Administrator] or preserved for any period up to three years specified in the rule or order.

(i)

Every registration statement is effective for one year from its effective date, or any longer period during which the security is being offered or distributed in a non-exempted transaction by or for the account of the issuer or other person on whose behalf the offering is being made or by any underwriter or broker-dealer who is still offering part of an unsold allotment or subscription taken by him as a participant in the distribution, except during the time a stop order is in effect under section 306. All outstanding securities of the same class as a registered security are considered to be registered for the purpose of any non-issuer transaction (1) so long as the registration statement is effective and (2) between the thirtieth day after the entry of any stop order suspending or revoking the effectiveness of the registration statement under section 306 (if the registration statement did not relate in whole or in part to a non-issuer distribution) and one year from the effective date of the registration statement. A registration statement may not be withdrawn for one year from its effective date if any securities of the same class are outstanding. A registration statement may be withdrawn otherwise only in the discretion of the [Administrator].

(j)

So long as a registration statement is effective, the [Administrator] may by rule or order require the person who filed the registration statement to file reports, not more often than quarterly, to keep reasonably current the information

contained in the registration statement and to disclose the progress of the offering.

(k)

A registration statement relating to a security issued by a face-amount certificate company or a redeemable security issued by an open-end management company or unit investment trust, as those terms are defined in the Investment Company Act of 1940, may be amended after its effective date so as to increase the securities specified as proposed to be offered. Such an amendment becomes effective when the [Administrator] so orders. Every person filing such an amendment shall pay a filing fee, calculated in the manner specified in subsection (b), with respect to the additional securities proposed to be offered.

[As amended August 1958.]

Official Code Comment Subsec. (a). This section contains a number of provisions which are equally applicable to all three types of registration, or in a few cases to two of the three types. The reference here to "any other person on whose behalf the offering is to be made" is designed for non-issuer distributions. See the comment under § 305(i). This section makes it possible for a local broker-dealer to file a registration statement, independently of the issuer or underwriters, especially in coordination cases so that the issuer and underwriters will not be able to veto the making of an offering and the establishment of a market in any state in which they do not choose to register. Subsec. (b). On the fee problem with respect to convertible securities and offerings by way of warrants or rights, see the comment under § 401(j)(5). Subsec. (c). This subsection, like every other provision having to do with the content of the registration statement, must be read in the light of the fact that the accuracy and completeness of the registration statement are judged under § 306(a)(2)(A) as of its effective date unless a proceeding to deny effectiveness is instituted before the effective date. That is to say, the registration statement must be kept current with changing developments until the effective date, but it need not be amended thereafter except to correct inaccuracies or deficiencies which existed as of the effective date. If the Administrator wants some or all registration statements to be brought up to date periodically, he may do so by requiring reports under § 305(j). Clause (3) does not require that notice be given with respect to any order permitting withdrawal of a registration statement. The Administrator may nevertheless require such information in qualification cases under § 304(b)(17). Subsec. (d). The language in brackets is included only because some states do not keep files indefinitely. If a particular state does not keep files for as long as five years, or if it keeps them longer, some other appropriate figure should be substituted for "five." But if files are kept indefinitely, the bracketed language should be omitted. Subsec. (f). See paragraph 10 of the comment under § 305(i). Subsec. (g). The "but" clause at the end of the subsection is designed to break the impasse which arises when each of several Administrators imposes an escrow or impounding requirement and insists that the depository be in his state. Subsec. (h). This provision is included to take care of the few states in which this regulatory device is used. No implication is intended that this authority should be used by the Administrator in states in which it is not traditional. Subsecs. (i) and (j) and Related Sections Referring to Non-Issuer Distributions. The statutory scheme with respect to non-issuer distributions and the related question of how long a registration statement remains effective is as follows:

1.

Section 301(a) applies broadly to any offer or sale by any person. Thus, it is literally unlawful for A to sell five shares of X Corp. to B unless there is registration or an exemption.

2.

The term "non-issuer" is defined in § 401(h) to mean simply "not directly or indirectly for the benefit of the issuer."

3.

Section 402(b)(1) exempts from registration "any isolated non-issuer transaction, whether effected through a broker-dealer or not."

4.

When the non-issuer distribution is something more than an "isolated transaction," however that phrase is construed, it may still be exempted under one of the following sections: 402(a)(8), 402(b)(3), 402(b)(6), 402(b)(7), 402(b)(8), or 402(b)(9). See the comments under those sections.

5.

Apart from these exemptions of general applicability, § 402(b)(2) affords an exemption which is specifically designed for certain non-issuer distributions. An Administrator who chooses to do so may keep track of the securities sold under this exemption by requiring under § 203(a) that registered broker-dealers prepare and keep lists of those securities.

6.

If no exemption is available for the non-issuer distribution, the security must be registered. Under the first sentence of § 305(i) every registration statement is effective for at least one year and for any longer period during which the security is being distributed, except while a stop order is in effect. Under Clause (1) of the second sentence all outstanding securities "of the same class" as the registered security are considered to be registered for the purpose of any non-issuer transaction so long as the registration statement remains effective. And § 305(j) gives the Administrator power by rule or order to require the registrant to file reports so long as the registration remains effective. With respect to the applicability of § 305(j) to convertible securities and rights offerings, see the comment under § 401(j)(5). The effect is that as long as a registration statement is effective, no matter who has filed it or how many units of the class have been registered, all securities of the same class can be legally traded by anybody as if they were registered.

7.

Clause (2) of the second sentence of § 305(i) is designed to take care of the situation where the Administrator finds it necessary to enter a stop order during the year after the effective date. When the registration which thus becomes the subject of a stop order was itself filed in connection with the non-issuer distribution, it would substantially nullify the effect of the stop order to continue to permit a secondary market on the class registration theory of the first sentence of § 305(i). But, when the registration statement related entirely to a primary distribution by the issuer, and a substantial part of the offering was made in the state before the stop order was entered, Clause (2) avoids indefinitely locking the buyers in. Clause (2) stops all trading based on the class registration theory of the first sentence of § 304(i), as distinct

from trading based on the "isolated transaction" exemption in § 402(b)(1) or some other exemption, for thirty days after the entry of the stop order, so that the public may become aware of the stop order and the reason for its entry. Thereafter such trading may resume until the year has expired.

8.

If securities of the class being registered are outstanding when the registration statement becomes effective, or if some of the registered securities have been sold, post-effective withdrawal of the registration statement would interfere with the privilege of persons generally to engage in non-issuer trading for a minimum period of one year after the effective date. Since sellers might not always know of the withdrawal, they might thus be subjected to civil liability through no fault of their own. For this reason § 305(i) provides that a registration statement may not be withdrawn for one year from its effective date if any securities of the same class are outstanding.

9.

If no exemption is available for a non-issuer distribution and a registration statement for securities of the same class is not effective, there arises for the first time the necessity of filing a special registration statement to permit a non-issuer distribution. As in the case of a distribution for the account of the issuer, registration may be effected here by coordination, notification or qualification. Concerning the exclusion of oil, gas and mining interests from § 302(a)(2), see the comment under that section. A registration for a non-issuer distribution, like any other registration, is considered to register all outstanding securities of the same class, and thus to permit anybody to trade for a minimum of one year or however much longer it may take to complete the registered non-issuer distribution. It is thus immaterial whether the registration statement specifically covers 100 shares or 100,000 shares, because the Administrator may not permit the registration statement to become effective unless the statutory standards are satisfied.

10.

Section 306(f) is designed only to take care of the case where the seller cannot obtain certified financial statements and other data normally required. The phrase "without unreasonable effort or expense" is borrowed from § 10(a)(3) of the Securities Act of 1933, 15 U.S.C. § 77j(a)(3) [15 U.S.C.A. § 77j(a)(3)]. In the case of a non-issuer distribution by a person who is in a control relationship with the issuer or otherwise has access to required information, that phrase is not meant to apply to the expense which is merely incident to supplying the information required to register. Moreover, § 305(f) does not excuse the filing of the financial data required by § 302(b)(6) if a non-issuer distribution is registered by notification; for § 305(f) applies by its terms only to §§ 304 (registration by qualification) and 305(j) (reports). The person filing the registration statement can always register by qualification. Although he may not be able to obtain the financial data required by § 302(b)(6) to demonstrate eligibility for the notification procedure, he may be able to obtain other information which the Administrator might wish to require under § 304.Subsec. (k). Investment companies of the types here specified are distinguished by the fact that they are continually offering their securities. Therefore, they do not lend themselves readily to the concept of registering a security in connection with a proposed distribution. For that reason Congress in 1954 added a new § 24(e) to the Investment Company Act of 1940, 15 U.S.C. § 80a-24(e), providing an amendment procedure for registration statements filed under the Securities Act of 1933 by investment companies of these types. Since these investment companies typically offer in many states, the same provision is incorporated in § 305(k). Normally the investment company will presumably wish to use the coordination procedure under § 303. See the last paragraph of the comment under § 303(a). But it will find § 305(k) useful when it runs out of locally registered securities in a particular state before it has to file an amendment to its

federal registration statement.

§ 306 Denial, Suspension, and Revocation of Registration

(a)

The [Administrator] may issue a stop order denying effectiveness to, or suspending or revoking the effectiveness of, any registration statement if [he] finds (1) that the order is in the public interest and (2) that

(A)

the registration statement as of its effective date or as of any earlier date in the case of an order denying effectiveness, or any amendment under section 305(k) as of its effective date, or any report under section 305(j) is incomplete in any material respect or contains any statement which was, in the light of the circumstances under which it was made, false or misleading with respect to any material fact;

(B)

any provision of this act or any rule, order, or condition lawfully imposed under this act has been willfully violated, in connection with the offering, by (i) the person filing the registration statement, (ii) the issuer, any partner, officer, or director of the issuer, any person occupying a similar status or performing similar functions, or any person directly or indirectly controlling or controlled by the issuer, but only if the person filing the registration statement is directly or indirectly controlled by or acting for the issuer, or (iii) any underwriter;

(C)

the security registered or sought to be registered is the subject of an administrative stop order or similar order or a permanent or temporary injunction of any court of competent jurisdiction entered under any other federal or state act applicable to the offering; but (i) the [Administrator] may not institute a proceeding against an effective registration statement under clause (C) more than one year from the date of the order or injunction relied on, and (ii) [he] may not enter an order under clause (C) on the basis of an order or injunction entered under any other state act unless that order or injunction was based on facts which would currently constitute a ground for a stop order under this section;

(D)

the issuer's enterprise or method of business includes or would include activities which are illegal where performed;

(E)

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the offering has worked or tended to work a fraud upon purchasers or would so operate;

(F)

the offering has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, or promoters' profits or participation, or unreasonable amounts or kinds of options;

(G)

when a security is sought to be registered by notification, it is not eligible for such registration;

(H)

when a security is sought to be registered by coordination, there has been a failure to comply with the undertaking required by section 303(b)(4); or

(I)

the applicant or registrant has failed to pay the proper filing fee; but the [Administrator] may enter only a denial order under this clause and [he] shall vacate any such order when the deficiency has been corrected. The [Administrator] may not institute a stop-order proceeding against an effective registration statement on the basis of a fact or transaction known to him when the registration statement became effective unless the proceeding is instituted within the next thirty days.

(b)

The [Administrator] may by order summarily postpone or suspend the effectiveness of the registration statement pending final determination of any proceeding under this section. Upon the entry of the order, the [Administrator] shall promptly notify each person specified in subsection (c) that it has been entered and of the reasons therefor and that within fifteen days after the receipt of a written request the matter will be set down for hearing. If no hearing is requested and none is ordered by the [Administrator], the order will remain in effect until it is modified or vacated by the [Administrator]. If a hearing is requested or ordered, the [Administrator], after notice of and opportunity for hearing to each person specified in subsection (c), may modify or vacate the order or extend it until final determination.

(c)

No stop order may be entered under any part of this section except the first sentence of subsection (b) without (1) appropriate prior notice to the applicant or registrant, the issuer, and the person on whose behalf the securities are to be or have been offered, (2) opportunity for hearing, and (3) written findings of fact and conclusions of law.

(d)

The [Administrator] may vacate or modify a stop order if [he] finds that the conditions which prompted entry have changed or that it is otherwise in the public interest to do so.

Official Code Comment Subsec. (a). This subsection applies equally to all three types of registration. Clause (A): The completeness and accuracy of the registration statement are to be tested as of its effective date in a suspension or revocation proceeding. That is to say, the fact that a registration statement has become misleading by virtue of developments occurring after its effective date is not a ground for the issuance of a stop order revoking its effectiveness under Clause (A). Post-effective amendments are not necessary except to reflect inaccuracies as of the effective date. If a particular Administrator wants the registration statement to be kept more or less currently accurate so long as it remains effective, he may require reports as often as quarterly by rule or order under § 305(j). In that event, filing a misleading report would be a basis for a stop order under Clause (A) and failure to file such a report would be a basis for a stop order under Clause (B). On the other hand, in a proceeding to deny effectiveness to a pending registration statement, its completeness and accuracy cannot be tested as of the effective date. This explains the first "or" clause in Clause (A). Clause (B): Concerning the meaning of "willfully," see the comment under § 204(a)(2)(B). Under Clause (ii) a violation by the issuer has the same consequences whether the issuer has filed the registration statement itself or has had a local broker-dealer file the registration statement for it. But, when the registration is filed by a local broker-dealer who is acting independently, a provision authorizing the issuance of a stop order for a violation by the issuer or somebody connected with the issuer would be inconsistent with the statutory purpose of permitting (particularly in cases of registration by coordination) the making of an offering and the establishment of a market in any state in which a registered broker-dealer is willing to effect registration. See the comment under § 305(a). Clause (C): The word "is" at the beginning of Clause (C) means that a stop order or injunction which has expired by its terms or been vacated is not a ground for action under this clause. Clause (D): The reference here is to something like a racetrack or gambling casino which is conducted in a state where such an enterprise is illegal. The "public interest" standard in Clause (1) must always be considered. Thus the fact that a large department store had recently violated a statute on resale price maintenance or minimum wages would not justify action under Clause (D). Moreover, Clause (D) is not meant to apply to an enterprise which is lawful where conducted, although it would be illegal if conducted in the state where the registration statement is filed. Clause (E): Section 401(a) provides that the term "fraud" is not limited to common-law deceit. But this clause is not designed to be as broad as the "sound business principles" standard or the "fair, just, and equitable" standard found in some statutes. Clause (F): This clause is broad enough to cover the statement of policy on options which was adopted in 1946 by the National Association of Securities Administrators, as well as its 1955 statement of policy on so-called "cheap stock." 29 Proceedings of NASAA 84-90; 38 id. 113-15. Subsec. (c). This subsection is comparable to § 204(f) and the comment there is equally applicable here.

§ 401 Definitions

When used in this act, unless the context otherwise requires:

(a)

"[Administrator]" [substitute any other appropriate term, such as "Commission," "Commissioner," "Secretary," etc.] means the [official or agency designated in section 406(a)].

(b)

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"Agent" means any individual other than a broker-dealer who represents a broker-dealer or issuer in effecting or attempting to effect purchases or sales of securities. "Agent" does not include an individual who represents an issuer in (1) effecting transactions in a security exempted by clause (1), (2), (3), (10), or (11) of section 402(a), (2) effecting transactions exempted by section 402(b), or (3) effecting transactions with existing employees, partners, or directors of the issuer if no commission or other remuneration is paid or given directly or indirectly for soliciting any person in this state. A partner, officer, or director of a broker-dealer or issuer, or a person occupying a similar status or performing similar functions, is an agent only if he otherwise comes within this definition.

(c)

"Broker-dealer" means any person engaged in the business of effecting transactions in securities for the account of others or for his own account. "Broker-dealer" does not include (1) an agent, (2) an issuer, (3) a bank, savings institution, or trust company, or (4) a person who has no place of business in this state if (A) he effects transactions in this state exclusively with or through (i) the issuers of the securities involved in the transactions, (ii) other broker-dealers, or (iii) banks, savings institutions, trust companies, insurance companies, investment companies as defined in the Investment Company Act of 1940, pension or profit-sharing trusts, or other financial institutions or institutional buyers, whether acting for themselves or as trustees, or (B) during any period of twelve consecutive months he does not direct more than fifteen offers to sell or buy into this state in any manner to persons other than those specified in clause (A), whether or not the offeror or any of the offerees is then present in this state.

(d)

"Fraud," "deceit," and "defraud" are not limited to common-law deceit.

(e)

"Guaranteed" means guaranteed as to payment of principal, interest, or dividends.

(f)

"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, issues or promulgates analyses or reports concerning securities. "Investment adviser" does not include (1) a bank, savings institution, or trust company; (2) a lawyer, accountant, engineer, or teacher whose performance of these services is solely incidental to the practice of his profession; (3) a broker-dealer whose performance of these services is solely incidental to the conduct of his business as a broker-dealer and who receives no special compensation for them; (4) a publisher of any bona fide newspaper, news magazine, or business or financial publication of general, regular, and paid circulation; (5) a person whose advice, analyses, or reports relate only to securities exempted by section 402(a)(1); (6) a person who has no place of business in this state if (A) his only clients in this state are other investment advisers, broker-dealers, banks, savings institutions, trust companies, insurance companies, investment companies as defined in the Investment Company Act of 1940, pension or profit-sharing trusts, or other financial institutions or institutional buyers, whether acting for themselves or as trustees, or (B) during any period of twelve consecutive months he does not direct business

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communications into this state in any manner to more than five clients other than those specified in clause (A), whether or not he or any of the persons to whom the communications are directed is then present in this state; or (7) such other persons not within the intent of this paragraph as the [Administrator] may by rule or order designate.

(g)

"Issuer" means any person who issues or proposes to issue any security, except that (1) with respect to certificates of deposit, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors or persons performing similar functions or of the fixed, restricted management, or unit type, the term "issuer" means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which the security is issued; and (2) with respect to certificates of interest or participation in oil, gas, or mining titles or leases or in payments out of production under such titles or leases, there is not considered to be any "issuer."

(h)

"Non-issuer means not directly or indirectly for the benefit of the issuer.

(i)

"Person" means an individual, a corporation, a partnership, an association, a joint-stock company, a trust where the interests of the beneficiaries are evidenced by a security, an unincorporated organization, a government, or a political subdivision of a government.

(j)

(1)

"Sale" or "sell" includes every contract of sale of, contract to sell, or disposition of, a security or interest in a security for value.

(2)

"Offer" or "offer to sell" includes every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security for value.

(3)

Any security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing is considered to constitute part of the subject of the purchase and to have been offered and sold for value.

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(4)

A purported gift of assessable stock is considered to involve an offer and sale.

(5)

Every sale or offer of a warrant or right to purchase or subscribe to another security of the same or another issuer, as well as every sale or offer of a security which gives the holder a present or future right or privilege to convert into another security of the same or another issuer, is considered to include an offer of the other security.

(6)

The terms defined in this subsection do not include (A) any bona fide pledge or loan; (B) any stock dividend, whether the corporation distributing the dividend is the issuer of the stock or not, if nothing of value is given by stockholders for the dividend other than the surrender of a right to a cash or property dividend when each stockholder may elect to take the dividend in cash or property or in stock; (C) any act incident to a class vote by stockholders, pursuant to the certificate of incorporation or the applicable corporation statute, on a merger, consolidation, reclassification of securities, or sale of corporate assets in consideration of the issuance of securities of another corporation; or (D) any act incident to a judicially approved reorganization in which a security is issued in exchange for one or more outstanding securities, claims, or property interests, or partly in such exchange and partly for cash.

(k)

"Securities Act of 1933," "Securities Exchange Act of 1934," "Public Utility Holding Company Act of 1935," and "Investment Company Act of 1940" mean the federal statutes of those names as amended before or after the effective date of this act.

(l)

"Security" means any note; stock; treasury stock; bond; debenture; evidence of indebtedness; certificate of interest or participation in any profit-sharing agreement; collateral-trust certificate; preorganization certificate or subscription; transferable share; investment contract; voting-trust certificate; certificate of deposit for a security; certificate of interest or participation in an oil, gas, or mining title or lease or in payments out of production under such a title or lease; or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for guarantee of, or warrant or right to subscribe to or purchase any of the foregoing. "Security" does not include any insurance or endowment policy or annuity contract under which an insurance company promises to pay [a fixed sum of] money either in a lump sum or periodically for life or for some other specified period.

(m)

"State" means any state, territory, or possession of the United States, the District of Columbia, and Puerto Rico. As amended August 1958.

Official Code Comment Subsec. (b). Whether a particular individual who represents a broker-dealer or issuer is an "agent" or is himself a "broker-dealer" depends upon much the same factors which create an agency relationship at common law. That is to say, the question turns essentially on whether the individual has manifested a consent to the broker-dealer or issuer to act subject to his control. See Restatement of Agency § 1. The last sentence does not require every partner, officer or director to file a separate application for registration, because the last sentence of § 202(a) provides that registration of a broker-dealer automatically constitutes registration of any agent who is a partner, officer or director. See the comment under § 202(a).Subsec. (c). With respect to the distinction between a person who is "engaged in the business of effecting transactions for his own account" and an ordinary investor who buys and sells with some frequency, see Loss, Securities Regulation (1951 with 1955 Supp.), pp. 720-22.Clause (4): See paragraph 12 of the comment under § 414(a)-(f). The reference in Clause (B) to fifteen offers during any period of twelve consecutive months in the case of persons without a place of business in the state is not intended to carry any implication that a person who effects more than fifteen transactions for his own account in the course of ordinary investment during any period of twelve months is for that reason alone a "broker-dealer."Subsec. (d). This subsection codifies the holdings that "fraud" as used in federal and state securities statutes, as well as the federal mail fraud statute, is not limited to common-law deceit. See the cases cited in Loss, Securities Regulation (1951 with 1955 Supp.), p. 817, notes 30-31.Subsec. (f). In general: This subsection has been taken almost verbatim from the definition in § 202(a)(11) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(11) [15 U.S.C.A. § 80b-2(a)(11)]. On the administrative construction of the federal definition, see Loss, Securities Regulation (1951 with 1955 Supp.), pp. 788-92. Clause (6) has been added; see paragraph 12 of the comment under § 414(a)-(f).Clause (3): The model of this clause in the federal act has been thus explained in an opinion of the SEC's General Counsel (Investment Advisers Act Release No. 2): "[This clause] amounts to a recognition that brokers and dealers commonly give a certain amount of advice to their customers in the course of their regular business, and that it would be inappropriate to bring them within the scope of the Investment Advisers Act merely because of this aspect of their business. On the other hand, that portion of clause [(3)] which refers to 'special compensation' amounts to an equally clear recognition that a broker or dealer who is specially compensated for the rendition of advice should be considered an investment adviser and not be excluded from the purview of the Act merely because he is also engaged in effecting market transactions in securities. It is well known that many brokers and dealers have investment advisory departments which furnish investment advice for compensation in the same manner as does an investment adviser who operates solely in an advisory capacity. The essential distinction to be borne in mind in considering borderline cases is the distinction between compensation for advice itself and compensation for services of another character to which advice is merely incidental."Clause (4): The word "paid," which does not appear in the federal definition, has been added to emphasize that a person who periodically distributes a "tipster sheet" free as a way to get paying clients is not excluded from the definition as a "publisher."Subsec. (g). The phraseology is taken almost verbatim from § 2(4) of the Securities Act of 1933, 15 U.S.C. § 77b(4), [15 U.S.C.A. § 77b(4)]. The peculiar types of securities other than those dealt with in Clause (1)--for example, equipment-trust certificates--may be handled under the rule-making power in § 412(a).Subsec. (h). See the comment under § 305(i).Subsec. (j). Clauses (1)-(2): The phraseology is borrowed substantially from § 2(3) of the Securities Act of 1933, 15 U.S.C. § 77b(3) [15 U.S.C.A. § 77b(3)], as amended in 1954 to split the definitions of "sale" and "offer." See the comment under § 402(b)(12).Clause (5): This clause provides that there is always an "offer" of the security called for by a conversion privilege or the warrant. Hence that security must be registered (unless some exemption is available) before the convertible security or the warrants are offered. Even if the warrants are themselves distributed without consideration, so that the warrants are not "sold," a gift of a warrant involves an offer to sell the stock called for by the warrant. Hence registration of the stock is necessary before the warrants may even be given away. Moreover, since the security called for is being continuously "offered" so long as the conversion privilege or the purchase right remains exercisable, the security called for remains registered all that time under § 305(i), and the person who files the registration statement is subject to the Administrator's power to require the filing of reports under § 305(j).Under certain conditions, however, § 402(b)(11) exempts offers to existing security holders, specifically including "persons who at the time of the transaction are holders of convertible securities, non-transferable warrants, or transferable warrants

exercisable within not more than ninety days of their issuance. That exemption does not excuse registration of the second security (that is, the security called for by the warrant or conversion privilege) unless the offering of the first security itself (that is, the warrants or the convertible security) comes within the exemption; for there is a present "offer" of the second security under § 401(j)(5) and the offerees are not yet existing security holders. But the exemption under § 402(b)(11) will normally be available when the conversion privilege or warrant is exercised. Hence, if the first security is not being offered or distributed more than one year from the effective date of the registration statement, the effectiveness of the registration statement terminates at the end of the one-year period under § 305(i) and the power to require reports terminates at the same time. The registration fee in the case of warrants or rights should be based on the total offering price of the security called for by the warrants or rights, together with the offering price of the warrants or rights themselves if they are not given away. In the convertible security situation, since no consideration is given for the second security except the surrender of the first, the fee should be based solely on the offering price of the convertible security and there should be no double fee. Subsec. (l). This subsection is identical with § 2(1) of the Securities Act of 1933, 15 U.S.C. § 77b(1) [15 U.S.C.A. § 77b(1)], except for oil, gas and mineral interests and the addition of the last sentence. Section 2(1) was modeled on the definitions in some of the state statutes, and the federal definition has in turn influenced many of the new state statutes enacted since 1933. Moreover, substantially that definition--particularly the phrase "investment contract"--has been broadly construed by both state and federal courts. See, e. g., *SEC v. W. J. Howey Co.*, 66 S.Ct. 1100, 328 U.S. 293, 90 L.Ed. 1244 (1946); for citations to other federal and state cases, as well as a discussion of the administrative construction of the several phrases in the definition, see Loss, *Securities Regulation* (1951 with 1955 Supp.), pp. 299-329. Oil, gas and mineral interests: Section 2(1) of the Securities Act of 1933 uses the phrase "fractional undivided interest in oil, gas, or other mineral rights." The phrase in this statute is modeled on the language in § 2508(a) of the California act--"certificate of interest in an oil, gas, or mining title or lease"--which may be slightly broader than the federal phrase and in any event is by far the most commonly found phrase in the state statutes. The words which have been added to the California language are intended to make it clear that so-called "oil payments" are securities whether or not they may be regarded as interests in a title or lease. Very few states go so far as to include entire leasehold interests. However, it is clear that even entire leasehold interests may be offered under such circumstances that a security is involved in the nature of an "investment contract." *SEC v. C. M. Joiner Leasing Corp.*, 64 S.Ct. 120, 320 U.S. 344, 88 L.Ed. 88 (1943); for other cases, see Loss, *Securities Regulation* (1951 with 1955 Supp.), p. 312, n. 31. The last sentence has been explicitly phrased so as not to exclude from the definition the so-called "variable annuities" which have recently been developed. See also the comment under § 402(a)(5). If it is desired to exclude variable annuities along with orthodox annuities on the ground that the former are sufficiently regulated by the insurance authorities in the particular state, the bracketed language should be deleted.

§ 402 Exemptions

(a)

The following securities are exempted from sections 301 and 403:

(1)

any security (including a revenue obligation) issued or guaranteed by the United States, any state, any political subdivision of a state, or any agency or corporate or other instrumentality of one or more of the foregoing; or any certificate of deposit for any of the foregoing;

(2)

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any security issued or guaranteed by Canada, any Canadian province, any political subdivision of any such province, any agency or corporate or other instrumentality of one or more of the foregoing, or any other foreign government with which the United States currently maintains diplomatic relations, if the security is recognized as a valid obligation by the issuer or guarantor;

(3)

any security issued by and representing an interest in or a debt of, or guaranteed by, any bank organized under the laws of the United States, or any bank, savings institution, or trust company organized and supervised under the laws of any state;

(4)

any security issued by and representing an interest in or a debt of, or guaranteed by, any federal savings and loan association, or any building and loan or similar association organized under the laws of any state and authorized to do business in this state;

(5)

any security issued by and representing an interest in or a debt of, or guaranteed by, any insurance company organized under the laws of any state and authorized to do business in this state; [but this exemption does not apply to an annuity contract, investment contract, or similar security under which the promised payments are not fixed in dollars but are substantially dependent upon the investment results of a segregated fund or account invested in securities;]

(6)

any security issued or guaranteed by any federal credit union or any credit union, industrial loan association, or similar association organized and supervised under the laws of this state;

(7)

any security issued or guaranteed by any railroad, other common carrier, public utility, or holding company which is (A) subject to the jurisdiction of the Interstate Commerce Commission; (B) a registered holding company under the Public Utility Holding Company Act of 1935 or a subsidiary of such a company within the meaning of that act; (C) regulated in respect of its rates and charges by a governmental authority of the United States or any state; or (D) regulated in respect of the issuance or guarantee of the security by a governmental authority of the United States, any state, Canada, or any Canadian province;

(8)

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any security listed or approved for listing upon notice of issuance on the New York Stock Exchange, the American Stock Exchange, or the Midwest Stock Exchange [, or listed on the (insert names of appropriate regional stock exchanges)]; any other security of the same issuer which is of senior or substantially equal rank; any security called for by subscription rights or warrants so listed or approved; or any warrant or right to purchase or subscribe to any of the foregoing;

(9)

any security issued by any person organized and operated not for private profit but exclusively for religious, educational, benevolent, charitable, fraternal, social, athletic, or reformatory purposes, or as a chamber of commerce or trade or professional association;

(10)

any commercial paper which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which evidences an obligation to pay cash within nine months of the date of issuance, exclusive of days of grace, or any renewal of such paper which is likewise limited, or any guarantee of such paper or of any such renewal;

(11)

any investment contract issued in connection with an employees' stock purchase, savings, pension, profit-sharing, or similar benefit plan if the [Administrator] is notified in writing thirty days before the inception of the plan or, with respect to plans which are in effect on the effective date of this act, within sixty days thereafter (or within thirty days before they are reopened if they are closed on the effective date of this act);

[(12) insert any desired exemption for cooperatives.]

(b)

The following transactions are exempted from sections 301 and 403:

(1)

Any isolated non-issuer transaction, whether effected through a broker-dealer or not;

(2)

any non-issuer distribution of an outstanding security if (A) a recognized securities manual contains the names of the issuer's officers and directors, a balance sheet of the issuer as of a date within eighteen months, and a profit and

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loss statement for either the fiscal year preceding that date or the most recent year of operations, or (B) the security has a fixed maturity or a fixed interest or dividend provision and there has been no default during the current fiscal year or within the three preceding fiscal years, or during the existence of the issuer and any predecessors if less than three years, in the payment of principal, interest, or dividends on the security;

(3)

any non-issuer transaction effected by or through a registered broker-dealer pursuant to an unsolicited order or offer to buy; but the [Administrator] may by rule require that the customer acknowledge upon a specified form that the sale was unsolicited, and that a signed copy of each such form be preserved by the broker-dealer for a specified period;

(4)

any transaction between the issuer or other person on whose behalf the offering is made and an underwriter, or among underwriters;

(5)

any transaction in a bond or other evidence of indebtedness secured by a real or chattel mortgage or deed of trust, or by an agreement for the sale of real estate or chattels, if the entire mortgage, deed of trust, or agreement, together with all the bonds or other evidences of indebtedness secured thereby, is offered and sold as a unit;

(6)

any transaction by an executor, administrator, sheriff, marshal, receiver, trustee in bankruptcy, guardian, or conservator;

(7)

any transaction executed by a bona fide pledgee without any purpose of evading this act;

(8)

any offer or sale to a bank, savings institution, trust company, insurance company, investment company as defined in the Investment Company Act of 1940, pension or profit-sharing trust, or other financial institution or institutional buyer, or to a broker-dealer, whether the purchaser is acting for itself or in some fiduciary capacity;

(9)

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any transaction pursuant to an offer directed by the offeror to not more than ten persons (other than those designated in paragraph (8)) in this state during any period of twelve consecutive months, whether or not the offeror or any of the offerees is then present in this state, if (A) the seller reasonably believes that all the buyers in this state (other than those designated in paragraph (8)) are purchasing for investment, and (B) no commission or other remuneration is paid or given directly or indirectly for soliciting any prospective buyer in this state (other than those designated in paragraph (8)); but the [Administrator] may by rule or order as to any security or transaction or any type of security or transaction, withdraw or further condition this exemption, or increase or decrease the number of offerees permitted, or waive the conditions in Clauses (A) and (B) with or without the substitution of a limitation on remuneration;

(10)

any offer or sale of a preorganization certificate or subscription if (A) no commission or other remuneration is paid or given directly or indirectly for soliciting any prospective subscriber, (B) the number of subscribers does not exceed ten, and (C) no payment is made by any subscriber;

(11)

any transaction pursuant to an offer to existing security holders of the issuer, including persons who at the time of the transaction are holders of convertible securities, non-transferable warrants, or transferable warrants exercisable within not more than ninety days of their issuance, if (A) no commission or other remuneration (other than a standby commission) is paid or given directly or indirectly for soliciting any security holder in this state, or (B) the issuer first files a notice specifying the terms of the offer and the [Administrator] does not by order disallow the exemption within the next five full business days;

(12)

any offer (but not a sale) of a security for which registration statements have been filed under both this act and the Securities Act of 1933 if no stop order or refusal order is in effect and no public proceeding or examination looking toward such an order is pending under either act.

(c)

The [Administrator] may by order deny or revoke any exemption specified in clause (9) or (11) of subsection (a) or in subsection (b) with respect to a specific security or transaction. No such order may be entered without appropriate prior notice to all interested parties, opportunity for hearing, and written findings of fact and conclusions of law, except that the [Administrator] may by order summarily deny or revoke any of the specified exemptions pending final determination of any proceeding under this subsection. Upon the entry of a summary order, the [Administrator] shall promptly notify all interested parties that it has been entered and of the reasons therefor and that within fifteen days of the receipt of a written request the matter will be set down for hearing. If no hearing is requested and none is ordered by the [Administrator], the order will remain in effect until it is modified or vacated by the [Administrator]. If a hearing is requested or ordered, the [Administrator], after notice of and opportunity for hearing to all interested persons, may modify or vacate the order or extend it until final determination. No order under this subsection may operate retroactively. No person may be considered to have violated section 301 or 403 by reason of any offer or sale effected

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after the entry of an order under this subsection if he sustains the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the order.

(d)

In any proceeding under this act, the burden of proving an exemption or an exception from a definition is upon the person claiming it.

[As amended August 1958.]

Official Code Comment Subsec. (a). The distinction between exemptions and exceptions from definitions is important in view of the fact that the exemptions enumerated in § 402 are not exemptions from the anti-fraud provisions of §§ 101 and 410(a)(2). See the exceptions from the definition of "agent" in § 401(b), the definition of "broker-dealer" in § 401(c), the definition of "investment adviser" in § 401(f), the definitions of "sale" and "offer" in § 401(j)(6), and the definition of "security" in the last sentence of § 401(l). Subsec. (a)(3). Each of the exemptions in Clauses (3)-(5) applies only if the security represents an interest in or a debt of the particular issuer, or is guaranteed by the particular issuer. The purpose is to make it clear that these exemptions do not apply when, for example, a bank acting as depository for a protective committee in a reorganization issues certificates of deposit, which in no sense represent an interest in or a claim against the bank. The exemption for bank securities in Illinois was so construed even before it was specifically limited as it now is. *Jaffe v. Goldner* 251 Ill.App. 188 (1929); see also *Commissioner of Banks v. Chase Securities Corp.*, 298 Mass. 285, 301-05, 10 N.E.2d 472, 485-87 (1937), appeal dismissed, 302 U.S. 660. But it required an amendment in California [§ 25100(c)] to override a contrary interpretation. *Young v. Three for One Royalties*, 31 P.2d 789 (Cal.1934), rehearing denied with opinion, 1 Cal.2d 639, 36 P.2d 1065 (1934). Subsec. (a)(4). See the comment under § 402(a)(3). Subsec. (a)(5). See the comment under § 402(a)(3). With respect to the status of insurance policies and annuities, see the comment under the last sentence of § 401(l). By virtue of that section, the orthodox insurance policy or annuity is not a "security" and the blue sky law has no impact on it, whereas securities issued by insurance companies are exempted from registration under the conditions of § 402(a)(5) and hence are subject to the fraud provisions. The purpose of the "but" clause in § 402(a)(5) is to make it clear that the so-called "variable annuities" which have recently been developed, and which are securities under § 401(l), are not exempted. If the bracketed language in § 401(1) is deleted (see the Commissioners' Note under that section), the bracketed language in § 402(a)(5) should be deleted for the same reason. Subsec. (a)(6). The reference to federal credit unions is to those organized under 12 U.S.C. § 1751 et seq. [12 U.S.C.A. § 1751 et seq.]. Subsec. (a)(7). Twelve of the forty statutes with some sort of public-utility exemption refer specifically to regulation by municipal as well as state authority. The others do not necessarily exclude the possibility of municipal regulation. The reference in § 402(a)(7) to a "a governmental authority of any state" is broad enough to include a municipal authority. Subsec. (a)(10). This exemption is modeled on § 3(a)(3) of the Securities Act of 1933, 15 U.S.C. § 77c(a)(3) [15 U.S.C.A. § 77c(a)(3)]. On the SEC construction of the phrase "current transaction," see Loss, *Securities Regulation* (1951 with 1955 Supp.), p. 356. See also § 402(b)(8), which exempts an offer or sale of any security to banks and other institutional buyers. The two exemptions substantially overlap. Subsec. (a)(11). This exemption is designed to solve the problem which arises in those states whose Administrators take the position, also taken by the SEC, that employees' benefit plans of various kinds involve an offer of a security in the nature of an "investment contract," at least if participation is voluntary with each employee and he must contribute under the plan in order to participate. See Loss, *Securities Regulation* (1951 with 1955 Supp.), pp. 326-29. Subsec. (b)(1)(2). See the comment under § 305(i). Subsec. (b)(3). If necessary, the Administrator may use his rule-making authority under § 412(a) to define the term "solicitation." On the construction of the term in § 4(2) of the Securities Act of 1933, 15 U.S.C. § 77d(2) [15 U.S.C.A. § 77d(2)], see Loss, *Securities Regulation* (1951 with 1955 Supp.), pp. 405-06. In one important respect § 402(b)(3) is broader than § 4(2) of the federal statute, which the SEC has always interpreted as exempting only the broker's part of the transaction. In the SEC's view, the selling customer must find his own exemption--normally the exemption in § 4(1) of the federal act which is comparable to the exemption in §

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402(b)(1) of this Act for "any isolated non-issuer transaction." Section 402(b)(3) is not intended to be so limited. Of course, the exemption can in no case be used by an issuer, since it is limited to "any non-issuer transaction." Subsec. (b)(5). This exemption is severely restricted by the requirement that everything be both offered and sold as a unit. But it permits a public offering as a unit. Subsec. (b)(8). The term "institutional buyer" is broad enough to cover, for example, a college purchasing for its endowment fund or perhaps a labor union investing its surplus funds on a substantial scale. The term may be either left to ad hoc interpretation or defined by an interpretative rule under § 412(a). Subsec. (b)(9). The figure ten is in substance only a prima facie figure. An Administrator, for example, may want to reduce it for uranium stocks or oil royalties or increase it for a close corporation which wants to solicit twenty or thirty friends or relatives of the owners for additional capital. The section does not require a written representation by each buyer that he is taking for investment, but it would be prudent on the part of the seller to obtain something in writing. Moreover, one who in good faith buys for investment can later change his mind and resell, although the shorter the interval the harder it will be to show that there was a bona fide change of mind. Clause (B) is not intended to preclude solicitation by directors or officers or employees of the issuer so long as it is only an incidental function of their regular duties and they receive no additional compensation. It is also relevant whether such persons are specially hired in connection with the offering, particularly if they have a background in the securities business either as professional promoters or otherwise. Subsec. (b)(10). Subsections (b)(9) and (b)(10), though interrelated, serve different purposes. Since the purpose of § 402(b)(10) is to enable a new enterprise to obtain the minimum number of subscriptions required by the corporation law, the limitation is on the number of subscribers rather than the number of offerees. Hence there may be a publicly advertised offering of preorganization subscriptions. But there may be no payment until effective registration unless another exemption is available. One of the other exemptions which might be available is § 402(b)(9). In that event registration would not be required at all. But § 402(b)(10) itself simply postpones registration; it does not excuse registration altogether. Subsec. (b)(11). The reference to a "standby commission" in Clause (A) is designed to permit payment to an underwriter for his risk and services in connection with his commitment to take down any portion of the offering which is not taken down by the security holders. As to what constitutes the payment of remuneration otherwise, see the comment under § 402(b)(9). The specific authority to disallow by order under Clause (B) is not subject to the general procedure set out in § 402(c) for denying any of the exemptions specified in § 402(b). Subsec. (b)(12). The Securities Act of 1933 [15 U.S.C.A. § 77a et seq.] and the SEC rules severely restrict the types of written offers that may be made before the effective date. Subsec. (c). This subsection permits the Administrator by order to deny or revoke the exemption for any of the exempted transactions, as well as two types of exempted securities, but only with respect to a specific case. He has no authority by rule or otherwise to revoke any statutory exemption generally. Subsec. (d). This codifies existing law. See the cases cited in Loss, Securities Regulation (1951 with 1955 Supp.), p. 414, n. 365.

§ 403 Filing of Sales and Advertising Literature

The [Administrator] may by rule or order require the filing of any prospectus, pamphlet, circular, form letter, advertisement, or other sales literature or advertising communication addressed or intended for distribution to prospective investors, including clients or prospective clients of an investment adviser unless the security or transaction is exempted by Section 402.

[As amended August 1958.]

Official Code Comment

Many statutes require advertising and sales literature to be approved by the Administrator before it is used. Some require merely filing prior to use. Some, particularly with respect to securities registered by notification, require sales literature to be filed either concurrently with or after its use. Section 403 affords the necessary flexibility, in conjunction with the authority in § 412(a) to classify, so that the Administrator may by rule or order apply any or all of these formulas to certain types of securities. Consistently with the "unless" clause, any rules or orders under this section can apply only to the person filing a registration statement or his principal.

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This amendment calls for a change in Appendix C-1 of the Uniform Securities Act, which should be amended by inserting the following language at the appropriate place: Sec. 403: Delete "including clients or prospective clients of an investment adviser."

§ 404 Misleading Filings

It is unlawful for any person to make or cause to be made, in any document filed with the [Administrator] or in any proceeding under this act, any statement which is, at the time and in the light of the circumstances under which it is made, false or misleading in any material respect.

§ 405 Unlawful Representations Concerning Registration or Exemption

(a)

Neither (1) the fact that an application for registration under Volume 2 or a registration statement under Volume 3 has been filed nor (2) the fact that a person or security is effectively registered constitutes a finding by the [Administrator] that any document filed under this act is true, complete, and not misleading. Neither any such fact nor the fact that an exemption or exception is available for a security or a transaction means that the [Administrator] has passed in any way upon the merits or qualifications of, or recommended or given approval to, any person, security, or transaction.

(b)

It is unlawful to make, or cause to be made, to any prospective purchaser, customer, or client any representation inconsistent with subsection (a).

§ 406 Administration of Act

(a)

This act shall be administered by the [insert name of local administrative agency and any related provisions on method of selection, salary, term of office, budget, selection and remuneration of personnel, annual reports to the legislature or governor, etc., which are appropriate to the particular state].

(b)

It is unlawful for the [Administrator] or any of [his] officers or employees to use for personal benefit any information which is filed with or obtained by the [Administrator] and which is not made public. No provision of this act authorizes the [Administrator] or any of [his] officers or employees to disclose any such information except among themselves or when necessary or appropriate in a proceeding or investigation under this act. No provision of this act either creates or derogates from any privilege which exists at common law or otherwise when documentary or other evidence is sought under a subpoena directed to the [Administrator] or any of his officers or employees. [(c) Insert a provision, if desired, covering fees for examinations, filings under section 403, and other miscellaneous filings for

which no fees are specified elsewhere in this act.]

Official Code Comment Subsec. (b). The "except" clause in the second sentence takes care of cases in which the Administrator or a member of his staff is subpoenaed. The law of evidence is not clear in such cases whether and to what extent non-public information in the files of a governmental agency is privileged. The last sentence makes it clear that nothing in the Act affects the question of evidentiary privilege one way or the other. That question is left to the general law in the particular state. Subsec. (c). The only fees specifically provided for in this statute are the registration fees under §§ 202(b) and 305(b). Many statutes specify a wide variety of additional fees for certain filings, examinations, interpretative opinions and other special purposes.

§ 407 Investigations and Subpoenas

(a)

The [Administrator] in [his] discretion (1) may make such public or private investigations within or outside of this state as [he] deems necessary to determine whether any person has violated or is about to violate any provision of this act or any rule or order hereunder, or to aid in the enforcement of this act or in the prescribing of rules and forms hereunder, (2) may require or permit any person to file a statement in writing, under oath or otherwise as the [Administrator] determines, as to all the facts and circumstances concerning the matter to be investigated, and (3) may publish information concerning any violation of this act or any rule or order hereunder.

(b)

For the purpose of any investigation or proceeding under this act, the [Administrator] or any officer designated by [him] may administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, agreements, or other documents or records which the [Administrator] deems relevant or material to the inquiry.

(c)

In case of contumacy by, or refusal to obey a subpoena issued to, any person, the [insert name of appropriate court], upon application by the [Administrator], may issue to the person an order requiring him to appear before the [Administrator], or the officer designated by [him], there to produce documentary evidence if so ordered or to give evidence touching the matter under investigation or in question. Failure to obey the order of the court may be punished by the court as a contempt of court.

(d)

No person is excused from attending and testifying or from producing any document or record before the [Administrator], or in obedience to the subpoena of the [Administrator] or any officer designated by [him], or in any proceeding instituted by the [Administrator], on the ground that the testimony or evidence (documentary or otherwise) required of him may tend to incriminate him or subject him to a penalty or forfeiture; but no individual may be prosecuted or subjected to any penalty or forfeiture for or on account of any transaction, matter, or thing concerning

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which he is compelled, after claiming his privilege against self-incrimination, to testify or produce evidence (documentary or otherwise), except that the individual testifying is not exempt from prosecution and punishment for perjury or contempt committed in testifying.

Official Code Comment This section is modeled generally on § 21(a)-(d) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u(a)-(d) [15 U.S.C.A. § 78u(a)-(d)]. The immunity provision in subsection (d) is of the broader variety which forecloses subsequent prosecution and not merely the use of the compelled testimony. Compare *Councilman v. Hitchcock*, 142 U.S. 547 (1892), with *Ullmann v. United States*, 76 S.Ct. 497, 350 U.S. 422, 100 L.Ed. 511 (1956). The words "or contempt" in the "except" clause at the end do not appear in § 21(d) of the Securities Exchange Act of 1934 [15 U.S.C.A. § 78u(d)], but they do appear in the 1954 revision of § 3486 of the United States Criminal Code, 68 Stat. 745, 18 U.S.C. § 3486 [18 U.S.C.A. § 3486], the statute construed in the *Ullmann* case. The purpose is to assure against a witness' obtaining immunity, answering a few questions and then balking. See *United States v. Bryan*, 339 U.S. 323, 335 et seq. (1950). The compulsion of testimony under state process does not grant immunity from federal prosecution so far as the Fifth Amendment is concerned. *Feldman v. United States*, 64 S.Ct. 1082, 322 U.S. 487, 88 L.Ed. 1408 (1944) (prosecution under mail fraud statute); *Dunham v. Ottinger*, 243 N.Y. 423, 438, 154 N.E. 298, 302 (1926), cert. dismissed for want of a substantial federal question, 276 U.S. 592 (the compulsory testimony provision of the New York blue sky law [McKinney's General Business Law, § 352 et seq.] satisfies the Fifth Amendment so long as it guarantees against state prosecution). On the other hand, compulsion of testimony under state process may violate the self-incrimination clause of the state constitution if there is no guarantee against a resulting federal prosecution. *People v. Den Uyl*, 318 Mich. 645, 29 N.W.2d 284, 2 A.L.R.2d 625 (1947); *State ex rel. Mitchell v. Kelly*, 71 So.2d 887, 895 et seq. (Fla.1954).

§ 408 Injunctions

Whenever it appears to the [Administrator] that any person has engaged or is about to engage in any act or practice constituting a violation of any provision of this act or any rule or order hereunder, [he] may in [his] discretion bring an action in the [insert name of appropriate court] to enjoin the acts or practices and to enforce compliance with this act or any rule or order hereunder. Upon a proper showing a permanent or temporary injunction, restraining order, or writ of mandamus shall be granted and a receiver or conservator may be appointed for the defendant or the defendant's assets. The court may not require the [Administrator] to post a bond.

Official Code Comment

This section is modeled on §§ 21(e) and 21(f) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78u(e), 78u(f), [15 U.S.C.A. §§ 78u(e)(f)].

§ 409 Criminal Penalties

(a)

Any person who willfully violates any provision of this act except section 404, or who willfully violates any rule or order under this act, or who willfully violates section 404 knowing the statement made to be false or misleading in any material respect, shall upon conviction be fined not more than \$5,000 or imprisoned not more than three years, or both; but no person may be imprisoned for the violation of any rule or order if he proves that he had no knowledge of the rule or order. [No indictment or information may be returned under this act more than five years after the alleged violation.]

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(b)

The [Administrator] may refer such evidence as is available concerning violations of this act or of any rule or order hereunder to the [attorney general or the proper district attorney], who may, with or without such a reference, institute the appropriate criminal proceedings under this act.

(c)

Nothing in this act limits the power of the state to punish any person for any conduct which constitutes a crime by statute or at common law.

Official Code Comment On the meaning of "willfully," see the comment under § 204(a)(2)(B). The sentence in brackets in § 409(a) is an optional provision for any state which does not have a general criminal statute of limitations.

§ 410 Civil Liabilities

(a)

Any person who

(1)

offers or sells a security in violation of section 201(a), 301, or 405(b), or of any rule or order under section 403 which requires the affirmative approval of sales literature before it is used, or of any condition imposed under section 304(d), 305(g), or 305(h), or

(2)

offers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading (the buyer not knowing of the untruth or omission), and who does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission, is liable to the person buying the security from him, who may sue either at law or in equity to recover the consideration paid for the security, together with interest at six percent per year from the date of payment, costs, and reasonable attorneys' fees, less the amount of any income received on the security, upon the tender of the security, or for damages if he no longer owns the security.

(b)

Every person who directly or indirectly controls a seller liable under subsection (a), every partner, officer, or director of such a seller, every person occupying a similar status or performing similar functions, every employee of

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such a seller who materially aids in the sale, and every broker-dealer or agent who materially aids in the sale are also liable jointly and severally with and to the same extent as the seller, unless the non-seller who is so liable sustains the burden of proof that he did not know, and in exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist. There is contribution as in cases of contract among the several persons so liable.

(c)

Any tender specified in this section may be made at any time before entry of judgment.

(d)

Every cause of action under this statute survives the death of any person who might have been a plaintiff or defendant.

(e)

No person may sue under this section more than two years after the contract of sale. No person may sue under this section (1) if the buyer received a written offer, before suit and at a time when he owned the security, to refund the consideration paid together with interest at six percent per year from the date of payment, less the amount of any income received on the security, and he failed to accept the offer within thirty days of its receipt, or (2) if the buyer received such an offer before suit and at a time when he did not own the security, unless he rejected the offer in writing within thirty days of its receipt.

(f)

No person who has made or engaged in the performance of any contract in violation of any provision of this act or any rule or order hereunder, or who has acquired any purported right under any such contract with knowledge of the facts by reason of which its making or performance was in violation, may base any suit on the contract.

(g)

Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this act or any rule or order hereunder is void.

(h)

The rights and remedies provided by this act are in addition to any other rights or remedies that may exist at law or in equity, but this act does not create any cause of action not specified in this section or section 202(e).

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[As amended August 1958.]

Official Code Comment Subsec. (a). For a detailed breakdown of the civil liabilities under the present statutes, with annotations of some of the leading cases, see Loss, *Securities Regulation* (1951 with 1955 Supp.), pp. 962-82. Clause (1): Clause (1) imposes civil liability when the offer violates one of the specified provisions even though the sale does not. The making of a non-exempted offer before the effective date can create no civil rights in the offeree unless the offer results in a sale. But when it does, this language means that the buyer may recover even though no contract was made until after the effective date. Clause (2): This clause is almost identical with § 12(2) of the Securities Act of 1933, 15 U.S.C. § 77l (2), which was also borrowed almost verbatim in § 451.116 of the Michigan statute and § 13.1-522(a)(2) of the new Virginia act. For a comparison of § 12(2) of the federal statute with equitable rescission, from which it was adapted, see Loss, *Securities Regulation* (1951 with 1955 Supp.), pp. 997-1001, 1003-11. Section 410(a)(2), like § 101, the general fraud provision, applies regardless of whether the security is registered, exempted, or sold in violation of the registration requirements. Measure of damages: The measure of damages, when the plaintiff is not in a position to tender back the security, is the same under Clauses (1) and (2). It is designed to be the substantial equivalent of rescission. Subsec. (b). The defense of lack of knowledge is modeled on § 15 of the Securities Act of 1933, 15 U.S.C. § 77o [15 U.S.C.A. § 77o], and § 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t(a) [15 U.S.C.A. § 78t(a)]. The last sentence, with reference to contribution, is a safeguard to avoid the common-law rule which prohibits contribution among joint tort-feasors. Subsec. (d). This subsection is designed to codify the majority view of the few cases which have ruled on the question of survivability under the state and federal securities statutes. For the cases, see Loss, *Securities Regulation* (1951 with 1955 Supp.), pp. 1077-78. Although the question whether a statutory cause of action is assignable involves much the same considerations as whether it survives the death of either party, that question is left to the general law, whether decisional or under the general assignment statutes which exist in some states. Subsec. (e). The purpose of subsection (e)(2) is to take care of the case where the buyer has already disposed of the security before the rescission offer is made to him. In such a case the buyer is not foreclosed from bringing suit if he is not satisfied with the seller's computation of damages, but in order to do so he must reject the rescission offer within thirty days so that the seller may know where he stands. Subsec. (f). This result has been quite generally reached by the courts even in the absence of a specific provision. See the cases cited in Loss, *Securities Regulation* (1951 with 1955 Supp.), p. 967, n. 63. Subsec. (h). The mere presence of certain specific liability provisions in a statute is no assurance that other liabilities will not be implied by the courts under the doctrine which creates a common-law tort action for violation of certain criminal statutes. Restatement of Torts §§ 286-88. Notwithstanding the presence of several specific liability provisions in each of the several SEC statutes, the federal courts have implied a civil cause of action by a defrauded seller against the buyer under SEC Rule X-10B-5. See Loss, *Securities Regulation* (1951 with 1955 Supp.), pp. 1052-66. The "but" clause in § 410(h) is designed to assure that no comparable development is based on violation of § 101 of this Act.

§ 411 Judicial Review of Orders

(a)

Any person aggrieved by a final order of the [Administrator] may obtain a review of the order in the [insert name of appropriate court] by filing in court, within sixty days after the entry of the order, a written petition praying that the order be modified or set aside in whole or in part. A copy of the petition shall be forthwith served upon the [Administrator], and thereupon the [Administrator] shall certify and file in court a copy of the filing and evidence upon which the order was entered. When these have been filed, the court has exclusive jurisdiction to affirm, modify, enforce, or set aside the order, in whole or in part. The findings of the [Administrator] as to the facts, if supported by competent, material and substantial evidence, are conclusive. If either party applies to the court for leave to adduce additional material evidence, and shows to the satisfaction of the court that there were reasonable grounds for failure to adduce the evidence in the hearing before the [Administrator], the court may order the additional evidence to be taken before the

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[Administrator] and to be adduced upon the hearing in such manner and upon such conditions as the court considers proper. The [Administrator] may modify [his] findings and order by reason of the additional evidence and shall file in court the additional evidence together with any modified or new findings or order. [The judgment of the court is final, subject to review by the (insert name of appropriate court).]

(b)

The commencement of proceedings under subsection (a) does not, unless specifically ordered by the court, operate as a stay of the [Administrator's] order.

Official Code Comment This section is modeled partly on § 12 of the Model State Administrative Procedure Act, this volume, and Handbook of National Conference of Commissioners on Uniform State Laws 334 (1944), and partly on § 25 of the Securities Exchange Act of 1934, 15 U.S.C. § 78y [15 U.S.C.A. § 78y].

§ 412 Rules, Forms, Orders, and Hearings

(a)

The [Administrator] may from time to time make, amend, and rescind such rules, forms, and orders as are necessary to carry out the provisions of this act, including rules and forms governing registration statements, applications, and reports, and defining any terms, whether or not used in this act, insofar as the definitions are not inconsistent with the provisions of this act. For the purpose of rules and forms the [Administrator] may classify securities, persons, and matters within [his] jurisdiction, and prescribe different requirements for different classes.

(b)

No rule, form, or order may be made, amended, or rescinded unless the [Administrator] finds that the action is necessary or appropriate in the public interest or for the protection of investors and consistent with the purposes fairly intended by the policy and provisions of this act. In prescribing rules and forms the [Administrator] may cooperate with the securities administrators of the other states and the Securities and Exchange Commission with a view to effectuating the policy of this statute to achieve maximum uniformity in the form and content of registration statements, applications, and reports wherever practicable.

(c)

The [Administrator] may by rule or order prescribe (1) the form and content of financial statements required under this act, (2) the circumstances under which consolidated financial statements shall be filed, and (3) whether any required financial statements shall be certified by independent or certified public accountants. All financial statements shall be prepared in accordance with generally accepted accounting practices.

(d)

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All rules and forms of the [Administrator] shall be published.

(e)

No provision of this act imposing any liability applies to any act done or omitted in good faith in conformity with any rule, form, or order of the [Administrator], notwithstanding that the rule, form, or order may later be amended or rescinded or be determined by judicial or other authority to be invalid for any reason.

(f)

Every hearing in an administrative proceeding shall be public unless the [Administrator] in [his] discretion grants a request joined in by all the respondents that the hearing be conducted privately.

Official Code Comment Subsec. (a). This subsection is largely modeled on the rule-making provisions of the SEC statutes. Some states have Administrative Procedure Acts which cut across this area. An order, of course, is directed to one or more particular persons, and a rule or form is of general applicability. Hence, when the Administrator is authorized to adopt rules or forms, he may not act by order, and vice versa. Subsec. (d). Local Administrative Procedure Acts may provide specific procedures for publishing rules and forms. In the absence of any such statute, § 412(d) leaves the procedure of publication to each Administrator. Subsec. (e). Section 412(e) is modeled on the comparable provisions in the SEC acts and many other federal administrative statutes.

§ 413 Administrative Files and Opinions

(a)

A document is filed when it is received by the [Administrator].

(b)

The [Administrator] shall keep a register of all applications for registration and registration statements which are or have ever been effective under this act and all denial, suspension, or revocation orders which have been entered under this act. The register shall be open for public inspection.

(c)

The information contained in or filed with any registration statement, application, or report may be made available to the public under such rules as the [Administrator] prescribes.

(d)

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Upon request and at such reasonable charges as [he] prescribes, the [Administrator] shall furnish to any person photostatic or other copies (certified under [his] seal of office if requested) of any entry in the register or any document which is a matter of public record. In any proceeding or prosecution under this act, any copy so certified is prima facie evidence of the contents of the entry or document certified.

(e)

The [Administrator] in [his] discretion may honor requests from interested persons for interpretative opinions.

Official Code Comment Subsec. (a). This subsection prescribes no particular method of filing, although the Administrator is free to do so by rule under § 412(a). Subsec. (b). This subsection refers to a register of the applications and registration statements, not the physical documents.

§ 414 Scope of the Act and Service of Process

(a)

Sections 101, 201(a), 301, 405, and 410 apply to persons who sell or offer to sell when (1) an offer to sell is made in this state, or (2) an offer to buy is made and accepted in this state.

(b)

Sections 102, 201(a), and 405 apply to persons who buy or offer to buy when (1) an offer to buy is made in this state, or (2) an offer to sell is made and accepted in this state.

(c)

For the purpose of this section, an offer to sell or to buy is made in this state, whether or not either party is then present in this state, when the offer (1) originates from this state or (2) is directed by the offeror to this state and received at the place to which it is directed (or at any post office in this state in the case of a mailed offer).

(d)

For the purpose of this section, an offer to buy or to sell is accepted in this state when acceptance (1) is communicated to the offeror in this state and (2) has not previously been communicated to the offeror, orally or in writing, outside this state; and acceptance is communicated to the offeror in this state, whether or not either party is then present in this state, when the offeree directs it to the offeror in this state reasonably believing the offeror to be in this state and it is received at the place to which it is directed (or at any post office in this state in the case of a mailed acceptance).

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(e)

An offer to sell or to buy is not made in this state when (1) the publisher circulates or there is circulated on his behalf in this state any bona fide newspaper or other publication of general, regular, and paid circulation which is not published in this state, or which is published in this state but has had more than two-thirds of its circulation outside this state during the past twelve months or (2) a radio or television program originating outside this state is received in this state.

(f)

Sections 102 and 201(c), as well as section 405 so far as investment advisers are concerned, apply when any act instrumental in effecting prohibited conduct is done in this state, whether or not either party is then present in this state.

(g)

Every applicant for registration under this act and every issuer who proposes to offer a security in this state through any person acting on an agency basis in the common-law sense shall file with the [Administrator], in such form as [he] by rule prescribes, an irrevocable consent appointing the [Administrator] or [his] successor in office to be his attorney to receive service of any lawful process in any non-criminal suit, action, or proceeding against him or his successor executor or administrator which arises under this act or any rule or order hereunder after the consent has been filed, with the same force and validity as if served personally on the person filing the consent. A person who has filed such a consent in connection with a previous registration need not file another. Service may be made by leaving a copy of the process in the office of the [Administrator], but it is not effective unless (1) the plaintiff, who may be the [Administrator] in a suit, action, or proceeding instituted by [him], forthwith sends notice of the service and a copy of the process by registered mail to the defendant or respondent at his last address on file with the [Administrator], and (2) the plaintiff's affidavit of compliance with this subsection is filed in the case on or before the return day of the process, if any, or within such further time as the court allows.

(h)

When any person, including any nonresident of this state, engages in conduct prohibited or made actionable by this act or any rule or order hereunder, and he has not filed a consent to service of process under subsection (g) and personal jurisdiction over him cannot otherwise be obtained in this state, that conduct shall be considered equivalent to his appointment of the [Administrator] or [his] successor in office to be his attorney to receive service of any lawful process in any non-criminal suit, action, or proceeding against him or his successor executor or administrator which grows out of that conduct and which is brought under this act or any rule or order hereunder, with the same force and validity as if served on him personally. Service may be made by leaving a copy of the process in the office of the [Administrator], and it is not effective unless (1) the plaintiff, who may be the [Administrator] in a suit, action, or proceeding instituted by [him], forthwith sends notice of the service and a copy of the process by registered mail to the defendant or respondent at his last known address or takes other steps which are reasonably calculated to give actual notice, and (2) the plaintiff's affidavit of compliance with this subsection is filed in the case on or before the return day of the process, if any, or within such further time as the court allows.

(i)

When process is served under this section, the court, or the [Administrator] in a proceeding before [him], shall order such continuance as may be necessary to afford the defendant or respondent reasonable opportunity to defend.

[As amended August 1958]

Official Code Comment This section defines and delimits the application of the Act in interstate or international transactions with only some of their elements in the state. It is not limited in its impact to the civil liability provisions of § 410. Section 414 and its appendages, §§ 401(c)(4) and 401(f)(6), determine the scope of the Act for all kinds of proceedings--civil, criminal, injunctive and administrative. It is quite clear that a person may violate the law of a given state, even criminally, without ever being within the state or performing within the state every act necessary to complete the offense. *Strassheim v. Daly*, 221 U.S. 280 (1911). So far as applying the Act in civil or injunctive or administrative proceedings is concerned, see the comment under §§ 414(g) and 414(h). Subsecs. (a)-(f). Section 414(a)-(f) can best be explained in the context of a civil action under § 410(a) by a buyer in State B against a selling broker-dealer in State S:

1.

The basic approach of § 414(a)(1) is to apply the specified sections when "an offer to sell is made in this state."

2.

Section 414(c) provides, in substance, that an offer which originates in State S and is directed to State B is made in both states. Hence the statute of State B applies under § 414(c)(2) in the hypothetical case.

3.

By the same token, the statute of State S also applies to the offer under § 414(c)(1), on the theory that State S should not be used as a base of operations for defrauding persons in other states. It is thus quite possible for more than one statute to apply to a given transaction.

4.

Section 414(e)(1) deals with the problem of offers in the form of newspaper and magazine advertisements. It provides, in substance, that an advertisement in a regular newspaper or periodical is not an "offer" in any state other than the state of publication. Thus a seller may insert an advertisement in the *New York Times* and have it circulated freely in other states.

5.

A slight variation of this problem occurs in connection with magazines of national circulation. The place of publication of these magazines is purely fortuitous so far as the purposes of § 414 are concerned. Accordingly, §

414(e)(1) refers also to a publication which is published within the state but has more than two-thirds of its circulation outside the state.

6.

Section 414(e)(2) treats radio and television programs originating outside the state in the same way as newspapers or magazines published outside the state. For purposes of this section a radio or television program is considered to originate in the state where the microphone or television camera is, not at any relay station.

7.

The door left open in § 414(a) is then closed somewhat by § 414(a)(2), which provides in effect that a person in State B who makes an offer to buy as a result of an advertisement he sees in a paper published in State S (or a radio or television program originating in State S) may render the statute applicable if the seller then accepts the offer "in this state" (that is, State B). And § 414(d) specifies when an offer is "accepted in this state."

8.

If the selling dealer in State S merely sends a confirmation or delivers the security into State B, or the buyer in State B sends a check in payment from within State B, the statute of State B does not apply except when under § 414(d) the confirmation or delivery constitutes the seller's acceptance of the buyer's offer to buy.

9.

The parenthetical references in §§ 414(c) and 414(d) to "any post office in this state" are designed to make it clear that, when a person in State X directs an offer or acceptance to a person in State Y who has moved or gone temporarily to State Z, the act of State Y does apply and the act of State Z does not. This prevents entrapment of innocent persons who have no reason to believe that a communication will be forwarded into another state whose act has not been complied with.

10.

The applicability of the statute to buyers as distinct from sellers is covered by § 414(b), which is precisely the converse of § 414(a). Here, of course, there is no civil liability.

11.

Section 414(f) applies only to investment advisers.

12.

Sections 401(c)(4) and 401(f)(6) exclude from the definitions of "broker-dealer" and "investment adviser" certain persons who have no place of business in the state. Clause (A) of each section has much the same rationale as the exemption in § 402(b)(8) for sales to institutional buyers or broker-dealers. Clause (A) of § 401(c)(4), insofar as it refers to issuers or other broker-dealers, has the additional purpose of making it unnecessary for an out-of-state underwriter to register as a broker-dealer before negotiating with an issuer in the state or setting up a selling group with local broker-dealers in it. Clause (B) of each section is designed to permit a New York broker-dealer or investment adviser, for example, to take care of a few customers who live in New Jersey or are vacationing in Florida without registering as a broker-dealer or investment adviser in those states, as he would otherwise have to do under § 414.

13.

Nothing in the statute requires or permits one state to enforce the criminal provisions of another state's blue sky-law. Subsec. (g). The issuer does not have to file a consent to service unless it proposes to offer the security in the state through somebody acting on an agency basis in the common-law sense. Subsec. (h). The purpose of § 414(h) is to provide for substituted service of process when a seller in State S directs an offer into State B in violation of the registration provisions of State B or fraudulently. Under § 414(h) the buyer may sue the seller in State B and then bring suit on the judgment in State S. The section has been closely modeled on the type of nonresident motorist statute whose constitutionality was sustained in *Hess v. Pawlowski*, 47 S.Ct. 633, 274 U.S. 352, 71 L.Ed. 1091 (1927). Recent cases indicate that it is due process of law for a court of State B to enter a judgment in the hypothetical case discussed in this paragraph if the person in State S effected only an isolated transaction in State B without ever entering the state. In addition to the nonresident motorist precedents, see *Travelers Health Ass'n v. Commonwealth of Virginia ex rel. State Corporation Commission*, 70 S.Ct. 927, 339 U.S. 643, 94 L.Ed. 1154 (1950); *International Shoe Co. v. State of Washington*, 66 S.Ct. 154, 326 U.S. 310, 90 L.Ed. 95 (1945); *Parmalee v. Iowa State Traveling Mens Ass'n*, 206 F.2d 518 (5th Cir. 1953), cert. denied 98 L.Ed 385, 346 U.S. 877, 74 S.Ct. 130; *Schutt v. Commercial Travelers Mutual Accident Ass'n*, 206 F.2d 158 (2d Cir. 1956). If this is correct, a court in State S will have to give full faith and credit to the judgment of the court of State B.

§ 415 Statutory Policy

This act shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it and to coordinate the interpretation and administration of this act with the related federal regulation.

§ 416 Short Title

This act may be cited as the Uniform Securities Act.

§ 417 Severability of Provisions

If any provision of this act or the application thereof to any person or circumstance is held invalid, the invalidity shall not affect other provisions or applications of the act which can be given effect without the invalid provision or application, and to this end the provisions of this act are severable.

§ 418 Repeal and Saving Provisions

2-UA Blue Sky Regulation

(a)

The [identify the existing act or acts] is [are] repealed except as saved in this section.

(b)

Prior law exclusively governs all suits, actions, prosecutions, or proceedings which are pending or may be initiated on the basis of facts or circumstances occurring before the effective date of this act, except that no civil suit or action may be maintained to enforce any liability under prior law unless brought within any period of limitation which applied when the cause of action accrued and in any event within two years after the effective date of this act.

(c)

All effective registrations under prior law, all administrative orders relating to such registrations, and all conditions imposed upon such registrations remain in effect so long as they would have remained in effect if this act had not been passed. They are considered to have been filed, entered, or imposed under this act, but are governed by prior law.

(d)

Prior law applies in respect of any offer or sale made within one year after the effective date of this act pursuant to an offering begun in good faith before its effective date on the basis of an exemption available under prior law.

(e)

Judicial review of all administrative orders as to which review proceedings have not been instituted by the effective date of this act are governed by section 411, except that no review proceeding may be instituted unless the petition is filed within any period of limitation which applied to a review proceeding when the order was entered and in any event within sixty days after the effective date of this act.

§ 419 Time of Taking Effect

This act shall take effect on [insert date, which should be at least sixty days or ninety days after enactment].

Official Code Comment

If the act is adopted in a particular state before the more essential uniform forms and rules have been drafted, the effective date should be suitably delayed.

PREFATORY NOTE

The original Uniform Securities Act was promulgated by the National Conference of Commissioners on Uniform State Laws in 1956. The 1956 Act has been adopted, in whole or in part, in 37 jurisdictions.

2-UA Blue Sky Regulation

In undertaking to draft a revised Uniform Securities Act, the Drafting Committee was guided by the following principles:

(1)

The 1956 Act generally has worked well and the substantive content of that Act should be modified only if there is shown to be a need to do so;

(2)

The licensing and registration procedures specified in the 1956 Act should be modified only if there is shown to be a need to do so;

(3)

The authority of the state securities administrators in the enforcement area should be strengthened; and

(4)

Some expedited registration process should be available for certain 'seasoned' issuers where there appears less need for detailed securities review in order to protect investors. The Drafting Committee reviewed numerous drafts. The Committee had the assistance of advisors from several interested groups. including, alphabetically, the American Bankers Association, the American Bar Association, the American Stock Exchange, the Investment Company Institute, the National Association of Securities Dealers, Inc., the North American Securities Industry Association. In addition, the Reporter and individual members of the Drafting Committee met on various occasions with committees or representatives of these groups. Notwithstanding comprehensive reorganization and relocation, a very substantial amount of the statutory law of the 1957 Act has been retained in the Uniform Securities Act (1985). The cross-reference sheet included with these materials indicates where the provisions of the 1956 Act may be found in the draft Uniform Securities Act (1985). The structural reorganization undertaken follows the Conference's general drafting style. The Uniform Securities Act (1985) is divided into with sections as follows (the comparable sections of the 1956 Act are noted parenthetically):

While a state which previously has adopted the 1956 Act obviously could choose to update only certain of its law by adopting provisions from one or more Parts above the Drafting Committee strongly encourages that a state not do so. The revisions encompassed in this Act reflect a conscious effort to carefully balance the various interests involved in state securities regulation,

It should be noted that considerable effort was expended by the Drafting Committee to reach an accommodation of competing interests on the issues generating the most discussion. Thus, Section 302, the expedited registration of securities provision, was modified significantly from the draft presented to the Conference at the 1984 Annual Conference. In its final form, the section includes several criteria for eligibility designed to assure that the expedited registration process is available only to active operating companies with well established market activity for their securities.

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Similarly, the new provisions regarding administrative sanctions, Section 602, spells out the various enforcement sanctions available to an administrator and cross-referenced the procedural and substantive provisions applicable to the imposition of those sanctions.

To the extent practicable, the Uniform Securities Act (1985) encourages both greater coordination between federal and state securities law regulation and greater coordination between federal and state securities law regulation and greater cooperation among states. Sections 205 and 209 reflect the former theme in the licensing and post-licensing provisions applicable to broker-dealers and investment advisers. Section 704 specifies numerous areas in which it is hoped that the states will continue to work jointly and achieve a maximum degree of uniformity.

Section 705 sets forth in a single provision the general standards guiding the state securities administrator, which standards essentially are the same as those under the 1956 Act, namely that the action to be taken is "in the public interest and appropriate for the protection of investors" and is "consistent with the purposes fairly intended by the policy and provisions of this [Act]."

The comments following the sections have been prepared by the Reporter and the Chairmen of the Drafting Committee, based, among other sources, upon discussions and comments to comparable provisions of the 1956 Act, where applicable.

§ 101 Definitions.

As used in this [Act], unless the context otherwise requires:

(1)

Administrator [substitute any other appropriate term, such as *Commission*, *Commissioner*, *Secretary*] means the [insert name of administrative agency or individual].

[Amended from Unif. Securities Act § 410(a) (1956)]

(2)

Broker-dealer means a person engaged in the business of effecting transactions in securities for the account of others or for the person's own account. The term does not include:

(i)

a sales representative;

(ii)

an issuer, except when effecting transactions other than with respect to its own securities;

(iii)

a depository institution; or

(iv)

any other person the [Administrator], by rule or order, designates.

[Amended from Unif. Securities Act § 401(c) (1956)]

(3)

Depository institution means:

(i)

a person that is organized, chartered, or holding an authorization certificate under the laws of a state or of the United States which authorizes the person to receive deposits, including a savings, share, certificate, or deposit account, and which is supervised and examined for the protection of depositors by an official or agency of a state or the United States; and

(ii)

a trust company or other institution that is authorized by federal or state law to exercise fiduciary powers of the type a national bank is permitted to exercise under the authority of the Comptroller of the Currency and is supervised and examined by an official or agency of a state or the United States. The term does not include an insurance company or other organization primarily engaged in the insurance business or a Morris Plan bank, industrial loan company, or a similar bank or company unless its deposits are insured by a federal agency.

(4)

Filed means the actual delivery of a document or application to the [Administrator] or designee of the [Administrator] or to the principal office of the [Administrator].

[Amended from Unif. Securities Act § 413(a) (1956)]

(5)

Financial or institutional investor means any of the following, whether acting for itself or others in a fiduciary

capacity:

(i)

a depository institution;

(ii)

an insurance company;

(iii)

a separate account of an insurance company;

(iv)

an investment company as defined in the Investment Company Act of 1940;

(v)

an employee pension, profit-sharing, or benefit plan if the plan has total assets in excess of \$5,000,000 or its investment decisions are made by a named fiduciary, as defined in the Employee Retirement Income Security Act of 1974, that is either a broker-dealer registered under the Securities Exchange Act of 1934, an investment adviser registered or exempt from registration under the Investment Advisers Act of 1940, a depository institution, or an insurance company; and

(vi)

any other institutional buyer.

[Amended from Unif. Securities Act § 402(b)(8) (1956)]

(6)

Fraud, *deceit*, and *defraud* are not limited to common-law fraud or deceit.

[Amended from Unif. Securities Act § 401(d) (1956)]

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(7)

Investment adviser means a 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 a part of a business, issues or promulgates analyses or reports concerning securities. The term does not include:

(i)

an employee of an investment adviser;

(ii)

a depository institution;

(iii)

a lawyer, accountant, engineer, or teacher whose performance of investment advisory services is solely incidental to the practice of the person's profession;

(iv)

a broker-dealer whose performance of investment advisory services is solely incidental to the conduct of business as a broker-dealer and who receives no special compensation for the investment advisory services;

(v)

a publisher, employee, or columnist of a newspaper, news magazine, or business or financial publication, or an owner, operator, producer, or employee of a cable, radio, or television network, station, or production facility if, in either case, the financial or business news published or disseminated is made available to the general public and the content does not consist of rendering advice on the basis of the specific investment situation of each client;

(vi)

a person whose advice, analyses, or reports relate only to securities exempt under paragraph (1) of Section 401(b); and

(vii)

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any other person the [Administrator], by rule or order, designates.

[Amended from Unif. Securities Act § 401(f) (1956)]

(8)

Except as provided in subparagraph (i), (ii), or (iii), *issuer* means a person who issues or proposes to issue a security, but:

(i)

The *issuer* of a collateral trust certificate, voting trust certificate, certificate of deposit for a security, or share in an investment company without a board of directors or persons performing similar functions, is the person performing the acts and assuming the duties of depositor or manager pursuant to the trust or other agreement or instrument under which the security is issued.

(ii)

The *issuer* of an equipment trust certificate, including a conditional sales contract or similar security serving the same purpose, is the person to whom the equipment or property is or is to be leased or conditionally sold.

(iii)

The *issuer* of a fractional undivided interest in an oil, gas, or other mineral lease or in payments out of production under a lease, right, or royalty is the owner of an interest in the lease or in payments out of production under a lease, right, or royalty, whether whole or fractional, who creates fractional interests for the purpose of sale.

[Amended from Unif. Securities Act § 401(g) (1956)]

(9)

Nonissuer transaction means a transaction not directly or indirectly for the benefit of the issuer.

[Amended from Unif. Securities Act § 401(h) (1956)]

(10)

Person means an individual, corporation, business trust, estate, trust, partnership, association, joint venture, government, governmental subdivision or agency, or any other legal or commercial entity.

[Amended from Unif. Securities Act § 401(i) (1956)]

(11)

Price amendment means the amendment to a registration statement filed under the Securities Act of 1933 or, if no amendment is filed, the prospectus or prospectus supplement filed under the Securities Act of 1933, which includes a statement of the offering price, underwriting and selling discounts or commissions, amount of proceeds, conversion rates, call prices, and other matters dependent upon the offering price.

[New]

(12)

Promoter includes:

(i)

a person who, acting alone or in concert with one or more other persons, takes the entrepreneurial initiative in founding or organizing the business or enterprise of an issuer;

(ii)

an officer or director owning securities of an issuer or a person who owns, beneficially or of record, ten percent or more of a class of securities of the issuer if the officer, director, or person acquires any of those securities in a transaction within three years before the filing by the issuer of a registration statement under this [Act] and the transaction does not possess the indicia of arm's-length bargaining; and

(iii)

a member of the immediate family of a person within subparagraph (i) or (ii) if the family member receives securities of the issuer from that person in a transaction within three years before the filing by the issuer of a registration statement under this [Act] and the transaction does not possess the indicia of arm's-length bargaining.

[New]

(13)

Sale or *sell* includes every contract of sale, contract to sell, or other disposition, of a security or interest in a security for value. In this context:

(i)

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Offer to sell includes every attempt or offer to dispose of, or solicitation of an offer to purchase, a security or interest in a security for value.

(ii)

Offer to purchase includes every attempt or offer to obtain, or solicitation of an offer to sell, a security or interest in a security for value, but the term does not include a transaction that is subject to Section 14(d) of the Securities Exchange Act of 1934.

(iii)

A security given or delivered with, or as a bonus on account of, a purchase of securities or other item is considered to constitute part of the subject of the purchase and to have been offered and sold for value.

(iv)

A gift of assessable stock is deemed to involve an offer and sale.

(v)

A sale or offer of a warrant or right to purchase or subscribe to another security of the same or another issuer, or a sale or offer of a security that gives the holder a present or future right or privilege to convert into another security of the same or another issuer, is deemed to include an offer of the other security.

(vi)

The terms defined in this paragraph do not include the creation of a security interest or a loan; a stock dividend, whether the corporation distributing the dividend is the issuer of the stock or not, if nothing of value is given by stockholders for the dividend other than the surrender of a right to a cash or property dividend and each stockholder may elect to take the dividend in cash, property, or stock; or an act incident to a judicially approved reorganization in which a security is issued in exchange for one or more outstanding securities, claims, or property interests, or partly in exchange and partly for cash.

[Amended from Unif. Securities Act § 401(j) (1956)]

(14)

Sales representative means an individual, other than a broker-dealer, authorized to act and acting for a broker-dealer or issuer in effecting or attempting to effect purchases or sales of securities. A partner, officer, or director of a broker-dealer or issuer, or a person occupying a similar status or performing similar functions, is a sales

representative only if the person otherwise comes within the definition.

[Amended from Unif. Securities Act § 401(b) (1956)]

(15)

Securities Act of 1933, Securities Exchange Act of 1934, Public Utility Holding Company Act of 1935, Investment Company Act of 1940, Investment Advisers Act of 1940, Employee Retirement Income Security Act of 1974, National Housing Act, and Commodity Exchange Act mean the federal statutes of those names, as amended.

[Amended from Unif. Securities Act § 401(k) (1956)]

(16)

Security means: a note; stock; treasury stock; bond; debenture; evidence of indebtedness; certificate of interest or participation in a profit-sharing agreement; a limited partnership interest; collateral-trust certificate; preorganization certificate or subscription; transferable share; investment contract; voting-trust certificate; certificate of deposit for a security; fractional undivided interest in an oil, gas, or other mineral lease or in payments out of production under a lease, right, or royalty; a put, call, straddle, or option entered into on a national securities exchange relating to foreign currency; a put, call, straddle, or option on a security, certificate of deposit, or group or index of securities, including an interest in or based on the value of any of the foregoing; or, in general, an interest or instrument commonly known as a *security*, or a certificate of interest or participation in, temporary or interim certificate for, receipt for, whole or partial guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. The term does not include:

(i)

an insurance or endowment policy or annuity contract under which an insurance company promises to pay a fixed sum of money either in a lump sum or periodically for life or some other specified period; or

(ii)

an interest in a contributory or noncontributory pension or welfare plan subject to the Employee Retirement Income Security Act of 1974.

[Amended from Unif. Securities Act § 401(l) (1956)]

(17)

Self-regulatory organization means a national securities exchange registered under Section 6 of the Securities Exchange Act of 1934, a national securities association of brokers and dealers registered under Section 15A of the Securities Exchange Act of 1934, a clearing agency registered under Section 17A of the Securities Exchange Act of 1934, the Municipal Securities Rulemaking Board established under Section 15B(b)(1) of the Securities Exchange Act

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of 1934, or Section 21 of the Commodity Exchange Act.

[New]

(18)

State means a state, commonwealth, territory, or possession of the United States, the District of Columbia, or the Commonwealth of Puerto Rico.

[Amended from Unif. Securities Act § 401(m) (1956)]

§ 201 Licensing of Broker-Dealer and Sales Representative.

(a)

A person may not transact business in this State as a broker-dealer or sales representative unless licensed or exempt from licensing under this [Act].

[Amended from Unif. Securities Act § 201(a) (1956)]

(b)

A broker-dealer licensed under this [Act] and an issuer may not employ a person as a sales representative in this State unless the sales representative is licensed under this [Act] or is exempt from licensing under this [Act].

[Amended from Unif. Securities Act § 201(b) (1956)]

(c)

A broker-dealer or issuer engaged in offering securities in this State may not employ, directly or indirectly, a person to engage in any activity in this State contrary to a suspension or bar from association with a broker-dealer or investment advisor imposed against that person by the [Administrator]. A broker-dealer or issuer does not violate this subsection unless the broker-dealer or issuer knows or in the exercise of reasonable care should know of the suspension or bar. Upon request from a broker-dealer or issuer and for good cause shown, the [Administrator], by order, may waive the prohibition of this subsection with respect to a person suspended or barred.

[New]

§ 202 Exempt Broker-Dealers and Sales Representatives.

(a)

The following broker-dealers are exempt from the licensing requirements of Section 201:

(1)

a broker-dealer who either is registered or, except as provided in subsection (b), is not required to be registered under the Securities Exchange Act of 1934 and who has no place of business in this State if:

(i)

the transactions effected by the broker-dealer in this State are exclusively with the issuer of the securities involved in the transactions, other broker-dealers licensed or exempt under this [Act], or financial or institutional investors;

(ii)

the broker-dealer is licensed under the securities act of a state in which the broker-dealer maintains a place of business and the broker-dealer offers and sells in this State to a person who is an existing customer of the broker-dealer and whose principal place of residence is not in this State; or

(iii)

the broker-dealer is licensed under the securities law of a state in which the broker-dealer maintains a place of business and the broker-dealer during any 12 consecutive months does not effect more than [15] transactions with more than [5] persons in this State in addition to transactions with the issuers of the securities involved in the transactions, financial or institutional investors, or broker-dealers, whether or not the offeror or an offeree is then present in this State; and

(2)

other broker-dealers the [Administrator] by rule or order exempts.

[Amended from Unif. Securities Act § 401(c) (1956)]

(b)

The exemption provided in subsection (a)(1)(i) is not available to a broker-dealer who deals solely in government securities and is not registered under the Securities Exchange Act of 1934 unless the broker-dealer is subject to supervision as a dealer in government securities by the Federal Reserve Board.

[Amended from Unif. Securities Act § 401(b) (1956)]

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(c)

The following sales representatives are exempt from the licensing requirements of Section 201:

(i)

a sales representative acting for a broker-dealer exempt under subsection (a);

(ii)

a sales representative acting for an issuer in effecting transactions in a security exempted by paragraphs (1) through (4) and (11) through (13) of Section 401(b);

(iii)

a sales representative acting for an issuer effecting offers or sales of securities in transactions exempted by Section 402;

(iv)

a sales representative acting for an issuer effecting transactions with employees, partners, officers, or directors of the issuer, a parent or a wholly-owned subsidiary of the issuer, if no commission or other similar compensation is paid or given directly or indirectly to the sales representative for soliciting an employee, partner, officer, or director in this State; and

(v)

other sales representatives the [Administrator] by rule or order exempts.

[New]

§ 203 Licensing of Investment Adviser.

(a)

A person may not transact business in this State as an investment adviser unless licensed as an investment adviser or exempt from licensing under this [Act].

[Amended from Unif. Securities Act § 201(c) (1956)]

(b)

An investment adviser may not employ, directly or indirectly, a person to engage in any activity in this State contrary to a suspension or bar from association with a broker-dealer or investment adviser imposed against that person by the [Administrator]. An investment adviser does not violate this subsection unless the investment adviser knows or in the exercise of reasonable care should know of the suspension or bar. Upon request from an investment adviser and for good cause shown, the [Administrator], by order, may waive the prohibition of this subsection with respect to a person suspended or barred.

[New]

§ 204 Exempt Investment Advisers.

The following investment advisers are exempt from the licensing requirements of Section 203:

(1)

an investment adviser who is registered or is not required to be registered as an investment adviser under the Investment Advisers Act of 1940 if:

(i)

its only clients in this State are other investment advisers, broker-dealers, or financial or institutional investors;

(ii)

the investment adviser has no place of business in this State and the investment adviser directs business communications in this State to a person who is an existing client of the investment adviser and whose principal place of residence is not in this State; or

(iii)

the investment adviser has no place of business in this State and the investment adviser during any 12 consecutive months does not direct business communications in this State to more than [five] present or prospective clients other than those specified in subparagraph (i), whether or not the person or client to whom the communication is directed is present in this State; and

(2)

other investment advisers the [Administrator], by rule or order, exempts.

[§ 240 is Amended from Unif. Securities Act § 401(f) (1956)]

§ 205 Application.

(a)

An applicant for licensing as a broker-dealer, sales representative, or investment adviser shall file with the [Administrator] an application for licensing and a consent to service of process under Section 708. The application for licensing must contain the information that the [Administrator], by rule, requires.

(b)

The requirements of subsection (a) are satisfied by an applicant who has filed and maintains a completed and current registration with the Securities and Exchange Commission or a self-regulatory organization by filing with the [Administrator] notice of the registration in the form and content determined by the [Administrator], by rule, and a consent to service of process under Section 708. The registration information filed with the Securities and Exchange Commission or self-regulatory organization must be available to the [Administrator] through a central registration depository system approved by the [Administrator]. The [Administrator], by order, may require the submission of additional information by an applicant.

[§ 205 is Amended from Unif. Securities Act § 202(a) (1956)]

§ 206 Licensing Fees.

(a)

An applicant for licensing shall pay a licensing fee as follows:

(1)

broker-dealer [\$100] and for each branch office [\$50].

(2)

sales representative [\$25].

(3)

investment adviser [\$50].

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(b)

Except in a year in which a licensing fee is paid, a licensed person shall pay an annual fee as follows:

(1)

broker-dealer [\$75] and for each branch office [\$30].

(2)

sales representative [\$15].

(3)

investment adviser [\$35].

(c)

For purposes of this section, *branch office* means an office of a broker-dealer in this State, other than the principal office in this State of the broker-dealer, from which three or more sales representatives transact business.

(d)

If an application is denied or withdrawn or the license is revoked, suspended, or withdrawn, the [Administrator] shall retain the fee paid.

[§ 206 is Amended from Unif. Securities Act § 202(b) (1956)]

§ 207 Examinations.

(a)

The [Administrator], by rule or order, may require an examination of:

(1)

an applicant for licensing under this Part;

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(2)

a class of applicants; and

(3)

a class of persons who will represent an investment adviser in performing an act that requires licensing as an investment adviser in this State.

(b)

An examination may be administered by the [Administrator] or a designee of the [Administrator]. An examination may be oral or written, or both, and may differ for each class of applicants.

(c)

The [Administrator], by rule or order, may waive an examination as to a person or class of persons if the [Administrator] determines that an examination is not necessary for the protection of investors.

[§ 207 is Amended from Unif. Securities Act § 204(b)(6) (1956)]

§ 208 Licensing, General Provisions.

(a)

Unless a proceeding under Section 212 is instituted or the applicant is notified that the application is incomplete, the license of a broker-dealer, sales representative, or investment adviser becomes effective 30 days after the later of the date an application for licensing is filed and is complete or the date an amendment to an application is filed and is complete, in either case only if all requirements imposed under Section 207 are satisfied. An application is complete when the applicant has furnished information responsive to each applicable item of the application. The [Administrator] by order may authorize an earlier effective date of licensing.

(b)

The license of a broker-dealer, sales representative, or investment adviser is effective until terminated by expiration, revocation, or withdrawal.

(c)

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The license of a sales representative is effective only with respect to transactions effected on behalf of the broker-dealer or issuer for whom the sales representative is licensed.

(d)

A person may not act at any one time as a sales representative for more than one broker-dealer or for more than one issuer, unless the broker-dealers or issuers for whom the sales representative acts are affiliated by direct or indirect common control or the [Administrator], by rule or order, authorizes multiple licenses.

(e)

If a person licensed as a sales representative terminates association with a broker-dealer or issuer or ceases to be a sales representative, the sales representative and the broker-dealer or issuer on whose behalf the sales representative was acting shall promptly notify the [Administrator].

(f)

The [Administrator] by rule may authorize one or more special classifications of licenses as a broker-dealer, sales representative, or investment adviser to be issued to applicants subject to limitations and conditions on the nature of the activities that may be conducted by persons so licensed.

[§ 208 is Amended from Unif. Securities Act § 202(a),201(b) (1956)]

§ 209 Post-Licensing Requirements.

(a)

The [Administrator] by rule may require that:

(1)

a licensed broker-dealer who is not registered under the Securities Exchange Act of 1934 maintain minimum net capital and a prescribed ratio between net capital and aggregate indebtedness, which may vary with type or class of broker-dealer; or

(2)

a licensed investment adviser who is not registered under the Investment Advisers Act of 1940 maintain a minimum net worth.

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(b)

If a licensed broker-dealer or investment adviser knows, or has reasonable cause to know, that a requirement imposed on it under this subsection is not being met, the broker-dealer or investment adviser shall promptly notify the [Administrator] of its current financial condition.

(c)

The [Administrator] by rule may require a fidelity bond from a broker-dealer who is not registered under the Securities Exchange Act of 1934.

(d)

A licensed broker-dealer or investment adviser shall file with the [Administrator] the financial and other information the [Administrator] by rule or order requires, but:

(1)

A licensed broker-dealer required to file financial reports under the Securities Exchange Act of 1934 may satisfy periodic financial report requirements of this subsection by filing with the [Administrator] a copy of the financial reports filed under the Securities Exchange Act of 1934; and

(2)

A licensed investment adviser required to file financial reports under the Investment Advisers Act of 1940 may satisfy periodic financial report requirements of this subsection by filing with the [Administrator] a copy of the financial reports filed under the Investment Advisers Act of 1940.

(e)

A licensed broker-dealer, sales representative, or investment adviser shall maintain the records the [Administrator] by rule requires, but compliance with the record keeping requirements of the Securities Exchange Act of 1934 by a broker-dealer or the Investment Advisers Act of 1940 by an investment adviser satisfies the requirements of this subsection.

(f)

Required records may be maintained in any form of data storage if they are readily accessible to the [Administrator]. Required records must be preserved for [five] years unless the [Administrator] by rule specifies a

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different period for a particular type or class of records.

(g)

If the information contained in a document filed with the [Administrator] as part of the application for licensing or under this section, except information the [Administrator] by rule or order excludes, is or becomes inaccurate or incomplete in a material respect, the licensed person shall promptly file correcting information, unless notification of termination has been given under Section 208(e).

[§ 209 is Amended from Unif. Securities Act § 202(d),(e);203(a)-(e) (1956)]

§ 210 Licensing of Successor Firms.

(a)

A licensed broker-dealer or investment adviser may file an application for licensing of a successor, whether or not the successor is in existence, if the fee the [Administrator] prescribes for the application is submitted with the application.

(b)

If a broker-dealer or investment adviser succeeds to and continues the business of a licensed broker-dealer or investment adviser and the successor files an application for licensing within 30 days after the succession, the license of the predecessor remains effective as the license of the successor for 60 days after the succession.

(c)

Licensing of each licensed sales representative of the broker-dealer filing an application under subsection (a) or (b) continues without a separate filing or fee upon the licensing of the successor.

[§ 210 is Amended from Unif. Securities Act § 202(c) (1956)]

§ 211 Power of Inspection.

(a)

The [Administrator], without notice, may examine in a manner reasonable under the circumstances the records, within or without this State, of a licensed broker-dealer, sales representative, or investment adviser in order to determine compliance with this [Act]. Broker-dealers, sales representatives, and investment advisers shall make their records available to the [Administrator] in legible form.

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(b)

The [Administrator] may copy records or require a licensed person to copy records and provide the copies to the [Administrator] to the extent and in a manner reasonable under the circumstances.

(c)

The [Administrator] may impose a reasonable fee for the expense of conducting an examination under this section.

[§ 211 is Amended from Unif. Securities Act § 203(d) (1956)]

§ 212 Grounds for Denial, Suspension, or Revocation.

(a)

The [Administrator] by order may (i) deny, suspend, or revoke a license, (ii) limit the securities activities that an applicant or licensed person may perform in this State, (iii) bar an applicant or licensed person from association with a licensed broker-dealer or investment adviser, or (iv) bar from employment with a licensed broker-dealer or investment adviser a person who is a partner, officer, director, or a person occupying a similar status or performing a similar function for an applicant or licensed person. Subject to Section 213, those actions may be taken only if the [Administrator] finds that the order is in the public interest and that the applicant or licensed person or, in the case of a broker-dealer or investment adviser, a partner, officer, or director, a person occupying a similar status or performing similar functions, or a person directly or indirectly controlling the broker-dealer or investment adviser:

(1)

has filed an application for licensing with the [Administrator] which, as of its effective date or any date after filing in the case of an order denying effectiveness, was incomplete in a material respect or contained a statement that was, in light of the circumstances under which it was made, false or misleading with respect to a material fact;

(2)

has willfully violated or willfully failed to comply with this [Act], a predecessor act, or a rule or order under this [Act] or a predecessor act;

(3)

is the subject of an adjudication or determination, after notice and opportunity for hearing, within the last five years by a securities agency or administrator of another state or a court of competent jurisdiction that the person has willfully violated the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of

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1940, the Investment Company Act of 1940, or the Commodity Exchange Act, or the securities law of any other state but only if the acts constituting the violation of that state's law would constitute a violation of this [Act] had the acts occurred in this State;

(4)

within the last ten years, has been convicted of an offense that the [Administrator] finds:

(i)

involves the purchase or sale of a security, taking a false oath, making a false report, bribery, perjury, burglary, robbery, or attempt or conspiracy to commit any of those offenses;

(ii)

arises out of the conduct of business as a broker-dealer, investment adviser, depository institution, insurance company, or fiduciary; or

(iii)

involves the larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds or securities or an attempt or conspiracy to commit any of those offenses;

(5)

is permanently or temporarily enjoined by a court of competent jurisdiction from acting as an investment adviser, underwriter, broker-dealer, or as an affiliated person or employee of an investment company, depository institution, or insurance company, or from engaging in or continuing conduct or practice in connection with any of the foregoing activities, or in connection with the purchase or sale of a security;

(6)

is the subject of an order of the [Administrator] denying, suspending, or revoking the person's license as a broker-dealer, sales representative, or investment adviser;

(7)

is the subject of any of the following orders that are currently effective and were issued within the last five

years:

(i)

an order by the securities agency or administrator of another state or Canadian province or territory, or by the Securities and Exchange Commission, entered after notice and opportunity for hearing, denying, suspending, or revoking the person's license as a broker-dealer, sales representative, or investment adviser, or the substantial equivalent of those terms;

(ii)

a suspension or expulsion from membership in or association with a member of a self-regulatory organization;

(iii)

a United States Postal Service fraud order;

(iv)

a cease and desist order entered after notice and opportunity for hearing by the [Administrator], the securities agency or administrator of another state, or a Canadian province or territory, the Securities and Exchange Commission, or the Commodity Futures Trading Commission; or

(v)

an order by the Commodity Futures Trading Commission denying, suspending, or revoking registration under the Commodity Exchange Act;

(8)

has engaged in unethical or dishonest practices in the securities business;

(9)

is insolvent, either in the sense that liabilities exceed assets or in the sense that obligations cannot be met as they mature, but the [Administrator] may not enter an order against a broker-dealer or investment adviser under this subsection without a finding of insolvency as to the broker-dealer or investment adviser;

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(10)

is determined by the [Administrator] in compliance with Section 213 not to be qualified because of the lack of training, experience, and knowledge of the securities business;

(11)

has failed reasonably to supervise a sales representative or employee; or

(12)

has failed to pay the proper filing fee within 30 days after being notified by the [Administrator] of a deficiency, but the [Administrator] shall vacate an order under this subsection when the deficiency is corrected.

(b)

The [Administrator] may not begin a proceeding on the basis of a fact or transaction known to the [Administrator] when the license became effective unless the proceeding is begun within the 90 days after issuance of the license.

(c)

If the [Administrator] finds that an applicant or licensed person is no longer in existence, has ceased to do business as a broker-dealer, sales representative, or investment adviser, is adjudicated mentally incompetent or subjected to the control of a committee, conservator, or guardian, or cannot be located after reasonable search, the [Administrator], by order, may deny the application or revoke the license.

[§ 212 is Amended from Unif. Securities Act § 204(a), (b) (1956)]

§ 213 Denial, Suspension, or Revocation on Grounds of Lack of Qualification.

The [Administrator's] determination that an applicant or licensed person lacks qualification under Section 212 is limited by the following provisions:

(1)

The [Administrator] may not enter an order against a broker-dealer because of the lack of qualification of (i) a person other than the broker-dealer if the broker-dealer is an individual or (ii) a sales representative of the broker-dealer.

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(2)

The [Administrator] may not enter an order against an investment adviser because of the lack of qualification of (i) a person other than the investment adviser if the investment adviser is an individual or (ii) any other person who represents the investment adviser in doing an act that makes the person an investment adviser.

(3)

The [Administrator] may not enter an order solely because of lack of experience of the applicant or licensed person if the applicant or licensed person is qualified by training or knowledge, or both.

(4)

The [Administrator] shall consider that a sales representative who will work under the supervision of a licensed broker-dealer need not have the same qualifications as a broker-dealer.

(5)

The [Administrator] shall consider that an investment adviser is not necessarily qualified solely because of experience as a broker-dealer or sales representative.

[§ 213 is Amended from Unif. Securities Act § 204(b) (1956)]

§ 214 Withdrawal.

(a)

An application for a license may be withdrawn by the applicant without prejudice before the license becomes effective.

(b)

Withdrawal from licensing as a broker-dealer, sales representative, or investment adviser becomes effective 30 days after receipt by the [Administrator] of an application to withdraw or within any shorter period the [Administrator], by order, determines, unless:

(1)

a revocation or suspension proceeding is pending when the application is filed;

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(2)

a proceeding to revoke or suspend or to impose conditions upon the withdrawal is instituted within 30 days after the application is filed; or

(3)

additional information is requested by the [Administrator] regarding the withdrawal application.

(c)

If a proceeding is pending or instituted under subsection (b), withdrawal becomes effective at the time and upon the conditions the [Administrator] by order determines. If additional information is requested, withdrawal is effective 30 days after the additional information is filed. Although no proceeding is pending or instituted and withdrawal becomes effective, the [Administrator] may institute a proceeding under Section 212 within one year after withdrawal became effective and enter an order as of the last date on which licensing was effective.

[§ 214 is Amended from Unif. Securities Act § 204(e) (1956)]

§ 215 Custody of Client's Securities and Funds.

(a)

Unless prohibited by rule or order of the [Administrator], an investment adviser registered under the Investment Advisers Act of 1940 may take or retain custody of securities or funds of a client.

(b)

To the extent permitted by rule or order of the [Administrator], an investment adviser exempt from registration under the Investment Advisers Act of 1940, but licensed as an investment adviser under this [Act], may take or retain custody of securities or funds of a client.

[§ 215 is Amended from Unif. Securities Act § 102(c) (1956)]

§ 301 Registration Requirement.

A person may not offer to sell or sell a security in this State unless it is registered under this [Act] or the security or transaction is exempt under this [Act].

[§ 301 is Amended from Unif. Securities Act § 301 (1956)]

§ 302 Registration by Filing.

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(a)

Securities for which a registration statement has been filed under the Securities Act of 1933 in connection with the offering of the securities may be registered by filing, whether or not they are also eligible for registration under Section 303 or 304, if:

(1)

the issuer is organized under the laws of the United States or a state or, if the issuer is not organized under the laws of the United States or a state, it has appointed a duly authorized agent in the United States for service of process;

(2)

the issuer has actively engaged in business operations in the United States for a period of at least 36 consecutive calendar months immediately before the filing of the federal registration statement;

(3)

the issuer has registered a class of equity securities under Section 12(b) or 12(g) of the Securities Exchange Act of 1934, which class of securities is held of record by 500 or more persons;

(4)

the issuer has:

(i)

either a total net worth of \$4,000,000 or a total net worth of \$2,000,000 and net pretax income from operations before allowances for extraordinary items, for at least two of the three preceding fiscal years;

(ii)

not less than 400,000 units of the class of security registered under Section 12 of the Securities Exchange Act of 1934 held by the public, excluding securities held by officers and directors of the issuer, underwriters and persons beneficially owning ten percent or more of that class of security; and

(iii)

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no outstanding warrants and options held by the underwriters and executive officers and directors of the issuer in an amount exceeding ten percent of the total number of shares to be outstanding after completion of the offering of the securities being registered;

(5)

the issuer has been subject to the requirements of Section 12 of the Securities Exchange Act of 1934 and has filed all the material required to be filed under Sections 13 and 14 of that act for at least 36 consecutive calendar months immediately before the filing of the federal registration statement and the issuer has filed in a timely manner all reports required to be filed during the 12 calendar months next preceding the filing of the federal registration statement;

(6)

for at least 30 days during the three months next preceding the offering of the securities registered there have been at least four market makers for the class of equity securities registered under Section 12 of the Securities Exchange Act of 1934;

(7)

each of the underwriters participating in the offering of the security and each broker-dealer who will offer the security in this State is a member of or is subject to the rules of fair practice of a national association of securities dealers with respect to the offering and the underwriters have contracted to purchase the securities offered in a principal capacity;

(8)

the aggregate commissions or discounts to be received by the underwriters will not exceed ten percent of the aggregate price at which the securities being registered are offered to the public;

(9)

neither the issuer nor any of its subsidiaries, since the end of the fiscal year next preceding the filing of the registration statement, have (i) failed to pay a dividend or sinking fund installment on preferred stock, (ii) defaulted on indebtedness for borrowed money, or (iii) defaulted on the rental on one or more long-term leases, which defaults in the aggregate are material to the financial position of the issuer and its subsidiaries, taken as a whole; and

(10)

in the case of an equity security, the price at which the security will be offered to the public is not less than five dollars a share.

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(b)

A registration statement under this section must contain the following information and be accompanied by the following documents in addition to the information specified in Section 305(c) and the consent to service of process required by Section 708:

(1)

a statement demonstrating eligibility for registration by filing;

(2)

the name, address, and form of organization of the issuer;

(3)

with respect to a person on whose behalf a part of the offering is to be made in a nonissuer distribution: name and address; the amount of securities of the issuer held by the person as of the date of the filing of the registration statement; and a statement of the reasons for making the offering;

(4)

a description of the security being registered; and

(5)

a copy of the latest prospectus filed with the registration statement under and satisfying the requirements of Section 10 of the Securities Act of 1933.

(c)

If the information and documents required to be filed by subsection (b) have been on file with the [Administrator] for at least [five] business days or any shorter period the [Administrator] by rule or order allows and the applicable registration fee has been paid before the effectiveness of the federal registration statement, a registration statement under this section automatically becomes effective concurrently with the effectiveness of the federal registration statement. If the federal registration statement becomes effective before the conditions in this subsection are satisfied and they are not waived, the registration statement becomes effective when the conditions are satisfied. The registrant shall promptly notify the [Administrator] by telephone or telegram of the date and time when the federal

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registration statement became effective and the content of the price amendment, if any, and shall file promptly a post effective amendment containing the information and documents in the price amendment. The [Administrator] shall promptly acknowledge receipt of notification and effectiveness of the registration statement as of the date and time the registration statement became effective with the Securities and Exchange Commission.

[New]

§ 303 Registration by Coordination.

(a)

Securities for which a registration statement has been filed under the Securities Act of 1933 in connection with the offering of the securities may be registered by coordination.

[Amended from Unif. Securities Act § 303 (1956)]

(b)

A registration statement under this section must contain the following information and be accompanied by the following documents in addition to the information specified in Section 305(c) and the consent to service of process required by Section 708:

(1)

two copies of the latest form of prospectus filed under the Securities Act of 1933;

(2)

if the [Administrator] by rule or order requires: a copy of the articles of incorporation and bylaws or their substantial equivalents, currently in effect; a copy of any agreement with or among underwriters; a copy of an indenture or other instrument governing the issuance of the security to be registered; and a specimen, copy, or description of the security;

(3)

if the [Administrator] requests, subject to paragraph (2) of Section 703(b), any other information, or copies of any other document, filed under the Securities Act of 1933; and

(4)

an undertaking to forward promptly, and not later than the first business day after the day they are forwarded to

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or filed with the Securities and Exchange Commission, all future amendments to the federal prospectus, other than an amendment that delays the effective date of the registration statement.

[Amended from Unif. Securities Act § 303 (1956)]

(c)

A registration statement under this section becomes effective when the federal registration statement becomes effective if all of the following conditions are satisfied:

(1)

no stop order is in effect and no proceeding is pending under Section 306;

(2)

the registration statement has been on file with the [Administrator] for at least ten days, but if the registration statement is not filed with the [Administrator] within ten days after the initial filing under the Securities Act of 1933, the registration statement has been on file with the [Administrator] for 30 days or any shorter period the [Administrator], by rule or order, specifies; and

(3)

a statement of the maximum and minimum proposed offering prices and the maximum underwriting discounts and commissions has been on file for two full business days or any shorter period the [Administrator], by rule or order, specifies and the offering is made within those limitations.

[Amended from Unif. Securities Act § 303 (1956)]

(d)

The registrant shall promptly notify the [Administrator] by telephone or telegram of the date and time when the federal registration statement became effective and the content of the price amendment, if any, and shall promptly file a post-effective amendment containing the information and documents in the price amendment.

[Amended from Unif. Securities Act § 303 (1956)]

(e)

Upon failure to receive the required notification or post-effective amendment with respect to the price amendment, the [Administrator], without notice or hearing, may enter a stop order retroactively denying effectiveness to

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the registration statement or suspending its effectiveness until the registrant complies with subsection (d). The [Administrator] shall promptly notify the registrant by telephone or telegram, and promptly confirm by letter or telegram if the [Administrator] notifies by telephone, of the issuance of the order. If the registrant proves compliance with the requirements of subsection (d) as to notice and post-effective amendment, the stop order is void as of its entry.

[Amended from Unif. Securities Act § 303 (1956)]

(f)

The [Administrator] by rule or order may waive either or both of the conditions specified in subsection (c)(2) and (3).

[Amended from Unif. Securities Act § 303 (1956)]

(g)

If the federal registration statement becomes effective before all of the conditions in subsection (c) are satisfied and they are not waived, the registration statement becomes effective when all the conditions are satisfied. If the registrant advises the [Administrator] of the date when the federal registration statement is expected to become effective, the [Administrator] shall promptly advise the registrant by telephone or telegram, at the registrant's expense, whether all the conditions are satisfied and whether the [Administrator] then contemplates commencing a proceeding under Section 306; but the advice by the [Administrator] does not preclude the institution of a proceeding for a stop order suspending the effectiveness of the registration statement. A stop order issued under this subsection is not retroactive.

[Amended from Unif. Securities Act § 303 (1956)]

(h)

The [Administrator] by rule or order may waive or modify the application of a requirement of this section if a provision or an amendment, repeal, or other alteration of the securities registration provisions of the Securities Act of 1933, or the regulations adopted under that act, render the waiver or modification appropriate for further coordination of state and federal registration.

[New]

§ 304 Registration by Qualification.

(a)

A security may be registered by qualification.

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(b)

A registration statement under this section must contain the following information and be accompanied by the following documents in addition to the information specified in Section 305(c) and the consent to service of process required by Section 708:

(1)

with respect to the issuer and any significant subsidiary: its name, address, and form of organization; the state or foreign jurisdiction and date of its organization; the general character and location of its business; a description of its physical property and equipment; and a statement of the general competitive conditions in the industry or business in which it is or will be engaged;

(2)

with respect to every director and officer of the issuer, or person occupying a similar status or performing similar functions: name, address, and principal occupation for the last five years; the amount of securities of the issuer held by the person as of a specified date within 30 days before the filing of the registration statement; the amount of the securities covered by the registration statement to which the person has indicated an intention to subscribe; and a description of any material interest in any material transaction with the issuer or a significant subsidiary effected within the last three years or proposed to be effected;

(3)

with respect to persons covered by paragraph (2): the compensation paid or given, directly or indirectly, during the last 12 months and estimated to be paid during the next 12 months, by the issuer, together with all predecessors, parents, subsidiaries, and affiliates, to all those persons in the aggregate;

(4)

with respect to a person owning of record, or beneficially if known, ten percent or more of the outstanding shares of a class of equity security of the issuer: the information specified in paragraph (2) other than occupation;

(5)

with respect to a promoter, if the issuer was organized within the last three years: the information specified in paragraph (2), the amount paid or intended to be paid to the person within that period and the consideration for the payment;

(6)

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with respect to a person on whose behalf a part of the offering is to be made in a nonissuer distribution: name and address; the amount of securities of the issuer held by the person as of the date of the filing of the registration statement; a description of any material interest in any material transaction with the issuer, or a significant subsidiary, effected within the last three years or proposed to be effected; and a statement of the reasons for making the offering;

(7)

the capitalization and long-term debt, on both a current and a pro forma basis, of the issuer and any significant subsidiary, including a description of each security outstanding or being registered or otherwise offered, and a statement of the amount and kind of consideration, whether in the form of cash, physical assets, services, patents, goodwill, or anything else, for which the issuer or a subsidiary has issued its securities within the last two years or is obligated to issue its securities;

(8)

the kind and amount of securities to be offered; the proposed offering price or the method by which it is to be computed; any variation therefrom at which a proportion of the offering is to be made to a person or class of persons other than the underwriters, with a specification of the person or class; the basis upon which the offering is to be made if other than for cash; the estimated aggregate underwriting and selling discounts or commissions and finders' fees, including separately cash, securities, contracts, or anything else of value to accrue to the underwriters or finders in connection with the offering, or, if the selling discounts or commissions are variable, the basis of determining them and their maximum and minimum amounts; the estimated amounts of other selling expenses, including legal, engineering, and accounting charges; the name and address of every underwriter and every recipient of a finder's fee; a copy of any underwriting or selling-group agreement pursuant to which the distribution is to be made, or the proposed form of the agreement whose terms have not yet been determined; and a description of the plan of distribution of securities that are to be offered other than through an underwriter;

(9)

the estimated cash proceeds to be received by the issuer from the offering; the purposes for which the proceeds are to be used by the issuer; the amount to be used for each purpose; the order or priority in which the proceeds will be used for the purposes stated; the amounts of funds to be raised from other sources to achieve the purposes stated; the sources of the funds; and, if part of the proceeds is to be used to acquire property, including goodwill, other than in the ordinary course of business, the names and addresses of the vendors, the purchase price, the names of the persons who have received commissions in connection with the acquisition, and the amounts of commissions and any other expense in connection with the acquisition, including the cost of borrowing money to finance the acquisition;

(10)

a description of the stock options or other security options outstanding, or to be created in connection with the offering, and the amount of the options held or to be held by every person required to be named in paragraph (2), (4), (5), (6), or (8) and by a person who holds or will hold ten percent or more in the aggregate of the options;

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(11)

the dates of, parties to, and general effect concisely stated of, every management or other material contract made or to be made other than in the ordinary course of business, if it is to be performed in whole or in part at or after the filing of the registration statement or was made within the last two years; and a copy of the contract;

(12)

a description of any pending litigation or proceedings to which the issuer is a party and that materially affect its business or assets, including any litigation or proceeding known to be contemplated by a governmental authority;

(13)

a copy of any prospectus, pamphlet, circular, form letter, advertisement, or other sales literature intended as of the effective date to be used in connection with the offering;

(14)

a specimen, copy, or description of the security being registered; a copy of the issuer's articles of incorporation and by-laws, or their substantial equivalents, as currently in effect; and a copy of any indenture or other instrument covering the security to be registered;

(15)

a signed or conformed copy of an opinion of counsel as to the legality of the security being registered, with an English translation if it is in a foreign language, which states whether the security when sold will be legally issued, fully paid, and nonassessable, and, if a debt security, a binding obligation of the issuer;

(16)

the written consent of an accountant, engineer, appraiser, or other person whose profession gives authority to a statement made by the person, if the person is named as having prepared or certified a report or valuation, other than a public and official document or statement, which is used in connection with the registration statement;

(17)

a statement of financial condition of the issuer as of a date within four months preceding the filing of the registration statement; a statement of results of operations and analysis of surplus for each of the three fiscal years preceding the date of the statement of financial condition and for any period between the close of the last fiscal year and

2-UA Blue Sky Regulation

the date of the statement of financial condition, or for the period of the issuer's and any predecessors' existence if less than three years; and, if part of the proceeds of the offering is to be applied to the purchase of a business, the same financial statements that would be required if the business were the registrant; and

(18)

any additional information the [Administrator] by rule or order specifies.

(c)

A registration statement under this section becomes effective 30 calendar days, or any shorter period the [Administrator] by rule or order specifies, after the date the registration statement or the last amendment other than a price amendment is filed, if:

(1)

no stop order is in effect and no proceeding is pending under Section 306;

(2)

the [Administrator] has not ordered under subsection (d) that effectiveness be delayed; and

(3)

the registrant has not requested that effectiveness be delayed.

(d)

The [Administrator] may delay effectiveness for a single period of not more than 90 days if the [Administrator] determines the registration statement is not complete in all material respects and promptly notifies the registrant of that determination. The [Administrator] may delay effectiveness for a single period of not more than 30 days if the [Administrator] determines that the delay is necessary, whether or not the [Administrator] previously delayed effectiveness under this subsection.

[§ 304 is Amended from Unif. Securities Act § 304 (1956)]

§ 305 Provisions Applicable to Registration Generally.

(a)

2-UA Blue Sky Regulation

A registration statement may be filed by the issuer, any other person on whose behalf the offering is to be made, or a broker-dealer licensed under this [Act].

[Amended from Unif. Securities Act § 305(a) (1956)]

(b)

Except as provided in subsection (c), a person filing a registration statement shall pay a fee of [1/20 of one] percent of the maximum aggregate offering price at which the registered securities are to be offered in this State, but not less than [\$50] or more than [\$500]. If a registration statement is withdrawn before the effective date or a pre-effective stop order is entered under Section 306, the [Administrator] shall retain [\$50] of the fee.

[Amended from Unif. Securities Act § 305(b) (1956)]

(c)

An open-end management company, a face-amount certificate company, or a unit investment trust, as defined in the Investment Company Act of 1940, may register an indefinite amount of securities under a registration statement. The registrant, at the time of filing, shall pay a fee of [\$100] and within 60 days after the registrant's fiscal year during which its registration statement is effective, pay a fee of [\$500] or file a report on a form the [Administrator] by rule adopts, specifying its sale of securities to persons in this State during the fiscal year and pay a fee of [1/20 of one] percent of the aggregate sales price of the securities sold to persons in this State, but the latter fee must not be less than [\$50] or more than [\$500].

[New]

(d)

Except as permitted by subsection (c), a registration statement must specify the amount of securities to be offered in this State and the states in which a registration statement or similar document in connection with the offering has been or is to be filed and any adverse order, judgment, or decree entered by a court, the securities agency or administrator in any state, or the Securities and Exchange Commission in connection with the offering.

[Amended from Unif. Securities Act § 305(c) (1956)]

(e)

A document filed under this [Act] or a predecessor act [within five years preceding the filing of a registration statement] may be incorporated by reference in the registration statement if the document is currently accurate.

[Amended from Unif. Securities Act § 305(d) (1956)]

(f)

2-UA Blue Sky Regulation

The [Administrator] by rule or order may permit the omission of an item of information or document from a registration statement.

[Amended from Unif. Securities Act § 305(e) (1956)]

(g)

In the case of a nonissuer offering, the [Administrator] may not require information under subsection (n) or Section 304 unless it is known to the person filing the registration statement or to the person on whose behalf the offering is to be made, or can be furnished by the person without unreasonable effort or expense.

[Amended from Unif. Securities Act § 305(f) (1956)]

(h)

In the case of a registration under Section 303 or 304 by an issuer that has no public market for its shares or no significant earnings from continuing operations during the last five years or any shorter period of its existence, the [Administrator] by rule or order may require as a condition of registration that the following securities be deposited in escrow for not more than [three] years:

[Amended from Unif. Securities Act § 305(g) (1956)]

(i)

a security issued to a promoter within the three years next preceding the offering or to be issued to a promoter for a consideration substantially less than the offering price; and

(ii)

a security issued to a promoter for a consideration other than cash, unless the registrant demonstrates that the value of the noncash consideration received in exchange for the security is substantially equal to the offering price for the security.

(i)

The [Administrator] by rule or order may determine the conditions of an escrow required under subsection (h), but the [Administrator] may not reject a depository solely because of its location in another state.

[Amended from Unif. Securities Act § 305(g) (1956)]

(j)

2-UA Blue Sky Regulation

The [Administrator] by rule or order may require as a condition of registration under Section 303 or 304 that the proceeds from the sale of the registered security in this State be impounded until the issuer receives a specified amount from the sale of the security. The [Administrator] by rule or order may determine the conditions of an impoundment required under this subsection, but the [Administrator] may not reject a depository solely because of its location in another state.

[Amended from Unif. Securities Act § 305(g) (1956)]

(k)

If a security is registered under Section 302 or 303, the prospectus filed under the Securities Act of 1933 must be delivered to each purchaser in accordance with the prospectus delivery requirements of the Securities Act of 1933.

[New]

(l)

If a security is registered under Section 304, an offering document containing information the [Administrator] by rule or order designates must be delivered to each purchaser with or before the earliest of:

(1)

the first written offer made to the purchaser by or for the account of the issuer or another person on whose behalf the offering is being made, or by an underwriter or broker-dealer who is offering part of an unsold allotment or subscription taken by it as a participant in the distribution;

(2)

confirmation of a sale made by or for the account of a person named in paragraph (1);

(3)

payment pursuant to a sale; or

(4)

delivery pursuant to a sale.

[New]

2-UA Blue Sky Regulation

(m)

A registration statement remains effective for one year after its effective date unless the [Administrator] by rule or order extends the period of effectiveness. All outstanding securities of the same class as a registered security are considered to be registered for the purpose of a nonissuer transaction while the registration statement is effective, unless the [Administrator] by rule or order provides otherwise. A registration statement may not be withdrawn after its effective date if any of the securities registered have been sold in this State, unless the [Administrator], by rule or order, provides otherwise. A registration statement is not effective while a stop order is in effect under Section 306(a).

[Amended from Unif. Securities Act § 305(i) (1956)]

(n)

During the period in which an offering is being made pursuant to an effective registration statement, the [Administrator] by rule or order may require the person who filed the registration statement to file reports, not more often than quarterly, to keep reasonably current the information contained in the registration statement and to disclose the progress of the offering.

[Amended from Unif. Securities Act § 305(j)]

(o)

A registration statement filed under Section 302 or 303 may be amended after its effective date to increase the securities specified being offered and sold. The amendment becomes effective upon filing of the amendment and payment of an additional filing fee, calculated in the manner specified in subsection (b) or (c), with respect to the additional securities to be offered and sold. The effectiveness of the amendment relates back to the date of sale of the additional securities being registered.

[New]

(p)

A registration statement filed under Section 304 may be amended after its effective date to increase the securities specified to be offered and sold, if the public offering price and underwriters' discounts and commissions are not changed from the respective amounts of which the [Administrator] was informed. The amendment becomes effective when the [Administrator] so orders and relates back to the date of sale of the additional securities being registered. A person filing an amendment shall pay an additional filing fee [two] times the initial registration fee, calculated in the manner specified in subsection (b) or (c), with respect to the additional securities to be offered and sold.

[New]

§ 306 Denial, Suspension, and Revocation of Registration.

2-UA Blue Sky Regulation

(a)

The [Administrator] may issue a stop order denying effectiveness to, or suspending or revoking the effectiveness of, a registration statement if the [Administrator] finds that the order is in the public interest and that:

(1)

the registration statement as of its effective date or as of the proposed effective date in the case of an order denying effectiveness, an amendment under Section 305(o) or (p) as of its effective date, or a report under Section 305(n) is incomplete in a material respect or contains a statement that, in the light of the circumstances under which it was made, was false or misleading with respect to a material fact;

(2)

this [Act] or a rule, order, or condition lawfully imposed under this [Act] has been willfully violated, in connection with the offering, by the person filing the registration statement; by the issuer, a partner, officer, or director of the issuer, a person occupying a similar status or performing a similar function, or a person directly or indirectly controlling or controlled by the issuer, but only if the person filing the registration statement is directly or indirectly controlled by or acting for the issuer; or by an underwriter;

(3)

the security registered or sought to be registered is the subject of a permanent or temporary injunction of a court of competent jurisdiction or an administrative stop order or similar order entered under any other federal or state law applicable to the offering; but the [Administrator] may not institute a proceeding against an effective registration statement under this paragraph more than one year after the date of the order or injunction relied on, and the [Administrator] may not enter an order under this paragraph on the basis of an order or injunction entered under the securities act of another state unless the order or injunction was based on facts that currently would constitute a ground for a stop order under this section;

(4)

the issuer's enterprise or method of business includes or would include activities that are illegal where performed;

(5)

the offering has worked or tended to work a fraud upon purchasers or would so operate;[alternative subparagraph (5): the offering is being made on terms that are unfair, unjust, or inequitable;]

2-UA Blue Sky Regulation

(6)

the offering has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, or promoters' profits or participation, or unreasonable amounts or kinds of options;

(7)

a security sought to be registered under Section 302 is not eligible for registration under Section 302;

(8)

with respect to a security sought to be registered under Section 303, there has been a failure to comply with the undertaking required by paragraph (4) of Section 303(b); or

(9)

the applicant or registrant has failed to pay the proper filing fee; but the [Administrator] may enter only a denial order under this paragraph and shall vacate the order if the deficiency is corrected.

(b)

The [Administrator] may not institute a stop-order proceeding:

(1)

against an effective registration statement on the basis of a fact or transaction known to the [Administrator] when the registration statement became effective unless the proceeding is begun within 30 days after the registration statement became effective; or

(2)

with respect to a registration statement filed under Section 302, on the basis of paragraph (5) or (6) of subsection (a).

(c)

The [Administrator] by order under Section 712 may summarily postpone or suspend the effectiveness of a registration statement pending final determination of an administrative proceeding. Upon the entry of the order, the

2-UA Blue Sky Regulation

[Administrator] shall promptly notify each person specified in subsection (d) that the order has been entered and of the reasons for the postponement or suspension and that within 15 days after the receipt of a written request from the person the matter will be set down for hearing. If no hearing is requested and none is ordered by the [Administrator], the order remains in effect until it is modified or vacated by the [Administrator]. If a hearing is requested or ordered, the [Administrator], after notice of and opportunity for hearing to each person specified in subsection (d), may modify or vacate the order or extend it until final determination.

(d)

A stop order may not be entered under subsection (a) or (b) without (i) appropriate notice to the applicant or registrant, the issuer, and the person on whose behalf the securities are to be or have been offered, (ii) opportunity for hearing, and (iii) written findings of fact and conclusions of law [in accordance with the state administrative procedure act].

(e)

The [Administrator] may modify or vacate a stop order entered under this section if the [Administrator] finds that the conditions that prompted entry have changed or that it is otherwise in the public interest.

[§ 306 is Amended from Unif. Securities Act § 306 (1956)]

§ 401 Exempt Securities.

(a)

As used in this section:

(1)

Guaranteed means guaranteed as to payment of all or substantially all of principal and interest or dividends.

(2)

Insured means insured as to payment of all or substantially all of principal and interest or dividends.

[Amended from §§ 401(e) (1965)]

(b)

The following securities are exempt from Sections 301 and 405:

2-UA Blue Sky Regulation

(1)

a security, including a revenue obligation, issued, insured, or guaranteed by the United States, an agency or corporate or other instrumentality of the United States, an international agency or corporate or other instrumentality of which the United States and one or more foreign governments are members, a state, a political subdivision of a state, or an agency or corporate or other instrumentality of one or more states or their political subdivisions; or a certificate of deposit for any of the foregoing [, but this exemption does not include a security payable solely from revenues to be received from a nongovernmental industrial or commercial enterprise unless the payments are insured or guaranteed by a person whose securities are exempt from registration under paragraph (2), (3), (4), (5), (7), (9), or (13) or the revenues from which the payments are to be made are a direct obligation of such a person];

[Amended from Unif. Securities Act § 402(a)(1) (1965)]

(2)

a security issued, insured, or guaranteed by Canada, a Canadian province or territory, a political subdivision of Canada or a Canadian province or territory, an agency or corporate or other instrumentality of one or more of the foregoing, or any other foreign government or governmental combination or entity with which the United States maintains diplomatic relations, if the security is recognized as a valid obligation by the issuer, insurer, or guarantor;

[Amended from Unif. Securities Act § 402(a)(2) (1965)]

(3)

a security issued by and representing an interest in or a direct obligation of, or guaranteed by, a depository institution if the deposit or share accounts of the depository institution are insured by the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation, the National Credit Union Share Insurance Fund, or a successor to an applicable agency authorized by federal law;

[Amended from Unif. Securities Act § 402(a)(3), (4), (6) (1965)]

(4)

a security issued by and representing an interest in or a direct obligation of, or insured or guaranteed by, an insurance company organized under the laws of any state and authorized to do business in this State;

[Amended from Unif. Securities Act § 402(a)(5) (1965)]

(5)

a security issued or guaranteed by a railroad, other common carrier, public utility, or holding company that is:

2-UA Blue Sky Regulation

(i)

subject to the jurisdiction of the Interstate Commerce Commission;

(ii)

a registered holding company under the Public Utility Holding Company Act of 1935 or a subsidiary of a registered holding company within the meaning of that act;

(iii)

regulated in respect to its rates and charges by a governmental authority of the United States or a state; or

(iv)

regulated in respect to the issuance or guarantee of the security by a governmental authority of the United States, a state, Canada, or a Canadian province or territory;

[Amended from Unif. Securities Act § 402(a)(7) (1965)]

(6)

equipment trust certificates in respect to equipment leased or conditionally sold to a person, if securities issued by the person would be exempt under this section;

[New]

(7)

a security listed or approved for listing upon notice of issuance on the New York Stock Exchange, the American Stock Exchange, or the Midwest Stock Exchange [, or listed on the (insert names of appropriate regional stock exchange)], if, in either case, quotations have been available and public trading has taken place for the class of security listed before the offer or sale of a security in reliance upon this exemption; any other security of the same issuer which is of senior or substantially equal rank; a security called for by subscription right or warrant so listed or approved; or a warrant or right to purchase or subscribe to any of the foregoing;

[Amended from Unif. Securities Act § 402(a)(8) (1965)]

(8)

2-UA Blue Sky Regulation

a security designated or approved for designation upon issuance for inclusion in the national market system by the National Association of Securities Dealers, Inc., if, in either case, quotations have been available and public trading has taken place for the class of security designated before the offer or sale of a security in reliance upon this exemption; any other security of the same issuer which is of senior or substantially equal rank; a security called for by subscription right or warrant so designated; or a warrant or a right to purchase or subscribe to any of the foregoing;

[New]

(9)

an option issued by a clearing agency registered under the Securities Exchange Act of 1934, other than an off-exchange futures contract or substantially similar arrangement, if the security, currency, commodity, or other interest underlying the option:

(i)

is registered under Section 302, 303, or 304;

(ii)

is exempt under this section; or

(iii)

is not otherwise required to be registered under this [Act];

[New]

(10)

a security issued by a person organized and operated not for private profit but exclusively for a religious, educational, benevolent, charitable, fraternal, social, athletic, or reformatory purpose, or as a chamber of commerce or trade or professional association [if at least ten days before a sale of the security the person has filed with the [Administrator] a notice setting forth the material terms of the proposed sale and copies of any sales and advertising literature to be used and the [Administrator] by order does not disallow the exemption within the next five full business days];

[Amended from Unif. Securities Act § 402(a)(9) (1965)]

(11)

2-UA Blue Sky Regulation

a promissory note, draft, bill of exchange, or banker's acceptance that evidences an obligation to pay cash within nine months after the date of issuance, exclusive of days of grace, is issued in denominations of at least \$50,000, and receives a rating in one of the three highest rating categories from a nationally recognized statistical rating organization; or a renewal of such an obligation that is likewise limited, or a guarantee of such an obligation or of a renewal;

[Amended from Unif. Securities Act § 402(a)(10) (1965)]

(12)

a security issued in connection with an employees' stock purchase, savings, option, profit-sharing, pension, or similar employees' benefit plan;

[Amended from Unif. Securities Act § 402(a)(11) (1965)]

(13)

a membership or equity interest in, or a retention certificate or like security given in lieu of a cash patronage dividend issued by, a cooperative organized and operated as a nonprofit membership cooperative under the cooperative laws of any state if not traded to the public;

[New]

(14)

a security issued by an issuer registered as an open-end management investment company or unit investment trust under Section 8 of the Investment Company Act of 1940 if:

(i)

the issuer is advised by an investment adviser that is a depository institution exempt from registration under the Investment Adviser Act of 1940 or that is currently registered as an investment adviser, and has been registered, or is affiliated with an adviser that has been registered, as an investment adviser under the Investment Advisers Act of 1940 for at least three years next preceding an offer or sale of a security claimed to be exempt under this paragraph; and the issuer has acted, or is affiliated with an investment adviser that has acted, as investment adviser to one or more registered investment companies or unit investment trusts for at least three years next preceding an offer or sale of a security claimed to be exempt under this paragraph; or

(ii)

the issuer has a sponsor that has at all times throughout the three years before an offer or sale of a security claimed to be exempt under this paragraph sponsored one or more registered investment companies or unit investment

2-UA Blue Sky Regulation

trusts the aggregate total assets of which have exceeded [\$100,000,000]. For the purpose of this paragraph, an investment adviser is affiliated with another investment adviser if it controls, is controlled by, or is under common control with the other investment adviser.

[New]

§ 402 Exempt Transactions.

The following transactions are exempt from Sections 301 and 405:

(1)

an isolated nonissuer transaction, whether or not effected through a broker-dealer;

[Amended from Unif. Securities Act § 402(b)(1) (1965)]

(2)

a nonissuer transaction in an outstanding security if the issuer of the security has a class of securities subject to registration under Section 12 of the Securities Exchange Act of 1934 and has been subject to the reporting requirements of Sections 13 or 15(d) of the Securities Exchange Act of 1934 for not less than 90 days next preceding the transaction; or has filed and maintained with the [Administrator] for not less than 90 days next preceding the transaction information, in such form as the [Administrator] by rule specifies, substantially comparable to the information the issuer would be required to file under Section 12(b) or Section 12(g) of the Securities Exchange Act were the issuer to have a class of its securities registered under Section 12 of the Securities Exchange Act of 1934, and paid a fee with the filing of [\$150];

[New]

(3)

a nonissuer transaction in a security of a class outstanding in the hands of the public for not less than 90 days next preceding the transaction if a nationally recognized securities manual designated by the [Administrator] by rule or order contains:

(i)

the names of the issuer's officers and directors,;

(ii)

a statement of financial condition of the issuer as of a date within the last 18 months,; and

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(iii)

a statement of income or operations (a) for either the last fiscal year before that date or the most recent year of operation each of the two years next preceding the date of the statement of condition or (b) for the period as of the date of the statement of financial condition if the period of existence is less than two years;

[Amended from Unif. Securities Act § 402(b)(2) (1965)]

(4)

a nonissuer transaction in a security that has a fixed maturity or a fixed interest or dividend provision and there has been no default during the current fiscal year or within the three next preceding years, or during the existence of the issuer, and any predecessors if less than three years, in the payment of principal, interest, or dividends on the security;

[Amended from Unif. Securities Act § 402(b)(2) (1965)]

(5)

a nonissuer transaction effected by or through a registered broker-dealer pursuant to an unsolicited order or offer to purchase;

[Amended from Unif. Securities Act § 402(b)(3) (1965)]

(6)

a transaction between the issuer or other person on whose behalf the offering of a security is made and an underwriter, or a transaction among underwriters;

[Amended from Unif. Securities Act § 402(b)(4) (1965)]

(7)

a transaction in a bond or other evidence of indebtedness secured by a real estate mortgage, deed of trust, personal property security agreement, or by an agreement for the sale of real estate or personal property, if the entire mortgage, deed of trust, or agreement, together with all the bonds or other evidences of indebtedness secured thereby, is offered and sold as a unit;

[Amended from Unif. Securities Act § 402(b)(5) (1965)]

(8)

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a transaction by an executor, administrator, sheriff, marshal, receiver, trustee in bankruptcy, guardian, or conservator;

[Amended from Unif. Securities Act § 402(b)(6) (1965)]

(9)

a transaction executed by a bona fide secured party without a purpose of evading this [Act];

[Amended from Unif. Securities Act § 402(b)(7) (1965)]

(10)

an offer to sell or sale of a security to a financial or institutional investor or to a broker-dealer;

[Amended from Unif. Securities Act § 402(b)(8) (1965)]

(11)

a transaction pursuant to an offer to sell securities of an issuer, if the transaction is part of an issue in which there are no more than 25 purchasers in this State, other than those designated in paragraph (10), during any 12 consecutive months; no general solicitation or general advertising is used in connection with the offer to sell or sale of the securities; and no commission or other similar compensation is paid or given, directly or indirectly, to a person, other than a broker-dealer licensed or not required to be licensed under this [Act], for soliciting a prospective purchaser in this State; and either (i) the seller reasonably believes that all the purchasers in this State, other than those designated in paragraph (10), are purchasing for investment; or (ii) immediately before and immediately after the transaction, the issuer reasonably believes that the securities of the issuer are held by 50 or fewer beneficial owners, other than those designated in paragraph (10), and the transaction is part of an aggregate offering that does not exceed [\$500,000] during any 12 consecutive months; but the [Administrator] by rule or order as to a security or transaction or a type of security or transaction, may withdraw or further condition this exemption or waive one or more of the conditions in this paragraph;

[Amended from Unif. Securities Act § 402(b)(9) (1965)]

(12)

an offer to sell or sale of a preorganization certificate or subscription if no commission or other similar compensation is paid or given, directly or indirectly, for soliciting a prospective subscriber; no public advertising or general solicitation is used in connection with the offer to sell or sale; the number of subscribers does not exceed ten; and no payment is made by a subscriber;

[Amended from Unif. Securities Act § 402(b)(10) (1965)]

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(13)

an offer to sell or sale of a preorganization certificate or subscription issued in connection with the organization of a depositary institution if that organization is under the supervision of an official or agency of a state or of the United States which has and exercises the authority to regulate and supervise the organization of the depositary institution. For purpose of this paragraph, supervision of the organization by an official or agency means that the official or agency by law has authority to require disclosures to prospective investors similar to that required under Section 304, impound proceeds from the sale of a preorganization certificate or subscription until organization of the depositary institution is completed, and require refund to investors if the depositary institution does not obtain a grant of authority from the appropriate official or agency;

[New]

(14)

a transaction pursuant to an offer to sell to existing security holders of the issuer, including persons who at the time of the transaction are holders of transferable warrants exercisable within not more than 90 days after their issuance, convertible securities, or nontransferable warrants, if:

(i)

no commission or other similar compensation other than a standby commission, is paid or given, directly or indirectly, for soliciting a security holder in this State; or

(ii)

the issuer first files a notice specifying the terms of the offer to sell and the [Administrator] does not by order disallow the exemption within the next five full business days;

[Amended from Unif. Securities Act § 402(b)(11) (1965)]

(15)

a transaction involving an offer to sell, but not a sale, of a security not exempt from registration under the Securities Act of 1933 if:

(i)

a registration or offering statement or similar document as required under the Securities Act of 1933 has been filed, but is not effective;

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(ii)

a registration statement, if required, has been filed under this [Act], but is not effective; and

(iii)

no stop order of which the offeror is aware has been entered by the [Administrator] or the Securities and Exchange Commission, and no examination or public proceeding that may culminate in that kind of order is known by the offeror to be pending;

[Amended from Unif. Securities Act § 402(b)(12) (1965)]

(16)

a transaction involving an offer to sell, but not a sale, of a security exempt from registration under the Securities Act of 1933 if:

(i)

a registration statement has been filed under this [Act], but is not effective; and

(ii)

no stop order of which the offeror is aware has been entered by the [Administrator] and no examination or public proceeding that may culminate in that kind of order is known by the offeror to be pending; [and]

[Amended from Unif. Securities Act § 402(b)(12) (1965)]

(17)

a transaction involving the distribution of the securities of an issuer to the security holders of another person in connection with a merger, consolidation, exchange of securities, sale of assets, or other reorganization to which the issuer, or its parent or subsidiary, and the other person, or its parent or subsidiary, are parties, if:

(i)

the securities to be distributed are registered under the Securities Act of 1933 before the consummation of the transaction; or

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(ii)

the securities to be distributed are not required to be registered under the Securities Act of 1933, written notice of the transaction and a copy of the materials, if any, by which approval of the transaction will be solicited is given to the [Administrator] at least ten days before the consummation of the transaction and the [Administrator] does not disallow by order the exemption within the next ten days [.][]; and]

[New][(18) (i) a transaction involving the offer to sell or sale of one or more promissory notes each of which is directly secured by a first lien on a single parcel of real estate, or a transaction involving the offer to sell or sale of participation interests in the notes if the notes and participation interests are originated by a depository institution and are offered and sold subject to the following conditions:

(A)

the minimum aggregate sales price paid by each purchaser may not be less than \$250,000;

(B)

each purchaser must pay cash either at the time of the sale or within 60 days after the sale; and

(C)

each purchaser may buy for that person's own account only;

(ii)

a transaction involving the offer to sell or sale of one or more promissory notes directly secured by a first lien on a single parcel of real estate or participation interests in the notes, if the notes and participation interests are originated by a mortgagee approved by the Secretary of Housing and Urban Development under Sections 203 and 211 of the National Housing Act and are offered or sold, subject to the conditions specified in paragraph (i), to a depository institution or insurance company, the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, or the Government National Mortgage Association; and

(iii)

a transaction between any of the persons described in paragraph (ii) involving a nonassignable contract to buy or sell the securities described in paragraph (i) which contract is to be completed within two years, if:

(A)

the seller of the securities pursuant to the contract is one of the parties described in paragraph (i) or (ii) who

may originate securities;

(B)

the purchaser of securities pursuant to a contract is any other person described in paragraph (ii); and

(C)

the conditions described in paragraph (i) are fulfilled.]

[New]

§ 403 Additional Exemptions.

(a)

The [Administrator] by rule may exempt any other security or transaction or class of securities or transactions from Sections 301 and 405.

(b)

The [Administrator] by rule may adopt a limited offering transactional exemption that will further the objectives of compatibility with the exemptions from securities registration authorized by the Securities Act of 1933 and uniformity among the states.

[§ 403 is New]

§ 404 Revocation of Exemptions.

(a)

The [Administrator] by order may deny or revoke an exemption specified in paragraph (7), (8), (10), or (12) of Section 401(b) or in Section 402, with respect to a specific security or transaction.

(b)

A stop An order issued under this section is not retroactive. A person does not violate Section 301 or 405 by reason of an offer to sell or sale effected after the entry of an order under this section if the person did not know, and in the exercise of reasonable care could not have known, of the order.

[§ 404 is Amended from Unif. Securities Act § 402(c) (1956)]

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§ 405 Filing of Sales and Advertising Literature.

The [Administrator] by rule or order may require the filing of a prospectus, pamphlet, circular, form letter, advertisement, or other sales literature or advertising communication addressed or intended for distribution to prospective investors, including clients or prospective clients of an investment adviser, unless the security or transaction is exempt under Section 401 or 402 or the investment adviser is exempt under Section 204.

[Sec.405 is Amended from Unif. Securities Act § 403 (1956)]

Uniform Securities Act § 501 (1985)

§ 501 Offer, Sale, and Purchase.

In connection with an offer to sell, sale, offer to purchase, or purchase, of a security, a person may not, directly or indirectly:

(1)

employ a device, scheme, or artifice to defraud;

(2)

make an untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made not misleading, in the light of the circumstances under which they are made; or

(3)

engage in an act, practice, or course of business that operates or would operate as a fraud or deceit upon a person.

[§ 501 Amended from Unif. Securities Act § 101 (1956)]

§ 502 Manipulation of Market.

(a)

Without limiting the general applicability of Section 501, a person may not:

(1)

quote a fictitious price with respect to a security;

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(2)

effect a transaction in a security which involves no change in the beneficial ownership of the security for the purpose of creating a false or misleading appearance of active trading in a security or with respect to the market for the security;

(3)

enter an order for the purchase of a security with the knowledge that an order of substantially the same size and at substantially the same time and price for the sale of the security has been, or will be, entered by or for the same, or affiliated, person for the purpose of creating a false or misleading appearance of active trading in a security or with respect to the market for the security;

(4)

enter an order for the sale of a security with knowledge that an order of substantially the same size and at substantially the same time and price for the purchase of the security has been, or will be, entered by or for the same, or affiliated, person for the purpose of creating a false or misleading appearance of active trading in a security or with respect to the market for the security; or

(5)

employ any other deceptive or fraudulent device, scheme, or artifice to manipulate the market in a security.

(b)

A transaction effected in compliance with, or conduct that does not violate, the applicable provisions of the Securities Exchange Act of 1934 and the rules and regulations of the Securities and Exchange Commission thereunder is not a manipulation of the market under violation of subsection (a).

[§ 502 is New]

§ 503 Prohibited Transactions by Investment Advisers.

An investment adviser or person who represents an investment adviser in performing an act that requires licensing as an investment adviser under this [Act] may not, directly or indirectly:

(1)

employ a device, scheme, or artifice to defraud a client; or

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(2)

engage in an act, practice, or course of business that operates or would operate as a fraud or deceit upon a client.

[§ 503 is Amended from Unif. Securities Act § 102(a) (1956)]

§ 504 Misleading Filings.

A person may not make or cause to be made, in a document filed with the [Administrator] or in a proceeding under this [Act], a statement that the person knows or has reasonable grounds to know is, at the time and in the light of the circumstances under which it is made, false or misleading in a material respect.

[§ 504 is Amended from Unif. Securities Act § 404 (1956)]

§ 505 Unlawful Representation Concerning Licensing, Registration, or Exemption.

(a)

Neither the fact that an application for licensing or a registration statement has been filed under this [Act] nor the fact that a person is licensed or a security is registered under this [Act] constitutes a finding by the [Administrator] that a document filed under this [Act] is true, complete, and not misleading. Neither of those facts nor the fact that an exemption or exception is available for a security or a transaction means that the [Administrator] has passed upon the merits or qualifications of, or recommended or given approval to, a person, security, or transaction.

(b)

A person may not make, or cause to be made, to a purchaser, customer, or client a representation inconsistent with subsection (a).

[§ 505 is Amended from Unif. Securities Act § 405 (1956)]

§ 601 Investigation; Subpoena Power.

(a)

The [Administrator] may make any investigation, within or without this State, the [Administrator] finds necessary to determine whether a person has violated or is about to violate this [Act] or a rule or order of the [Administrator] under this [Act] or to aid in enforcement of this [Act].

(b)

Except as provided in Section 703(c), the [Administrator] may publish information concerning a violation of this

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[Act] or a rule or order of the [Administrator] under this [Act] or concerning types of securities or acts or practices in the offer to sell, sale, offer to purchase, or purchase of types of securities which may operate as a fraud or deceit.

(c)

For purposes of an investigation or proceeding under this [Act], the [Administrator] or an officer or employee designated by the [Administrator] by rule or order may administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production, by subpoena or otherwise, of books, papers, correspondence, memoranda, agreements, other documents, and records the [Administrator] considers to be relevant and material to the investigation or proceeding. The [Administrator] may require or permit a person to file a statement, under oath or otherwise as the [Administrator] directs, as to the facts and circumstances concerning the matter to be investigated.

(d)

If the activities constituting an alleged violation for which the information is sought would be a violation of this [Act] had the activities occurred in this State, the [Administrator] may issue and apply to enforce subpoenas in this State at the request of a securities agency or administrator of another state.

(e)

If a person does not testify or produce the documents required by the [Administrator] or a designated officer or employee pursuant to subpoena, the [Administrator] or designated officer or employee may apply to the court for an order compelling compliance.

(f)

A request for an order of compliance may be addressed to:

(1)

the [designate court having general trial jurisdiction] Court if the person is subject to service of process in this State; or

(2)

a court of another state able to assert jurisdiction over the person refusing to testify or produce, if the person is not subject to service of process in this State.

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(g)

Not later than the time the [Administrator] requests an order for compliance, the [Administrator] shall either send notice of the request by registered or certified mail, return receipt requested, to the respondent at the last known address or take other steps reasonably calculated to give the respondent actual notice.

[§ 601 is Amended from Unif. Securities Act § 407(a),(b) (1956)]

§ 602 Enforcement.

(a)

If the [Administrator] reasonably believes, whether or not based upon an investigation conducted under Section 601, that (i) the sale of a security is subject to registration under this [Act] and the security is being offered or has been offered or sold by the issuer or another person in violation of Section 301 or (ii) a person is acting as a broker-dealer or investment adviser in violation of Section 201 or 203, the [Administrator], in addition to any specific power granted under this [Act] and subject to compliance with the requirements of Section 712, may issue, without a prior hearing, an order against the person engaged in the prohibited activities, directing the person to desist and refrain from further activity until the security is registered or the person is licensed under this [Act]. The cease and desist order must state the section of this [Act] or rule or order of the [Administrator] under this [Act] which the [Administrator] reasonably believes has been or is being violated.

(b)

If the [Administrator] reasonably believes, whether or not based upon an investigation conducted under Section 601, that a person has violated this [Act] or a rule or order of the [Administrator] under this [Act], the [Administrator], in addition to any specific power granted under this [Act], after notice and hearing in an administrative proceeding unless the right to notice and hearing is waived by the person against whom the sanction is imposed, may:

(1)

issue a cease and desist order against the person;

(2)

censure the person, if the person is a licensed broker-dealer, sales representative, or investment adviser;

(3)

bar or suspend the person from association with a licensed broker-dealer or investment adviser in this State;

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(4)

issue an order against an applicant, licensed person, or other person who knowingly violates this [Act] or a rule or order of the [Administrator] under this [Act], imposing a civil penalty up to a maximum of [\$2,500] for a single violation or of [\$25,000] for multiple violations in a single proceeding or a series of related proceedings; or

(5)

initiate one or more applicable actions specified in Section 603.

(c)

Imposition of the sanctions under this section is limited as follows:

(1)

if the [Administrator] revokes the license of a broker-dealer, sales representative, or investment adviser or bars a person from association with a licensed broker-dealer or investment adviser under this section or Section 212, the imposition of that sanction precludes imposition of the sanction specified in paragraph (4) of subsection (b); and

(2)

the imposition by the [Administrator] of one or more sanctions under subsection (b) with respect to a specific violation precludes the [Administrator] from later imposing any other sanctions under paragraphs (1) through (4) of subsection (b) with respect to the violation.

(d)

For purposes of determining any sanction to be imposed under paragraphs (1) through (4) of subsection (b), the [Administrator] shall consider, among other factors, the frequency and persistence of the conduct constituting a violation of this [Act] or a rule or order of the [Administrator] under this [Act], the number of persons adversely affected by the conduct, and the resources of the person committing the violation.

[§ 602 is New]

§ 603 Power of Court to Grant Relief.

(a)

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Upon a showing by the [Administrator] that a person has violated or is about to violate this [Act] or a rule or order of the [Administrator] under this [Act], the [designate the appropriate court] may grant or impose one or more of the following appropriate legal or equitable remedies:

(1)

upon a showing of a violation of this [Act] or a rule or order of the [Administrator] under this [Act]:

(i)

a temporary restraining order, permanent or temporary prohibitory or mandatory injunction, or a writ of prohibition or mandamus;

(ii)

a civil penalty up to a maximum of [\$2,500] for a single violation or of [\$25,000] for multiple violations in a single proceeding or a series of related proceedings;

(iii)

a declaratory judgment;

(iv)

restitution to investors;

(v)

the appointment of a receiver or conservator for the defendant or the defendant's assets; and

(vi)

other relief the court considers just.

(2)

upon a showing that the defendant is about to violate this [Act] or a rule or order of the [Administrator] under

this [Act] only:

(i)

a temporary restraining order;

(ii)

a temporary or permanent injunction; or

(iii)

a writ of prohibition or mandamus.

(b)

In determining the appropriate relief under subsection (a), the court shall consider enforcement actions taken and sanctions imposed by the [Administrator] under Section 602 in connection with the transactions constituting violations of this [Act] or a rule or order of the [Administrator] under this [Act].

(c)

The [Administrator] is not required to post a bond in an action under this section.

(d)

Upon a showing by the securities agency or administrator of another state that a person has violated the securities act of that state or a rule or order of the securities agency or administrator of that state, the court, in addition to any other legal or equitable remedies, may impose one or more of the following remedies:

(1)

appointment of a receiver, conservator, or ancillary receiver or conservator for the defendant or the defendant's assets located in this State; and

(2)

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other relief the court considers just.

[§ 603 is Amended from Unif. Securities Act § 408 (1956)]

§ 604 Criminal Penalties.

(a)

A person who willfully violates a provision of this [Act], except Section 504, or a rule of the [Administrator] under this [Act], or who violates Section 504, knowing the statement made to be false or misleading in any material respect, is guilty of a [insert the language for felony under applicable state law].

(b)

A person who willfully violates a stop order or a cease and desist order issued by the [Administrator] under this [Act] is guilty of a [insert the language for misdemeanor under applicable state law].

(c)

A person convicted of violating a rule or order under this [Act] may be fined, but may not be imprisoned, if the person proves lack of knowledge of the rule or order.

(d)

A criminal prosecution may not be instituted under this section more than [five] years after the alleged violation.

(e)

The [Administrator] may refer evidence concerning violations of this [Act] or a rule or order of the [Administrator] under this [Act] to the [Attorney General or District Attorney] who, with or without a reference, may institute appropriate criminal prosecutions under this [Act].

(f)

This [Act] does not limit the power of this State to punish a person for conduct constituting a crime under other law.

[§ 604 is Amended from Unif. Securities Act § 409 (1956)]

§ 605 Civil Liability.

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(a)

A person who offers to sell or sells a security in violation of Section 201(a), 301, 305(k), 501(2), or 505(b) or of a condition imposed under Section 305(g), (h), or (i) is liable to one who purchases the security from that person. Upon tender of the security, the purchaser may recover the consideration paid for the security and interest at the legal rate of this State from the date of payment, costs, and reasonable attorney's fees as determined by the court, less the amount of income received on the security. Tender requires only notice of willingness to exchange the security for the amount specified. A purchaser who no longer owns the security may recover damages. Damages are the amount that would be recoverable upon a tender less the value of the security when the purchaser disposed of it, plus interest at the legal rate of this State from the date of disposition of the security, costs, and reasonable attorney's fees determined by the court.

(b)

A person who offers or sells a security in violation of Section 501(2) is not liable under subsection (a) if:

(1)

the purchaser knew of the untrue statement of a material fact or misleading omission of a statement of a material fact; or

(2)

the seller did not know and in the exercise of reasonable care could not have known of the untrue statement or misleading omission.

(c)

A person who willfully participates in an act or transaction in violation of Section 502 is liable to a person who purchases or sells a security, other than a security traded on a national securities exchange or quoted on a national automated quotation system administered by a self-regulatory organization, at a price that was affected by the act or transaction for the damages sustained as a result of the act or transaction. Damages are the difference between the price at which the securities were purchased or sold and the market value the securities would have had at the time of the person's purchase or sale in the absence of the act or transaction, plus interest at the legal rate of this State from the date of the act or transaction, costs, and reasonable attorney's fees determined by the court.

(d)

A person who directly or indirectly controls another person who is liable under subsection (a) or (c), a partner, officer, or director of the person liable, a person occupying a similar status or performing similar functions, an employee of the person liable if the employee materially aids in the act, omission, or transaction constituting the

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violation, and a broker-dealer or sales representative who materially aids in the act, omission, or transaction constituting the violation, are also liable jointly and severally with and to the same extent as the other person, but it is a defense that the person did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by which the liability is alleged to exist. With respect to a person who, directly or indirectly, controls another person who is liable under subsection (c), it is also a defense that the controlling person acted in good faith and did not, directly or indirectly, induce the act, omission, or transaction constituting the violation. Contribution among the several persons liable is the same as in cases arising out of breach of contract.

[§ 605 is Amended from Unif. Securities Act § 410(a),(b)]

§ 606 Statute of Limitations.

A person may not obtain relief under Section 605 unless suit is brought within the earliest of one year after the discovery of the violation, one year after discovery should have been made by the exercise of reasonable care, or three years after the act, omission, or transaction constituting the violation.

[§ 606 is Amended from Unif. Securities Act § 410(e) (1956)]

§ 607 Offer of Rescission or Settlement.

(a)

Relief may not be obtained under Section 605(a) if, before suit is commenced, the purchaser:

(1)

receives a written offer:

(i)

stating the respect in which liability under Section 605 may have arisen and fairly advising the purchaser of the purchaser's rights of rescission;

(ii)

if the basis for relief under Section 605(a) is a violation of Section 501(2), including financial and other information necessary to correct all material misstatements or omissions in the information which was required by this [Act] to be furnished to the purchaser as of the time of the sale of the security to the purchaser;

(iii)

offering to repurchase the security for cash, payable on delivery of the security, equal to the consideration

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paid, plus interest at the legal rate of this State from the date of payment, less income received thereon, or, if the purchaser no longer owns the security, offering to pay the purchaser upon acceptance of the offer an amount in cash equal to the damages computed under Section 605(a); and

(iv)

stating that the offer may be accepted by the purchaser within 30 days after the date of its receipt by the purchaser or any shorter period, not less than three days, the [Administrator] by order prescribes; and

(2)

fails to accept the offer in writing within the period specified under paragraph (1)(iv).

(b)

The [Administrator] by rule may prescribe the form in which the information specified in subsection (a) must be contained in an offer made under subsection (a).

(c)

An offer under subsection (a) must be delivered to the offeree or sent in a manner which assures actual receipt by the offeree.

(d)

If, after acceptance, a rescission offer is not performed in accordance with either its terms or this section, the offeree may obtain relief under Section 605 without regard to this section.

[§ 607 is Amended from Unif. Securities Act § 410(e) (1956)]

§ 608 Burden of Proof.

(a)

In a civil action or administrative proceeding under this [Act], a person claiming an exemption or an exception from a definition has the burden of proving the exemption or exception.

(b)

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In a criminal proceeding, the burden of going forward with evidence of a claim of exemption or exception from a definition is on the person claiming it.

[§ 608 is Amended from Unif. Securities Act § 402(d) (1956)]

§ 609 Liability; General Provisions.

(a)

Except as provided in Section 607, a tender required under this [Act] may be made before entry of judgment.

(b)

The rights and remedies provided by this [Act] are in addition to any other rights or remedies that exist at law or in equity, but this [Act] does not create any [claim for relief][cause of action] not specified in this Part.

(c)

A [claim for relief][cause of action] under this [Act] survives the death of a person who might have obtained relief as a plaintiff or defendant.

[§ 609 is Amended from Unif. Securities Act § 410(c), (d), (h) (1956)]

§ 701 Administration of [Act].

The [Administrator] shall administer this [Act] in accordance with [insert any related provision on method of selection, salary, term of office, budget, selection and compensation of personnel, annual report to the Legislature or Governor, which are appropriate to the particular state].

[§ 701 is Amended from Unif. Securities Act § 406(a) (1965)]

§ 702 Prohibitions on Use of Information.

Neither the [Administrator] nor an employee of the [Administrator] may use for personal gain or benefit information filed with or obtained by the [Administrator] which is not public information. Neither the [Administrator] nor an employee of the [Administrator] may conduct securities dealings based upon information filed with or obtained by the [Administrator], even though public, if there has not been sufficient time for the securities markets to assimilate the information.

[§ 702 is Amended from Unif. Securities Act § 406(b) (1965)]

§ 703 Public Information; Confidentiality.

(a)

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Except as provided in subsection (b), information and documents filed with or obtained by the [Administrator] are public information and are available for public examination under the [freedom of information or open records laws of this State].

(b)

The following information and documents do not constitute public information under subsection (a):

(1)

information or documents obtained by the [Administrator] in connection with an investigation under Section 601; and

(2)

information or documents filed with the [Administrator] in connection with a registration statement under Volume 3 or a report under Section 209 and constituting trade secrets or commercial or financial information of a person for which that person is entitled to, and has asserted, a claim of confidentiality or privilege authorized by law.

(c)

The [Administrator] may disclose:

(1)

information obtained in connection with an investigation under Section 601(a) to the extent provided in Section 601(b) subject to the restrictions of subsection (b)(2); and

(2)

information obtained in connection with an investigation under Section 601(a), if disclosure is for the purpose of a civil, administrative, or criminal investigation or proceeding by a securities agency, law enforcement agency, or administrator specified in Section 704(a), and the receiving agency or administrator represents in writing that under applicable law protections exist to preserve the integrity, confidentiality, and security of the information.

(d)

This [Act] does not create any privilege or diminish any privilege existing at common law, by statute, rule, or otherwise.

[§ 703 is Amended from Unif. Securities Act § 406(b) and 413(c) (1965)]

§ 704 Cooperation with Other Agencies.

(a)

To encourage uniform interpretation and administration of this [Act] and effective securities regulation and enforcement, the [Administrator] may cooperate with the securities agencies or administrators of one or more states, Canadian provinces or territories, or another country, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Securities Investor Protection Corporation, any self-regulatory organization, any national or international organization of securities officials or agencies, and any governmental law enforcement or regulatory agency.

(b)

The cooperation authorized by subsection (a) includes:

(1)

establishing a central depository for licensing or registration under this [Act] and for documents or records required or allowed to be maintained under this [Act];

(2)

making a joint license or registration examination or investigation;

(3)

holding a joint administrative hearing;

(4)

filing and prosecuting a joint civil or administrative proceeding;

(5)

sharing and exchanging personnel;

(6)

sharing and exchanging information and documents subject to the restrictions of [Section 703(b) and (c)][cite other applicable state law]; and

(7)

formulating, in accordance with the [administrative procedure act of this State], rules or proposed rules on matters such as statements of policy, guidelines, and interpretative opinions and releases.

[§ 704 is New]

§ 705 Rules, Forms, and Orders.

(a)

In addition to specific authority otherwise granted by this [Act], the [Administrator]:

(1)

shall adopt as a rule a description of the organization of the [Administrator's] office which states the general course and method of its organization and where and how a person may obtain information or make a submission or request;

(2)

shall adopt rules of practice setting forth the nature and requirements of all formal and informal procedures available to a person, including a description of all forms and instructions that are to be used by a person dealing with the [Administrator];

(3)

may adopt rules, in addition to those otherwise required by this [Act], embodying appropriate standards, principles, and procedural safeguards that the [Administrator] applies in the administration of this [Act]; and

(4)

may adopt rules defining any term, whether or not used in this [Act], insofar as the definition is not inconsistent with this [Act].

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(b)

To keep rules adopted by the [Administrator] in harmony with the regulations adopted by the Securities and Exchange Commission under the federal securities laws and to encourage uniformity with the rules of securities agencies and administrators in other states, the [Administrator], so far as is consistent with this [Act], shall take into consideration the regulations adopted by the Securities and Exchange Commission and the rules of securities agencies and administrators in other states that enact a law comparable to this [Act].

(c)

Unless specifically provided in this [Act] to the contrary, a rule or order may not be adopted, amended, or repealed unless the [Administrator] determines that the action is:

(1)

in the public interest and appropriate for the protection of investors; and

(2)

consistent with the purposes fairly intended by the policy and provisions of this [Act].

(d)

The [Administrator] may use his [or her] own experience, technical competence, specialized knowledge, and judgment in the adoption of a rule.

(e)

The [Administrator] by rule or order may prescribe:

(1)

the form and content of financial statements required under this [Act];

(2)

the circumstances under which consolidated financial statements must be filed; and

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(3)

whether a required financial statement must be certified and by whom. Unless the [Administrator] by rule or order provides otherwise, a financial statement required under this [Act] must be prepared in accordance with generally accepted accounting principles or other accounting principles as are prescribed for the issuer of the financial statement by the Securities and Exchange Commission.

(f)

The [Administrator] shall file [in the office of the Secretary of State or other location required by law] and in the [Administrator's] office each rule adopted or amended and all rules existing on the effective date of this [Act] that have not been previously filed. The filing must be done as soon after adoption or amendment of the rule as is practicable. The [Administrator] shall affix to each rule a certification of the time and date of filing and keep a permanent register open to public inspection of all filed rules.

[§ 705 is Amended from Unif. Securities Act § 412 (1965)]

§ 706 Declaratory Orders and Rulings.

(a)

Any person may petition the [Administrator] for a declaratory order as to the applicability to specified circumstances of a statute, rule, or order under this [Act]. The [Administrator] may issue a declaratory order in response to a petition for that order unless the [Administrator] determines that the petition fails to comply with the [Administrator's] rules or, if the order were issued, would substantially prejudice the rights of a person who would be a necessary party and who does not consent to the determination of the matter by a declaratory order.

(b)

The [Administrator], upon application by an interested party, may conduct a hearing and issue a declaratory ruling as to the applicability of this [Act] or a rule or order of the [Administrator] under this [Act] to a person, security, or transaction, or as to the meaning of a term used in this [Act].

[§ 706 is Amended from Unif. Securities Act § 413(e) (1965)]

§ 707 Good Faith Reliance.

No provision of this [Act] imposing liability applies to an act done or omitted in good faith in conformity with:

(1)

a rule or order adopted by the [Administrator], notwithstanding that the rule or order is later amended, repealed,

or determined by judicial or other authority to be invalid; or

(2)

a declaratory order or ruling issued by the [Administrator] under Section 706.

[§ 707 is Amended from Unif. Securities Act § 412(e) (1965)]

§ 708 Consent to Service of Process.

(a)

An applicant for licensing or registration under this [Act] or an issuer who proposes to offer a security in this State through an agent shall file with the [Administrator], in the form the [Administrator], by rule, prescribes, an irrevocable consent appointing the [Administrator] the person's agent for service of process in a noncriminal proceeding against the person, a successor, or personal representative, which arises under this [Act] or a rule or order of the [Administrator] under this [Act] after the consent is filed, with the same force and validity as if served personally on the person filing the consent.

(b)

A person who has filed a consent complying with subsection (a) in connection with a previous application for licensing or registration need not file an additional consent.

(c)

If a person, including a nonresident of this State, engages in conduct prohibited or made actionable by this [Act] or a rule or order of the [Administrator] under this [Act] and the person has not filed a consent to service of process under subsection (a), the engaging in the conduct constitutes the appointment of the [Administrator] as the person's agent for service of process in a noncriminal proceeding against the person, a successor, or personal representative which grows out of the conduct.

(d)

A consent to service filed on behalf of an issuer organized or domiciled under the laws of a foreign country whose securities are being offered in this State other than by or through underwriters, must be accompanied by an opinion of counsel stating that a judgment of United States courts will be recognized by the courts of the country in which the issuer is organized or domiciled.

(e)

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Service under subsection (a) or (c) may be made by leaving a copy of the process in the office of the [Administrator], but it is not effective unless:

(1)

the plaintiff, who may be the [Administrator], promptly sends notice of the service and a copy of the process by registered or certified mail, return receipt requested, to the defendant or respondent at the address set forth in the consent to service of process or, if no consent to service of process has been filed, at the last-known address, or takes other steps reasonably calculated to give actual notice; and

(2)

the plaintiff files an affidavit of compliance with this subsection in the proceeding on or before the return day of the process, if any, or within such further time as the court, or the [Administrator] in a proceeding before the [Administrator], allows.

(f)

Service as provided in subsection (e) may be used in a proceeding before the [Administrator] or by the [Administrator] in a proceeding in which the [Administrator] is the moving party.

(g)

If the process is served under subsection (e), the court, or the [Administrator] in a proceeding before the [Administrator], shall order continuances as may be necessary to afford the defendant or respondent reasonable opportunity to defend.

[§ 708 is Amended from Unif. Securities Act § 414(g)-(i) (1965)]

§ 709 Administrative Files and Records.

(a)

The [Administrator] shall keep one or more registers of:

(1)

all applications for licensing and registration under this [Act];

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(2)

all licenses and registration statements that become effective under this [Act];

(3)

all disciplinary and enforcement orders issued and reports of investigation made under this [Act];

(4)

all declaratory orders and rulings issued under this [Act]; and

(5)

all other orders issued under this [Act].[(b) The [Administrator] shall maintain records consistent with applicable law.][(b) The [Administrator] shall retain:

(1)

all licenses and related applications and all registration statements currently effective or that have been effective within the last [five] years;

(2)

all licenses and related applications and all registration statements that have been denied, suspended, or revoked within the last [five] years, and the order of suspension, denial, or revocation;

(3)

all investigatory files under this [Act] that are open or that have been closed within the last [five] years, and any disciplinary or file-closure order pertaining to the file;

(4)

the transcript or record of all administrative hearings held during the last [five] years; and

(5)

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any other orders of the [Administrator] entered under this [Act].]

(c)

All records required to be maintained by subsections (a) and (b) may be maintained in any form of data storage.

(d)

Upon request, the [Administrator] shall certify under the seal of office a copy as being a true and correct copy of the records maintained by the office. The [Administrator] by rule may establish reasonable charges for furnishing or certifying copies. In an investigation or proceeding under this [Act], a copy so certified is prima facie evidence of the contents of the records certified.

[§ 709 is Amended from Unif. Securities Act § 413(b),(d) (1965)]

§ 710 Administrative Proceedings.

The [Administrator] may commence an administrative proceeding at any time with respect to a matter within the [Administrator's] jurisdiction. The [Administrator] shall commence an administrative proceeding upon the application of a person, unless:

(1)

the [Administrator] lacks jurisdiction over the subject matter;

(2)

resolution of the matter requires the [Administrator] to exercise discretion to determine whether or not to issue an order;

(3)

a statute vests the [Administrator] with discretion to conduct or not to conduct an administrative proceeding before issuing an order to resolve the matter and, in the exercise of discretion, the [Administrator] determines not to conduct an administrative proceeding;

(4)

resolution of the matter does not require the [Administrator] to issue an order that determines the person's legal rights, duties, privileges, immunities, or other legal interests;

(5)

the matter is not timely submitted to the [Administrator]; or

(6)

the matter is not submitted in a form substantially complying with the rules of the [Administrator].

[§ 710 is New]

§ 711 Provisions Applicable to Administrative Proceedings.

(a)

All actions of the [Administrator] including administrative proceedings, adoption of rules, and issuance of orders are governed by [state administrative procedure act], but:

(1)

the issue of a stop order under Section 303(e) is governed by Section 303(e);

(2)

the issue of an order pursuant to an emergency administrative proceeding is governed by Section 712; and

(3)

the issue of a declaratory order or ruling is governed by Section 706.

(b)

All rules and orders issued under this [Act] are subject to judicial review [in accordance with the state administrative procedure act].

[§ 711 is New]

§ 712 Emergency Administrative Proceedings.

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(a)

The [Administrator] may use emergency administrative proceedings in a situation involving an immediate danger to the public welfare requiring immediate action.

(b)

The [Administrator] may take only such action as is necessary to prevent or avoid the immediate danger to the public welfare that justifies use of emergency administrative proceedings.

(c)

The [Administrator] shall issue an order, including a brief statement of findings of fact, conclusions of law, and, if it is an exercise of the agency's discretion, policy reasons for the decision to justify the determination of an immediate danger and the [Administrator's] decision to take the specific action.

(d)

The [Administrator] shall give such notice as is practicable to persons who are required to comply with the order. The order is effective when issued.

(e)

After issuing an order under this section, the [Administrator] shall proceed as quickly as feasible to complete proceedings that would be required [under the state administrative procedures act] if the matter did not involve an immediate danger.

(f)

The record of the [Administrator] consists of the documents regarding the matter that were considered or prepared by the [Administrator]. The [Administrator] shall maintain these documents as the official record.

(g)

Unless otherwise required by law, the [Administrator's] record need not constitute the exclusive basis for the [Administrator's] action in emergency administrative proceedings or for judicial review of the action.

(h)

An order issued under this section is subject to judicial review [in accordance with the state administrative procedure act].

[§ 712 is New]

§ 801 Scope of [Act].

(a)

Sections 201, 301, 501, 502, 505, and 605 apply to a person who sells or offers to sell a security if:

(1)

an offer to sell is made in this State; or

(2)

an offer to purchase is made and accepted in this State.

(b)

Sections 201, 501, 502, and 505 apply to a person who purchases or offers to purchase a security if:

(1)

an offer to purchase is made in this State; or

(2)

an offer to sell is made and accepted in this State.

(c)

For the purpose of this section, an offer to sell or to purchase is made in this State, whether or not either person is present in this State, if the offer:

(1)

originates in this State; or

(2)

is directed by the offeror to a destination in this State and received where it is directed, or at a post office in this State if the offer is mailed.

(d)

For the purpose of this section, an offer to purchase or to sell is accepted in this State if acceptance is communicated to the offeror in this State and has not previously been communicated to the offeror, orally or in writing, outside this State. Acceptance is communicated to the offeror in this State, whether or not either person is present in this State, if the offeree directs it to the offeror in this State reasonably believing the offeror is in this State and it is received where it is directed, or at a post office in this State if an acceptance is mailed.

(e)

For the purpose of subsections (a) through (d), an offer to sell or to purchase made in a newspaper or other publication of general, regular, and paid circulation is not made in this State if the publication:

(1)

is not published in this State; or

(2)

is published in this State, but has had more than two-thirds of its circulation outside this State during the last 12 months.

(f)

For the purpose of subsection (e), if a publication is published in editions, each edition is a separate publication except for material common to all editions.

(g)

For the purpose of subsections (a) through (d), an offer to sell or to purchase made in a radio or television program or other electronic communication received in this State which originates outside this State is not made in this State.

(h)

For the purpose of subsection (g), a radio or television program or other electronic communication is considered as having originated in this State if either the broadcast studio or the originating source of transmission is located in this State, unless:

(1)

the program or communication is syndicated and distributed from outside this State for redistribution to the general public in this State;

(2)

the program or communication is supplied by a radio, television, or other electronic network with the electronic signal originating from outside this State for redistribution to the general public in this State;

(3)

the program or communication is an electronic signal that originates outside this State and is captured for redistribution to the general public in this State by a community antenna or cable, radio, cable television, or other electronic system; or

(4)

the program or communication consists of an electronic signal that originates in this State, but which is not intended for redistribution to the general public in this State.

[§ 801 is Amended from Unif. Securities Act § 414(a)-(f) (1965)]

§ 802 Contract Provisions.

(a)

A person subject to this [Act] who makes or engages in the performance of a contract in violation of this [Act] or a rule or order of the [Administrator] under this [Act], or who acquires a right under a contract with knowledge of the facts by which its making or performance is in violation of this [Act], may not obtain relief on the contract.

(b)

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A provision in a contract entered into or effective in this State, binding a person acquiring a security to waive compliance with this [Act] or a rule or order of the [Administrator] under this [Act] is nonenforceable. A provision in a contract containing (i) an agreement to arbitrate or (ii) a choice of law provision in a contract between persons engaged in the securities business is not a provision waiving compliance with this [Act] and is enforceable in accordance with its terms.

[§ 802 is Amended from Unif. Securities Act § 410(f), (g) (1965)]

§ 803 Uniformity of Application and Construction.

This [Act] shall be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject of this [Act] among states enacting it and to coordinate the interpretation and administration of this [Act] with the related federal laws and regulations.

[§ 803 is Amended from Unif. Securities Act § 416 (1965)]

§ 804 Short Title.

This [Act] may be cited as the Uniform Securities Act (1985).

[§ 804 is Amended from Unif. Securities Act § 416 (1965)]

§ 805 Severability Clause.

If any provision of this [Act] or its application to any person or circumstance is held invalid, the invalidity does not affect other provisions or applications of this [Act] which can be given effect without the invalid provision or application, and to this end the provisions of the [Act] are severable.

[§ 805 is Amended from Unif. Securities Act § 417 (1965)]

§ 806 Effective Date.

This [Act] takes effect on [insert date, which should be at least 60 days after enactment].

[§ 806 is Amended from Unif. Securities Act § 419 (1965)]

§ 807 Repeal and Saving Provisions.

(a)

The [identify the existing act or acts] is [are] repealed except as saved in this section.

(b)

Law repealed by this [Act] exclusively governs a suit, action, prosecution, or proceeding that is pending on the effective date of this [Act] or may be initiated on the basis of facts or circumstances occurring before the effective date of this [Act], but a civil action or proceeding may not be maintained to enforce any liability under law repealed by this

[Act] unless brought within the earlier of the period of limitation that applied when the [claim for relief][cause of action] accrued or two years after the effective date of this [Act].

(c)

All effective registrations under law repealed by this [Act], all administrative orders relating to those registrations, and all conditions imposed upon those registrations remain in effect for as long as they would have remained in effect if this [Act] had not been enacted. They are considered to have been filed, issued, or imposed under this [Act], but are governed by the law repealed by this [Act].

(d)

A law repealed by this [Act] applies to an offer to sell or sale made within one year after the effective date of this [Act] pursuant to an offering begun in good faith before the effective date of this [Act] on the basis of an exemption available under the repealed law.

(e)

Judicial review of all administrative orders as to which review proceedings have not been instituted before the effective date of this [Act] are governed by [state administrative procedure act] but a review proceeding may not be instituted unless the petition for review is filed within the earlier of the period of limitation that applied to a review proceeding when the order was entered or 60 days after the effective date of this [Act]

[§ 806 is Amended from Unif. Securities Act § 419 (1965)]

(Last Revised or Amended in 2002)

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**NATIONAL CONFERENCE OF COMMISSIONERS
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Prefatory Note

There are two versions of the Uniform Securities Act currently in force.

The Uniform Securities Act of 1956 ("1956 Act") has been adopted at one time or another, in whole or in part, by 37 jurisdictions.

The Revised Uniform Securities Act of 1985 ("RUSA") has been adopted in only a few States.

Both Acts have been preempted in part by the National Securities Markets Improvement Act of 1996 and the Securities Litigation Uniform Standards Act of 1998.

The need to modernize the Uniform Securities Act is a consequence of a combination of the new federal preemptive legislation, significant recent changes in the technology of securities trading and regulation, and the increasingly

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interstate and international aspects of securities transactions.

The approach of this Act is to use the substance and vocabulary of the more widely adopted 1956 Act, when appropriate. The Act also takes into account RUSA, federal preemptive legislation, and the other developments that are described in this Preface and the Official Comments.

The Act has been reorganized to follow in large part the National Conference of Commissioners on Uniform State Laws ("NCCUSL") Procedural and Drafting Manual 15-41 (1997).

This is a new Uniform Securities Act. Amendment of the earlier 1956 Act or RUSA would not have been wise given the different versions of the 1956 Act enacted by the States and the determination to seek enactment in all state jurisdictions of the new Uniform Securities Act after it was adopted by the National Conference.

Nonetheless several sections of this Act are identical or substantively identical to sections of the 1956 Act or RUSA. It is not intended that adoption of a new Uniform Securities Act will reject earlier case decisions interpreting identical or substantively identical sections of the 1956 Act or RUSA unless specifically so stated in the Official Comments.

The Act is solely a new Uniform Securities Act. It does not codify or append related regulations or guidelines. The Act also authorizes state administrators in Section 203 to adopt further exemptions without statutory amendment. The Drafting Committee did not address state tender offer or control share provisions in its preparation of this Act.

The Act includes subheadings within sections as an aid to readers. Unlike section captions, subheadings are not a part of the official text. Each jurisdiction in which this Act is introduced may consider whether to adopt the subheadings as a part of the statute and whether to adopt a provision clarifying the effect, if any, to be given to the headings.

The Drafting Committee reviewed several drafts in meetings between 1998 and 2002. The drafts were made available on NCCUSL's public website before the meetings. The meetings were publicly noticed and open to all who wished to attend. The Committee had the assistance of advisors, consultants, and observers from several interested groups, including, among others, the American Bankers Association, the American Bar Association, the American Council of Life Insurers, the Certified Financial Planner Board of Standards, the Financial Planning Association, the Investment Company Institute, the Investment Counsel Association of America, the National Association of Securities Dealers, Inc., the New York Stock Exchange, the North American Securities Administrators Association, the Securities and Exchange Commission, and the Securities Industry Association. In addition, the Reporter and the Chair met on several occasions with committees or representatives of these and other groups.

In drafting the new Act, the Reporter and the Drafting Committee recognized two fundamental challenges. First, there was a general recognition among all involved of the desirability of drafting an Act that would receive broad support. The success of RUSA had been limited because of fundamental differences among relevant constituencies on several issues. After the National Securities Markets Improvement Act of 1996 preempted specified aspects of state securities law with respect to federal covered securities, the opportunity to draft an Act in a less contentious atmosphere was available. Given the number of industry, investor, and regulatory interests affected by the Act and the complexity of the Act itself, building consensus was the Act's most significant drafting challenge.

Second, there was the technical challenge of drafting a new Act that could achieve the basic goal of uniformity among states and with applicable federal law against the backdrop of 46 years of experience with the 1956 Act. Over time both Uniform and non-Uniform Act states have, to varying degrees, evolved local solutions to a number of securities law issues. In an increasingly global securities market, the need for uniformity has become more important. Drafting language to achieve the greatest practicable uniformity, given differences in state practice, was a key aspiration of this Act. In a few instances, such as dollar amounts for fees, the Act defers to local practice. On a few other issues, bracketed language or the Official Comments articulate an alternative some states may choose to adopt rather than the

language of the Act itself.

The Act is in seven Articles:

1.

General Provisions

2.

Exemptions from Registration of Securities

3.

Registration of Securities and Notice Filing of Federal Covered Securities

4.

Broker-Dealers, Agents, Investment Advisers, Investment Adviser Representatives, and Federal Covered Investment Advisers

5.

Fraud and Liabilities

6.

Administration and Judicial Review

7.

Transition

There are three overarching themes of the Act.

First, Section 608 articulates in greater detail than the 1956 Act's

Section 415 the objectives of uniformity, cooperation among relevant state and federal governments and self-regulatory organizations, investor protection and, to the extent practicable, capital formation. Section 608 is the reciprocal of the

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instruction on these subjects given by Congress in 1996 to the Securities and Exchange Commission in Section 19(c) of the Securities Act of 1933. The theme of uniformity and the aspiration of coordination of federal and state securities law is particularly stressed in the Act and Official Comments. Section 602(f), consistent with the Federal Securities Litigation Uniform Standard Act of 1998, is a new provision encouraging reciprocal state enforcement assistance.

A second overarching theme of the Act is achieving consistency with the National Securities Markets Improvement Act of 1996 ("NSMIA"). New definitions were added to define in Section 102(6), federal covered investment adviser, and in Section 102(7), federal covered security. NSMIA also had implications for several securities registration exemptions (see Sections 201(3), 201(4), 201(6), 202(4), 202(6), 202(13), 202(14), 202(15) and 202(16)); securities registration (Sections 301(1) and 302); and the broker-dealer, agent, investment adviser, and investment adviser representative provisions (see especially Sections 402(b)(1) and (5), 403(b)(1)(A) and (2), 405 and 411).

A third theme of the Act involves facilitating electronic records, signatures, and filing. New definitions were added to address filing (Section 102(8)), record (Section 102(25)), and sign (Section 102(30)). Section 105 expressly permits the filing of electronic signatures and records. Collectively these provisions are intended to permit electronic filing in central information depositories such as the Web-CRD (Central Registration Depository), the Investment Adviser Registration Depository (IARD), the Securities and Exchange Commission's Electronic Data Gathering, Analysis and Retrieval System (EDGAR) or successor institutions. Electronic communication also has led to an amplification of the jurisdiction Section 610.

The new Act makes several other significant changes compared to the 1956 Act or RUSA.

(1)

The definition of "security" in Section 102(28) has been modernized to take into account amendments to the counterpart federal provisions; add new language to expressly include uncertificated securities; exclude contributory or noncontributory ERISA plans; and amplify the definition of investment contract so that it can expressly reach interests in limited partnerships, limited liability companies, or viatical settlement agreements, among other contracts, when they satisfy the definition of investment contract. The new Act does not expressly exclude from the definition of security variable insurance products, but does exempt variable insurance products from securities registration in Section 201(4). The states are divided on the question of whether variable insurance products should be excluded (and not subject to fraud enforcement) or exempted (and subject to fraud enforcement). For those states that wish to continue to provide or adopt an exclusion for variable insurance products from the definition of security, the brackets should be removed from the phrase "or variable." For those states that wish variable insurance products to be included in the definition of security, the bracketed phrase should be removed.

(2)

Nineteen new definitions were added to define "bank" (Section 102(3)), "depository institution" (Section 102(5)), "federal covered investment adviser" (Section 102(6)), "federal covered security" (Section 102(7)), "filing" (Section 102(8)), "institutional investor" (Section 102(11)), "insurance company" (Section 102(12)), "insured" (Section 102(13)), "international banking institution" (Section 102(14)), "investment adviser representative" (Section 102(16)), "offer to purchase" (Section 102(19)), "place of business" (Section 102(21)), "predecessor act" (Section 102(22)), "price amendment" (Section 102(23)), "principal place of business" (Section 102(24)), "record" (Section 102(25)), "Securities and Exchange Commission" (Section 102(27)), "self-regulatory organization" (Section 102(29)), and "sign" (Section 102(30)). The growth in definitions is suggestive of the increased complexity and detail of several revised provisions in the new Act.

(3)

Specific exemptions from securities registration are broadened. Most significant is Section 202(13) which builds on a new definition of institutional investors that parallels Rule 501(a) of the Securities Act of 1933, but with \$10 million rather than \$5 million thresholds in Sections 102(11)(F) through (K), and (O), and addresses specified employee plans, trusts, *Internal Revenue Code Section 501(c)(3)* organizations, small business investment companies licensed by the Small Business Administration, private business development companies under Section 202(a)(22) of the Investment Advisers Act, and other institutional purchasers. The definition of institutional investor also reaches qualified institutional buyers under Rule 144A(a)(i) of the Securities Act of 1933, major U.S. institutional investors as defined in Rule 15a-6(b)(4)(i) of the Securities Exchange Act of 1934, and federal covered investment advisers acting for their own accounts. The new institutional investor transaction exemption in Section 202(13) will also reach other persons specified by rule or order of the administrator. The limited offering transaction exemption in Section 202(14) was broadened to reach 25 persons, in addition to those exempted by the institutional investor exemption, on condition that the transaction is part of a single issue, and other specified conditions are satisfied. If the SEC adopts a new definition of qualified purchaser, as it has proposed under Rule 146(c) of the Securities Act of 1933, there may ultimately be four preemptive or exemptive types of provision applicable to the new Act: (1) the SEC qualified purchaser provision; (2) Section 18(b)(4)(D) which provides preemptive treatment for Rule 506 offerings under the Securities Act of 1933; (3) specified investors in Section 202(13); and (4) limited offerings in Section 202(14). The options exemption in Section 201(6) was broadened; the "manual" exemption in Section 202(2) has been modernized for an electronic age; a broadened exemption has been provided for specified foreign securities in Section 202(3); a new exemption has been added for nonissuer transactions in securities subject to Securities Exchange Act reporting in Section 202(4); a new exemption has been added for nonissuer transactions rated at the time of a transaction by a nationally recognized statistical rating organization in one of the four highest rating categories in Section 202(5)(A); and new exemptions were added for specified exchange transactions in Section 202(9), control transactions in Section 202(18), specified out-of-state offers or sales in Section 202(20), specified sales transactions in Section 202(22), and specified foreign issuers whose securities are traded on designated securities markets in Section 202(23). The administrator may expressly authorize one of three regulatory plans for the offering of notes, bonds, debentures, or other evidences of indebtedness for nonprofit organizations under Section 201(7). New conditions have been added to the unit secured transaction exemption in Section 202(11) to address two substantial areas of state regulatory concern. The emphasis in the securities registration exemptive area is on flexibility. Securities administrators are given broad powers both to exempt other securities, transactions, or offers in Section 203 and to deny, suspend, condition or limit specified exemptions in Section 204.

(4)

Relatively modest changes were made to Article 3, which concerns registration of securities. A new notice filing provision was added in Section 302 for federal covered securities. A generic waiver and modification provision was added in Section 307. New procedural provisions for stop orders were added in Section 306(d) through (f). Merit regulation was among the most divisive issues that confronted the RUSA Drafting Committee. After the National Securities Markets Improvement Act of 1996 preempted states from applying merit regulation provisions to federal covered securities, this became a less controversial issue. The approach in this Act retains two widely adopted merit regulation provisions in Section 306(a)(7)(A) and (B):

a.

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the offering will work or tend to work a fraud upon purchasers or would so operate; or

b.

the offering has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, or promoters' profits or participations or unreasonable amounts or kinds of options.

In addition, bracketed Section 306(a)(7)(C) includes the less widely adopted formulation, "the offering is being made on terms that are unfair, unjust, or inequitable." A new Section 306(b) provides: "To the extent practicable the administrator, by rule adopted or order issued under this [Act] shall publish standards that provide notice of conduct that violates subsection (a)(7)." NASAA Guidelines provide this type of published standard. This hortatory Section is intended to address one type of criticism of merit regulation.

(5)

Article 4, which concerns broker-dealers, agents, investment advisers, investment adviser representatives, and federal covered investment advisers was substantially revised to take into account NSMIA and significant changes in administrative practice such as those occasioned by the electronic WEB-CRD and the IARD. New developments had an impact on the definitions of "agent" (Section 102(2)), "broker-dealer" (Section 102(4)), "investment adviser" (Section 102(15)), and "investment adviser representative" (Section 102(16)). NSMIA led also to the new federal covered investment adviser notice filing procedure in Section 405. "[A] bank, savings institution or trust company" was excluded from the 1956 Act Section 401(c) definition of broker-dealer. After the Gramm-Leach-Bliley Act was adopted in 1999, the generic exclusion of banks from the definition of broker and dealer in Sections 3(a)(4) and (5) of the Securities Exchange Act of 1934 was rescinded in favor of functional regulation. At the federal level this means that banks, unless limiting their securities activities to a specific list of excluded activities, are required to register as broker-dealers. This Act generally follows the federal approach with exceptions for private securities offerings addressed by Section 3(a)(4)(B)(vii) of the Securities Exchange Act of 1934 and de minimis transactions in Section 3(a)(4)(B)(xi) which in the new Act are limited to unsolicited transactions. The administrator is given a residual power in Section 102(4)(E) to adopt further exclusions for banks, by rule or order. Securities issued by banks, other depository institutions, and international banking institutions are exempt from securities registration in Section 201(3). Banks, savings institutions, and other depository institutions, when not excluded from the definition of broker-dealer, will be required to register by Section 401 and generally, like all other broker-dealers, be subject to the regulatory and liability provisions of the Act in Article 4 and 5.

(6)

Article 5 on fraud and liabilities and the definition of fraud in Section 102(9) are substantively little changed. This includes the general fraud provision in Section 501, the filing of sales and advertising literature in Section 504, misleading filings in Section 505, and misrepresentations concerning registration or exemption in Section 506. Technical changes were made to the evidentiary burden Section 503 and the criminal penalties Section 508. Section 502(a), fraud in providing investment advice, is unchanged. New rulemaking authority was added in Sections 502(b) and (c) to succeed earlier statutory provisions in Section 102 of the 1956 Act. This will give the administrator broad flexibility and recognizes that most state provisions regulating investment advisers in recent years have been adopted through rules. Section 507 is a new qualified immunity provision to protect a broker-dealer or investment adviser from

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defamation claims based on information filed with the SEC, a state administrator, or self-regulatory organization "unless the person knew, or should have known at the time that the statement was made, that it was false in a material respect or the person acted in reckless disregard of the statement's truth or falsity." This Section, which is consistent with most litigated cases to date and is a response to concerns that defamation lawsuits have deterred broker-dealers and investment advisers from full and complete disclosure of problems with departing employees. The Drafting Committee was also sensitive to the concern that such immunity could allow broker-dealers and investment advisers to unfairly characterize employees to protect their "book" of clients. Because of this concern the Drafting Committee rejected proposals for an absolute immunity. Section 510 is a new rescission offer provision that should be read with the definition of offer to purchase in Section 102(19) and the exemption for rescission offers in Section 202(19). Section 510 is consistent with administrative practice in many states today, although some states also have a filing requirement. More thought was devoted to the civil liability Section 509 than any other provision. As ultimately drafted much in this Section is little changed from the 1956 Act. New subsections were added to recognize the preemptive Securities Litigation Act of 1998 (Section 509(a)) and civil liability for investment advice (Sections 509(e) and (f)). Significant changes were made in the statute of limitations Section 509(j). Current state law provides a wide range of statutes of limitations. The 1956 Act contained a "two years after the contract of sale" statute of limitations. The new Act has two statute of limitations provisions. Section 509(j)(1) limits violations of registration provisions to "one year after the violation occurred." Section 509(j)(2) follows the pattern of federal securities law statutes of limitations, as amended in July 2002 by the Sarbanes-Oxley Act, and limits fraud violations to the earlier of "two years after the discovery of the facts constituting the violation or five years after such violation." The derivative liability provision in Section 509(g) is not intended to change the predicates for liability for one who "materially aids" violative conduct.

(7)

Several changes are made in Article 6, which concerns Administration and Judicial Review. Most are technical in nature. A new authorization for the administrator to develop and implement investor education initiatives has been added in Sections 601(d) and (e). Considerable attention was devoted to enforcement of the Act. The 1956 Act Section 408 was a slender provision providing for injunctions. Sections 603 and 604, in contrast, provide a broad array of civil and administrative techniques including asset freezes, rescission orders, and civil penalties. Under Section 604 the administrator may issue a cease and desist order. Two other enforcement provisions in the Act are (1) stop orders in Sections 306(d) through (f), and (2) broker-dealer, agent, investment adviser, and investment adviser representative denials, revocations, suspensions, withdrawal, restrictions, conditions, or limitations of registration in Section 412. Each of the enforcement provisions in the Act includes both summary process and due process requirements either through judicial process or guarantees of appropriate notice, opportunity for hearing, and findings of facts and conclusions of law in a written record. Section 607 is a new provision that clarifies the scope of nonpublic records and the administrator's discretion to disclose in light of the extensive development of freedom of information and open records laws since the 1956 Act was adopted. The jurisdiction and service of process provisions, Sections 610 and 611, generally follow Section 414 of the 1956 Act, but have been modernized to take into account electronic communications.

(8)

Section 103 preserves the ability of the Act to reflect later amendments of specified federal statutes and rules to the extent they are preemptive or this is otherwise permitted by state law. All involved in the drafting of this new Act owe a particular debt of gratitude to Richard B. Smith who served as our chair. His efforts were pivotal to the initiation of this project. His indefatigable leadership and high standards immeasurably improved the final Act.

Legislative Note Each state, the District of Columbia, Guam, and Puerto Rico have enacted an administrative procedure act. The procedural provisions of the Act in some instances are intended to augment the state administrative

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procedure act. In so doing, this Act differs from other uniform acts promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in that it contains procedural provisions on topics such as administrative rulemaking and adjudication, service of process, judicial review of administrative adjudications, public records, public hearings, and use immunity. Normally a uniform act promulgated by NCCUSL defers to existing state procedural provisions on such matters. This Act reflects a policy decision that these matters should be addressed in this Act to promote uniformity in securities regulation. When a conflict exists between this Act and a state administrative procedure act, this Act is intended to supersede the state administrative procedure act. When, however, a reference is made in this Act to the state administrative procedure act, this Act is intended to follow the state's existing administrative procedure act. In general in this Act a rule will apply generally and an order will apply to a specific individual, transaction, or matter, although the term order may also apply generally in those states that permit orders of general applicability.

§ 101. SHORT TITLE.

This [Act] may be cited as the Uniform Securities Act (2002).

§ 102. DEFINITIONS.

In this [Act], unless the context otherwise requires:

(1)

"Administrator" means the [insert title of administrative agency or official].

(2)

"Agent" means an individual, other than a broker-dealer, who represents a broker-dealer in effecting or attempting to effect purchases or sales of securities or represents an issuer in effecting or attempting to effect purchases or sales of the issuer's securities. But a partner, officer, or director of a broker-dealer or issuer, or an individual having a similar status or performing similar functions is an agent only if the individual otherwise comes within the term. The term does not include an individual excluded by rule adopted or order issued under this [Act].

(3)

"Bank" means:

(A)

a banking institution organized under the laws of the United States;

(B)

a member bank of the Federal Reserve System;

(C)

any other banking institution, whether incorporated or not, doing business under the laws of a State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to be exercised by national banks under the authority of the Comptroller of the Currency pursuant to Section 1 of Public Law 87-722 (*12 U.S.C. Section 92a*), and which is supervised and examined by a state or federal agency having supervision over banks, and which is not operated for the purpose of evading this [Act]; and

(D)

a receiver, conservator, or other liquidating agent of any institution or firm included in subparagraph (A), (B), or (C).

(4)

"Broker-dealer" means a person engaged in the business of effecting transactions in securities for the account of others or for the person's own account. The term does not include:

(A)

an agent;

(B)

an issuer;

(C)

a bank or savings institution if its activities as a broker-dealer are limited to those specified in subsections 3(a)(4)(B)(i) through (vi), (viii) through (x), and (xi) if limited to unsolicited transactions; 3(a)(5)(B); and 3(a)(5)(C) of the Securities Exchange Act of 1934 (*15 U.S.C. Sections 78c(a)(4)* and (5)) or a bank that satisfies the conditions described in subsection 3(a)(4)(E) of the Securities Exchange Act of 1934 (*15 U.S.C. Section 78c(a)(4)*);

(D)

an international banking institution; or

(E)

a person excluded by rule adopted or order issued under this [Act].

(5)

"Depository institution" means:

(A)

a bank; or

(B)

a savings institution, trust company, credit union, or similar institution that is organized or chartered under the laws of a State or of the United States, authorized to receive deposits, and supervised and examined by an official or agency of a State or the United States if its deposits or share accounts are insured to the maximum amount authorized by statute by the Federal Deposit Insurance Corporation, the National Credit Union Share Insurance Fund, or a successor authorized by federal law. The term does not include:

(i)

an insurance company or other organization primarily engaged in the business of insurance;

(ii)

a Morris Plan bank; or

(iii)

an industrial loan company.

(6)

"Federal covered investment adviser" means a person registered under the Investment Advisers Act of 1940.

(7)

"Federal covered security" means a security that is, or upon completion of a transaction will be, a covered security under Section 18(b) of the Securities Act of 1933 (*15 U.S.C. Section 77r(b)*) or rules or regulations adopted pursuant to that provision.

(8)

"Filing" means the receipt under this [Act] of a record by the administrator or a designee of the administrator.

(9)

"Fraud," "deceit," and "defraud" are not limited to common law deceit.

(10)

"Guaranteed" means guaranteed as to payment of all principal and all interest.

(11)

"Institutional investor" means any of the following, whether acting for itself or for others in a fiduciary capacity:

(A)

a depository institution or international banking institution;

(B)

an insurance company;

(C)

a separate account of an insurance company;

(D)

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an investment company as defined in the Investment Company Act of 1940;

(E)

a broker-dealer registered under the Securities Exchange Act of 1934;

(F)

an employee pension, profit-sharing, or benefit plan if the plan has total assets in excess of \$10,000,000 or its investment decisions are made by a named fiduciary, as defined in the Employee Retirement Income Security Act of 1974, that is a broker-dealer registered under the Securities Exchange Act of 1934, an investment adviser registered or exempt from registration under the Investment Advisers Act of 1940, an investment adviser registered under this [Act], a depository institution, or an insurance company;

(G)

a plan established and maintained by a State, a political subdivision of a State, or an agency or instrumentality of a State or a political subdivision of a State for the benefit of its employees, if the plan has total assets in excess of \$10,000,000 or its investment decisions are made by a duly designated public official or by a named fiduciary, as defined in the Employee Retirement Income Security Act of 1974, that is a broker-dealer registered under the Securities Exchange Act of 1934, an investment adviser registered or exempt from registration under the Investment Advisers Act of 1940, an investment adviser registered under this [Act], a depository institution, or an insurance company;

(H)

a trust, if it has total assets in excess of \$10,000,000, its trustee is a depository institution, and its participants are exclusively plans of the types identified in subparagraph (F) or (G), regardless of the size of their assets, except a trust that includes as participants self-directed individual retirement accounts or similar self-directed plans;

(I)

an organization described in *Section 501(c)(3) of the Internal Revenue Code* (26 U.S.C. *Section 501(c)(3)*), corporation, Massachusetts trust or similar business trust, limited liability company, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of \$10,000,000;

(J)

a small business investment company licensed by the Small Business Administration under Section 301(c) of the Small Business Investment Act of 1958 (*15 U.S.C. Section 681(c)*) with total assets in excess of \$10,000,000;

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(K)

a private business development company as defined in Section 202(a)(22) of the Investment Advisers Act of 1940 (*15 U.S.C. Section 80b-2(a)(22)*) with total assets in excess of \$10,000,000;

(L)

a federal covered investment adviser acting for its own account;

(M)

a "qualified institutional buyer" as defined in Rule 144A(a)(1), other than Rule 144A(a)(1)(H), adopted under the Securities Act of 1933 (*17 C.F.R. 230.144A*);

(N)

a "major U.S. institutional investor" as defined in Rule 15a-6(b)(4)(i) adopted under the Securities Exchange Act of 1934 (*17 C.F.R. 240.15a-6*);

(O)

any other person, other than an individual, of institutional character with total assets in excess of \$10,000,000 not organized for the specific purpose of evading this [Act]; or

(P)

any other person specified by rule adopted or order issued under this [Act].

(12)

"Insurance company" means a company organized as an insurance company whose primary business is writing insurance or reinsuring risks underwritten by insurance companies and which is subject to supervision by the insurance commissioner or a similar official or agency of a State.

(13)

"Insured" means insured as to payment of all principal and all interest.

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(14)

"International banking institution" means an international financial institution of which the United States is a member and whose securities are exempt from registration under the Securities Act of 1933.

(15)

"Investment adviser" means a person that, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or the advisability of investing in, purchasing, or selling securities or that, for compensation and as a part of a regular business, issues or promulgates analyses or reports concerning securities. The term includes a financial planner or other person that, as an integral component of other financially related services, provides investment advice to others for compensation as part of a business or that holds itself out as providing investment advice to others for compensation. The term does not include:

(A)

an investment adviser representative;

(B)

a lawyer, accountant, engineer, or teacher whose performance of investment advice is solely incidental to the practice of the person's profession;

(C)

a broker-dealer or its agents whose performance of investment advice is solely incidental to the conduct of business as a broker-dealer and that does not receive special compensation for the investment advice;

(D)

a publisher of a bona fide newspaper, news magazine, or business or financial publication of general and regular circulation;

(E)

a federal covered investment adviser;

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(F)

a bank or savings institution;

(G)

any other person that is excluded by the Investment Advisers Act of 1940 from the definition of investment adviser; or

(H)

any other person excluded by rule adopted or order issued under this [Act].

(16)

"Investment adviser representative" means an individual employed by or associated with an investment adviser or federal covered investment adviser and who makes any recommendations or otherwise gives investment advice regarding securities, manages accounts or portfolios of clients, determines which recommendation or advice regarding securities should be given, provides investment advice or holds herself or himself out as providing investment advice, receives compensation to solicit, offer, or negotiate for the sale of or for selling investment advice, or supervises employees who perform any of the foregoing. The term does not include an individual who:

(A)

performs only clerical or ministerial acts;

(B)

is an agent whose performance of investment advice is solely incidental to the individual acting as an agent and who does not receive special compensation for investment advisory services;

(C)

is employed by or associated with a federal covered investment adviser, unless the individual has a "place of business" in this State as that term is defined by rule adopted under Section 203A of the Investment Advisers Act of 1940 (*15 U.S.C. Section 80b-3a*) and is

(i)

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an "investment adviser representative" as that term is defined by rule adopted under Section 203A of the Investment Advisers Act of 1940 (*15 U.S.C. Section 80b-3a*); or

(ii)

not a "supervised person" as that term is defined in Section 202(a)(25) of the Investment Advisers Act of 1940 (*15 U.S.C. Section 80b-2(a)(25)*); or

(D)

is excluded by rule adopted or order issued under this [Act].

(17)

"Issuer" means a person that issues or proposes to issue a security, subject to the following:

(A)

The issuer of a voting trust certificate, collateral trust certificate, certificate of deposit for a security, or share in an investment company without a board of directors or individuals performing similar functions is the person performing the acts and assuming the duties of depositor or manager pursuant to the trust or other agreement or instrument under which the security is issued.

(B)

The issuer of an equipment trust certificate or similar security serving the same purpose is the person by which the property is or will be used or to which the property or equipment is or will be leased or conditionally sold or that is otherwise contractually responsible for assuring payment of the certificate.

(C)

The issuer of a fractional undivided interest in an oil, gas, or other mineral lease or in payments out of production under a lease, right, or royalty is the owner of an interest in the lease or in payments out of production under a lease, right, or royalty, whether whole or fractional, that creates fractional interests for the purpose of sale.

(18)

"Nonissuer transaction" or "nonissuer distribution" means a transaction or distribution not directly or indirectly for the benefit of the issuer.

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(19)

"Offer to purchase" includes an attempt or offer to obtain, or solicitation of an offer to sell, a security or interest in a security for value. The term does not include a tender offer that is subject to Section 14(d) of the Securities Exchange Act of 1934 (*15 U.S.C. 78n(d)*).

(20)

"Person" means an individual; corporation; business trust; estate; trust; partnership; limited liability company; association; joint venture; government; governmental subdivision, agency, or instrumentality; public corporation; or any other legal or commercial entity.

(21)

"Place of business" of a broker-dealer, an investment adviser, or a federal covered investment adviser means:

(A)

an office at which the broker-dealer, investment adviser, or federal covered investment adviser regularly provides brokerage or investment advice or solicits, meets with, or otherwise communicates with customers or clients; or

(B)

any other location that is held out to the general public as a location at which the broker-dealer, investment adviser, or federal covered investment adviser provides brokerage or investment advice or solicits, meets with, or otherwise communicates with customers or clients.

(22)

"Predecessor act" means the act repealed by Section 702.

(23)

"Price amendment" means the amendment to a registration statement filed under the Securities Act of 1933 or, if an amendment is not filed, the prospectus or prospectus supplement filed under the Securities Act of 1933 that includes a statement of the offering price, underwriting and selling discounts or commissions, amount of proceeds, conversion rates, call prices, and other matters dependent upon the offering price.

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(24)

"Principal place of business" of a broker-dealer or an investment adviser means the executive office of the broker-dealer or investment adviser from which the officers, partners, or managers of the broker-dealer or investment adviser direct, control, and coordinate the activities of the broker-dealer or investment adviser.

(25)

"Record," except in the phrases "of record," "official record," and "public record," means information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form.

(26)

"Sale" includes every contract of sale, contract to sell, or disposition of, a security or interest in a security for value, and "offer to sell" includes every attempt or offer to dispose of, or solicitation of an offer to purchase, a security or interest in a security for value. Both terms include:

(A)

a security given or delivered with, or as a bonus on account of, a purchase of securities or any other thing constituting part of the subject of the purchase and having been offered and sold for value;

(B)

a gift of assessable stock involving an offer and sale; and

(C)

a sale or offer of a warrant or right to purchase or subscribe to another security of the same or another issuer and a sale or offer of a security that gives the holder a present or future right or privilege to convert the security into another security of the same or another issuer, including an offer of the other security.

(27)

"Securities and Exchange Commission" means the United States Securities and Exchange Commission.

(28)

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"Security" means a note; stock; treasury stock; security future; bond; debenture; evidence of indebtedness; certificate of interest or participation in a profit-sharing agreement; collateral trust certificate; preorganization certificate or subscription; transferable share; investment contract; voting trust certificate; certificate of deposit for a security; fractional undivided interest in oil, gas, or other mineral rights; put, call, straddle, option, or privilege on a security, certificate of deposit, or group or index of securities, including an interest therein or based on the value thereof; put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency; or, in general, an interest or instrument commonly known as a "security"; or a certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. The term:

(A)

includes both a certificated and an uncertificated security;

(B)

does not include an insurance or endowment policy or annuity contract under which an insurance company promises to pay a fixed [or variable] sum of money either in a lump sum or periodically for life or other specified period;

(C)

does not include an interest in a contributory or noncontributory pension or welfare plan subject to the Employee Retirement Income Security Act of 1974;

(D)

includes as an "investment contract" an investment in a common enterprise with the expectation of profits to be derived primarily from the efforts of a person other than the investor and a "common enterprise" means an enterprise in which the fortunes of the investor are interwoven with those of either the person offering the investment, a third party, or other investors; and

(E)

includes as an "investment contract," among other contracts, an interest in a limited partnership and a limited liability company and an investment in a viatical settlement or similar agreement.

(29)

"Self-regulatory organization" means a national securities exchange registered under the Securities Exchange Act

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of 1934, a national securities association of broker-dealers registered under the Securities Exchange Act of 1934, a clearing agency registered under the Securities Exchange Act of 1934, or the Municipal Securities Rulemaking Board established under the Securities Exchange Act of 1934.

(30)

"Sign" means, with present intent to authenticate or adopt a record:

(A)

to execute or adopt a tangible symbol; or

(B)

to attach or logically associate with the record an electronic symbol, sound, or process.

(31)

"State" means a State of the United States, the District of Columbia, Puerto Rico, the United States Virgin Islands, or any territory or insular possession subject to the jurisdiction of the United States.

Official Comments Prior Provisions: 1956 Act Section 401; RUSA 101.

1.

Under Section 605(a) the administrator has the power to define by rule any term, whether or not used in this Act, as long as the definitions are not inconsistent with the Act.

2.

All definitions include corresponding meanings. For example, "filing" would include "file" or "filed"; "sale" would include "sell."

3.

Prefatory Phrase: "In this [Act], unless the context otherwise requires": Prior Provisions: 1956 Act Section 401 Preface; RUSA Section 101 Preface. This prefatory phrase which is in the counterpart provisions of the federal securities statutes, see, e.g., Securities Act of 1933 Section 2(a), provides the basis for the courts to take into account the statutory and factual context of each definition, see, e.g., *Reves v. Ernst & Young*, 494 U.S. 56 (1990); 2 Louis Loss &

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Joel Seligman, Securities Regulation 927-929 (3d ed. rev. 1999), and will allow the courts to harmonize this Act's definitions with the counterpart federal securities definitions to the extent appropriate. Cf. *Akin v. Q-L Inv., Inc.*, 959 F.2d 521, 532 (5th Cir. 1992) ("Texas courts generally look to decisions of the federal courts to interpret the Texas Securities Act because of obvious similarities between the state and federal laws"); *Koch v Koch Indus., Inc.* 203 F.3d 1202, 1235 (10th Cir. 2000) (following federal definition of materiality); *Biales v. Young*, 432 S.E.2d 482, 484 (S.C. 1993) ("Section 35-1-1490(2) is substantially similar to Section 12(1) of the Federal Securities Act").

4.

Section 102(2): Agent: Prior Provisions: 1956 Act Section 401(b); RUSA Section 101(14). Section 102(2), in part, follows the 1956 Act definition. The 1956 Act used the term "agent" while the RUSA Section 101(14) used the term "sales representative." Given the broader enactment of the 1956 Act, this Act also uses the term "agent." Certain exclusions from the 1956 Act are exemptions in this Act. See Section 402(b). Whether a particular individual who represents a broker-dealer or issuer is an "agent" depends upon much the same factors that create an agency relationship at common law. See, e.g., *Norwest Bank Hastings v. Clapp*, 394 N.W.2d 176, 179 (Minn. Ct. App. 1986) (following Official Comment that establishing agency under the Uniform Securities Act "depends upon much the same factors which create an agency relationship at common law"); *Shaughnessy & Co., Inc. v. Commissioner of Sec.*, 1971-1978 Blue Sky L. Rep. (CCH) P 71,348 (Wis. Cir. Ct. 1977) (unlicensed person who took information relevant to securities transactions and turned it over to securities agents was himself an agent). An individual can be an agent for a broker-dealer or issuer for a purpose other than effecting or attempting to effect purchases or sales of securities and not be a statutory agent under this Act. See, e.g., *Baker, Watts & Co. v. Miles & Stockridge*, 620 A.2d 356, 367 (Md. Ct. App. 1993) (attorney-client relationship is generally one of agency, but that alone does not bring an attorney within securities act definition of agent). An individual will not be an agent under Section 102(2) because of the person's status as a partner, officer, or director of a broker-dealer or issuer if such an individual does not effect or attempt to effect purchases or sales of securities. See, e.g., *Abell v. Potomac Ins. Co.*, 858 F.2d 1104 (5th Cir. 1988). Section 102(2) is intended to include any individual who acts as an agent, whether or not the individual is an employee or independent contractor. Cf. *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. *en banc* 1990), *cert. denied*, 499 U.S. 976 (1991). The word "individual" in the definition of the term "agent" is limited to human beings and does not include a juridical "person" such as a corporation. Cf. definition of "person" in Section 102(20). The 1956 Act Section 401(b) similarly was limited to individuals and did not include juridical persons. See, e.g., *Connecticut Nat'l Bank v. Giacomi*, 699 A.2d 101, 111-112 (Conn. 1997) ("agent" only includes natural persons when it used the term individual); *Schpok v. Fodale*, 236 N.W.2d 97, 99 (Mich. Ct. App. 1975) (agent defined to be individual and did not include a corporation). An individual whose acts are solely clerical or ministerial would not be an agent under Section 102(2). Cf. Section 402(b)(8). Ministerial or clerical acts might include preparing written communications or responding to inquiries.

5.

Section 102(3): Bank: Prior Provision: Subsection 3(a)(6) of the Securities Exchange Act of 1934. A United States branch of a foreign bank that otherwise satisfies this definition would be a bank.

6.

Section 102(4): Broker-Dealer: Prior Provisions: 1956 Act Section 401(c); RUSA Section 101(2). This definition generally follows the definition of broker-dealer in the 1956 Act and RUSA. The use of the compound term is

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meant to include either a broker or a dealer. The recognized distinction is that a broker acts for the benefit of another while a dealer acts for itself in buying for or selling securities from its own inventory. The distinction between "a person engaged in the business of effecting transactions in securities" and an investor, who may buy and sell with some frequency and is outside the scope of this term, has been well developed in the case law. See 6 Louis Loss & Joel Seligman, *Securities Regulation* 2980-2984 (3d ed. 1990). The 1956 Act Section 401(c) excluded from the definition of broker-dealer a person who during any 12 consecutive months did not direct more than 15 offers to buy or sell in this State. In this Act exemptions from broker-dealer registration are provided in Section 401(b). The Gramm-Leach-Bliley Act, signed into law in November 1999, rescinded the blanket exemption of banks from the definition of broker and dealer in Sections 3(a)(4) and (5) of the Securities Exchange Act of 1934. The Gramm-Leach-Bliley Act permits a bank to avoid registration as a broker or dealer at the federal level if the bank limits its activities to those specified in the Securities Exchange Act. This Act generally adopts the activity focused exceptions for banks included in the Gramm-Leach-Bliley Act, with minor modifications relating to the private placement and de minimis brokerage activities of banks (15 U.S.C. 78c(a)(4)(B)(vii) and (xi)). This Act also reaches savings institutions. A state may decide to adopt an exclusion in Section 102(4)(C) that fully conforms with the bank exceptions contained in the Gramm-Leach-Bliley Act. For states that choose this approach, the language of Section 102(4)(C) should read:

(C) a bank or savings institution if its activities as broker-dealer are limited to those specified in Section 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934 (15 U.S.C. Section 78c(a)(4) and (5)), or a bank that satisfies the conditions specified in Section 3(a)(4)(E) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(4)).

Section 102(4)(E) of this Act also permits a securities administrator to adopt additional exclusions that exclude banks and other depository institutions, in whole or in part, from the definition of "broker-dealer." States that promptly adopt this Act should consider whether it is appropriate to provide banks a transition period to comply with the Act's new activity focused exceptions. The activity focused exceptions for banks in the Gramm-Leach-Bliley Act were originally to become effective at the federal level on May 12, 2001. However, the Securities and Exchange Commission has delayed the effective date of these activity focused exceptions and thus continued the blanket exemption for banks beyond May 12, 2001, and commenced a rulemaking designed to clarify and define the scope of the bank exceptions in the Gramm-Leach-Bliley Act. See Sec. Ex. Act Rels. 44,291, 74 SEC Dock. 2155 (2001) (proposal); 45,897, 77 SEC Dock. 1555 (2002) (proposal). To avoid disrupting the activities of banks, states should consider delaying implementation of the activity focused exceptions in this Act until these exceptions are implemented at the federal level. Section 15(h)(1) of the Securities Exchange Act of 1934, as amended by the National Securities Markets Improvement Act of 1996, preempts state law from "[establishing] capital, custody, margin, financial responsibility, making and keeping records, bonding, or financial or operational reporting requirements for brokers, dealers, municipal securities dealers, government securities brokers, or government securities dealers that differ from, or are in addition to the requirements in those areas established under [the Securities Exchange Act]." These preemptions are recognized in the substantive broker-dealer provisions in Article 4.

7.

Section 102(5): Depository institution: No Prior Provision. A depository institution's securities are addressed by the exemption in Section 201(3). A depository institution is an institutional investor in Section 102(11)(A).

8.

Section 102(6): Federal covered investment adviser: No Prior Provision. This provision is necessitated by Section 203A of the Investment Advisers Act of 1940, added by Title III of the National Securities Markets Improvement Act of 1996, which allocates to primary state regulation most advisers with assets under management of

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less than \$25 million. SEC registration is permitted, but not required, for investment advisers having between \$25 and \$30 million of assets under management and is required of investment advisers having at least \$30 million of assets under management. Investment Advisers Act of 1940 Rule 203A-1. Most advisers with assets under management of \$25 million or more register solely under Section 203 of the Investment Advisers Act of 1940 and not state law. This division of labor is intended to eliminate duplicative regulation of investment advisers.

9.

Section 102(7): Federal covered security: No Prior Provision. The National Securities Markets Improvement Act of 1996, as subsequently amended, partially preempted state law in the securities offering and reporting areas. Under Section 18(a) of the Securities Act of 1933, no state statute, rule, order, or other administrative action may apply to:

(1)

The registration of a "covered" security or a security that will be a covered security upon completion of the transaction;

(2)

(A)

any offering document prepared by or on behalf of the issuer of a covered security;

(2)

(B)

any proxy statement, report to shareholders, or other disclosure document relating to a covered security or its issuer that is required to be filed with the SEC or any national securities association registered under Section 15A of the Securities Exchange Act such as the National Association of Securities Dealers (NASD); or

(3)

the merits of a covered security or a security that will be a covered security upon completion of the transaction. Section 18(b) of the Securities Act of 1933 applies to four types of "covered securities":

(1)

Securities listed or authorized for listing on the New York Stock Exchange (NYSE), the American Stock

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Exchange (Amex); the National Market System of the Nasdaq stock market; or securities exchanges registered with the Securities and Exchange Commission (SEC) (or any tier or segment of their trading) if the SEC determines by rule that their listing standards are substantially similar to those of the NYSE, Amex, or Nasdaq National Market System, which the SEC has done through Rule 146; and any security of the same issuer that is equal in seniority or senior to any security listed on the NYSE, Amex, or Nasdaq National Market System;

(2)

securities issued by an investment company registered with the SEC (or one that has filed a registration statement under the Investment Company Act of 1940);

(3)

securities offered or sold to "qualified purchasers." This category of covered securities will become operational when the SEC defines the term "qualified purchaser" as used in Section 18(b)(3) of the Securities Act of 1933, by rule. To date the SEC has proposed, but not adopted, Rule 146(c) of the Securities Act of 1933; and

(4)

securities issued under the following specified exemptions of the Securities Act of 1933:

(A)

Sections 4(1) (transactions by persons other than an issuer, underwriter or dealer), and 4(3) (dealers after specified periods of time), but only if the issuer files reports with the Commission under Sections 13 or 15(d) of the Securities Exchange Act;

(B)

Section 4(4) (unsolicited brokerage transactions);

(C)

Securities Act exemptions in Section 3(a) with the exception of the charitable exemption in Section 3(a)(4), the exchange exemption in Section 3(a)(10), the intrastate exemption in Section 3(a)(11), and the municipal securities exemption in Section 3(a)(2) but only with "respect to the offer or sale of such [municipal] security in the State in which the issuer of such security is located"; and

(D)

securities issued in compliance with SEC rules under Section 4(2) (private placements). Section 18(c)(1) preserves state authority "to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions." The National Securities Markets Improvement Act, in essence, preempts aspects of the securities registration and reporting processes for specified federal covered securities. The Act does not diminish state authority to investigate and bring enforcement actions generally with respect to securities transactions. The States are authorized to require filings of any document filed with the SEC for notice purposes "together with annual or periodic reports of the value of securities sold or offered to be sold to persons located in the State (if such sales data is not included in documents filed with the Commission), solely for notice purposes and the assessment of any fee, together with a consent to service of process and any required fee." Section 18(c)(2). However, no filing or fee may be required with respect to any listed security that is a covered security under Section 18(b)(1) (traded on specified stock markets). Section 302 of this Act addresses notice filings and fees applicable to federal covered securities.

10.

Section 102(8): Filing: Prior Provision: RUSA Section 101(4). The RUSA definition was revised to recognize that records may be filed in paper form or electronically with the administrator, or designees such as the Web-CRD (Central Registration Depository) or Investment Adviser Registration Depository (IARD) or the Securities and Exchange Commission's Electronic Data Gathering, Analysis and Retrieval System (EDGAR) or successor systems. In the RUSA definition, the term "filed" referred to "actual delivery of a document or application." This Act substitutes the term "record" which is defined in Section 102(25) to refer broadly to "information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perishable form". This definition requires the receipt of a record. The definition does not limit filing to any specific medium such as mail, certified mail, or a particular electronic system. The definition is intended to permit an administrator to accept filings over the Internet or through a direct modem system, both of which are now used to transmit documents to EDGAR, or through new electronic systems as they evolve. "Receipt" refers to the actual delivery of a record to the administrator or a designee and does not refer to a subsequent examination of the record by the administrator. See, e.g., *Fehrman v. Blunt*, 825 S.W.2d 658 (Mo. Ct. App. 1992). If a deficient form was provided to a designee, but not provided to the administrator because of the deficiency, it would not be filed under this definition.

11.

Section 102(9): Fraud, deceit and defraud: Prior Provisions: 1956 Act Section 401(d); RUSA Section 101(6). This definition, which is identical to the 1956 Act and RUSA, codifies the holdings that "fraud" as used in the federal and state securities statutes is not limited to common law deceit. See generally 7 Louis Loss & Joel Seligman, *Securities Regulation* 3421-3448 (3d ed. 1991).

12.

Section 102(10): Guaranteed: Prior Provisions: 1956 Act Section 401(e); RUSA Section 401(a)(1). The 1956 Act definition of "guaranteed" applies generally to payment of "principal, interest, or dividends." The RUSA definition of "guaranteed," which was solely applicable to exempt securities, applied to the guarantee of "all or substantially all of principal and interest or dividends." Section 102(10) follows the 1956 Act approach and applies generally to the

guarantee of "all principal and all interest." Any method of guarantee that results in a guarantee of payment of all principal and all interest will suffice including, for example, an irrevocable letter of credit. This definition does not address whether or not a guarantee, whether whole or partial, is itself a security. That issue is addressed by the definition of "security" in Section 102(28).

13.

Section 102(11): Institutional investor: Prior Provisions: RUSA Section 101(5); Securities Act of 1933 Rules 144A and 501(a). Sections 102(11)(A) through (K) are based on Rule 501(a) of the Securities Act of 1933, but do not include the paragraphs of Rule 501(a) that address individuals. Given the significant period of time since Rule 501(a) was adopted, this Act has used a \$10 million minimum for several categories of institutional investor rather than \$5 million minimum used in Rule 501(a). Section 102(11)(H) concludes with an except clause meant to exclude self-directed plans for individuals from this definition. With respect to the exclusion of Rule 144A(a)(1)(H) from Section 102(11)(M), the substance of Rule 144A(a)(1)(H) appears in Section 102(11)(I), but with a requirement of total assets in excess of \$10,000,000. Section 102(11)(O) is meant to reach persons similar to those listed in Sections 102(11)(A) through (N), but not otherwise listed. Under Section 503, if challenged in a proceeding, the burden of proving the availability of an exemption is on the person claiming it. An interpretive opinion may be sought from the administrator under Section 605(d).

14.

Section 102(12): Insurance company: No Prior Provision. This definition is based on Securities Act of 1933 Section 2(a)(13).

15.

Section 102(13): Insured: Prior Provision: RUSA Section 401(a)(2). The RUSA definition of "insured," which was solely applicable to exempt securities, applied to the insurance of "all or substantially all of principal, interest, or dividends." Section 102(13) is applicable generally but is limited to "payment of all principal and all interest."

16.

Section 102(14): International banking institution: No Prior Provision. Securities issued or guaranteed by the International Bank for Reconstruction and Development, 22 U.S.C. *Section 286k-1(a)*; the Inter-American Development Bank, 22 U.S.C. *Section 283h(a)*; the Asian Development Bank, 22 U.S.C. *Section 285h(a)*; the African Development Bank, 22 U.S.C. *Section 290i-9*; and the International Finance Corporation, see 22 U.S.C. *Section 282k*; are treated as exempt securities under Section 3(a)(2) of the Securities Act of 1933, see generally 3 Louis Loss & Joel Seligman, Securities Regulation 1191-1194 (3d ed. rev. 1999), and are within this term.

17.

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Section 102(15): Investment adviser: Prior Provisions: 1956 Act Section 401(f); RUSA Section 101(7). This term generally follows the definition in Section 202(a)(11) of the Investment Advisers Act of 1940, but has been updated to take into account new media such as the Internet. The first sentence in Section 102(15) is identical to the first sentence in the 1956 Act Section 401(f) and the counterpart language in Section 202(a)(11). The RUSA definition deleted the phrases "either directly or through publications or writings" and "regular" before business. These terms have been returned to Section 102(15) because of the intention that this definition be construed uniformly with the definition in Section 202(a)(11) of the Investment Advisers Act of 1940. This first sentence would not reach the author of a book who did not receive compensation as part of a regular business for providing investment advice. The second sentence in the term addressing financial planners is new. The purpose of this sentence is to achieve functional regulation of financial planners who satisfy the definition of investment adviser. Cf. Investment Advisers Act Release 1092, 39 SEC Dock. 494 (1987) (similar approach in Securities and Exchange Commission interpretative Release). This reference is not intended to preclude persons who hold a formally recognized financial planning or consulting designation or certification from using this designation. The use by a person of a title, designation or certification as a financial planner or other similar title, designation, or certification alone does not require registration as an investment adviser. Sections 102(15)(A) through (H) are exclusions from the term "investment adviser." An excluded person can be held liable for fraud in providing investment advice, see Section 502, but would not be subject to the registration and regulatory provisions in Article 4. Sections 102(15)(A) and (E) are new and recognize that investment adviser representatives and federal covered investment advisers are separately treated in this Act. See definitions in Sections 102(6) and 102(16); registration and exemptions in Sections 404-405. Sections 102(15)(B), (C), and (G) are substantively identical to the 1956 Act, RUSA, and the Investment Advisers Act of 1940. The Official Comment to the 1956 Act Section 401(f) quoted an opinion of the Securities and Exchange Commission General Counsel in Investment Advisers Act Release 2 on the meaning of "special compensation" included in Section 102(15)(C):

[This clause] amounts to a recognition that brokers and dealers commonly give a certain amount of advice to their customers in the course of their regular business, and that it would be inappropriate to bring them within the scope of the Investment Advisers Act merely because of this aspect of their business. On the other hand, that portion of clause [(C)] which refers to 'special compensation' amounts to an equally clear recognition that a broker or dealer who is specially compensated for the rendition of advice should be considered an investment adviser and not be excluded from the purview of the Act merely because he is also engaged in effecting market transactions in securities... . The essential distinction to be borne in mind in considering borderline cases ... is the distinction between compensation for advice itself and compensation for services of another character to which advice is merely incidental. Similarly, other broker-dealer employees such as research analysts who receive no special compensation from third parties for investment advice would not be required to register as investment advisers. The 1956 Act definition added the word "paid" in Section 401(f)(4) to the counterpart exclusion in Section 202(a)(11) of the Investment Advisers Act "to emphasize," as the Official Comment explained, "that a person who periodically distributes a 'tipster sheet' free as a way to get paying clients is not excluded from the definition as a 'publisher.'" After the 1956 Act was published, the United States Supreme Court construed the definition of investment adviser in *Lowe v. SEC*, 472 U.S. 181 (1985), and concluded:

Congress did not intend to exclude publications that are distributed by investment advisers as a normal part of the business of servicing their clients. The legislative history plainly demonstrates that Congress was primarily interested in regulating the business of rendering personalized investment advice, including publishing activities that are a normal incident thereto. On the other hand, Congress, plainly sensitive to First Amendment concerns, wanted to make clear that it did not seek to regulate the press through the licensing of nonpersonalized publishing activities.

Id. at 185. Responsive to this language RUSA rewrote this exclusion to provide:

a publisher, employee, or columnist of a newspaper, news magazine, or business or financial publication, or an owner, operator, or employee of a cable, radio, or television network, station, or

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production facility, if, in either case, the financial or business news published or disseminated is made available to the general public and the content does not consist of rendering advice on the basis of the specific investment situation of each client.

Recent experience at the federal and state levels suggest that the 1956 Act and RUSA approaches may be too broad. The retention of the Investment Advisers Act approach provides a better balance between First Amendment concerns and protection of investors from non-"bona fide" publicizing of investment advice. The exclusion in Section 102(15)(D) is intended to exclude publishers of Internet or electronic media, but only if the Internet or electronic media publication or website satisfies the "bona fide" and "publication of general and regular circulation" requirements. Cf. SEC v. Park, 99 F. Supp. 2d 889, 895-896 (N.D. Ill. 2000) (court declined to dismiss complaint against an Internet website when there were allegations that the website was not "bona fide" or of "general and regular circulation"). The exclusion in Section 102(15)(G) is required by the National Securities Markets Improvement Act of 1996. This exclusion will reach banks and bank holding companies as described in Investment Advisers Act Section 202(a)(11)(A) and persons whose advice solely concerns United States government securities as described in Section 202(a)(11)(E).

18.

Section 102(16): Investment adviser representative: No Prior Provision. Investment adviser representatives have not been required to register under the federal Investment Advisers Act, before or after the National Securities Markets Improvement Act. The term investment adviser representative is not intended to preclude persons who hold a formally recognized financial planning or consulting title, designation, or certification from using such a designation. The use by a person of a title, designation or certification as a financial planner, or other similar title, designation, or certification alone does not require registration as an investment adviser representative.

19.

Section 102(17): Issuer: Prior Provisions: 1956 Act Section 401(g); RUSA Section 101(8). This Section generally follows the 1956 Act and RUSA. In paragraph (B), the phrase "or that is otherwise contractually responsible for assuring payment of the certificate" is intended to address forms of payment other than leases or conditional sales contracts. It would also reach guarantors.

20.

Section 102(18): Nonissuer transaction or nonissuer distribution: Prior Provisions: 1956 Act Section 401(h); RUSA Section 101(9). This definition is relevant to several exempt transactions in Section 202. In *TechnoMedical Labs, Inc. v. Utah Sec. Div.*, 744 P.2d 320 (Utah Ct. App. 1987), the court declined to limit the term benefit to monetary benefits and instead held a spinoff transaction could provide direct or indirect benefits to an issuer. *Id.* at 323-324, *following* SEC v. *Datronics Eng'r, Inc.*, 490 F.2d 250 (4th Cir. 1973), *cert. denied*, 416 U.S. 937; SEC v. *Harwin Indus. Corp.*, 326 F. Supp. 943 (S.D.N.Y. 1971). In a similar fashion, transactions by officers, directors, promoters, and other insiders of the issuer may benefit the issuer and may not qualify as nonissuer transactions.

21.

Section 102(19): Offer to purchase: No Prior Provision: A rescission offer under Section 510 would be an

offer to purchase with respect to a security that earlier had been sold.

22.

Section 102(20): Person: Prior Provisions: 1956 Act Section 401(i); RUSA Section 101(10). This is the standard definition used by the National Conference of Commissioners for Uniform State Laws with the addition of "limited liability company" to reflect current usage. The use of the concluding phrase "or any other legal or commercial entity" is intended to be broad enough to include other forms of business entities that may be created or popularized in the future.

23.

Section 102(21): Place of business: Prior Provision: Rules 203A-3(b) and 222-1 of the Investment Advisers Act of 1940.

24.

Section 102(23): Price amendment: Prior Provision: RUSA Section 101(11). A price amendment may be used in a registration coordinated with the Securities and Exchange Commission procedure in Section 303(d). In the case of noncash offerings, required information concerning such matters as the offering price and underwriting arrangements is normally filed in a "price" amendment after the rest of the registration statement has been reviewed by the Securities and Exchange Commission staff. See generally 1 Louis Loss & Joel Seligman, Securities Regulation 542-550 (3d ed. rev. 1998).

25.

Section 102(24): Principal place of business: Prior Provision: Rule 222-1(b) of the Investment Advisers Act of 1940.

26.

Section 102(25): Record: Prior Provision: Uniform Electronic Transactions Act Section 2(13). Cf. Section 3(a)(37) of the Securities Exchange Act of 1934. The Uniform Electronic Transactions Act § 2(13) defines record in nearly identical terms. The Official Comment explains:

This is a standard definition designed to embrace all means of communicating or storing information except human memory. It includes any method for storing or communicating information, including "writings." A record need not be indestructible or permanent, but the term does not include oral or other communications which are not stored or preserved by some means.

This term is intended to embrace new forms of records that are created or popularized in the future. A record would include, but not be limited to, a registration statement, report, application, book, publication, account, paper, correspondence, memorandum, agreement, document, computer file, or disk, microfilm, photograph, or audio or visual

tape.

27.

Section 102(26): Sale: Prior Provisions: 1956 Act Section 401(j); RUSA Section 101(13). Both the 1956 Act and RUSA definition of "sale" are modeled on Section 2(a)(3) of the Securities Act of 1933. Language in Section 401(j) of the 1956 Act addressed the now rescinded SEC "no sale" doctrine and has been eliminated. Merger transactions are usually sales under Section 102(26), but may be exempted from the securities registration requirements by Section 202(18).

28.

Section 102(28): Security: Prior Provisions: 1956 Act Section 401(1); RUSA Section 101(16). Much of the definition in Section 102(28), like the definitions in the 1956 Act Section 401(l) and RUSA Section 101(16), is identical to the definition in Section 2(a)(1) of the Securities Act. State courts interpreting the Uniform Securities Act definition of security have often looked to interpretations of the federal definition of security. See generally 2 Louis Loss & Joel Seligman, *Security Regulation* 923-1138.19 (3d ed. rev. 1999). The most recent amendments to Section 2(a)(1) of the Securities Act of 1933 were added by the Commodities Futures Modernization Act of 2000 which added or revised language in the Securities Act addressing security futures and securities puts, calls, straddles, options, or privileges. Identical language has been included in Section 102(28) of this Act to harmonize interpretation of the federal and state definition of a "security." With respect to a security futures product, Section 28(a) of the Securities Exchange Act of 1934, as amended by the Commodity Futures Modernization Act of 2000, further provides: "No provision of any State law regarding the offer, sale or distribution of securities shall apply to any transaction in a security futures product, except that this sentence shall not be construed as limiting any State antifraud law of general applicability." Preorganization certificates or subscriptions are included in this term, obviating the need for a separate definition as was included in RUSA Section 402(13). Section 102(28) uses RUSA's "fractional undivided interest in oil, gas or other mineral rights" formulation, which originated in Section 2(a)(1) of the Securities Act of 1933, rather than the 1956 Act formulation, "certificate of interest or participation in an oil, gas or mining title." In recent years, courts interpreting Section 2(a)(1) of the Securities Act of 1933 have found certain oil, gas or mineral rights to be investment contracts (that is, securities). 2 Louis Loss & Joel Seligman, *Securities Regulation* 979-982 (3d ed. rev. 1999). A new sentence was added in Section 102(28)(A) referring to certificated or uncertificated securities to indicate that the term is intended to apply whether or not a security is evidenced by a writing. Section 102(28)(A) is intended to reject *Thomas v. State of Tex.*, 65 S.W.3d 38 (Tex. Crim. App. 2001) (Under Texas law evidence of indebtedness requires a writing). Insurance or endowment policies or endowment or annuity contracts, other than those on which an insurance company promises to make variable payments, are excluded from this term. Variable insurance products are also excluded in many states and are exempted from securities registration in others under provisions such as Section 201(4). When variable products are included in the definition of security and exempted from registration state securities administrators can bring enforcement actions concerning variable insurance sales practices. The Drafting Committee recognized that the decision whether to exclude variable annuities from the definition of security will be made on a state-by-state basis. Those states which intend to exclude variable products from the definition of security should add the words "or variable" to Section 102(28)(B) so that it will read:

(B) The term does not include an insurance or endowment policy or annuity contract under which an insurance company promises to pay a fixed or variable sum of money either in a lump sum or periodically for life or other specified period.

In the view of the American Council of Life Insurers:

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The brackets around the words "or variable" should be removed to follow the majority of jurisdictions. Thirty-seven jurisdictions [including Guam] currently exclude all insurance, endowment and annuity contracts from the definition of security. Removal of the brackets around the words "or variable," therefore, would incorporate the approach taken in the majority of jurisdictions. The removal of these brackets also prevents a statutory conflict with [up to] 48 jurisdictions that grant the insurance commissioner exclusive jurisdiction to regulate the issuance and sale of variable contracts. Moreover, this approach recognizes that the issuance and sale of variable contracts is comprehensively regulated by the Securities and Exchange Commission, the National Association of Securities Dealers, 50 state insurance departments, and in the case of group life and annuities, the Department of Labor. Like all other financial products, this approach imposes only one, rather than two, levels of regulation in each state and reflects the philosophy of financial services modernization.

In the view of the North American Securities Administrators Association variable products should be exempted from registration, not excluded from the definition of securities:

One of the goals of this Act is to align state and federal law. The United States Supreme Court ruled that a variable annuity is a security in *SEC v. Variable Annuity Life Insurance Company of America*, 359 U.S. 65 (1959). More recently, it has been confirmed that variable insurance products are "covered securities" as defined in the National Securities Markets Improvement Act of 1996 (NSMIA) and in the Securities Litigation Uniform Standards Act of 1998 (SLUSA), see *Lander v. Hartford Life Annuity Ins.*, 251 F.3d 101 (2d Cir. 2001).

When variable products are included in the definition of security and exempted from registration, state securities administrators can bring enforcement actions concerning variable insurance sales practices. This approach toward functional regulation is supported by the National Association of Securities Dealers as evidenced by a February 2001 letter from Mary Schapiro, President of Regulatory Policy & Oversight: "Based on our experience, we have found that variable products' sales-related problems parallel those of mutual funds and other securities ... Because of the substantial similarities between variable contracts and other securities products, we believe it is incongruous for agents and sales practices involved in variable annuities not to be covered by state securities laws."

State securities regulators support the functional regulation of agents because: 1) insurance companies are not affected since state securities regulators are preempted from requiring the registration of variable products; 2) the vast majority of broker-dealer subsidiaries of insurance companies are already registered to sell securities in most states; and 3) the vast majority of agents are already dually licensed to sell insurance and securities in most states.

Section 102(28)(C) includes the exclusion in RUSA from the 1956 definition of security for "an interest in a contributory or noncontributory pension or welfare plan subject to the Employee Retirement Income Security Act of 1974." The first clause in Section 102(28)(D) is derived from the leading case of *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), which has been widely followed by federal and state courts. The second clause in Section 102(28)(D) is based, in part, on the leading case of *SEC v. Glenn W. Turner Enter., Inc.*, 474 F.2d 476, 482 n.7 (9th Cir. 1973), *cert. denied*, 419 U.S. 900 (1974). The courts have divided over the interpretation of the "common enterprise" element of an investment contract. The courts generally recognize that "horizontal" commonality (for example, the pooling of an investment by two or more investors) is a common enterprise. A small minority of the federal circuits will also find a common enterprise in a "vertical" relationship when a single investor is dependent upon the expertise of a single commodities broker. Since two or more persons do not share in the profitability of an undertaking, it is difficult to argue that there is a common enterprise. Section 102(28)(D) follows a significantly larger number of federal circuits and adopts a more restrictive form of vertical commonality that occurs only when there is profit sharing between two persons even if, for example, one is a conventional investor and one is a promoter. See generally 2 Louis Loss & Joel Seligman, *Securities Regulation* 989-997 (3d ed. Rev. 1999). In interpreting all elements of the investment contract, the courts have emphasized substance, not form. A conventional partnership involving two individuals who actively

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participate in its management and who each own 50 percent interest of its profits has consistently not been viewed as an investment contract because profits do not come from the efforts of others. On the other hand, investments in limited partnership interests which are traded on stock exchanges consistently have been held to be investment securities because profits do come substantially from the efforts of others. Indeed, interests in an entity called a general partnership may be a security when the general partnership functions like a limited partnership. See, e.g., *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir. 1981), *cert. denied*, 454 U.S. 897 (1981); see generally 2 Loss & Seligman, *supra*, at 1019-1033. Section 102(28)(E) is consistent with state and federal securities laws which have recognized interests in limited liability companies and limited partnerships in some circumstances as "securities," see 2 Louis Loss & Joel Seligman, *Securities Regulation* 1028-1031 (3d ed. rev. 1999), when consistent with the court decisions interpreting the investment contract concept. This Act also refers to an investment in a viatical settlement or a similar agreement to make unequivocally clear that viatical settlement and similar agreements, which otherwise satisfy the definition of an investment contract, are securities. This is intended to reject the holding of one court that a viatical contract could not be a security. See *SEC v. Life Partners Inc.*, 87 F.3d 536 (D.C. Cir. 1996), *reh'g denied*, 102 F.3d 587 (D.C. Cir. 1996). A number of states have done so by statute. Judicial construction of the term "investment contract" has been the most frequently litigated issue concerning the term "security." See Gabaldon, *A Sense of Security: An Empirical Study*, 25 J. Corp. L. 307 (2000), explaining that there had been 792 cases decided to that date in which the definition of a security played a prominent role. *Id.* at 308. Some 461 of the 792 cases (58 percent) concerned investment contracts. *Id.* at 322. A number of states, by statute, rule, or case law have also adopted the "risk capital" test to find a security when an investment is subject to the risks of an enterprise with the expectation of profit or other valuable benefit and the investor has no direct control over the management of the enterprise. See, e.g., 2 Loss & Seligman, *supra*, at 939-940 n.50.

29.

Section 102(29): Self-regulatory organization: Prior Provision: RUSA Section 101(17). This definition was added by RUSA and is based on a counterpart provision in the American Law Institute Federal Securities Code. At the current time national securities exchanges are registered under Section 6 of the Securities Exchange Act of 1934; national securities associations under Section 15A; clearing agencies under Section 17A; and the Municipal Securities Rulemaking Board under Section 15B.

30.

Section 102(30): Sign: No Prior Provision. This definition is intended to facilitate electronic signatures, to the extent permitted by Section 105.

31.

Section 102(31): State: Prior Provisions: 1956 Act Section 401(m); RUSA Section 101(18). This is the standard definition used by the National Conference of Commissioners on Uniform State Laws. It does include territories and possessions of the United States, as well as the District of Columbia and Puerto Rico, but does not include foreign governments, their territories, or their possessions. In this Act "foreign" always refers to activity, a government, or person outside of the United States, not a different state within the United States.

§ 103. REFERENCES TO FEDERAL STATUTES.

"Securities Act of 1933" (15 U.S.C. Section 77a et seq.), "Securities Exchange Act of 1934" (15 U.S.C. Section 78a et

seq.), "Public Utility Holding Company Act of 1935" (15 U.S.C. Section 79 et seq.), "Investment Company Act of 1940" (15 U.S.C. Section 80a-1 et seq.), "Investment Advisers Act of 1940" (15 U.S.C. Section 80b-1 et seq.), "Employee Retirement Income Security Act of 1974" (29 U.S.C. Section 1001 et seq.), "National Housing Act" (12 U.S.C. Section 1701 et seq.), "Commodity Exchange Act" (7 U.S.C. Section 1 et seq.), "Internal Revenue Code" (26 U.S.C. Section 1 et seq.), "Securities Investor Protection Act of 1970" (15 U.S.C. Section 78aaa et seq.), "Securities Litigation Uniform Standards Act of 1998" (112 Stat. 3227), "Small Business Investment Act of 1958" (15 U.S.C. Section 661 et seq.), and "Electronic Signatures in Global and National Commerce Act" (15 U.S.C. Section 7001 et seq.) mean those statutes and the rules and regulations adopted under those statutes, as in effect on the date of enactment of this [Act] [, or as later amended].

Official Comments

Prior Provisions: 1956 Act Section 401(k); RUSA Section 101(15).

1.

There are a large number of references to other laws in this Act, particularly to the federal securities laws identified in Section 103, and to rules adopted by the Securities and Exchange Commission under those laws. One of the main objectives of this Act is to take account of those provisions in the federal laws that are preemptive, and to coordinate with other, nonpreemptive provisions of the federal laws where coordination between federal and state securities law is in the public interest.

2.

Section 12(d) of the Uniform Statute and Rule Construction Act, adopted by NCCUSL in 1995, provides: "A statute or rule that incorporates by reference a statute or rule of another jurisdiction does not incorporate a later enactment or adoption or amendment of the other statute or rule." Nevertheless, it is not uncommon for States to permit later amendments to statutes and rules referenced in enacted legislation to become automatically effective. In those states the final bracketed language in this Section should be included in the Act.

3.

In those states which do not permit automatic effectiveness of later amendments and that follow Section 12(d) of the Uniform Statute and Rule Construction Act, this problem has been addressed by either giving the administrator the power to update by rule or the duty to notify the legislature when amendment is necessary. When the legislature notification approach is adopted, to prevent a gap period, the administrator might be given the power to act by rule until the legislature has acted.

4.

After enactment, amendments to a preemptive federal statute, to rules adopted by a federal agency under a preemptive provision of a federal statute, or to amendments to such rules should be enforced in all states under the Supremacy Clause of the United States Constitution. A number of such references are in this Act.

§ 104. REFERENCES TO FEDERAL AGENCIES.

A reference in this [Act] to an agency or department of the United States is also a reference to a successor agency or department.

Official Comment

No Prior Provision.

§ 105. ELECTRONIC RECORDS AND SIGNATURES.

This [Act] modifies, limits, and supersedes the federal Electronic Signatures in Global and National Commerce Act, but does not modify, limit, or supersede Section 101(c) of that act (*15 U.S.C. Section 7001(c)*) or authorize electronic delivery of any of the notices described in Section 103(b) of that act (*15 U.S.C. Section 7003(b)*). This [Act] authorizes the filing of records and signatures, when specified by provisions of this [Act] or by a rule adopted or order issued under this [Act], in a manner consistent with Section 104(a) of that act (*15 U.S.C. Section 7004(a)*).

Official Comment

No Prior Provision. The purpose of this Section is to permit the filing of electronic signatures and electronic records.

Official Comments

Section 201 includes exempt securities and Section 202 includes exempt transactions. Both exempt securities and exempt transactions are exempt from the securities registration, notice filing requirement of Section 302, and the filing of sales literature Section 504 of this Act. Neither Section 201 nor Section 202 provides an exemption from the Act's antifraud provisions in Article 5, nor the broker-dealer, agent, investment adviser, or investment adviser registration requirements in Article 4.

A Section 201 exempt security retains its exemption when initially issued and in subsequent trading.

A Section 202 transaction exemption must be established for each transaction.

Neither the exempt security nor the transaction exemptions are meant to be mutually exclusive. A security or transaction may qualify for two or more exemptions.

Article 2 is not available to any security, transaction, or offer that, although in technical compliance with a specific section in Article 2, is part of an unlawful plan or scheme to evade the registration provisions of Article 3. In such cases registration is required. Cf. Prelim. Note 6 to Regulation D adopted under the Securities Act of 1933.

§ 201. EXEMPT SECURITIES.

The following securities are exempt from the requirements of Sections 301 through 306 and 504:

(1)

a security, including a revenue obligation or a separate security as defined in Rule 131 (*17 C.F.R. 230.131*)

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adopted under the Securities Act of 1933, issued, insured, or guaranteed by the United States; by a State; by a political subdivision of a State; by a public authority, agency, or instrumentality of one or more States; by a political subdivision of one or more States; or by a person controlled or supervised by and acting as an instrumentality of the United States under authority granted by the Congress; or a certificate of deposit for any of the foregoing;

(2)

a security issued, insured, or guaranteed by a foreign government with which the United States maintains diplomatic relations, or any of its political subdivisions, if the security is recognized as a valid obligation by the issuer, insurer, or guarantor;

(3)

a security issued by and representing or that will represent an interest in or a direct obligation of, or be guaranteed by:

(A)

an international banking institution;

(B)

a banking institution organized under the laws of the United States; a member bank of the Federal Reserve System; or a depository institution a substantial portion of the business of which consists or will consist of receiving deposits or share accounts that are insured to the maximum amount authorized by statute by the Federal Deposit Insurance Corporation, the National Credit Union Share Insurance Fund, or a successor authorized by federal law or exercising fiduciary powers that are similar to those permitted for national banks under the authority of the Comptroller of Currency pursuant to Section 1 of Public Law 87-722 (*12 U.S.C. Section 92a*); or

(C)

any other depository institution, unless by rule or order the administrator proceeds under Section 204;

(4)

a security issued by and representing an interest in, or a debt of, or insured or guaranteed by, an insurance company authorized to do business in this State;

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(5)

a security issued or guaranteed by a railroad, other common carrier, public utility, or public utility holding company that is:

(A)

regulated in respect to its rates and charges by the United States or a State;

(B)

regulated in respect to the issuance or guarantee of the security by the United States, a State, Canada, or a Canadian province or territory; or

(C)

a public utility holding company registered under the Public Utility Holding Company Act of 1935 or a subsidiary of such a registered holding company within the meaning of that act;

(6)

a federal covered security specified in Section 18(b)(1) of the Securities Act of 1933 (*15 U.S.C. Section 77r(b)(1)*) or by rule adopted under that provision or a security listed or approved for listing on another securities market specified by rule under this [Act]; a put or a call option contract; a warrant; a subscription right on or with respect to such securities; or an option or similar derivative security on a security or an index of securities or foreign currencies issued by a clearing agency registered under the Securities Exchange Act of 1934 and listed or designated for trading on a national securities exchange, a facility of a national securities exchange, or a facility of a national securities association registered under the Securities Exchange Act of 1934 or an offer or sale, of the underlying security in connection with the offer, sale, or exercise of an option or other security that was exempt when the option or other security was written or issued; or an option or a derivative security designated by the Securities and Exchange Commission under Section 9(b) of the Securities Exchange Act of 1934 (*15 U.S.C. Section 78i(b)*);

(7)

a security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, social, athletic, or reformatory purposes, or as a chamber of commerce, and not for pecuniary profit, no part of the net earnings of which inures to the benefit of a private stockholder or other person, or a security of a company that is excluded from the definition of an investment company under Section 3(c)(10)(B) of the Investment Company Act of 1940 (*15 U.S.C. Section 80b-3(c)(10)(B)*); except that with respect to the offer or sale of a note, bond, debenture, or other evidence of indebtedness issued by such a person, a rule may be adopted under this [Act] limiting the availability of this exemption by classifying securities, persons, and transactions, imposing different requirements for different classes, specifying with respect to paragraph (B) the scope of the exemption and the grounds for denial or

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suspension, and requiring an issuer:

(A)

to file a notice specifying the material terms of the proposed offer or sale and copies of any proposed sales and advertising literature to be used and provide that the exemption becomes effective if the administrator does not disallow the exemption within the period established by the rule;

(B)

to file a request for exemption authorization for which a rule under this [Act] may specify the scope of the exemption, the requirement of an offering statement, the filing of sales and advertising literature, the filing of consent to service of process complying with Section 611, and grounds for denial or suspension of the exemption; or

(C)

to register under Section 304;

(8)

a member's or owner's interest in, or a retention certificate or like security given in lieu of a cash patronage dividend issued by, a cooperative organized and operated as a nonprofit membership cooperative under the cooperative laws of a State, but not a member's or owner's interest, retention certificate, or like security sold to persons other than bona fide members of the cooperative; and

(9)

an equipment trust certificate with respect to equipment leased or conditionally sold to a person, if any security issued by the person would be exempt under this section or would be a federal covered security under Section 18(b)(1) of the Securities Act of 1933 (*15 U.S.C. Section 77r(b)(1)*).

Official Comments Prior Provisions: 1956 Act Section 402(a); RUSA Section 401(b).

1.

Section 201(1): United States government and municipal securities: Prior Provisions: 1956 Act Section 402(a)(1); RUSA Section 401(b)(1). This exemption generally follows the 1956 Act except that it adds securities "insured" by a specified government to those "issued" or "guaranteed." RUSA, in contrast, also addressed foreign governments, which in this Act are treated separately in Section 201(2). Rule 131 issued under the Securities Act of 1933 defines separate securities issued under governmental obligations. A significant minority of states have excluded

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from the Section 201(1) exemption industrial revenue bonds. Interest on these securities is solely repayable from revenues received from a nongovernmental industrial or commercial enterprise. Typically this exclusion will not operate if (A) the payments are made or unconditionally guaranteed by a person whose securities are exempt from registration under Section 18(b)(1) of the Securities Act of 1933, or (B) in accordance with a rule under this [Act], the issuer first files a notice in a record specifying the terms of the proposed offer or sale and a copy of the offering statement and the administrator does not disallow the exemption within the time period established by the rule.

2.

Section 201(2): Foreign government securities: Prior Provisions: 1956 Act Section 402(a)(2); RUSA Section 401(b)(2). The 1956 Act, as amended, and RUSA both reached foreign governments as specified in Section 201(2) and separately treated "a security issued, insured, or guaranteed by Canada, a Canadian province or territory, a political subdivision of Canada or a Canadian province or territory, an agency or corporate or other instrumentality of one or more of the foregoing." The separate treatment of Canadian securities is largely redundant and has been eliminated from this Section.

3.

Section 201(3): Depository institution and international banking institution securities: Prior Provision: RUSA 401(b)(3). Section 402(a)(3) of the 1956 Act exempts specified bank and similar depository institutions; Section 402(a)(4) exempts specified savings and loan and similar thrift institution securities; and Section 402(a)(6) exempts specified credit union securities. RUSA Section 401(b)(3) combines the three types of depository institutions into a common definition (see RUSA Section 101(13)) which are adopted in this Act as Sections 102(3) and 102(5)) and a common exemption (see RUSA Section 401(b)(3)) which is adopted in this subsection. Banks specified in Section 3(a)(2) of the Securities Act of 1933 issue federal covered securities under Section 18(b)(4)(C) of the Securities Act of 1933. Section 201(3)(C) applies to securities issued by depository institutions without depository insurance. Under Section 204, the administrator will have the ability to revoke or limit this exemption.

4.

Section 201(4): Insurance company securities: Prior Provisions: 1956 Act Section 402(a)(5); RUSA Section 401(b)(4). The issuance, insurance, or guarantee of securities by an insurance company is extensively regulated by state insurance commissions or other state agencies. Under this Act insurance, endowment policies, or annuity contracts under which an insurance company promises to pay fixed sums are excluded from the definition of a security in Section 102(28)(B). Unless brackets are removed from the words "or variable" in Section 102(28)(B), a variable annuity or other variable insurance product would be considered a security under this Act and under federal securities law. See *SEC v. Variable Annuity Life Ins. Co. of Am.*, 359 U.S. 65 (1959); *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967). A variable annuity or other variable insurance product issued by an investment company registered with the Securities and Exchange Commission under the Investment Company Act of 1940 would be a "federal covered security," see Section 102(7). See *Lander v. Hartford Life & Annuity Ins. Co.*, 251 F.3d 101 (2d Cir. 2001). A variable annuity or other variable insurance product not issued by a registered investment company would be exempted by Section 201(4), but would be subject to the antifraud provisions in Article 5.

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5.

Section 201(5): Common carrier and public utility securities: Prior Provisions: 1956 Act Section 401(a)(7); RUSA Section 401(b)(5). Both the 1956 Act and RUSA include references, omitted here, to the Interstate Commerce Commission, whose enabling legislation subsequently was repealed. Public utility holding companies covered by this exemption are subject both to the Public Utility Holding Company Act and to state or Canadian utility regulation.

6.

Section 201(6): Certain options and rights: No Prior Provision. The 1956 Act Section 402(a)(8) provided an exemption for securities listed on the New York, American, Midwest (now Chicago), or other designated stock exchanges, senior or substantially equal securities of the same issuer listed on the exchange and any security covered by listed or approved subscription rights or warrants, or any warrant or right to purchase or subscribe to any security exempted by Section 402(a)(8). RUSA essentially retained this exemption in Section 401(b)(7) and added securities designated for inclusion in the National Market System by the National Association of Securities Dealers in Section 401(b)(8) and specified options issued by a clearing agency registered under the Securities Exchange Act of 1934 in Section 401(b)(9). In 1996 Congress enacted the National Securities Markets Improvement Act and provided in Section 18(b)(1) that securities listed on the New York, American or Nasdaq Stock Exchange, or designated by rule of the Securities and Exchange Commission, as well as any security of the same issuer that is equal in seniority or senior to any of these securities will be a federal covered security. Under Rule 146 the SEC has designated as federal covered securities under Section 18(b)(1) Tier I of the Pacific Exchange; Tier I of the Philadelphia Stock Exchange; and The Chicago Board Options Exchange on condition that the relevant listing standards continue to be substantially similar to those of the New York, American, or Nasdaq stock markets. See Reporter's Note to Section 102(7). A federal covered security subject to Section 18(b)(1) of the Securities Act of 1933 will not be subject to the securities registration requirements of Sections 301 and 303 through 306. The exemption in Section 201(6) addresses specified options, warrants, and rights that are not federal covered securities under Section 18(b)(1) of the Securities Act of 1933, but generally would have been exempted under RUSA. The 1956 Act, which was narrower, was drafted before the computerized Nasdaq stock market began trading the National Market List and the development of standardized options markets. The final clause of Section 201(6) makes clear that any offer or sale of the underlying security that occurs as a result of the offer or sale of an option or other derivative security exempted under this provision or as the result of the exercise of the option or other derivative security, is covered by the exemption if the option met the terms of the exemption at the time such derivative security was written (that is, sold) or issued. The sale of the underlying security when an option is exercised would be exempt even if the underlying security is not at that time subject to any exemption under the Act. This is consistent with existing precedent under federal law suggesting that the legality of the sale of an underlying security when an option is exercised should be determined by the status of the security at the time the option was written rather than at the time of exercise. See, e.g., *H. Kook & Co., Inc. v. Scheinman, Hochstin & Trotta, Inc.*, 414 F.2d 93 (2d Cir. 1969). Any transaction in an underlying security that results from the offer, sale, or exercise of any derivative security issued by a registered clearing agency and traded on a national securities exchange or association is exempt if the derivative security when written was exempt under Section 201(6). The Securities and Exchange Commission has adopted Rule 9b-1 under Section 9(b).

7.

Section 201(7): Nonprofit organization securities: Prior Provision: Section 3(a)(4) of the Securities Act of 1933. Section 402(a)(9) of the 1956 Act and Section 401(b)(10) of RUSA exempt specified nonprofit securities. Both are modeled on Section 3(a)(4) of the Securities Act, which was subsequently amended. Securities issued under Section 3(a)(4) of the Securities Act of 1933 are not treated as federal covered securities in Section 18(b)(4)(C), although a

separate Section 3(a)(13) exemption which addresses certain church plan securities are federal covered securities under Section 18(b)(4)(C). RUSA included an optional notice and review requirement for nonprofit securities in Section 401(b)(10) "if at least ten days before a sale of the security the person has filed with the administrator a notice setting forth the material terms of the proposed sale and copies of any sales and advertising literature to be used and the administrator by order does not disallow the exemption within the next five full business days." The nonprofit exemption is of particular concern to state securities administrators. See, e.g., State Regulators Announce Dramatic Rise in Religious Scams; Tens of Thousands Lured, 33 Sec. Reg. & L. Rep. (BNA) 1189 (2001). Under Section 6 of the Philanthropy Protection Act, Congress preempted application of the registration provisions of state securities laws to issuance of securities covered by Section 3(c)(10) of the Investment Company Act of 1940 unless states acted within three years of enactment (December 1998) to pass special state legislation cancelling federal preemption. Ten states enacted such legislation. Those states may preserve this treatment of Section 3(c)(10) securities by deleting from Section 201(7) the phrase "or a security of a company that is excluded from the definition of an investment company under Section 3(c)(10)(B) of the Investment Company Act of 1940." Section 201(7) provides statutory authority for the states to adopt rules with respect to notes, bonds, debentures and other evidences of indebtedness issued by nonprofit organizations. Each state may adopt different rules tailored for various types of nonprofit debt offerings, (e.g., local church bond offerings, national church bond offerings, church extension funds, charitable gift annuities). For states that do not wish to provide an automatic exemption from registration for a particular type of nonprofit debt instrument or offering, Section 201(7) creates three categories of regulatory review that may be required by rule: (a) exemption by notice filing, (b) exemption by state authorization, and (c) registration by qualification. These categories are consistent with the manner in which many states currently review different types of nonprofit debt securities. See Horner & Makens, Securities Regulation of Religious and Other Nonprofit Organizations, 27 Stetson L. Rev. 473 (1997).

8.

Section 201(8): Cooperatives: Prior Provision: RUSA Section 401(b)(13). Section 201(8) is derived from RUSA Section 401(b)(13) which was included in that act after a number of states had adopted exemptions for securities issued by cooperatives. Section 201(8) is not intended to be available if securities are offered or sold to the public generally. The 1956 Act Section 402(a)(12) had instead provided: "insert any desired exemption for cooperatives." The Reporter for the 1956 Act had found such sharp variation among the 18 states that then had adopted a cooperative exemption that "no common pattern can be found." Louis Loss, Commentary on the Uniform Securities Act 118 (1976).

9.

Section 201(9): Equipment trust certificates: Prior Provision: RUSA Section 401(b)(6). The Securities Act of 1933 Section 3(a)(6) includes a narrower exemption for railroad equipment trusts. Section 201(9) follows RUSA. The Official Comment to RUSA Section 401(b)(6) explained: The new paragraph (b)(6) reflects the extensive development of equipment lease financing through leveraged leases, conditional sales, and other devices. The underlying premise is that if the securities of the person using such a financing device would be exempt under some other paragraph of Section 401, the equipment trust certificate or other security issued to acquire the property in question also is exempt.

§ 202. EXEMPT TRANSACTIONS.

The following transactions are exempt from the requirements of Sections 301 through 306 and 504:

(1)

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an isolated nonissuer transaction, whether effected by or through a broker-dealer or not;

(2)

a nonissuer transaction by or through a broker-dealer registered, or exempt from registration under this [Act], and a resale transaction by a sponsor of a unit investment trust registered under the Investment Company Act of 1940, in a security of a class that has been outstanding in the hands of the public for at least 90 days, if, at the date of the transaction:

(A)

the issuer of the security is engaged in business, the issuer is not in the organizational stage or in bankruptcy or receivership, and the issuer is not a blank check, blind pool, or shell company that has no specific business plan or purpose or has indicated that its primary business plan is to engage in a merger or combination of the business with, or an acquisition of, an unidentified person;

(B)

the security is sold at a price reasonably related to its current market price;

(C)

the security does not constitute the whole or part of an unsold allotment to, or a subscription or participation by, the broker-dealer as an underwriter of the security or a redistribution; and

(D)

a nationally recognized securities manual or its electronic equivalent designated by rule adopted or order issued under this [Act] or a record filed with the Securities and Exchange Commission that is publicly available contains:

(i)

a description of the business and operations of the issuer;

(ii)

the names of the issuer's executive officers and the names of the issuer's directors, if any;

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(iii)

an audited balance sheet of the issuer as of a date within 18 months before the date of the transaction or, in the case of a reorganization or merger when the parties to the reorganization or merger each had an audited balance sheet, a pro forma balance sheet for the combined organization; and

(iv)

an audited income statement for each of the issuer's two immediately previous fiscal years or for the period of existence of the issuer, whichever is shorter, or, in the case of a reorganization or merger when each party to the reorganization or merger had audited income statements, a pro forma income statement; or

(E)

the issuer of the security has a class of equity securities listed on a national securities exchange registered under the Securities Exchange Act of 1934 or designated for trading on the National Association of Securities Dealers Automated Quotation System, unless the issuer of the security is a unit investment trust registered under the Investment Company Act of 1940; or the issuer of the security, including its predecessors, has been engaged in continuous business for at least three years; or the issuer of the security has total assets of at least \$2,000,000 based on an audited balance sheet as of a date within 18 months before the date of the transaction or, in the case of a reorganization or merger when the parties to the reorganization or merger each had the audited balance sheet, a pro forma balance sheet for the combined organization;

(3)

a nonissuer transaction by or through a broker-dealer registered or exempt from registration under this [Act] in a security of a foreign issuer that is a margin security defined in regulations or rules adopted by the Board of Governors of the Federal Reserve System;

(4)

a nonissuer transaction by or through a broker-dealer registered or exempt from registration under this [Act] in an outstanding security if the guarantor of the security files reports with the Securities and Exchange Commission under the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934 (*15 U.S.C. 78m or 78o(d)*);

(5)

a nonissuer transaction by or through a broker-dealer registered or exempt from registration under this [Act] in a security that:

(A)

is rated at the time of the transaction by a nationally recognized statistical rating organization in one of its four highest rating categories; or

(B)

has a fixed maturity or a fixed interest or dividend, if:

(i)

a default has not occurred during the current fiscal year or within the three previous fiscal years or during the existence of the issuer and any predecessor if less than three fiscal years, in the payment of principal, interest, or dividends on the security; and

(ii)

the issuer is engaged in business, is not in the organizational stage or in bankruptcy or receivership, and is not and has not been within the previous 12 months a blank check, blind pool, or shell company that has no specific business plan or purpose or has indicated that its primary business plan is to engage in a merger or combination of the business with, or an acquisition of, an unidentified person;

(6)

a nonissuer transaction by or through a broker-dealer registered or exempt from registration under this [Act] effecting an unsolicited order or offer to purchase;

(7)

a nonissuer transaction executed by a bona fide pledgee without the purpose of evading this [Act];

(8)

a nonissuer transaction by a federal covered investment adviser with investments under management in excess of \$100,000,000 acting in the exercise of discretionary authority in a signed record for the account of others;

(9)

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a transaction in a security, whether or not the security or transaction is otherwise exempt, in exchange for one or more bona fide outstanding securities, claims, or property interests, or partly in such exchange and partly for cash, if the terms and conditions of the issuance and exchange or the delivery and exchange and the fairness of the terms and conditions have been approved by the administrator after a hearing;

(10)

a transaction between the issuer or other person on whose behalf the offering is made and an underwriter, or among underwriters;

(11)

a transaction in a note, bond, debenture, or other evidence of indebtedness secured by a mortgage or other security agreement if:

(A)

the note, bond, debenture, or other evidence of indebtedness is offered and sold with the mortgage or other security agreement as a unit;

(B)

a general solicitation or general advertisement of the transaction is not made; and

(C)

a commission or other remuneration is not paid or given, directly or indirectly, to a person not registered under this [Act] as a broker-dealer or as an agent;

(12)

a transaction by an executor, administrator of an estate, sheriff, marshal, receiver, trustee in bankruptcy, guardian, or conservator;

(13)

a sale or offer to sell to:

(A)

an institutional investor;

(B)

a federal covered investment adviser; or

(C)

any other person exempted by rule adopted or order issued under this [Act];

(14)

a sale or an offer to sell securities of an issuer, if part of a single issue in which:

(A)

not more than 25 purchasers are present in this State during any 12 consecutive months, other than those designated in paragraph (13);

(B)

a general solicitation or general advertising is not made in connection with the offer to sell or sale of the securities;

(C)

a commission or other remuneration is not paid or given, directly or indirectly, to a person other than a broker-dealer registered under this [Act] or an agent registered under this [Act] for soliciting a prospective purchaser in this State; and

(D)

the issuer reasonably believes that all the purchasers in this State, other than those designated in paragraph (13), are purchasing for investment;

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(15)

a transaction under an offer to existing security holders of the issuer, including persons that at the date of the transaction are holders of convertible securities, options, or warrants, if a commission or other remuneration, other than a standby commission, is not paid or given, directly or indirectly, for soliciting a security holder in this State;

(16)

an offer to sell, but not a sale, of a security not exempt from registration under the Securities Act of 1933 if:

(A)

a registration or offering statement or similar record as required under the Securities Act of 1933 has been filed, but is not effective, or the offer is made in compliance with Rule 165 adopted under the Securities Act of 1933 (*17 C.F.R. 230.165*); and

(B)

a stop order of which the offeror is aware has not been issued against the offeror by the administrator or the Securities and Exchange Commission, and an audit, inspection, or proceeding that is public and that may culminate in a stop order is not known by the offeror to be pending;

(17)

an offer to sell, but not a sale, of a security exempt from registration under the Securities Act of 1933 if:

(A)

a registration statement has been filed under this [Act], but is not effective;

(B)

a solicitation of interest is provided in a record to offerees in compliance with a rule adopted by the administrator under this [Act]; and

(C)

a stop order of which the offeror is aware has not been issued by the administrator under this [Act] and an

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audit, inspection, or proceeding that may culminate in a stop order is not known by the offeror to be pending;

(18)

a transaction involving the distribution of the securities of an issuer to the security holders of another person in connection with a merger, consolidation, exchange of securities, sale of assets, or other reorganization to which the issuer, or its parent or subsidiary and the other person, or its parent or subsidiary, are parties;

(19)

a rescission offer, sale, or purchase under Section 510;

(20)

an offer or sale of a security to a person not a resident of this State and not present in this State if the offer or sale does not constitute a violation of the laws of the State or foreign jurisdiction in which the offeree or purchaser is present and is not part of an unlawful plan or scheme to evade this [Act];

(21)

employees' stock purchase, savings, option, profit-sharing, pension, or similar employees' benefit plan, including any securities, plan interests, and guarantees issued under a compensatory benefit plan or compensation contract, contained in a record, established by the issuer, its parents, its majority-owned subsidiaries, or the majority-owned subsidiaries of the issuer's parent for the participation of their employees including offers or sales of such securities to:

(A)

directors; general partners; trustees, if the issuer is a business trust; officers; consultants; and advisors;

(B)

family members who acquire such securities from those persons through gifts or domestic relations orders;

(C)

former employees, directors, general partners, trustees, officers, consultants, and advisors if those individuals were employed by or providing services to the issuer when the securities were offered; and

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(D)

insurance agents who are exclusive insurance agents of the issuer, or the issuer's subsidiaries or parents, or who derive more than 50 percent of their annual income from those organizations;

(22)

a transaction involving:

(A)

a stock dividend or equivalent equity distribution, whether the corporation or other business organization distributing the dividend or equivalent equity distribution is the issuer or not, if nothing of value is given by stockholders or other equity holders for the dividend or equivalent equity distribution other than the surrender of a right to a cash or property dividend if each stockholder or other equity holder may elect to take the dividend or equivalent equity distribution in cash, property, or stock;

(B)

an act incident to a judicially approved reorganization in which a security is issued in exchange for one or more outstanding securities, claims, or property interests, or partly in such exchange and partly for cash; or

(C)

the solicitation of tenders of securities by an offeror in a tender offer in compliance with Rule 162 adopted under the Securities Act of 1933 (*17 C.F.R. 230.162*); or

(23)

a nonissuer transaction in an outstanding security by or through a broker-dealer registered or exempt from registration under this [Act], if the issuer is a reporting issuer in a foreign jurisdiction designated by this paragraph or by rule adopted or order issued under this [Act]; has been subject to continuous reporting requirements in the foreign jurisdiction for not less than 180 days before the transaction; and the security is listed on the foreign jurisdiction's securities exchange that has been designated by this paragraph or by rule adopted or order issued under this [Act], or is a security of the same issuer that is of senior or substantially equal rank to the listed security or is a warrant or right to purchase or subscribe to any of the foregoing. For purposes of this paragraph, Canada, together with its provinces and territories, is a designated foreign jurisdiction and The Toronto Stock Exchange, Inc., is a designated securities exchange. After an administrative hearing in compliance with [the state administrative procedure act], the administrator, by rule adopted or order issued under this [Act], may revoke the designation of a securities exchange under this paragraph, if the administrator finds that revocation is necessary or appropriate in the public interest and for the protection of investors.

Official Comments Prior Provisions: 1956 Act Section 402(b); RUSA Section 402.

1.

Sections 202(1) through (8) are available only for nonissuer transactions. An issuer selling securities in an initial public offering or other offering may not rely on Sections 202(1) through (8). A nonissuer, however, can rely on any issuer transaction exemption such as Section 202(13), when the exemption would be applicable to a nonissuer. The term "nonissuer transaction or nonissuer distribution" is defined in Section 102(18); the term "issuer" is defined in Section 102(17).

2.

Section 202(1): Isolated nonissuer transactions: Prior Provisions: 1956 Act Section 402(b)(1); RUSA Section 402(1). The term "isolated transaction" is not defined in this Act, but left to the states to develop. Historically under state law there has been somewhat varied case law development of the term "isolated transactions." See, e.g., *Blinder, Robinson & Co., Inc. v. Goettsch*, 403 N.W.2d 772 (Iowa 1987) (isolated nonissuer transaction exemption is not unconstitutionally vague); *Allen v. Schauf*, 449 P.2d 1010 (Kan. 1969) (regulation defined isolated transactions to not exceed four persons solicited in a 12 month period); *Nelson v. State*, 355 P.2d 413, 420 (Okla. Ct. Crim. App. 1960) ("[a]n isolated sale means one standing alone, disconnected from any other"); see generally 1 Louis Loss & Joel Seligman, *Securities Regulation* 125-130 (3d ed. rev. 1998). In general this subsection is intended to cover the occasional sale by a person. It would not exempt multiple or successive transactions by a person or group, whether those sales are sufficient to constitute a "distribution" as that term is used for purposes of the federal securities laws, see 2 Louis Loss & Joel Seligman, *Securities Regulation* 1138.50-1138.52 (3d ed. rev. 1999), or merely too frequent to be considered "isolated" under the relevant state law. Limited issuer offering transactions are separately addressed in Section 202(14).

3.

Section 202(2): Nonissuer transactions in specified outstanding securities: Prior Provisions: 1956 Act Section 402(b)(2); RUSA Sections 402(3) and (4). This Section represents a modernization of the securities manual exemption which was included in both the 1956 Act and RUSA. NASAA recommended an amendment to the 1956 Act Section 402(b) after discussion with the Securities Industry Association and others in the securities industry. This Section generally follows the NASAA amendment. Rule 419 issued under the Securities Act of 1933 defines a "blank check company" to be a company that "is a development stage company that has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies, or other entity or person." A "blind pool" is similar and would involve an investment in a blank check or other entity with no identified business plan or purpose. A "shell company" is also similar and would involve an entity which, to date, has no significant business assets, plan, or purpose.

4.

Section 202(3): Nonissuer transactions in specified foreign transactions: No Prior Provision. The NASAA

recommendation that was the basis of Section 202(2) also included specified foreign nonissuer transactions subject to a manual exemption when there was disclosure of the issuer's officers and directors in the issuer's country of domicile. This subsection uses margin securities as an alternative approach to identify sufficiently seasoned foreign securities. Margin securities are required to be in compliance with Regulation T which was adopted by the Board of Governors of the Federal Reserve System.

5.

Section 202(4): Nonissuer transactions in securities subject to Securities Exchange Act reporting: Prior Provision: RUSA Section 402(2). RUSA added this exemption to authorize nonissuer secondary trading in the securities of issuers that were subject to the periodic reporting requirements of the Securities Exchange Act of 1934. To bar immediate secondary trading in nonregistered initial public offerings, there was a further requirement that these securities be subject to the reporting requirements of Sections 13 or 15(d) of the Securities Exchange Act of 1934 for not less than 90 days. Section 202(4) only covers the guarantor because if the issuer of the security is a reporting company under Sections 13 or 15(d) of the Securities Exchange Act of 1934, the transaction is preempted by Section 18(b)(4)(A) of the Securities Act of 1933. Section 18(b)(4)(A) of the National Securities Markets Improvement Act of 1996 defines nonissuer transactions under Section 4(1) of the Securities Act of 1933 ("transactions by persons other than an issuer, underwriter, or dealer") as "federal covered securities," see Section 102(7), if the issuer files reports with the Securities and Exchange Commission under Sections 13 or 15(d) of the Securities Exchange Act of 1934. Under Section 18(a) of the Securities Act of 1933 no state statute, rule, order, or other administrative action with respect to registration of securities or reporting requirements may apply to a federal covered security. To harmonize Section 202(4) with Sections 18(a) and 18(b)(4)(A) of the Securities Act of 1933, the 90 day reporting period in RUSA Section 402(2) is not adopted in this Act.

6.

Section 202(5): Nonissuer transactions in specified fixed income securities: Prior Provisions: 1956 Act Section 402(b)(2)(B); RUSA Section 402(4). The concept of a fixed income security rated by a nationally recognized statistical rating organization in one of its four highest rating categories described in Section 202(5)(A) is well established in federal securities law in Form S-3 adopted under the Securities Act of 1933 and the net capital Rule 15c3-1(c)(2)(vi)(F) adopted under the Securities Exchange Act of 1934. See 2 Louis Loss & Joel Seligman, Securities Regulation 649-653 (3d ed. rev. 1999). Nationally recognized statistical rating organizations have been identified by the Securities and Exchange Commission and include such organizations as Moody's and Standard and Poor's. Rating categories typically begin with AAA and under this Act would include BBB as the fourth highest rating category. Section 202(5)(B) follows the 1956 Act and RUSA, but also addresses blank check and similar offerings, which became major concerns at the state and federal levels during the past two decades. Cf. Securities Act of 1933 Rule 419. See Official Comment (3). This subsection includes both debt securities with fixed maturity or a fixed interest rate and preferred stock with fixed dividend provisions.

7.

Section 202(6): Unsolicited brokerage transactions: Prior Provisions: 1956 Act Section 402(b)(3); RUSA Section 402(5). Section 18(b)(4)(B) of the Securities Act of 1933 defines as federal covered securities those subject to Section 4(4) of the Securities Act of 1933: "brokerage transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders." Section 202(6) is intended to provide exemption

for nonagency transactions by dealers not within the scope of Section 4(4). The 1956 Act Section 402(b)(3) had provided that the administrator "may by rule require that the customer acknowledge upon a specified form that the same was unsolicited, and that a signed copy of each such form be preserved by the broker-dealer for a specified period." This type of requirement is preempted by Section 18(a) of the Securities Act of 1933 for federal covered securities and is viewed as unnecessary for the limited class of dealer nonagency transactions that will be exempted by Section 202(6).

8.

Section 202(7): Nonissuer transactions by pledgees: Prior Provisions: 1956 Act Section 402(b)(7); RUSA Section 402(9). This subsection is identical to the 1956 Act and substantively identical to RUSA.

9.

Section 202(8): Nonissuer transactions with federal covered investment advisers: No Prior Provision. This exemption was added because of a recognition that federal covered investment advisers are sophisticated financial professionals capable of determining the merits of a security and do not require the protections provided by requiring registration in a particular state.

10.

Section 202(9): Specified exchange transactions: No Prior Provision. Section 202(9) provides a state counterpart to the exemption in Section 3(a)(10) of the Securities Act of 1933.

11.

Section 202(10): Underwriter transactions: Prior Provisions: 1956 Act Section 402(b)(4); RUSA Section 402(6). This subsection is substantively identical to the 1956 Act and RUSA.

12.

Section 202(11): Unit secured transactions: Prior Provisions: 1956 Act Section 402(b)(5); RUSA Section 402(7). In recent years the application of this exemption has been one of concern to state securities administrators. The conditions that conclude this exemption are new and are intended to address these concerns.

13.

Section 202(12): Bankruptcy, guardian, or conservator transactions: Prior Provisions: 1956 Act Section 402(b)(6); RUSA Section 402(8). This subsection is identical to that in the 1956 Act and RUSA.

14.

Section 202(13): Transactions with specified investors: Prior Provision: 1956 Act Section 402(b)(8). The 1956 Act contains similar but less inclusive language in Section 402(b)(8). If the Securities and Exchange Commission adopts a rule defining "qualified purchaser" as used in Section 18(b)(3) of the Securities Act to specify certain purchasers of federal covered securities, part or all of this exemption will be redundant. As of September 2002, the Commission has proposed, but not adopted, Rule 146(c). Section 202(13)(B) is limited to transactions for the account of a federal covered investment adviser and is not intended to reach transactions on behalf of others by such adviser.

15.

Section 202(14): Limited offering transactions: Prior Provisions: 1956 Act Section 402(b)(9); RUSA Section 402(11). The reference in the prefatory language to "a single issue" signifies that two or more issues can be "integrated" and potentially destroy the exemption. There are two general tests for integration under the federal securities laws. The states similarly have followed generally these types of integration principles with respect to securities transaction exemptions. First, there is a six month "buffer" before and after an offer, offer to sell, or sale of a transaction exempt under Section 202(14) during which no other issue can be distributed if integration automatically is to be avoided. See Rule 147(b)(2) and Rule 502(a) of the Securities Act of 1933. Second, if two issues occur within six months, integration may occur depending upon the following factors:

(i)

are the offerings part of a single plan of financing;

(ii)

do the offerings involve issuance of the same class of securities;

(iii)

are the offerings made at or about the same time;

(iv)

is the same type of consideration to be received; and

(v)

are the offerings made for the same general purpose.

See generally 3 Louis Loss & Joel Seligman, Securities Regulation 1231-1248 (3d ed. rev. 1999).

Section 402(b)(9) of the 1956 Act and Section 402(11) of the 1985 Act provide alternative limited offering transaction exemptions. The 1956 Act was limited to offers to no more than ten persons (other than institutional investors specified in Section 402(b)(8)); all purchasers in the State had to purchase for investment; and no remuneration was given for soliciting prospective purchasers in the State. RUSA, in contrast, was limited to no more than 25 purchasers (other than financial or institutional investors); no general solicitation or advertising; and no remuneration was paid to a person other than a broker-dealer for soliciting a prospective purchaser.

This Section would apply to preorganization limited offerings as well as operating company limited offerings. The Securities Act of 1933 Sections 3(b) and 4(2) also apply to both. In contrast, the 1956 Act Section 402(b)(10) and RUSA Section 402(12) used similar concepts in separate Sections to apply to preorganization limited offerings.

Section 18(b)(4)(D) of the Securities Act of 1933 defines as federal covered securities those issued under Securities and Exchange Commission rules under Section 4(2) of the Securities Act. This would include Rule 506, which uses the "accredited investor" definition in Rule 501(a). When a transaction involves Rule 506, Section 18(b)(4)(D) further provides "that this paragraph does not prohibit a state from imposing notice filing requirements that are substantially similar to those required by rule or regulation under Section 4(2) that are in effect on September 1, 1996." These notice requirements are found in Section 302(c) of this Act.

A majority of states have adopted a Uniform Limited Offering Exemption, coordinate to varying degrees with Regulation D. The authority to adopt this and other exemptive rules is provided in Section 203.

16.

Section 202(15): Transactions with existing security holders: Prior Provisions: 1956 Act Section 402(b)(11); RUSA Section 402(14). Section 3(a)(9) of the Securities Act of 1933 exempts exchange offerings with existing security holders. Under Section 18(b)(4)(C) transactions subject to Section 3(a)(9) are federal covered securities. See Section 102(7). Notice requirements in the earlier 1956 Act and RUSA accordingly would be preempted by the Securities Act of 1933. See Section 18(a) of the Securities Act of 1933. Otherwise this exemption is substantively identical to the 1956 Act and RUSA.

17.

Section 202(16): Offerings registered under this [Act] and the Securities Act of 1933: Prior Provisions: 1956 Act Section 402(b)(12); RUSA Section 402(15). This exemption generally follows the 1956 Act and RUSA. Rule 165 of the Securities Act of 1933, which was adopted in 1999, allows the offeror of securities in a business combination to make written communications that offer securities for sale before a registration statement is filed as long as specified conditions are satisfied. RUSA Section 402(15)(ii) also required that a registration statement be filed under this Act, but not yet be effective. By eliminating the filing requirement this exemption will reach the offer (but not the sale) of a security that is anticipated to be a federal covered security by applying for listing on the New York Stock Exchange or other exchange specified in Section 18(b)(1) of the Securities Act of 1933, but the listing and federal covered security status has not yet become effective.

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18.

Section 202(17): Offerings when registration has been filed, but is not effective under this [Act] and exempt from the Securities Act of 1933: Prior Provisions: RUSA Section 402(16). If a rule is adopted by the administrator a solicitation of interest document must accompany a registration by qualification as specified in Section 304(b)(13). Oral offers may be made after a registration statement has been filed, both before and after a registration statement is effective. This exemption does not operate unless the administrator adopts a rule under 202(17)(B).

19.

Section 202(18): Control transactions: Prior Provision: RUSA Section 402(17). Until 1972 mergers and similar transactions were not considered to involve sales and did not have to register under the Securities Act of 1933. In 1972 the Securities and Exchange Commission adopted Rule 145 defining many mergers and similar transactions to be sales and abandoned its earlier "no sale" doctrine. See 3 Louis Loss & Joel Seligman, Securities Regulation 1262-1280 (3d ed. rev. 1999). Because most merger and similar transactions require shareholder approval and shareholders often have appraisal rights if they choose to dissent, the potential for abuse is less than in an offering of securities for cash. When appropriate the administrator can deny, condition, limit or revoke this exemption under Section 204. Section 202(18) does not follow the requirement in RUSA Section 402(17) that written notice of the transactions and a copy of the solicitation materials be given to the administrator 10 days before the consummation of the transaction and, that the administrator is empowered to disallow the exemption within the next 10 days.

20.

Section 202(19): Rescission offers: No Prior Provision. See Section 510 for discussion of rescission offers.

21.

Section 202(20): Out-of-state offers or sales: Source of law: Colo. Section 11-51-102(7). Compare A.S. Goldmen & Co., Inc. v. New Jersey Bur. of Sec., 163 F.3d 780 (3d Cir. 1999), which held that under the United States Constitution's Commerce Clause a State could authorize a securities administrator to prevent a broker-dealer from selling securities from a State to purchasers in other States where purchase of the securities was authorized. The concluding phrase "and is not part of an unlawful plan or scheme to evade this [Act]" is intended to preclude reliance on this exemption by boiler rooms and others engaged in illegal activities. Section 202(20) provides an exemption from securities registration and does not address an administrator's power to investigate and bring enforcement actions under Articles 5 and 6.

22.

Section 202(21): Employee benefit plans: Prior Provision: RUSA Section 401(b)(12). The 1956 Act Section 402(a)(11) was limited to investment contracts issued in connection with specified employee benefit plans if the administrator was given 30 days written notice. In 1979, the United States Supreme Court in *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551 (1979), held that a noncontributory, mandatory pension plan subject to the Employee Retirement Income Security Act of 1974 (ERISA) was not a security within the meaning of the Securities Act of 1933 or the Securities Exchange Act of 1934. The Securities and Exchange Commission staff subsequently took the position

that the interests of employees in involuntary, contributory plans are not securities. Sec. Act Rel. 6188, 19 SEC Dock. 465, 473 (1980). Both contributory and noncontributory pension or welfare plans subject to ERISA are excluded from the definition of security in Section 102(28). In this definition, the term "advisors" does not mean "investment advisers," as defined in Section 102(15). With respect to employee benefit plans that are securities, Section 202(21) provides an exemption, but follows RUSA in not limiting the exemption to investment contracts and not requiring 30 days notice to the administrator. Section 202(21) is modeled, in part, on Rule 701(c) adopted under the Securities Act of 1933. Compliance with Rule 701 will provide compliance with this exemption. Both the 1956 Act and RUSA, for unstated reasons, treated employee benefit plans as exempt securities, rather than exempt securities transactions. There appears to be no appropriate reason to do so. Resale of employee benefit plan securities can occur under appropriate section 202 transaction exemptions. Section 202(21) is not intended to provide a new method of publicly issuing securities. The administrator, when appropriate, can deny, condition, limit, or revoke an exemption under Section 202(21). See Section 204.

23.

Section 202(22): Specified dividends and tender offers and judicially recognized reorganizations: Prior Provision: 1956 Act Section 401(j)(6)(B) and (D); RUSA Section 101(13)(vi). Section 202(22)(A) and (B) generally follow exclusions from the definition of sale in the 1956 Act and RUSA. Section 202(22)(C) is new and corresponds to Rule 162, recently adopted under the Securities Act of 1933, which allows the offeror in a stock exchange offer to solicit tenders of securities before a registration statement is effective as long as no securities are purchased until the registration statement is effective and the tender offer has expired.

24.

Section 202(23): Nonissuer transactions involving specified foreign issuer securities traded on designated securities exchanges. This exemption expressly covers Toronto Stock Exchange issuers that are public reporting companies under Canadian securities law and meet the 180 day continuous reporting requirement. In conformance with the North American Free Trade Agreement (NAFTA) and General Agreement on Trade in Services (GATS), the exemption separately provides authority for the administrator to designate by rule or order other specific foreign jurisdictions and their trading exchanges upon an adequate showing. The exemption also provides authority for an administrator to revoke any designation if necessary or appropriate in the public interest and for the protection of investors.

§ 203. ADDITIONAL EXEMPTIONS AND WAIVERS.

A rule adopted or order issued under this [Act] may exempt a security, transaction, or offer; a rule under this [Act] may exempt a class of securities, transactions, or offers from any or all of the requirements of Sections 301 through 306 and 504; and an order under this [Act] may waive, in whole or in part, any or all of the conditions for an exemption or offer under Sections 201 and 202.

Official Comments

Prior Provision: RUSA Section 403.

1.

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Under this type of authority, 50 of 53 jurisdictions through September 2002 had adopted the Uniform Limited Offering Exemption (ULOE) or a Regulation D exemption, and 32 jurisdictions had adopted a Rule 144A exemption. This Act does not incorporate ULOE or a Rule 144A exemption because of their complexity and the likelihood of periodic updating of their provisions. Rule 144A, and similar exemptions in ULOE, can be most effectively implemented by rule rather than statute.

2.

Under Section 203 a state would also be authorized to adopt by rule or order new exemptions as circumstances warrant for new technologies such as the Internet. Cf. NASAA Resolution Regarding Securities Offered on Internet, NASAA Rep. P 7040 (Jan. 7, 1996).

3.

It is the intent of this Section that ULOE, Rule 144A, and additional exemptions or waivers be adopted uniformly by states, to the extent this is practicable.

§ 204. DENIAL, SUSPENSION, REVOCATION, CONDITION, OR LIMITATION OF EXEMPTIONS.

(a) [Enforcement related powers.] Except with respect to a federal covered security or a transaction involving a federal covered security, an order under this [Act] may deny, suspend application of, condition, limit, or revoke an exemption created under Section 201(3)(C), (7) or (8) or 202 or an exemption or waiver created under Section 203 with respect to a specific security, transaction, or offer. An order under this section may be issued only pursuant to the procedures in Section 306(d) or 604 and only prospectively.

(b) [Knowledge of order required.] A person does not violate Section 301, 303 through 306, 504, or 510 by an offer to sell, offer to purchase, sale, or purchase effected after the entry of an order issued under this section if the person did not know, and in the exercise of reasonable care could not have known, of the order.

Official Comments Prior Provisions: 1956 Act Section 402(c); RUSA Section 404.

1.

Section 204 is potentially far reaching. The ability to deny, condition, limit, or revoke the exemptions specified in Sections 201(3)(C), 201(7), 201(8), 202, or 203 is adopted concomitant with the breadth of these exemptions. One or more than one security, transaction, or offer can be covered by a Section 204 order.

2.

The courts have given a securities administrator's decision to deny or revoke an exemption substantial deference when there was compliance with applicable due process and statutory requirements. See, e.g., *Johnson-Bowles Co., Inc. v. Div. of Sec.*, 829 P.2d 101 (Utah Ct. App. 1992).

§ 301. SECURITIES REGISTRATION REQUIREMENT.

It is unlawful for a person to offer or sell a security in this State unless:

(1)

the security is a federal covered security;

(2)

the security, transaction, or offer is exempted from registration under Sections 201 through 203; or

(3)

the security is registered under this [Act].

Official Comments Prior Provisions: 1956 Act Section 301; RUSA Section 301.

1.

This Section is substantively identical to the 1956 Act and RUSA except for the addition of Section 301(1), which is necessitated by the National Securities Markets Improvement Act of 1996. See Section 102(7).

2.

Except for federal covered securities, exempt securities, or securities offered or sold in exempt transactions, no sale of a security may be made in this State before the security is registered. "Sale" is defined in Section 102(26); "in this State" is addressed in Section 610; and securities registration is addressed in Sections 303 through 306.

3.

The Securities Act of 1933 permits certain types of offers during the "waiting period" between the filing and effectiveness of a registration statement. The exemptive provisions of Sections 202(16) and (17) operate to permit similar offers for securities that are not federal covered securities and are in the process of registration under federal or state statutes or both.

4.

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Notice filings and fees applicable to federal covered securities, see Section 102(7), are addressed in Section 302.

§ 302. NOTICE FILING.

(a) [Required filing of records.] With respect to a federal covered security, as defined in Section 18(b)(2) of the Securities Act of 1933 (*15 U.S.C. Section 77r(b)(2)*), that is not otherwise exempt under Sections 201 through 203, a rule adopted or order issued under this [Act] may require the filing of any or all of the following records:

(1)

before the initial offer of a federal covered security in this State, all records that are part of a federal registration statement filed with the Securities and Exchange Commission under the Securities Act of 1933 and a consent to service of process complying with Section 611 signed by the issuer and the payment of a fee of \$[_____];

(2)

after the initial offer of the federal covered security in this State, all records that are part of an amendment to a federal registration statement filed with the Securities and Exchange Commission under the Securities Act of 1933; and

(3)

to the extent necessary or appropriate to compute fees, a report of the value of the federal covered securities sold or offered to persons present in this State, if the sales data are not included in records filed with the Securities and Exchange Commission and payment of a fee of \$[_____].

(b) [Notice filing effectiveness and renewal.] A notice filing under subsection (a) is effective for one year commencing on the later of the notice filing or the effectiveness of the offering filed with the Securities and Exchange Commission. On or before expiration, the issuer may renew a notice filing by filing a copy of those records filed by the issuer with the Securities and Exchange Commission that are required by rule or order under this [Act] to be filed and by paying a renewal fee of \$[_____]. A previously filed consent to service of process complying with Section 611 may be incorporated by reference in a renewal. A renewed notice filing becomes effective upon the expiration of the filing being renewed.

(c) [Notice filings for federal covered securities under Section 18(b)(4)(D).] With respect to a security that is a federal covered security under Section 18(b)(4)(D) of the Securities Act of 1933 (*15 U.S.C. Section 77r(b)(4)(D)*), a rule under this [Act] may require a notice filing by or on behalf of an issuer to include a copy of Form D, including the Appendix, as promulgated by the Securities and Exchange Commission, and a consent to service of process complying with Section 611 signed by the issuer not later than 15 days after the first sale of the federal covered security in this State and the payment of a fee of \$[_____]; and the payment of a fee of \$[_____] for any late filing.

(d) [Stop orders.] Except with respect to a federal security under Section 181(b)(1) of the Securities Act of 1933 (15 U.S.C. Section 77r(b)(1)), if the administrator finds that there is a failure to comply with a notice or fee requirement of this section, the administrator may issue a stop order suspending the offer and sale of a federal covered security in this State. If the deficiency is corrected, the stop order is void as of the time of its issuance and no penalty may be imposed by the administrator.

Official Comments No Prior Provision.

1.

The little used "registration by notification" in the 1956 Act Section 302 or "registration by filing" in RUSA Section 302 are omitted from this Act because of the notice filing approach required by Section 18(b)(2) of the Securities Act of 1933 for federal covered securities, which, in essence, replaces the need for registration by notification.

2.

For Rule 506 offerings which are addressed by Section 18(d)(4)(D) of the Securities Act of 1933, the Securities and Exchange Commission requires the filing of Form D. See Rule 503. When an issuer meets the conditions of Rule 506, Section 302(c) is intended to limit required state filings to no more than a requirement of filing a copy of Form D, including the Appendix, a consent to service of process, and a fee.

3.

The definition of "filing" in Section 102(8) will permit states to receive electronic filing of records under this Section. An administrator may also accept under this Section a signed consent filed electronically with a designee of the administrator. See Section 105.

4.

If a State prefers to have the fees in this section established by rule, replace the phrase "a fee of \$[_____]" in subsections (a), (b), and (c) with the phrase "a fee established by the administrator by rule". See Comment 3 to Section 410.

§ 303. SECURITIES REGISTRATION BY COORDINATION.

(a) [Registration permitted.] A security for which a registration statement has been filed under the Securities Act of 1933 in connection with the same offering may be registered by coordination under this section.

(b) [Required records.] A registration statement and accompanying records under this section must contain or be

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accompanied by the following records in addition to the information specified in Section 305 and a consent to service of process complying with Section 611:

(1)

a copy of the latest form of prospectus filed under the Securities Act of 1933;

(2)

a copy of the articles of incorporation and bylaws or their substantial equivalents currently in effect; a copy of any agreement with or among underwriters; a copy of any indenture or other instrument governing the issuance of the security to be registered; and a specimen, copy, or description of the security that is required by rule adopted or order issued under this [Act];

(3)

copies of any other information or any other records filed by the issuer under the Securities Act of 1933 requested by the administrator; and

(4)

an undertaking to forward each amendment to the federal prospectus, other than an amendment that delays the effective date of the registration statement, promptly after it is filed with the Securities and Exchange Commission.

(c) [Conditions for effectiveness of registration statement.] A registration statement under this section becomes effective simultaneously with or subsequent to the federal registration statement when all the following conditions are satisfied:

(1)

a stop order under subsection (d) or Section 306 or issued by the Securities and Exchange Commission is not in effect and a proceeding is not pending against the issuer under Section 412; and

(2)

the registration statement has been on file for at least 20 days or a shorter period provided by rule adopted or order issued under this [Act].

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(d) [Notice of federal registration statement effectiveness.] The registrant shall promptly notify the administrator in a record of the date when the federal registration statement becomes effective and the content of any price amendment and shall promptly file a record containing the price amendment. If the notice is not timely received, the administrator may issue a stop order, without prior notice or hearing, retroactively denying effectiveness to the registration statement or suspending its effectiveness until compliance with this section. The administrator shall promptly notify the registrant of an order by telegram, telephone, or electronic means and promptly confirm this notice by a record. If the registrant subsequently complies with the notice requirements of this section, the stop order is void as of the date of its issuance.

(e) [Effectiveness of registration statement.] If the federal registration statement becomes effective before each of the conditions in this section is satisfied or is waived by the administrator, the registration statement is automatically effective under this [Act] when all the conditions are satisfied or waived. If the registrant notifies the administrator of the date when the federal registration statement is expected to become effective, the administrator shall promptly notify the registrant by telegram, telephone, or electronic means and promptly confirm this notice by a record, indicating whether all the conditions are satisfied or waived and whether the administrator intends the institution of a proceeding under Section 306. The notice by the administrator does not preclude the institution of such a proceeding.

Official Comments Prior Provisions: 1956 Act Section 303; RUSA Section 303.

1.

Registration by coordination was one of the key innovations of the 1956 Act. As in the 1956 Act, Section 303 streamlines the content of the registration statement and the procedure by which a registration statement becomes effective, but not the substantive standards governing the effectiveness of a registration statement.

2.

The phrase "in connection with the same offering" in Section 303 does not require that the federal and state registration statements be filed simultaneously or become effective simultaneously. A registration by coordination can be filed in a State after the effectiveness of the federal registration statement as long as the administrator does not conclude that the interval was too long to consider the State registration statement "the same offering."

3.

Section 303 is similar to the 1956 Act except that these provisions have been modernized to include electronic filing and electronic notification. Cf. Sections 102(8), 102(25), 105. It is anticipated that this will facilitate simultaneous filing with the Securities and Exchange Commission and the States which is consistent with the uniformity intended by this Act. Simultaneous or sequential filing could be administered through a designee similar to the current Web-CRD or in conjunction with the Securities and Exchange Commission's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system or otherwise.

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4.

Section 303(b) is not intended to limit the administrator to requiring only the information and records filed with the Securities and Exchange Commission.

5.

Sections 303(c) through (e) describe the conditions to be satisfied to achieve effectiveness of a coordinated filing. "Price amendment" is defined in Section 102(23). The administrator retains the right to test the registration statement by the substantive standards of Section 306(a) and may issue a stop or denial order if the administrator believes any of those provisions are applicable.

§ 304. SECURITIES REGISTRATION BY QUALIFICATION.

(a) [Registration permitted.] A security may be registered by qualification under this section.

(b) [Required records.] A registration statement under this section must contain the information or records specified in Section 305, a consent to service of process complying with Section 611, and, if required by rule adopted under this [Act], the following information or records:

(1)

with respect to the issuer and any significant subsidiary, its name, address, and form of organization; the State or foreign jurisdiction and date of its organization; the general character and location of its business; a description of its physical properties and equipment; and a statement of the general competitive conditions in the industry or business in which it is or will be engaged;

(2)

with respect to each director and officer of the issuer, and other person having a similar status or performing similar functions, the person's name, address, and principal occupation for the previous five years; the amount of securities of the issuer held by the person as of the 30th day before the filing of the registration statement; the amount of the securities covered by the registration statement to which the person has indicated an intention to subscribe; and a description of any material interest of the person in any material transaction with the issuer or a significant subsidiary effected within the previous three years or proposed to be effected;

(3)

with respect to persons covered by paragraph (2), the aggregate sum of the remuneration paid to those persons during the previous 12 months and estimated to be paid during the next 12 months, directly or indirectly, by the issuer, and all predecessors, parents, subsidiaries, and affiliates of the issuer;

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(4)

with respect to a person owning of record or owning beneficially, if known, 10 percent or more of the outstanding shares of any class of equity security of the issuer, the information specified in paragraph (2) other than the person's occupation;

(5)

with respect to a promoter, if the issuer was organized within the previous three years, the information or records specified in paragraph (2), any amount paid to the promoter within that period or intended to be paid to the promoter, and the consideration for the payment;

(6)

with respect to a person on whose behalf any part of the offering is to be made in a nonissuer distribution, the person's name and address; the amount of securities of the issuer held by the person as of the date of the filing of the registration statement; a description of any material interest of the person in any material transaction with the issuer or any significant subsidiary effected within the previous three years or proposed to be effected; and a statement of the reasons for making the offering;

(7)

the capitalization and long term debt, on both a current and pro forma basis, of the issuer and any significant subsidiary, including a description of each security outstanding or being registered or otherwise offered, and a statement of the amount and kind of consideration, whether in the form of cash, physical assets, services, patents, goodwill, or anything else of value, for which the issuer or any subsidiary has issued its securities within the previous two years or is obligated to issue its securities;

(8)

the kind and amount of securities to be offered; the proposed offering price or the method by which it is to be computed; any variation at which a proportion of the offering is to be made to a person or class of persons other than the underwriters, with a specification of the person or class; the basis on which the offering is to be made if otherwise than for cash; the estimated aggregate underwriting and selling discounts or commissions and finders' fees, including separately cash, securities, contracts, or anything else of value to accrue to the underwriters or finders in connection with the offering or, if the selling discounts or commissions are variable, the basis of determining them and their maximum and minimum amounts; the estimated amounts of other selling expenses, including legal, engineering, and accounting charges; the name and address of each underwriter and each recipient of a finder's fee; a copy of any underwriting or selling group agreement under which the distribution is to be made or the proposed form of any such agreement whose terms have not yet been determined; and a description of the plan of distribution of any securities that are to be offered otherwise than through an underwriter;

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(9)

the estimated monetary proceeds to be received by the issuer from the offering; the purposes for which the proceeds are to be used by the issuer; the estimated amount to be used for each purpose; the order or priority in which the proceeds will be used for the purposes stated; the amounts of any funds to be raised from other sources to achieve the purposes stated; the sources of the funds; and, if a part of the proceeds is to be used to acquire property, including goodwill, otherwise than in the ordinary course of business, the names and addresses of the vendors, the purchase price, the names of any persons that have received commissions in connection with the acquisition, and the amounts of the commissions and other expenses in connection with the acquisition, including the cost of borrowing money to finance the acquisition;

(10)

a description of any stock options or other security options outstanding, or to be created in connection with the offering, and the amount of those options held or to be held by each person required to be named in paragraph (2), (4), (5), (6), or (8) and by any person that holds or will hold 10 percent or more in the aggregate of those options;

(11)

the dates of, parties to, and general effect concisely stated of each managerial or other material contract made or to be made otherwise than in the ordinary course of business to be performed in whole or in part at or after the filing of the registration statement or that was made within the previous two years, and a copy of the contract;

(12)

a description of any pending litigation, action, or proceeding to which the issuer is a party and that materially affects its business or assets, and any litigation, action, or proceeding known to be contemplated by governmental authorities;

(13)

a copy of any prospectus, pamphlet, circular, form letter, advertisement, or other sales literature intended as of the effective date to be used in connection with the offering and any solicitation of interest used in compliance with Section 202(17)(B);

(14)

a specimen or copy of the security being registered, unless the security is uncertificated; a copy of the issuer's articles of incorporation and bylaws or their substantial equivalents, in effect; and a copy of any indenture or other instrument covering the security to be registered;

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(15)

a signed or conformed copy of an opinion of counsel concerning the legality of the security being registered, with an English translation if it is in a language other than English, which states whether the security when sold will be validly issued, fully paid, and nonassessable and, if a debt security, a binding obligation of the issuer;

(16)

a signed or conformed copy of a consent of any accountant, engineer, appraiser, or other person whose profession gives authority for a statement made by the person, if the person is named as having prepared or certified a report or valuation, other than an official record, that is public, which is used in connection with the registration statement;

(17)

a balance sheet of the issuer as of a date within four months before the filing of the registration statement; a statement of income and changes in financial position for each of the three fiscal years preceding the date of the balance sheet and for any period between the close of the immediately previous fiscal year and the date of the balance sheet, or for the period of the issuer's and any predecessor's existence if less than three years; and, if any part of the proceeds of the offering is to be applied to the purchase of a business, the financial statements that would be required if that business were the registrant; and

(18)

any additional information or records required by rule adopted or order issued under this [Act].

(c) [Conditions for effectiveness of registration statement.] A registration statement under this section becomes effective 30 days, or any shorter period provided by rule adopted or order issued under this [Act], after the date the registration statement or the last amendment other than a price amendment is filed, if:

(1)

a stop order is not in effect and a proceeding is not pending under Section 306;

(2)

the administrator has not issued an order under Section 306 delaying effectiveness; and

(3)

the applicant or registrant has not requested that effectiveness be delayed.

(d) [Delay of effectiveness of registration statement.] The administrator may delay effectiveness once for not more than 90 days if the administrator determines the registration statement is not complete in all material respects and promptly notifies the applicant or registrant of that determination. The administrator may also delay effectiveness for a further period of not more than 30 days if the administrator determines that the delay is necessary or appropriate.

(e) [Prospectus distribution may be required.] A rule adopted or order issued under this [Act] may require as a condition of registration under this section that a prospectus containing a specified part of the information or record specified in subsection (b) be sent or given to each person to which an offer is made, before or concurrently, with the earliest of:

(1)

the first offer made in a record to the person otherwise than by means of a public advertisement, by or for the account of the issuer or another person on whose behalf the offering is being made or by an underwriter or broker-dealer that is offering part of an unsold allotment or subscription taken by the person as a participant in the distribution;

(2)

the confirmation of a sale made by or for the account of the person;

(3)

payment pursuant to such a sale; or

(4)

delivery of the security pursuant to such a sale.

Official Comments Prior Provisions: 1956 Act Section 304; RUSA Section 304.

1.

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This Section generally follows the 1956 Act and RUSA. Any security may be registered by qualification, whether or not another type of registration is available. Ordinarily, however, registration by qualification will only be used by an issuer when no other procedure is available.

2.

Section 304(b) originally was modeled on Schedule A of the Securities Act of 1933.

3.

In Section 304(b)(12) pending litigation can include litigation that has not yet been filed.

4.

Section 304(b)(17) uses the same terminology as is used currently in Regulation S-X of the Securities and Exchange Commission. Under Sections 605(a) and (c) the administrator is authorized to specify the form and content of rules and forms governing registration statements and the form and content of financial statements required under this Act.

5.

Under Sections 304(b)(18) and 307 the administrator may require additional information or may waive in whole or in part or condition any of the requirements of Section 304(b). Section 304(b)(18), for example, would authorize the administrator to require that a report by an accountant, engineer, appraiser or other professional person be filed. Section 304(b)(18) would also authorize that securities of designated classes under a trust indenture contain additional specified information.

§ 305. SECURITIES REGISTRATION FILINGS.

(a) [Who may file.] A registration statement may be filed by the issuer, a person on whose behalf the offering is to be made, or a broker-dealer registered under this [Act].

(b) [Filing fee.] A person filing a registration statement shall pay a filing fee of \$[_____]. If a registration statement is withdrawn before the effective date or a preeffective stop order is issued under Section 306, the administrator shall retain \$[_____] of the fee.

(c) [Status of offering.] A registration statement filed under Section 303 or 304 must specify:

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(1)

the amount of securities to be offered in this State;

(2)

the States in which a registration statement or similar record in connection with the offering has been or is to be filed; and

(3)

any adverse order, judgment, or decree issued in connection with the offering by a State securities regulator, the Securities and Exchange Commission, or a court.

(d) [Incorporation by reference.] A record filed under this [Act] or the predecessor act within five years preceding the filing of a registration statement may be incorporated by reference in the registration statement to the extent that the record is currently accurate.

(e) [Nonissuer distribution.] In the case of a nonissuer distribution, information or a record may not be required under subsection (i) or Section 304, unless it is known to the person filing the registration statement or to the person on whose behalf the distribution is to be made or unless it can be furnished by those persons without unreasonable effort or expense.

(f) [**Escrow and impoundment.**] A rule adopted or order issued under this [Act] may require as a condition of registration that a security issued within the previous five years or to be issued to a promoter for a consideration substantially less than the public offering price or to a person for a consideration other than cash be deposited in escrow; and that the proceeds from the sale of the registered security in this State be impounded until the issuer receives a specified amount from the sale of the security either in this State or elsewhere. The conditions of any escrow or impoundment required under this subsection may be established by rule adopted or order issued under this [Act], but the administrator may not reject a depository institution solely because of its location in another State.

(g) [Form of subscription.] A rule adopted or order issued under this [Act] may require as a condition of registration that a security registered under this [Act] be sold only on a specified form of subscription or sale contract and that a signed or conformed copy of each contract be filed under this [Act] or preserved for a period specified by the rule or order, which may not be longer than five years.

(h) [Effective period.] Except while a stop order is in effect under Section 306, a registration statement is effective for one year after its effective date, or for any longer period designated in an order under this [Act] during which the

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security is being offered or distributed in a nonexempted transaction by or for the account of the issuer or other person on whose behalf the offering is being made or by an underwriter or broker-dealer that is still offering part of an unsold allotment or subscription taken as a participant in the distribution. For the purposes of a nonissuer transaction, all outstanding securities of the same class identified in the registration statement as a security registered under this [Act] are considered to be registered while the registration statement is effective. If any securities of the same class are outstanding, a registration statement may not be withdrawn until one year after its effective date. A registration statement may be withdrawn only with the approval of the administrator.

(i) [Periodic reports.] While a registration statement is effective, a rule adopted or order issued under this [Act] may require the person that filed the registration statement to file reports, not more often than quarterly, to keep the information or other record in the registration statement reasonably current and to disclose the progress of the offering.

(j) [Posteffective amendments.] A registration statement may be amended after its effective date. The posteffective amendment becomes effective when the administrator so orders. If a posteffective amendment is made to increase the number of securities specified to be offered or sold, the person filing the amendment shall pay a registration fee of \$[_____]. A posteffective amendment relates back to the date of the offering of the additional securities being registered if, within one year after the date of the sale, the amendment is filed and the additional registration fee is paid.

Official Comments Prior Provisions: 1956 Act Section 305; RUSA Section 305.

1.

Section 305 generally follows the 1956 Act and RUSA except that earlier provisions in both Acts referring to Investment Company Act of 1940 securities, which are federal covered securities, see Section 102(7), have been deleted.

2.

Section 305 is applicable both to registration by coordination, see Section 303, and to registration by qualification, see Section 304.

3.

Section 305(a) expressly authorizes registration by "a person on whose behalf the offering is to be made." This would permit a nonissuer, cf. Section 102(18), or a broker-dealer to file a registration statement independent of the issuer.

4.

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This Act is intended, to the extent practicable, to be revenue neutral in its impact on existing state law, see Comment 3 to Section 608. Accordingly, Section 305(b) does not specify what fees states should provide. If a State prefers to have the fees in this section established by rule, replace the phrase "a fee of \$[_____]" in subsections (b) and (j) with the phrase "a fee established by the administrator by rule pursuant to the [state administrative procedure act]" and replace the phrase "\$[_____]" of the fee" in subsection (b) with the phrase "an amount of the fee established by the administrator by rule". See Comment 3 to Section 410.

5.

Section 305(c), which generally follows the 1956 Act and RUSA, does not require in Section 305(c)(3) disclosure of an order permitting the withdrawal of a registration statement. The administrator may, however, require disclosure of this information in a registration by qualification under Section 304(b)(18).

6.

Section 305(c), like every other provision concerned with the content of the registration statement, must be read with Section 306(a)(1) which judges the accuracy and completeness of the registration statement as of its effective date unless an order denying effectiveness had been entered before the effective date. A registration statement must be kept current with changing developments until the effectiveness date, but a registration statement is not required to be amended after the effective date except to correct inaccuracies or deficiencies which existed as of the effective date. An administrator, however, separately may require under Section 305(i) or (j) periodic reports or amendments to keep reasonably current the information contained in the registration statement.

7.

Under Section 305(d) incorporation by reference is permitted as a matter of administrative practice.

8.

Section 305(e) is the substantive equivalent to provisions in the 1956 Act and RUSA. This subsection is designed to address nonissuer offerings where the seller cannot obtain certified financial statements and other normally required records. The phrase "without unreasonable effort or expense" originated in Section 10(a)(3) of the Securities Act of 1933. It is not meant to apply to expenses incidental to supplying required information required for registration in the case of a nonissuer distribution by a person in a control relationship with the issuer or otherwise having access to or contractual rights to obtain the required information. Section 305(e) applies only to registration by qualification under Section 304 and periodic reports for either registration by coordination or registration by qualification under Section 305(i).

9.

Section 305(f), follows the 1956 Act and RUSA, and authorizes the administrator to require the impoundment of funds until the issuer receives a specified amount from the sale of the security in this State or elsewhere and to require

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the escrow of promotional stock until specific conditions are met. This Section is limited to a security issued within the past five years or to be issued to a promoter for a consideration substantially different from the public offering price or to a person for a consideration other than cash. The typical distribution subject to Section 305(f) will be a relatively new promotional or speculative offering. Section 305(f) follows the 1956 Act and RUSA and provides that the administrator may not reject a depository solely because of its location in another state. Unlike the statute in *Schwaemmle Const. Co. v. Michigan Dep't of Commerce*, 360 N.W.2d 141 (Mich. 1984), Section 305(f) broadly provides that the administrator "may determine the conditions of any escrow or impoundment under this subsection." As in *Schwaemmle*, this power will operate only until the impounded funds or escrowed shares are released.

10.

Section 305(g) follows the 1956 Act in authorizing the administrator to specify the form of a subscription or sale contract.

11.

Section 305(h) generally follows the 1956 Act and RUSA. The term "nonissuer transaction" or "nonissuer distribution" is defined in Section 102(18). A sale by a nonissuer would have to be registered under Section 301 unless it is exempted or involves a federal covered security. Section 202(1) exempts "isolated nonissuer transactions." When a nonissuer transaction is not exempt under Section 202(1), it may still be exempted under other transaction exemptions. If no exemption is available for a nonissuer distribution, and it does not involve a federal covered security, the security must be registered under Article 3. Under the first sentence of Section 305(h) each registration statement remains effective for at least one year and for any longer period the administrator may determine. However, no registration statement is effective while a stop order with respect to it is in effect under Section 306. For the purposes of a nonissuer transaction, all outstanding securities of the same class as a registered security are considered to be registered as long as the registration statement remains effective. This means that during the effective period of a registration statement under this Act all outstanding securities of the same class can be traded by anyone, including nonissuers, as if they were registered. Section 305(h) also provides that, unless the administrator determines otherwise, a registration statement cannot be withdrawn until one year after its effective date if any securities of the same class are outstanding. This is designed to protect sellers who would be unaware of a withdrawal from being subject to civil liability.

12.

Section 305(j) follows RUSA and a procedure limited to investment companies in the 1956 Act in allowing posteffective date amendments. Under Section 305(j), when a posteffective amendment increases the number of securities to be offered or sold, an additional registration fee is required.

§ 306. DENIAL, SUSPENSION, AND REVOCATION OF SECURITIES REGISTRATION.

(a) [Stop orders.] The administrator may issue a stop order denying effectiveness to, or suspending or revoking the effectiveness of, a registration statement if the administrator finds that the order is in the public interest and that:

(1)

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the registration statement as of its effective date or before the effective date in the case of an order denying effectiveness, an amendment under Section 305(j) as of its effective date, or a report under Section 305(i), is incomplete in a material respect or contains a statement that, in the light of the circumstances under which it was made, was false or misleading with respect to a material fact;

(2)

this [Act] or a rule adopted or order issued under this [Act] or a condition imposed under this [Act] has been willfully violated, in connection with the offering, by the person filing the registration statement; by the issuer, a partner, officer, or director of the issuer or a person having a similar status or performing a similar function; a promoter of the issuer; or a person directly or indirectly controlling or controlled by the issuer; but only if the person filing the registration statement is directly or indirectly controlled by or acting for the issuer; or by an underwriter;

(3)

the security registered or sought to be registered is the subject of a permanent or temporary injunction of a court of competent jurisdiction or an administrative stop order or similar order issued under any federal, foreign, or state law other than this [Act] applicable to the offering, but the administrator may not institute a proceeding against an effective registration statement under this paragraph more than one year after the date of the order or injunction on which it is based, and the administrator may not issue an order under this paragraph on the basis of an order or injunction issued under the securities act of another State unless the order or injunction was based on conduct that would constitute, as of the date of the order, a ground for a stop order under this section;

(4)

the issuer's enterprise or method of business includes or would include activities that are unlawful where performed;

(5)

with respect to a security sought to be registered under Section 303, there has been a failure to comply with the undertaking required by Section 303(b)(4);

(6)

the applicant or registrant has not paid the filing fee, but the administrator shall void the order if the deficiency is corrected; or

(7)

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the offering:

(A)

will work or tend to work a fraud upon purchasers or would so operate; [or]

(B)

has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, or promoters' profits or participations, or unreasonable amounts or kinds of options[; or

(C)

is being made on terms that are unfair, unjust, or inequitable].

(b) [Enforcement of subsection (a)(7).] To the extent practicable, the administrator by rule adopted or order issued under this [Act] shall publish standards that provide notice of conduct that violates subsection (a)(7).

(c) [Institution of stop order.] The administrator may not institute a stop order proceeding against an effective registration statement on the basis of conduct or a transaction known to the administrator when the registration statement became effective unless the proceeding is instituted within 30 days after the registration statement became effective.

(d) [Summary process.] The administrator may summarily revoke, deny, postpone, or suspend the effectiveness of a registration statement pending final determination of an administrative proceeding. Upon the issuance of the order, the administrator shall promptly notify each person specified in subsection (e) that the order has been issued, the reasons for the revocation, denial, postponement, or suspension, and that within 15 days after the receipt of a request in a record from the person the matter will be scheduled for a hearing. If a hearing is not requested and none is ordered by the administrator, within 30 days after the date of service of the order, the order becomes final. If a hearing is requested or ordered, the administrator, after notice of and opportunity for hearing for each person subject to the order, may modify or vacate the order or extend the order until final determination.

(e) [Procedural requirements for stop order.] A stop order may not be issued under this section without:

(1)

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appropriate notice to the applicant or registrant, the issuer, and the person on whose behalf the securities are to be or have been offered;

(2)

an opportunity for hearing; and

(3)

findings of fact and conclusions of law in a record [in accordance with the state administrative procedure act].

(f) [Modification or vacation of stop order.] The administrator may modify or vacate a stop order issued under this section if the administrator finds that the conditions that caused its issuance have changed or that it is necessary or appropriate in the public interest or for the protection of investors.

Official Comments Prior Provisions: 1956 Act Section 306; RUSA Section 306.

1.

This Section generally follows the 1956 Act and RUSA and applies to both registration by coordination under Section 303 and registration by qualification under Section 304.

2.

Section 306(a)(1) follows the 1956 Act and RUSA in testing in a suspension or revocation proceeding the completeness and accuracy of a registration statement as of the registration statement's effective date. A registration statement that becomes misleading because of a development that occurs after its effective date is not a ground for the issuance of a stop order under Section 306(a)(1). An administrator, however, may require periodic reports under Section 305(i) or a posteffective amendment under Section 305(j). With respect to periodic reports under Section 305(i), a misleading report would be the basis of a stop order under Section 306(a)(1) if it is materially inaccurate as of the date it was filed.

3.

On the meaning of "willfully," see Comment 2 under Section 508.

4.

A violation by an issuer has the same consequences whether the issuer has filed a registration statement or has had a broker-dealer file it. But this is not the case when the registration statement is filed by a broker-dealer acting independently.

5.

The verb "is" at the beginning of Section 306(a)(3) means that a stop order or injunction that has expired or been vacated is not the ground for action under this paragraph.

6.

Section 306(a)(4) applies to activity that is conducted in a State where that activity is illegal. It does not apply if the activity is not illegal under that State's law. This paragraph is not meant to apply to activity which is lawful where conducted but would be illegal if conducted in the State where the registration statement is filed.

7.

Sections 306(a)(5) and (6) follow the 1956 Act and RUSA.

8.

Sections 306(a)(7) and (b) address merit regulation. Sections 306(E) and (F) of the 1956 Act authorized a stop order when an "offering has worked or tended to work a fraud upon purchasers or would so operate" or "the offering has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, or promoters' profits or participation, or unreasonable amounts or kinds of options." By 1985 a majority of states which had adopted the 1956 Act had adopted this approach to merit regulation rather than the earlier and broader "unfair, unjust or inequitable" standard that then applied in a minority of States. RUSA Sections 306(a)(5) and (6) adopted provisions substantively identical to the 1956 Act and included in brackets an "unfair, unjust, or inequitable" alternative. The National Securities Markets Improvement Act of 1996 subsequently preempted merit regulation of federal covered securities. See Section 102(7). Sections 306(a)(7) and (b) take a different approach. Subject to the National Securities Markets Improvement Act of 1996, merit standards are retained but hortatory paragraph 306(b) encourages the administrator, to the extent practicable, to adopt, by rule or order, standards that provide notice to issuers of a state's merit standards. Notice will address one criticism of merit regulation. See generally 1 Louis Loss & Joel Seligman, *Securities Regulation* 111-124 (3d ed. rev. 1998). Statements of Policy of the North American Securities Administrator Association that have been adopted by a state would provide notice in compliance with Section 306(b). Similarly other state rules or orders could be adopted in the future to address new types of securities as they occur. An order under Section 306(b) can be adopted after a securities registration statement has been filed. Under Section 306(b) an administrator, by rule or order, for example, could adopt a standard that would provide the basis for a stop order denying effectiveness to a development stage company that has no specific business purpose or plan or has indicated that its primary business plan is to engage in a merger or acquisition with an unidentified company, entity, or person. "Blank check offerings" are subject to Rule 419 adopted under the Securities Act of 1933. See Comment 3 to Section 202.

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9.

Section 306(c) follows the 1956 Act and RUSA and allows an administrator up to 30 days after a registration statement becomes effective to institute a stop order proceeding on the basis of a fact or transaction known when the registration statement became effective. This is to avoid the necessity of an administrator issuing a stop order prematurely.

10.

Sections 306(d) and (e) assure each person subject to a stop order of notice, opportunity for a hearing, and findings of fact and conclusions of law contained in a record.

11.

An administrator must consider the public interest when issuing a stop order and may under Section 306(f) consider the public interest when modifying or vacating a stop order. See, e.g., *TechnoMedical Lab., Inc. v. Utah Sec. Div.*, 744 P.2d 320, 324-325 (Utah Ct. App. 1987) (a state has a valid public interest in stopping the issuance of hundreds of thousands of public shares that did not comply with the disclosure requirements of securities registration); cf. stop orders under the Securities Act of 1933, see 1 Louis Loss & Joel Seligman, *Securities Regulation* 576-589 (3d ed. rev. 1998).

12.

As of September 2002 46 jurisdictions had adopted a form of Section 306(a)(7)(A) ("will tend to work a fraud or would so operate"); 34 jurisdictions had adopted a form of Section 306(a)(7)(B) ("unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, or promoter profits or participations, or unreasonable amounts or kinds of options"); and 16 jurisdictions had adopted a form of bracketed Section 306(a)(7)(C) ("terms that are unfair, unjust, or inequitable").

§ 307. WAIVER AND MODIFICATION.

The administrator may waive or modify, in whole or in part, any or all of the requirements of Sections 302, 303, and 304(b) or the requirement of any information or record in a registration statement or in a periodic report filed pursuant to Section 305(i).

Official Comments

Prior Provision: RUSA Section 303(h). Section 307 follows RUSA Section 303(h) and empowers the administrator to waive or modify any of the requirements of 302, 303, 304(b), or the requirement of any information or record in a registration statement. An example would be the expedited procedure several states have adopted to coordinate with shelf registration under Rule 415 of the Securities Act of 1933. In waiving or modifying requirements the administrator must make a finding satisfying the requirements of Section 605(b).

§ 401. BROKER-DEALER REGISTRATION REQUIREMENT AND EXEMPTIONS.

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(a) [Registration requirement.] It is unlawful for a person to transact business in this State as a broker-dealer unless the person is registered under this [Act] as a broker-dealer or is exempt from registration as a broker-dealer under subsection (b) or (d).

(b) [Exemptions from registration.] The following persons are exempt from the registration requirement of subsection (a):

(1)

a broker-dealer without a place of business in this State if its only transactions effected in this State are with:

(A)

the issuer of the securities involved in the transactions;

(B)

a person registered as a broker-dealer under this [Act] or not required to be registered as a broker-dealer under this [Act];

(C)

an institutional investor;

(D)

a nonaffiliated federal covered investment adviser with investments under management in excess of \$100,000,000 acting for the account of others pursuant to discretionary authority in a signed record;

(E)

a bona fide preexisting customer whose principal place of residence is not in this State and the person is registered as a broker-dealer under the Securities Exchange Act of 1934 or not required to be registered under the Securities Exchange Act of 1934 and is registered under the securities act of the State in which the customer maintains a principal place of residence;

(F)

a bona fide preexisting customer whose principal place of residence is in this State but was not present in this State when the customer relationship was established, if:

(i)

the broker-dealer is registered under the Securities Exchange Act of 1934 or not required to be registered under the Securities Exchange Act of 1934 and is registered under the securities laws of the State in which the customer relationship was established and where the customer had maintained a principal place of residence; and

(ii)

within 45 days after the customer's first transaction in this State, the person files an application for registration as a broker-dealer in this State and a further transaction is not effected more than 75 days after the date on which the application is filed, or, if earlier, the date on which the administrator notifies the person that the administrator has denied the application for registration or has stayed the pendency of the application for good cause;

(G)

not more than three customers in this State during the previous 12 months, in addition to those customers specified in subparagraphs (A) through (F) and under subparagraph (H), if the broker-dealer is registered under the Securities Exchange Act of 1934 or not required to be registered under the Securities Exchange Act of 1934 and is registered under the securities act of the State in which the broker-dealer has its principal place of business; and

(H)

any other person exempted by rule adopted or order issued under this [Act]; and

(2)

a person that deals solely in United States government securities and is supervised as a dealer in government securities by the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, or the Office of Thrift Supervision.

(c) [Limits on employment or association.] It is unlawful for a broker-dealer, or for an issuer engaged in offering, offering to purchase, purchasing, or selling securities in this State, directly or indirectly, to employ or associate with an individual to engage in an activity related to securities transactions in this State if the registration of the individual is suspended or revoked or the individual is barred from employment or association with a broker-dealer, an issuer, an investment adviser, or a federal covered investment adviser by an order of the administrator under this [Act], the

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Securities and Exchange Commission, or a self-regulatory organization. A broker-dealer or issuer does not violate this subsection if the broker-dealer or issuer did not know and in the exercise of reasonable care could not have known, of the suspension, revocation, or bar. Upon request from a broker-dealer or issuer and for good cause, an order under this [Act] may modify or waive, in whole or in part, the application of the prohibitions of this subsection to the broker-dealer.

(d) [Foreign transactions.] A rule adopted or order issued under this [Act] may permit:

(1)

a broker-dealer that is registered in Canada or other foreign jurisdiction and that does not have a place of business in this State to effect transactions in securities with or for, or attempt to effect the purchase or sale of any securities by:

(A)

an individual from Canada or other foreign jurisdiction who is temporarily present in this State and with whom the broker-dealer had a bona fide customer relationship before the individual entered the United States;

(B)

an individual from Canada or other foreign jurisdiction who is present in this State and whose transactions are in a self-directed tax advantaged retirement plan of which the individual is the holder or contributor in that foreign jurisdiction; or

(C)

an individual who is present in this State, with whom the broker-dealer customer relationship arose while the individual was temporarily or permanently resident in Canada or the other foreign jurisdiction; and

(2)

an agent who represents a broker-dealer that is exempt under this subsection to effect transactions in securities or attempt to effect the purchase or sale of securities in this State as permitted for a broker-dealer described in paragraph (1).

Official Comments Prior Provisions: 1956 Act Section 201; RUSA Sections 201-202.

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1.

"Broker-dealer" is defined in Section 102(4). The scope of the Section 401(a) reference "to transact business in this State" is specified in Section 610. "Transacts a business" has been held to mean "more than a trivial or *de minimis* business." *United States v. Schwartz*, 464 F.2d 499, 506 (2d Cir. 1972), *cert. denied*, 409 U.S. 1009 (1972).

2.

Under Section 401(a) a person can be required to register as a securities broker-dealer only if the person transacts business in securities. See, e.g., *AMR Realty Co. v. State*, 373 A.2d 1002 (N.J. Supr. Ct. App. Div. 1977) (requirement that the transactions involve securities).

3.

"Bona fide" is a much construed term particularly in the U.C.C. context. See, e.g., *MCC Proceeds, Inc. v. Advest, Inc.*, 743 N.Y.S.2d 1 (N.Y. A.D. 2002) (comparing bona fide to good faith standard).

4.

Section 401(b)(1)(D) was added to provide relief in situations where a broker-dealer is accepting orders from a sophisticated financial professional who is making the investment decisions for its customers.

5.

Under 401(b)(1)(E) and (F) preexisting customers must be bona fide. A principal place of residence, for example, normally would be the residence where the customer spends a majority of time. These exemptions were intended to facilitate ongoing broker-customer relationships with customers who have established a second or other residence for such purposes as a winter home (i.e. "snowbirds").

6.

Section 401(c) prohibits a broker-dealer or issuer from employing or associating with an individual in a capacity for which that individual has been suspended by the administrator. Violation of this provision does not result in strict liability. In order for a broker-dealer or issuer to be liable, the broker-dealer or issuer must have known or should have known of the administrator's order to the individual suspended or barred. Cf. Comment 17 to Section 412.

7.

Section 401(d) recognizes the increasingly transnational nature of securities brokerage and permits, if the administrator adopts a rule or order, transactions by a Canadian or a foreign broker-dealer with a person from Canada or

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other foreign jurisdiction who is resident in this State. This subsection is not self-executing and is effective only if the administrator adopts a rule or order.

8.

To give effect to action taken by rule or order under Section 401(d), there must be a transaction registration exemption that will enable securities transactions to take place in customer accounts involving the broker-dealers and agents contemplated in Section 401(d). See Sections 202 and 203.

§ 402. AGENT REGISTRATION REQUIREMENT AND EXEMPTIONS.

(a) [Registration requirement.] It is unlawful for an individual to transact business in this State as an agent unless the individual is registered under this [Act] as an agent or is exempt from registration as an agent under subsection (b).

(b) [Exemptions from registration.] The following individuals are exempt from the registration requirement of subsection (a):

(1)

an individual who represents a broker-dealer in effecting transactions in this State limited to those described in Section 15(h)(2) of the Securities Exchange Act of 1934 (15 U.S.C. Section 78(o)(2));

(2)

an individual who represents a broker-dealer that is exempt under Section 401(b) or (d);

(3)

an individual who represents an issuer with respect to an offer or sale of the issuer's own securities or those of the issuer's parent or any of the issuer's subsidiaries, and who is not compensated in connection with the individual's participation by the payment of commissions or other remuneration based, directly or indirectly, on transactions in those securities;

(4)

an individual who represents an issuer and who effects transactions in the issuer's securities exempted by Section 202, other than Section 202(11) and (14);

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(5)

an individual who represents an issuer that effects transactions solely in federal covered securities of the issuer, but an individual who effects transactions in a federal covered security under Section 18(b)(3) or 18(b)(4)(D) of the Securities Act of 1933 (*15 U.S.C. Section 77r(b)(3) or 77r(b)(4)(D)*) is not exempt if the individual is compensated in connection with the agent's participation by the payment of commissions or other remuneration based, directly or indirectly, on transactions in those securities;

(6)

an individual who represents a broker-dealer registered in this State under Section 401(a) or exempt from registration under Section 401(b) in the offer and sale of securities for an account of a nonaffiliated federal covered investment adviser with investments under management in excess of \$100,000,000 acting for the account of others pursuant to discretionary authority in a signed record;

(7)

an individual who represents an issuer in connection with the purchase of the issuer's own securities;

(8)

an individual who represents an issuer and who restricts participation to performing clerical or ministerial acts; or

(9)

any other individual exempted by rule adopted or order issued under this [Act].

(c) [Registration effective only while employed or associated.] The registration of an agent is effective only while the agent is employed by or associated with a broker-dealer registered under this [Act] or an issuer that is offering, selling, or purchasing its securities in this State.

(d) [Limit on employment or association.] It is unlawful for a broker-dealer, or an issuer engaged in offering, selling, or purchasing securities in this State, to employ or associate with an agent who transacts business in this State on behalf of broker-dealers or issuers unless the agent is registered under subsection (a) or exempt from registration under subsection (b).

(e) [Limit on affiliations.] An individual may not act as an agent for more than one broker-dealer or one issuer at a time, unless the broker-dealer or the issuer for which the agent acts are affiliated by direct or indirect common control or

are authorized by rule or order under this [Act].

Official Comments Prior Provisions: RUSA Sections 201-202.

1.

"Agent" is defined in Section 102(2). The scope of the Section 402(a) reference to "transact business in this State" is specified in Section 610. An administrator may by rule or order take action under Section 401(d)(2) to address an agent.

2.

An independent contractor must be either a broker-dealer or an agent if the individual transacts business as a broker-dealer or agent. There is no other status permitted under this Act for securities activities.

3.

A broker-dealer in violation of Section 402(a) may be disciplined under Section 412 and be subject to a civil or administrative enforcement action under Section 603 or 604.

4.

Under Sections 402(b)(3) and (5) an agent may be exempt if acting for an issuer and receiving compensation (for example, as a corporate executive), as long as the compensation is not a commission or other remuneration based on transactions in the issuer's own securities. Such an agent could receive a salary with conventional benefits, including an annual bonus (related to his or her performance) as an executive, and still be within this exemption unless the agent is also being compensated directly or indirectly for participation in the specified securities transactions.

5.

Section 402(b)(6) was added to provide relief in situations where an agent is accepting orders from a sophisticated financial professional who is making the investment decisions for its customers.

6.

Ministerial or clerical acts in Section 402(b)(8) might include preparing routine written communications or responding to inquiries.

7.

Section 402(e) limits agents to a single employment or affiliation unless a rule or order of the administrator authorizes multiple affiliations. In any event an agent must be registered, see Section 402(a), or exempt from registration, see Section 402(b). Registration is effective only while an agent is employed by or associated with a broker-dealer or an issuer. See Section 402(c).

§ 403. INVESTMENT ADVISER REGISTRATION REQUIREMENT AND EXEMPTIONS.

(a) [Registration requirement.] It is unlawful for a person to transact business in this State as an investment adviser unless the person is registered under this [Act] as an investment adviser or is exempt from registration as an investment adviser under subsection (b).

(b) [Exemptions from registration.] The following persons are exempt from the registration requirement of subsection (a):

(1)

a person without a place of business in this State that is registered under the securities act of the State in which the person has its principal place of business if its only clients in this State are:

(A)

federal covered investment advisers, investment advisers registered under this [Act], or broker-dealers registered under this [Act];

(B)

institutional investors;

(C)

bona fide preexisting clients whose principal places of residence are not in this State if the investment adviser is registered under the securities act of the State in which the clients maintain principal places of residence; or

(D)

any other client exempted by rule adopted or order issued under this [Act];

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(2)

a person without a place of business in this State if the person has had, during the preceding 12 months, not more than five clients that are resident in this State in addition to those specified under paragraph (1); or

(3)

any other person exempted by rule adopted or order issued under this [Act].

(c) [Limits on employment or association.] It is unlawful for an investment adviser, directly or indirectly, to employ or associate with an individual to engage in an activity related to investment advice in this State if the registration of the individual is suspended or revoked or the individual is barred from employment or association with an investment adviser, federal covered investment adviser, or broker-dealer by an order under this [Act], the Securities and Exchange Commission, or a self-regulatory organization, unless the investment adviser did not know, and in the exercise of reasonable care could not have known, of the suspension, revocation, or bar. Upon request from the investment adviser and for good cause, the administrator, by order, may waive, in whole or in part, the application of the prohibitions of this subsection to the investment adviser.

(d) [Investment adviser representative registration required.] It is unlawful for an investment adviser to employ or associate with an individual required to be registered under this [Act] as an investment adviser representative who transacts business in this State on behalf of the investment adviser unless the individual is registered under Section 404(a) or is exempt from registration under Section 404(b).

Official Comments Prior Provisions: 1956 Act Section 201; RUSA Sections 203-204.

1.

"Investment adviser" is defined in Section 102(15). The scope of the Section 403(a) reference to "transact business in this State" is specified in Section 610.

2.

Excluded from the definition of investment adviser in Section 102(15)(C) is a broker-dealer who receives no special compensation for investment advisory services. Such a broker-dealer would not have to register as both a broker-dealer and investment adviser in this State. A broker-dealer that does receive special compensation, on the other hand, would also meet the statutory definition of investment adviser and would be required to register in both capacities.

3.

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Section 403(b)(2) is consistent with the National Securities Markets Improvement Act of 1996 which prohibits a State from regulating an investment adviser that does not have a place of business in this State and had fewer than six clients who were state residents during the preceding 12 months.

4.

Section 403(c) prohibits an investment adviser from employing an individual who is prohibited from such employment or association by the administrator. Violation of this provision does not result in strict liability. To be liable the investment adviser must have known or should have known of the administrator's order to the individual suspended or barred.

§ 404. INVESTMENT ADVISER REPRESENTATIVE REGISTRATION REQUIREMENT AND EXEMPTIONS.

(a) [Registration requirement.] It is unlawful for an individual to transact business in this State as an investment adviser representative unless the individual is registered under this [Act] as an investment adviser representative or is exempt from registration as an investment adviser under subsection (b).

(b) [Exemptions from registration.] The following individuals are exempt from the registration requirement of subsection (a):

(1)

an individual who is employed by or associated with an investment adviser that is exempt from registration under Section 403(b) or a federal covered investment adviser that is excluded from the notice filing requirements of Section 405; and

(2)

any other individual exempted by rule adopted or order issued under this [Act].

(c) [Registration effective only while employed or associated.] The registration of an investment adviser representative is not effective while the investment adviser representative is not employed by or associated with an investment adviser registered under this [Act] or a federal covered investment adviser that has made or is required to make a notice filing under Section 405.

(d) [Limit on affiliations.] An individual may transact business as an investment adviser representative for more than one investment adviser or federal covered investment adviser unless a rule adopted or order issued under this [Act] prohibits or limits an individual from acting as an investment adviser representative for more than one investment adviser or federal covered investment adviser.

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(e) [Limits on employment or association.] It is unlawful for an individual acting as an investment adviser representative, directly or indirectly, to conduct business in this State on behalf of an investment adviser or a federal covered investment adviser if the registration of the individual as an investment adviser representative is suspended or revoked or the individual is barred from employment or association with an investment adviser or a federal covered investment adviser by an order under this [Act], the Securities and Exchange Commission, or a self-regulatory organization. Upon request from a federal covered investment adviser and for good cause, the administrator, by order issued, may waive, in whole or in part, the application of the requirements of this subsection to the federal covered investment adviser.

(f) [Referral fees.] An investment adviser registered under this [Act], a federal covered investment adviser that has filed a notice under Section 405, or a broker-dealer registered under this [Act] is not required to employ or associate with an individual as an investment adviser representative if the only compensation paid to the individual for a referral of investment advisory clients is paid to an investment adviser registered under this [Act], a federal covered investment adviser who has filed a notice under Section 405, or a broker-dealer registered under this [Act] with which the individual is employed or associated as an investment adviser representative.

Official Comments No Prior Provision.

1.

"Investment adviser representative" is defined in Section 102(16). The scope of the Section 404(a) reference to "transacts business in this State" is specified in Section 610.

2.

Neither the 1956 Act nor RUSA provided for the registration of investment adviser representatives. In recent years, however, the states increasingly have done so.

3.

Under this Act a sole practitioner may register as an investment adviser. See Section 403. The Investment Adviser Registration Depository currently provides for entry of the legal name of the individual as the investment adviser and the entry of any name the individual is doing business under that is different from the individual's name. A sole practitioner is not required to register under Section 404 as an investment adviser representative, unless the administrator requires such registration.

4.

Section 404(e) prohibits an investment adviser representative from association with a federal covered investment adviser when such association is prohibited by an order of the administrator. Unlike similar provisions in Sections 401

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and 403, there is no culpability requirement that the investment adviser representative "knows or in the exercise of reasonable care should have known" of a suspension or bar because the order should be received by the investment adviser representative. As with Sections 401 and 403, the administrator may waive this prohibition. Cf. Comment 17 to Section 412.

5.

The administrator may adopt rules or orders under Section 404(f) in accordance with Section 605. The Securities and Exchange Commission has adopted a rule that addresses referral fees in Rule 206(4)-3 of the Investment Advisers Act of 1940.

6.

For a state that intends to extend Section 404(f) to those broker-dealers and investment advisers who are not required to register and those federal covered investment advisers not required to file a notice, this subsection should read:

(f) **[Referral Fees.]** An investment adviser registered under this [Act], a federal covered investment adviser that has filed a notice under Section 405, or a broker-dealer registered under this [Act] is not required to employ or associate with an individual as an investment adviser representative if the only compensation paid to the individual for a referral of investment advisory clients is paid to an investment adviser registered under this [Act], or not required to register under this [Act], a federal covered investment who has filed a notice under Section 405 or is not required to file a notice under Section 405, or a broker-dealer registered under this [Act] or not required to register under this [Act] with which the individual is employed or associated as an investment adviser representative.

§ 405. FEDERAL COVERED INVESTMENT ADVISER NOTICE FILING REQUIREMENT.

(a) [Notice filing requirement.] Except with respect to a federal covered investment adviser described in subsection (b), it is unlawful for a federal covered investment adviser to transact business in this State as a federal covered investment adviser unless the federal covered investment adviser complies with subsection (c).

(b) [Notice filing requirement not required.] The following federal covered investment advisers are not required to comply with subsection (c):

(1)

a federal covered investment adviser without a place of business in this State if its only clients in this State are:

(A)

federal covered investment advisers, investment advisers registered under this [Act], and broker-dealers

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registered under this [Act];

(B)

institutional investors;

(C)

bona fide preexisting clients whose principal places of residence are not in this State; or

(D)

other clients specified by rule adopted or order issued under this [Act];

(2)

a federal covered investment adviser without a place of business in this State if the person has had, during the preceding 12 months, not more than five clients that are resident in this State in addition to those specified under paragraph (1); and

(3)

any other person excluded by rule adopted or order issued under this [Act].

(c) [Notice filing procedure.] A person acting as a federal covered investment adviser, not excluded under subsection (b), shall file a notice, a consent to service of process complying with Section 611, and such records as have been filed with the Securities and Exchange Commission under the Investment Advisers Act of 1940 required by rule adopted or order issued under this [Act] and pay the fees specified in Section 410(e).

(d) [Effectiveness of filing.] The notice under subsection (c) becomes effective upon its filing.

Official Comments No Prior Provision.

1.

"Federal covered investment adviser" is defined in Section 102(6). The scope of the Section 405(a) reference to "transacts business in this State" is specified in Section 610.

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2.

Section 405(b)(2) is necessitated by the National Securities Markets Improvement Act of 1996 and is intended to coordinate this Act with the Investment Advisers Act of 1940.

3.

Section 404(c) provides limits on those who can be employed by or associated with a federal covered investment adviser.

4.

The succession provision of Section 407(a) is available to a federal covered investment adviser who has filed a notice under Section 405.

§ 406. REGISTRATION BY BROKER-DEALER, AGENT, INVESTMENT ADVISER, AND INVESTMENT ADVISER REPRESENTATIVE.

(a) [Application for initial registration.] A person shall register as a broker-dealer, agent, investment adviser, or investment adviser representative by filing an application and a consent to service of process complying with Section 611, and paying the fee specified in Section 410 and any reasonable fees charged by the designee of the administrator for processing the filing. The application must contain:

(1)

the information or record required for the filing of a uniform application; and

(2)

upon request by the administrator, any other financial or other information or record that the administrator determines is appropriate.

(b) [Amendment.] If the information or record contained in an application filed under subsection (a) is or becomes inaccurate or incomplete in a material respect, the registrant shall promptly file a correcting amendment.

(c) [Effectiveness of registration.] If an order is not in effect and a proceeding is not pending under Section 412, registration becomes effective at noon on the 45th day after a completed application is filed, unless the registration is denied. A rule adopted or order issued under this [Act] may set an earlier effective date or may defer the effective date

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until noon on the 45th day after the filing of any amendment completing the application.

(d) [Registration renewal.] A registration is effective until midnight on December 31 of the year for which the application for registration is filed. Unless an order is in effect under Section 412, a registration may be automatically renewed each year by filing such records as are required by rule adopted or order issued under this [Act], by paying the fee specified in Section 410, and by paying costs charged by the designee of the administrator for processing the filings.

(e) [Additional conditions or waivers.] A rule adopted or order issued under this [Act] may impose such other conditions, not inconsistent with the National Securities Markets Improvement Act of 1996. An order issued under this [Act] may waive, in whole or in part, specific requirements in connection with registration as are in the public interest and for the protection of investors.

Official Comments Prior Provisions: 1956 Act Section 202; RUSA Sections 205, 208.

1.

Under Section 406(a), the administrator is authorized to accept standardized forms such as Form B-D for broker-dealers; Form U-4 for agents and investment adviser representatives; and Form ADV for investment advisers, which are filed today through such designees as the Web-CRD or the Investment Adviser Registration Depository (IARD). While this Act generally encourages uniformity, Sections 406(a) and (e) are intended to give the administrator authority to augment or waive disclosure requirements in appropriate cases.

2.

Section 406(a) eliminates the listing of specified information delineated in Section 202 of the 1956 Act. As with RUSA Section 205, the intent is to facilitate coordination with widely used standardized forms.

3.

Under this Act a single person may act both as an agent and investment adviser representative if the person satisfies applicable registration requirements to be both an agent and investment adviser representative.

§ 407. SUCCESSION AND CHANGE IN REGISTRATION OF BROKER-DEALER OR INVESTMENT ADVISER.

(a) [Succession.] A broker-dealer or investment adviser may succeed to the current registration of another broker-dealer or investment adviser or a notice filing of a federal covered investment adviser, and a federal covered investment adviser may succeed to the current registration of an investment adviser or notice filing of another federal covered investment adviser, by filing as a successor an application for registration pursuant to Section 401 or 403 or a notice pursuant to Section 405 for the unexpired portion of the current registration or notice filing.

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(b) [Organizational change.] A broker-dealer or investment adviser that changes its form of organization or State of incorporation or organization may continue its registration by filing an amendment to its registration if the change does not involve a material change in its financial condition or management. The amendment becomes effective when filed or on a date designated by the registrant in its filing. The new organization is a successor to the original registrant for the purposes of this [Act]. If there is a material change in financial condition or management, the broker-dealer or investment adviser shall file a new application for registration. A predecessor registered under this [Act] shall stop conducting its securities business other than winding down transactions and shall file for withdrawal of broker-dealer or investment adviser registration within 45 days after filing its amendment to effect succession.

(c) [Name change.] A broker-dealer or investment adviser that changes its name may continue its registration by filing an amendment to its registration. The amendment becomes effective when filed or on a date designated by the registrant.

(d) [Change of control.] A change of control of a broker-dealer or investment adviser may be made in accordance with a rule adopted or order issued under this [Act].

Official Comments Prior Provisions: 1956 Act Section 202(c); RUSA 210.

1.

Section 407 is intended to avoid unnecessary interruptions of business by specifying procedures for a successor broker-dealer or investment adviser; a broker-dealer or investment adviser to maintain its registration if it changes its form of organization or name; or, in accordance with a rule or order adopted under this Act, a change of control of a broker-dealer or investment adviser.

2.

There is no filing fee under Section 407.

§ 408. TERMINATION OF EMPLOYMENT OR ASSOCIATION OF AGENT AND INVESTMENT ADVISER REPRESENTATIVE AND TRANSFER OF EMPLOYMENT OR ASSOCIATION.

(a) [Notice of termination.] If an agent registered under this [Act] terminates employment by or association with a broker-dealer or issuer, or if an investment adviser representative registered under this [Act] terminates employment by or association with an investment adviser or federal covered investment adviser, or if either registrant terminates activities that require registration as an agent or investment adviser representative, the broker-dealer, issuer, investment adviser, or federal covered investment adviser shall promptly file a notice of termination. If the registrant learns that the broker-dealer, issuer, investment adviser, or federal covered investment adviser has not filed the notice, the registrant may do so.

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(b) [Transfer of employment or association.] If an agent registered under this [Act] terminates employment by or association with a broker-dealer registered under this [Act] and begins employment by or association with another broker-dealer registered under this [Act]; or if an investment adviser representative registered under this [Act] terminates employment by or association with an investment adviser registered under this [Act] or a federal covered investment adviser that has filed a notice under Section 405 and begins employment by or association with another investment adviser registered under this [Act] or a federal covered investment adviser that has filed a notice under Section 405; then upon the filing by or on behalf of the registrant, within 30 days after the termination, of an application for registration that complies with the requirement of Section 406(a) and payment of the filing fee required under Section 410, the registration of the agent or investment adviser representative is:

(1)

immediately effective as of the date of the completed filing, if the agent's Central Registration Depository record or successor record or the investment adviser representative's Investment Adviser Registration Depository record or successor record does not contain a new or amended disciplinary disclosure within the previous 12 months; or

(2)

temporarily effective as of the date of the completed filing, if the agent's Central Registration Depository record or successor record or the investment adviser representative's Investment Adviser Registration Depository record or successor record contains a new or amended disciplinary disclosure within the preceding 12 months.

(c) [Withdrawal of temporary registration.] The administrator may withdraw a temporary registration if there are or were grounds for discipline as specified in Section 412 and the administrator does so within 30 days after the filing of the application. If the administrator does not withdraw the temporary registration within the 30 day period, registration becomes automatically effective on the 31st day after filing.

(d) [Power to prevent registration.] The administrator may prevent the effectiveness of a transfer of an agent or investment adviser representative under subsection (b)(1) or (2) based on the public interest and the protection of investors.

(e) [Termination of registration or application for registration.] If the administrator determines that a registrant or applicant for registration is no longer in existence or has ceased to act as a broker-dealer, agent, investment adviser, or investment adviser representative, or is the subject of an adjudication of incapacity or is subject to the control of a committee, conservator, or guardian, or cannot reasonably be located, a rule adopted or order issued under this [Act] may require the registration be canceled or terminated or the application denied. The administrator may reinstate a canceled or terminated registration, with or without hearing, and may make the registration retroactive.

Official Comments Prior Provision: 1956 Act Section 204(d).

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1.

Under Sections 402(c) and 404(c) registration of an agent or investment adviser representative is effective only while the agent or investment adviser representative is employed by or associated with a broker-dealer, issuer, or investment adviser, as may be the case. Section 408(a) specifies a procedure to inform the administrator of a notice of termination.

2.

To expedite transfer to a new broker-dealer or investment adviser, Section 408(b) provides a procedure by which agents or investment adviser representative registration will be effective immediately as of the date of new employment when there is no new or added disciplinary disclosure in the relevant Central Research Depository or Investment Adviser Registration Depository records. Both electronic systems are currently administered by the National Association of Securities Dealers. Section 408(d) is intended to ensure that the administrator has the authority to prevent immediate effectiveness in appropriate cases.

§ 409. WITHDRAWAL OF REGISTRATION OF BROKER-DEALER, AGENT, INVESTMENT ADVISER, AND INVESTMENT ADVISER REPRESENTATIVE.

Withdrawal of registration by a broker-dealer, agent, investment adviser, or investment adviser representative becomes effective 60 days after the filing of the application to withdraw or within any shorter period as provided by rule adopted or order issued under this [Act] unless a revocation or suspension proceeding is pending when the application is filed. If a proceeding is pending, withdrawal becomes effective when and upon such conditions as required by rule adopted or order issued under this [Act]. The administrator may institute a revocation or suspension proceeding under Section 412 within one year after the withdrawal became effective automatically and issue a revocation or suspension order as of the last date on which registration was effective if a proceeding is not pending.

Official Comments

Prior Provisions: 1956 Act Section 204(e); RUSA Section 214

1.

This section generally follows the 1956 Act Section 204(e) and RUSA Section 214. This section does not affect any applicant's privilege of withdrawal of an application from registration before the registration becomes effective. It is simply designed to prevent withdrawal of an effective registration under fire. The last sentence preserves the ability of the administrator to initiate an action under Section 412 when the administrator does not know of a reason to object to withdrawal until after withdrawal has become effective.

2.

Ordinarily today a registrant will file a standardized form such as Form U-5, BD-W or ADV-W to withdraw registration.

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§ 410. FILING FEES.

(a) [Broker-dealers.] A person shall pay a fee of \$[] when initially filing an application for registration as a broker-dealer and a fee of \$[] when filing a renewal of registration as a broker-dealer. If the filing results in a denial or withdrawal, the administrator shall retain \$[] of the fee.

(b) [Agents.] The fee for an individual is \$[] when filing an application for registration as an agent, a fee of \$[] when filing a renewal of registration as an agent, and a fee of \$[] when filing for a change of registration as an agent. If the filing results in a denial or withdrawal, the administrator shall retain \$[] of the fee.

(c) [Investment advisers.] A person shall pay a fee of \$[] when filing an application for registration as an investment adviser and a fee of \$[] when filing a renewal of registration as an investment adviser. If the filing results in a denial or withdrawal, the administrator shall retain \$[] of the fee.

(d) [Investment adviser representatives.] The fee for an individual is \$[] when filing an application for registration as an investment adviser representative, a fee of \$[] when filing a renewal of registration as an investment adviser representative, and a fee of \$[] when filing a change of registration as an investment adviser representative. If the filing results in a denial or withdrawal, the administrator shall retain \$[] of the fee.

(e) [Federal covered investment advisers.] A federal covered investment adviser required to file a notice under Section 405 shall pay an initial fee of \$[] and an annual notice fee of \$[].

(f) [Payment.] A person required to pay a filing or notice fee under this section may transmit the fee through or to a designee as a rule or order provides under this [Act].

[(g) [Dual agent/investment adviser representative.] An investment adviser representative who is registered as an agent under Section 402 and who represents a person that is both registered as a broker-dealer under Section 401 and registered as an investment adviser under Section 403 or required as a federal covered investment adviser to make a notice filing under Section 405 is not required to pay an initial or annual registration fee for registration as an investment adviser representative.]

Official Comments Prior Provisions: 1956 Act Section 202(b); RUSA Section 206.

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1.

Each state should determine the appropriate fee for each type of registration and for each type of renewal, denial, or withdrawal of a registration.

2.

Similarly each state should determine whether it wishes to remove the brackets from Section 410(g) and charge a single fee for dually registered agents and investment adviser representatives.

3.

If a State prefers to have the fees in this section established by rule, amend this section to read as follows, inserting the appropriate reference to the State's administrative procedure act:

[SECTION 410. FILING FEES.]

(a) **[Fee established by administrator.]** The administrator shall establish fees by rule pursuant to the [state administrative procedure act] for:

(1) an initial filing of an application as a broker-dealer and renewal of an application by a broker-dealer for registration, but, if the filing results in a denial or withdrawal, the administrator shall retain an amount of the fee established by the administrator;

(2) an application for registration as an agent and renewal of registration as an agent, but, if the filing results in a denial or withdrawal, the administrator shall retain an amount of the fee established by the administrator;

(3) an application for registration as an investment adviser and renewal of registration as an investment adviser, but, if the filing results in a denial or withdrawal, the administrator shall retain an amount of the fee established by the administrator.

(4) an application for registration as an investment adviser representative, a renewal of registration as an investment adviser representative, and a change of registration as an investment adviser representative, but, if the filing results in a denial or withdrawal, the administrator shall retain an amount of the fee established by the administrator; and

(5) an initial fee and annual notice fee for a federal covered investment adviser required to file a notice under Section 405.

(b) **[Payment.]** A person required to pay a filing or notice fee under this section may transmit the fee through or to a designee as a rule or order provides under this [Act].

(c) **[Dual agent/investment adviser representative.]** An investment adviser representative who is registered as an agent under Section 402 and who represents a person that is both registered as a broker-dealer under Section 401 and registered as an investment adviser under Section 403 or required as a federal covered investment adviser to make a notice filing under Section 405 is not required to pay an initial or annual registration fee for registration as an investment adviser representative.]

§ 411. POSTREGISTRATION REQUIREMENTS.

(a) [Financial requirements.] Subject to Section 15(h) of the Securities Exchange Act of 1934 (*15 U.S.C. Section 78o(h)*) or Section 222 of the Investment Advisers Act of 1940 (15 U.S.C. Section 80b-22), a rule adopted or order issued under this [Act] may establish minimum financial requirements for broker-dealers registered or required to be registered under this [Act] and investment advisers registered or required to be registered under this [Act].

(b) [Financial reports.] Subject to Section 15(h) of the Securities Exchange Act of 1934 (*15 U.S.C. Section 78o(h)*) or Section 222(b) of the Investment Advisers Act of 1940 (15 U.S.C. Section 80b-22), a broker-dealer registered or required to be registered under this [Act] and an investment adviser registered or required to be registered under this [Act] shall file such financial reports as are required by a rule adopted or order issued under this [Act]. If the information contained in a record filed under this subsection is or becomes inaccurate or incomplete in a material respect, the registrant shall promptly file a correcting amendment.

(c) [Recordkeeping.] Subject to Section 15(h) of the Securities Exchange Act of 1934 (*15 U.S.C. Section 78o(h)*) or Section 222 of the Investment Advisers Act of 1940 (15 U.S.C. Section 80b-22):

(1)

a broker-dealer registered or required to be registered under this [Act] and an investment adviser registered or required to be registered under this [Act] shall make and maintain the accounts, correspondence, memoranda, papers, books, and other records required by rule adopted or order issued under this [Act];

(2)

broker-dealer records required to be maintained under paragraph (1) may be maintained in any form of data storage acceptable under Section 17(a) of the Securities Exchange Act of 1934 (*15 U.S.C. Section 78q(a)*) if they are readily accessible to the administrator; and

(3)

investment adviser records required to be maintained under paragraph (1) may be maintained in any form of data storage required by rule adopted or order issued under this [Act].

(d) [Audits or inspections.] The records of a broker-dealer registered or required to be registered under this [Act] and of an investment adviser registered or required to be registered under this [Act] are subject to such reasonable periodic, special, or other audits or inspections by a representative of the administrator, within or without this State, as the administrator considers necessary or appropriate in the public interest and for the protection of investors. An audit or inspection may be made at any time and without prior notice. The administrator may copy, and remove for audit or

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inspection copies of, all records the administrator reasonably considers necessary or appropriate to conduct the audit or inspection. The administrator may assess a reasonable charge for conducting an audit or inspection under this subsection.

(e) [Custody and discretionary authority bond or insurance.] Subject to Section 15(h) of the Securities Exchange Act of 1934 (*15 U.S.C. Section 78o(h)*) or Section 222 of the Investment Advisers Act of 1940 (*15 U.S.C. Section 80b-22*), a rule adopted or order issued under this [Act] may require a broker-dealer or investment adviser that has custody of or discretionary authority over funds or securities of a customer or client to obtain insurance or post a bond or other satisfactory form of security in an amount not to exceed \$[_____]. The administrator may determine the requirements of the insurance, bond, or other satisfactory form of security. Insurance or a bond or other satisfactory form of security may not be required of a broker-dealer registered under this [Act] whose net capital exceeds, or of an investment adviser registered under this [Act] whose minimum financial requirements exceed, the amounts required by rule or order under this [Act]. The insurance, bond, or other satisfactory form of security must permit an action by a person to enforce any liability on the insurance, bond, or other satisfactory form of security if instituted within the time limitations in Section 509(j)(2).

(f) [Requirements for custody.] Subject to Section 15(h) of the Securities Exchange Act of 1934 (*15 U.S.C. Section 78o(h)*) or Section 222 of the Investment Advisers Act of 1940 (*15 U.S.C. Section 80b-22*), an agent may not have custody of funds or securities of a customer except under the supervision of a broker-dealer and an investment adviser representative may not have custody of funds or securities of a client except under the supervision of an investment adviser or a federal covered investment adviser. A rule adopted or order issued under this [Act] may prohibit, limit, or impose conditions on a broker-dealer regarding custody of funds or securities of a customer and on an investment adviser regarding custody of securities or funds of a client.

(g) [Investment adviser brochure rule.] With respect to an investment adviser registered or required to be registered under this [Act], a rule adopted or order issued under this [Act] may require that information or other record be furnished or disseminated to clients or prospective clients in this State as necessary or appropriate in the public interest and for the protection of investors and advisory clients.

(h) [Continuing education.] A rule adopted or order issued under this [Act] may require an individual registered under Section 402 or 404 to participate in a continuing education program approved by the Securities and Exchange Commission and administered by a self-regulatory organization or, in the absence of such a program, a rule adopted or order issued under this [Act] may require continuing education for an individual registered under Section 404.

Official Comments Prior Provisions: 1956 Act Sections 102(c), 202(d) and (e) and 203; RUSA Sections 209, 211 and 215.

1.

Sections 411(a) through (c) and (e) through (f) implicitly refer to "capital, custody, margin, financial responsibility, making and keeping records, bonding, or financial or operational reporting requirements." Under the

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National Securities Markets Improvement Act of 1996, States may not impose such requirements on covered broker-dealers and investment advisers greater than those specified in Section 15(h) of the Securities Exchange Act of 1934 and Section 222 of the Investment Advisors Act of 1940.

2.

Minimum financial requirements must be maintained during the entire time a person is registered and not merely at the time of the registration. See, e.g., *National Grange Mut. Ins. Co. v. Prioleau*, 236 S.E.2d 808 (S.C. 1977) (continuing bond requirement); *Ridgeway, McLeod & Assoc.*, 281 A.2d 390 (N.J. Super. Ct. App. Div. 1971) (continuing minimum capital requirement).

3.

The duty in Section 411(b) to correct or update information is limited to material information which a reasonable investor would continue to consider important in deciding whether to purchase or sell securities. Cf. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 444-450 (1970); Securities Act Release No. 6084, 17 SEC Dock. 1048, 1054 (1979) ("persons are continuing to rely on all or any material portion of the statements").

4.

Section 411(c)(1) authorizes the administrator to require all records to be preserved for the period the administrator prescribes by rule or order.

5.

Rule 17a-4 is the current rule under Section 17(a) of the Securities Exchange Act referred to in Section 411(c)(2) that addresses acceptable forms of data storage.

6.

The administrator's power to copy and examine records in Section 411(d) is subject to all applicable privileges. See, e.g., 10 Louis Loss & Joel Seligman, *Securities Regulation* 4921-4925 n.69 (3d ed. rev. 1996). The power in Section 411(d) to conduct audits or inspections is distinguishable from the administrator's enforcement powers under Section 602. No subpoena is necessary under Section 411(d). Failure to submit to a reasonable audit or inspection is a violation of this Act which may result in an action by the administrator under Section 412(d)(8), a criminal prosecution under Section 508, or an injunction under Section 603. An unreasonable audit, inspection or demand for information or documents would be subject to challenge in an appropriate court.

7.

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Section 411(f) broadens 1956 Act Section 102(c) and RUSA Section 215 to apply to agents as well as investment adviser representatives. Subject to Section 15(h) of the Securities Exchange Act of 1934 and Section 222 of the Investment Adviser Act of 1940, the administrator is given broad authority to prohibit, limit, or condition custody arrangements.

8.

Section 411(g) parallels Rule 204-3, adopted under the Investment Advisers Act of 1940, popularly known as the brochure rule, which authorizes the SEC to require dissemination to investment adviser clients of specified information about the investment adviser and investment advice.

§ 412. DENIAL, REVOCATION, SUSPENSION, WITHDRAWAL, RESTRICTION, CONDITION, OR LIMITATION OF REGISTRATION.

(a) [Disciplinary conditions-applicants.] If the administrator finds that the order is in the public interest and subsection (d) authorizes the action, an order issued under this [Act] may deny an application, or may condition or limit registration: (1) of an applicant to be a broker-dealer, agent, investment adviser, or investment adviser representative, and (2) if the applicant is a broker-dealer or investment adviser, of any partner, officer, director, person having a similar status or performing similar functions, or person directly or indirectly controlling the broker-dealer or investment adviser.

(b) [Disciplinary conditions -- registrants.] If the administrator finds that the order is in the public interest and subsection (d) authorizes the action an order issued under this [Act] may revoke, suspend, condition, or limit the registration of a registrant and if the registrant is a broker-dealer or investment adviser, any partner, officer, or director, any person having a similar status or performing similar functions, or any person directly or indirectly controlling the broker-dealer or investment adviser. However, the administrator

(1)

may not institute a revocation or suspension proceeding under this subsection based on an order issued by another State that is reported to the administrator or designee later than one year after the date of the order on which it is based; and

(2)

under subsection (d)(5)(A) and (B), may not issue an order on the basis of an order under the state securities act of another State unless the other order was based on conduct for which subsection (d) would authorize the action had the conduct occurred in this State.

(c) [Disciplinary penalties -- registrants.] If the administrator finds that the order is in the public interest and subsection (d)(1) through (6), (8), (9), (10), or (12) and (13) authorizes the action, an order under this [Act] may censure, impose a

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bar, or impose a civil penalty in an amount not to exceed a maximum of \$[] for a single violation or \$[] for several violations on a registrant and if the registrant is a broker-dealer or investment adviser, any partner, officer, or director, any person having similar functions or any person directly or indirectly controlling the broker-dealer or investment adviser.

(d) [Grounds for discipline.] A person may be disciplined under subsections (a) through (c) if the person:

(1)

has filed an application for registration in this State under this [Act] or the predecessor act within the previous 10 years, which, as of the effective date of registration or as of any date after filing in the case of an order denying effectiveness, was incomplete in any material respect or contained a statement that, in light of the circumstances under which it was made, was false or misleading with respect to a material fact;

(2)

willfully violated or willfully failed to comply with this [Act] or the predecessor act or a rule adopted or order issued under this [Act] or the predecessor act within the previous 10 years;

(3)

has been convicted of a felony or within the previous 10 years has been convicted of a misdemeanor involving a security, a commodity future or option contract, or an aspect of a business involving securities, commodities, investments, franchises, insurance, banking, or finance;

(4)

is enjoined or restrained by a court of competent jurisdiction in an action instituted by the administrator under this [Act] or the predecessor act, a State, the Securities and Exchange Commission, or the United States from engaging in or continuing an act, practice, or course of business involving an aspect of a business involving securities, commodities, investments, franchises, insurance, banking, or finance;

(5)

is the subject of an order, issued after notice and opportunity for hearing by:

(A)

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the securities, depository institution, insurance, or other financial services regulator of a State or by the Securities and Exchange Commission or other federal agency denying, revoking, barring, or suspending registration as a broker-dealer, agent, investment adviser, federal covered investment adviser, or investment adviser representative;

(B)

the securities regulator of a State or by the Securities and Exchange Commission against a broker-dealer, agent, investment adviser, investment adviser representative, or federal covered investment adviser;

(C)

the Securities and Exchange Commission or by a self-regulatory organization suspending or expelling the registrant from membership in the self-regulatory organization;

(D)

a court adjudicating a United States Postal Service fraud order;

(E)

the insurance regulator of a State denying, suspending, or revoking the registration of an insurance agent; or

(F)

a depository institution regulator suspending or barring a person from the depository institution business;

(6)

is the subject of an adjudication or determination, after notice and opportunity for hearing, by the Securities and Exchange Commission, the Commodity Futures Trading Commission; the Federal Trade Commission; a federal depository institution regulator, or a depository institution, insurance, or other financial services regulator of a State that the person willfully violated the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, the Investment Company Act of 1940, or the Commodity Exchange Act, the securities or commodities law of a State, or a federal or state law under which a business involving investments, franchises, insurance, banking, or finance is regulated;

(7)

is insolvent, either because the person's liabilities exceed the person's assets or because the person cannot meet

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the person's obligations as they mature, but the administrator may not enter an order against an applicant or registrant under this paragraph without a finding of insolvency as to the applicant or registrant;

(8)

refuses to allow or otherwise impedes the administrator from conducting an audit or inspection under Section 411(d) or refuses access to a registrant's office to conduct an audit or inspection under Section 411(d);

(9)

has failed to reasonably supervise an agent, investment adviser representative, or other individual, if the agent, investment adviser representative, or other individual was subject to the person's supervision and committed a violation of this [Act] or the predecessor act or a rule adopted or order issued under this [Act] or the predecessor act within the previous 10 years;

(10)

has not paid the proper filing fee within 30 days after having been notified by the administrator of a deficiency, but the administrator shall vacate an order under this paragraph when the deficiency is corrected;

(11)

after notice and opportunity for a hearing, has been found within the previous 10 years:

(A)

by a court of competent jurisdiction to have willfully violated the laws of a foreign jurisdiction under which the business of securities, commodities, investment, franchises, insurance, banking, or finance is regulated;

(B)

to have been the subject of an order of a securities regulator of a foreign jurisdiction denying, revoking, or suspending the right to engage in the business of securities as a broker-dealer, agent, investment adviser, investment adviser representative, or similar person; or

(C)

to have been suspended or expelled from membership by or participation in a securities exchange or securities association operating under the securities laws of a foreign jurisdiction;

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(12)

is the subject of a cease and desist order issued by the Securities and Exchange Commission or issued under the securities, commodities, investment, franchise, banking, finance, or insurance laws of a State;

(13)

has engaged in dishonest or unethical practices in the securities, commodities, investment, franchise, banking, finance, or insurance business within the previous 10 years; or

(14)

is not qualified on the basis of factors such as training, experience, and knowledge of the securities business. However, in the case of an application by an agent for a broker-dealer that is a member of a self-regulatory organization or by an individual for registration as an investment adviser representative, a denial order may not be based on this paragraph if the individual has successfully completed all examinations required by subsection (e). The administrator may require an applicant for registration under Section 402 or 404 who has not been registered in a State within the two years preceding the filing of an application in this State to successfully complete an examination.

(e) [Examinations.] A rule adopted or order issued under this [Act] may require that an examination, including an examination developed or approved by an organization of securities regulators, be successfully completed by a class of individuals or all individuals. An order issued under this [Act] may waive, in whole or in part, an examination as to an individual and a rule adopted under this [Act] may waive, in whole or in part, an examination as to a class of individuals if the administrator determines that the examination is not necessary or appropriate in the public interest and for the protection of investors.

(f) [Summary process.] The administrator may suspend or deny an application summarily; restrict, condition, limit, or suspend a registration; or censure, bar, or impose a civil penalty on a registrant before final determination of an administrative proceeding. Upon the issuance of an order, the administrator shall promptly notify each person subject to the order that the order has been issued, the reasons for the action, and that within 15 days after the receipt of a request in a record from the person the matter will be scheduled for a hearing. If a hearing is not requested and none is ordered by the administrator within 30 days after the date of service of the order, the order becomes final by operation of law. If a hearing is requested or ordered, the administrator, after notice of and opportunity for hearing to each person subject to the order, may modify or vacate the order or extend the order until final determination.

(g) [Procedural requirements.] An order issued may not be issued under this section, except under subsection (f), without:

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(1)

appropriate notice to the applicant or registrant;

(2)

opportunity for hearing; and

(3)

findings of fact and conclusions of law in a record [in accordance with the state administrative procedure act].

(h) [Control person liability.] A person that controls, directly or indirectly, a person not in compliance with this section may be disciplined by order of the administrator under subsections (a) through (c) to the same extent as the noncomplying person, unless the controlling person did not know, and in the exercise of reasonable care could not have known, of the existence of conduct that is a ground for discipline under this section.

(i) [Limit on investigation or proceeding.] The administrator may not institute a proceeding under subsection(a), (b), or (c) based solely on material facts actually known by the administrator unless an investigation or the proceeding is instituted within one year after the administrator actually acquires knowledge of the material facts.

Official Comments Prior Provisions: 1956 Act Section 204; RUSA Sections 207, 212-213.

1.

Section 412 generally follows Section 204 of the 1956 Act and Sections 207 and 212-213 of RUSA, but has been modified to reflect subsequent developments that have broadened the scope and remedies of counterpart federal and state statutes.

2.

Section 412 authorizes the administrator to seek a sanction based on the seriousness of the misconduct. Under Section 412 the administrator must prove that the denial, revocation, suspension, cancellation, withdrawal, restriction, condition, or limitation both is (1) in the public interest and (2) involves one of the enumerated grounds in Section 412(d). See, e.g., *Mayflower Sec. Co., Inc. v. Bureau of Sec.*, 312 A.2d 497 (N.J. 1973). The "public interest" is a much litigated concept that has come to have settled meanings. See generally 6 L. Loss & J. Seligman, *Securities Regulation* 3103.5-3103.18 (3d ed. rev. 2002) (under federal securities laws). The public interest will not require imposition of a sanction for every minor or technical violation of subsection (d).

3.

The term "foreign" means a jurisdiction outside of the United States, not a different state within the United States.

4.

Section 412(a) through (c) authorizes the administrator to proceed against an entire firm, regardless of whether the administrator proceeds against any individual, when an individual partner, officer, or director or person occupying a similar status or performing similar functions, or a controlling person is disciplined under subsection (d), but only if proceeding against the entire firm is in the public interest. The discipline of such an individual may not automatically be used against a broker-dealer or investment adviser. When, however, there is a failure to reasonably supervise, see Section 412(d)(9) or control person liability, see Section 412(h), the administrator is empowered to proceed against a firm in an appropriate case. In Section 412, "any partner, officer, or director, any person occupying a similar status or performing similar function." can include a branch manager, assistant branch manager, or other supervisor.

5.

In Section 412(d)(1) the completeness and accuracy of an effective application for registration is tested as of the appropriate effective date. An application that becomes incomplete or inaccurate after its effective date is not a ground for discipline under paragraph (d)(1). In an appropriate case, an action might be available under paragraph (d)(2) and Section 406(b). On the other hand, in a proceeding to deny effectiveness to a pending application for registration, the completeness and accuracy of the application is not limited to the effective date and can be judged on any date after filing.

6.

The term "willfully" in Section 412(d)(2) and (11)(A) is discussed in Comment 2 to Section 508.

7.

There is no time limit or statute of limitations on felony convictions in Section 412(d)(3) as a ground for disciplinary action.

8.

The present tense of the verb "is" in Sections 412(d)(4) through (6) and (12) means that an injunction, order, adjudication, or determination that has expired or been vacated is no longer a ground for discipline.

9.

In Sections 412(d)(5) and (6) the administrator is not required to prove the validity of the ground which led to the earlier disciplinary order.

10.

Under Section 412(d)(7) the administrator may not proceed against a broker-dealer or investment adviser firm on the basis of the insolvency of a partner, officer, director, controlling person or other person specified in subsection (b), unless it is a sole proprietorship.

11.

Section 412(d)(8) can be violated by a refusal to cooperate with an administrator's reasonable audit or inspection, including by withholding or concealing records, refusing to furnish required records, or refusing the administrator reasonable access to any office or location within an office to conduct an audit or inspection under this Act. However, a request by a person subject to an audit or inspection for a reasonable delay to obtain assistance of counsel does not constitute a violation of Section 412(d)(8).

12.

The term "failed to supervise reasonably" in Section 412(d)(9) includes not having reasonable supervisory procedures in place as well as a proper system of supervision and internal control. Cf. *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991). Section 15(b)(4)(E) of the Securities Exchange Act of 1934 similarly addresses "failure to supervise reasonably." See 6 Louis Loss & Joel Seligman, *Securities Regulation* 3097-3101 (3d ed. rev. 2002).

13.

The term "dishonest and unethical practices" in Section 412(d)(13) has been held not to be unconstitutionally vague. See, e.g., *Brewster v. Maryland Sec. Comm'n*, 548 A.2d 157, 160 (M.D. Ct. Spec. App. 1988) ("a broad statutory standard is not vague if it has a meaningful referent in business practice, custom or usage"); *Johnson-Bowles Co. v. Division of Sec.*, 829 P.2d 101, 114 (Utah Ct. App. 1992) (such legislative language bespeaks a legislative intent to delegate the interpretation of what constitutes "dishonest and unethical practices" in the securities industry to the administrator). Ministerial or clerical violations of a statute or rule, if immaterial and occurring without intent or recklessness, typically would not constitute dishonest or unethical practices.

14.

Under the counterparts to Section 412(d)(14) and (e) applicants to become agents of broker-dealers typically take standardized tests administered by the National Association of Securities Dealers, Inc.

15.

Sections 412(f) and (g) amplify the earlier procedures found in Section 204(f) of the 1956 Act and are intended to facilitate summary disciplinary proceedings, when these are appropriate.

16.

Section 412(i) parallels the language of Section 204 of the 1956 Act and Section 212(b) of RUSA with some significant changes. The time period in which the administrator can act has been extended to one year from 30 days in the 1956 Act and 90 days in RUSA. The limitation on instituting a proceeding can also be tolled by instituting a formal investigation. The addition of the word "solely" is intended to make it clear that an administrator may consider the prior history of an applicant or registrant even if that prior history had been known to the administrator for more than one year if there are additional material facts which are actually known to the administrator within the last year.

17.

"Actually known" in Section 412(i) is used to signify that the mere filing of material facts in the Central Registration Depository or Investment Advisory Registration Depository systems does not constitute actual knowledge, unless that information was received by the administrator, or, but for a decision by the administrator, would have been received by the administrator.

§ 501. GENERAL FRAUD.

It is unlawful for a person, in connection with the offer, sale, or purchase of a security, directly or indirectly:

(1)

to employ a device, scheme, or artifice to defraud;

(2)

to make an untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it is made, not misleading; or

(3)

to engage in an act, practice, or course of business that operates or would operate as a fraud or deceit upon another person.

Official Comments Prior Provisions: 1956 Act Section 101; RUSA Section 501.

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1.

Section 501, which was Section 101 in the 1956 Act, was modeled on Rule 10b-5 adopted under the Securities Exchange Act of 1934 and on Section 17(a) of the Securities Act of 1933. There has been significant later case development interpreting Rule 10b-5, Section 17(a), and Section 101 of the 1956 Act. Section 501 is not identical to either Rule 10b-5 or Section 17(a).

2.

There are no exemptions from Section 501.

3.

Section 501 applies to any securities offer, sale or purchase, including offers, sales, or purchases involving registered, exempt, or federal covered securities. It would also apply to a rescission offer under Section 510.

4.

The possible consequences of violating Section 501 are many. These include denial, suspension, or revocation of securities registration under Section 306; denial, revocation, suspension, withdrawal, restriction, condition or limitation of a broker-dealer, agent, investment adviser, or investment adviser representative registration under Section 412; criminal prosecution under Section 508; civil enforcement proceedings under Sections 603; and administrative proceedings under 604.

5.

Because Section 501, like Rule 10b-5, reaches market manipulation, see 8 Louis Loss & Joel Seligman, Securities Regulation Ch.10.D (3d ed. 1991), this Act does not include the RUSA market manipulation Section 502, which had no counterpart in the 1956 Act.

6.

The culpability required to be pled or proved under Section 501 is addressed in the relevant enforcement context. See, e.g., Section 508, criminal penalties, where "willfulness" must be proven; Section 509, civil liabilities, which includes a reasonable care defense; or civil and administrative enforcement actions under Sections 603 and 604, where no culpability is required to be pled or proven.

7.

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There is no private cause of action, express or implied, under Section 501. Section 509(m) expressly provides that only Section 509 provides a private cause of action for conduct that could violate Section 501.

§ 502. PROHIBITED CONDUCT IN PROVIDING INVESTMENT ADVICE.

(a) [Fraud in providing investment advice.] It is unlawful for a person that advises others for compensation, either directly or indirectly or through publications or writings, as to the value of securities or the advisability of investing in, purchasing, or selling securities or that, for compensation and as part of a regular business, issues or promulgates analyses or reports relating to securities:

(1)

to employ a device, scheme, or artifice to defraud another person; or

(2)

to engage in an act, practice, or course of business that operates or would operate as a fraud or deceit upon another person.

(b) [Rules defining fraud.] A rule adopted under this [Act] may define an act, practice, or course of business of an investment adviser or an investment adviser representative, other than a supervised person of a federal covered investment adviser, as fraudulent, deceptive, or manipulative, and prescribe means reasonably designed to prevent investment advisers and investment adviser representatives, other than supervised persons of a federal covered investment adviser, from engaging in acts, practices, and courses of business defined as fraudulent, deceptive, or manipulative.

(c) [Rules specifying contents of advisory contract.] A rule adopted under this [Act] may specify the contents of an investment advisory contract entered into, extended, or renewed by an investment adviser.

Official Comments Prior Provisions: 1956 Act Section 102(a); RUSA Section 503.

1.

Section 502(a) applies to any person that commits fraud in providing investment advice. Section 502(b) is not limited to persons registered as investment advisers or investment adviser representatives.

2.

A person can violate both Section 501 and Section 502 if the person violates Section 502 in connection with the offer, purchase, or sale of a security.

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3.

The rulemaking authority under Sections 502(b) and (c) would provide the basis for existing NASAA rules concerning investment advisers, to the extent these rules are not preempted by the National Securities Markets Improvement Act of 1996.

4.

Under Section 203A(b)(2) of the Investment Advisers Act States retain their authority to investigate and bring enforcement actions with respect to fraud or deceit against a federal covered investment adviser or a person associated with a federal covered investment adviser. Under Section 502(a), which applies to any person, a State could bring an enforcement action against a federal covered investment adviser, including a federal covered investment adviser excluded from the definition of investment adviser in Section 102(15)(E).

5.

There is no private cause of action, express or implied, under Section 502. Section 509(m) expressly provides that only Section 509 provides for a private cause of action for prohibited conduct in providing investment advice that could violate Section 502.

§ 503. EVIDENTIARY BURDEN.

(a) [Civil.] In a civil action or administrative proceeding under this [Act], a person claiming an exemption, exception, preemption, or exclusion has the burden to prove the applicability of the claim.

(b) [Criminal.] In a criminal proceeding under this [Act], a person claiming an exemption, exception, preemption, or exclusion has the burden of going forward with evidence of the claim.

Official Comment Prior Provisions: 1956 Act Section 402(d); RUSA Section 608.

1.

As specified in Section 503(a), in a civil or administrative action, the person claiming an exemption, exception, preemption, or exclusion has the burden of persuasion.

2.

In contrast, in a criminal action under Section 503(b), the prosecutor is required to prove each element of a crime "beyond a reasonable doubt." The defendant only has the burden of producing evidence of an exemption, exception, preemption, or exclusion. Some court decisions have characterized this burden as an affirmative defense. See, e.g.,

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United States ex. rel. Schott v. Tehan, 365 F.2d 191, 195 (6th Cir. 1966) (Ohio blue sky law constitutionally shifts burden of production to defendant); Commonwealth v. David, 309 N.E.2d 484, 488 (Mass. 1974) (exemption is an affirmative defense); State v. Frost, 387 N.E.2d 235, 238-239 (Ohio 1979) (it is not unconstitutional to require the burden of proof as an affirmative defense to prove a securities law exemption); State v. Andersen, 773 A.2d 328 (Conn. 2001) (an exemption from registration is an affirmative defense to the charge of selling unregistered securities).

§ 504. FILING OF SALES AND ADVERTISING LITERATURE.

(a) [Filing requirement.] Except as otherwise provided in subsection (b), a rule adopted or order issued under this [Act] may require the filing of a prospectus, pamphlet, circular, form letter, advertisement, sales literature, or other advertising record relating to a security or investment advice, addressed or intended for distribution to prospective investors, including clients or prospective clients of a person registered or required to be registered as an investment adviser under this [Act].

(b) [Excluded communications.] This section does not apply to sales and advertising literature specified in subsection (a) which relates to a federal covered security, a federal covered investment adviser, or a security or transaction exempted by Section 201, 202, or 203 except as required pursuant to Section 201(7).

Official Comments Prior Provisions: 1956 Act Section 403; RUSA Section 405.

1.

The prospectuses, pamphlets, circulars, form letters, advertisements, sales literature or advertising communications, include material disseminated electronically or available on a web site.

2.

The administrator may bring a civil enforcement action in a court under Section 603 or institute administrative enforcement under Section 604 to prevent publication, circulation or use of any materials required by the administrator to be filed under Section 504 that have not been filed.

3.

Section 504(b) is meant to refer to the communications described in Section 504(a).

§ 505. MISLEADING FILINGS.

It is unlawful for a person to make or cause to be made, in a record that is used in an action or proceeding or filed under this [Act], a statement that, at the time and in the light of the circumstances under which it is made, is false or misleading in a material respect, or, in connection with the statement, to omit to state a material fact necessary to make the statement made, in the light of the circumstances under which it was made, not false or misleading.

Official Comment

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Prior Provisions: 1956 Act Section 404; RUSA Section 504.

The definition of "materiality" in *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) ("an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote") has generally been followed in both federal and state securities law. See 4 Louis Loss & Joel Seligman, *Securities Regulation* 2071-2105 (3d ed. rev. 2000).

§ 506. MISREPRESENTATIONS CONCERNING REGISTRATION OR EXEMPTION.

The filing of an application for registration, a registration statement, a notice filing under this [Act], the registration of a person, the notice filing by a person, or the registration of a security under this [Act] does not constitute a finding by the administrator that a record filed under this [Act] is true, complete, and not misleading. The filing or registration or the availability of an exemption, exception, preemption, or exclusion for a security or a transaction does not mean that the administrator has passed upon the merits or qualifications of, or recommended or given approval to, a person, security, or transaction. It is unlawful to make, or cause to be made, to a purchaser, customer, client, or prospective customer or client a representation inconsistent with this section.

Official Comment

Prior Provisions: 1956 Act Section 405; RUSA Section 505.

This Section follows the 1956 Act and RUSA, as well as state securities statutes generally, in providing that a misrepresentation concerning registration or an exemption is unlawful.

§ 507. QUALIFIED IMMUNITY.

A broker-dealer, agent, investment adviser, federal covered investment adviser, or investment adviser representative is not liable to another broker-dealer, agent, investment adviser, federal covered investment adviser, or investment adviser representative for defamation relating to a statement that is contained in a record required by the administrator, or designee of the administrator, the Securities and Exchange Commission, or a self-regulatory organization, unless the person knew, or should have known at the time that the statement was made, that it was false in a material respect or the person acted in reckless disregard of the statement's truth or falsity.

Official Comments

Source of Law: National Association of Securities Dealers, Inc. Proposal Relating to Qualified Immunity in Arbitration Proceedings for Statements Made in Forms U-4 and U-5.

1.

In 1994 The Securities and Exchange Commission Division of Market Regulation published *The Large Firm Project: A Review of Hiring, Retention, and Supervisory Practices* (1994), which found that a small number of "rogue brokers" were responsible for a significant proportion of customer disciplinary complaints. These brokers in some instances moved from one broker-dealer firm to another, it was explained, without full and complete disclosure of disciplinary problems by the broker-dealer, because of broker-dealer firms' fear of state law defamation claims. See also GAO, *Actions Needed to Better Protect Investors against Unscrupulous Brokers* 3 (1994); Testimony of SEC Chairman Arthur Levitt Concerning the Large Firm Project, Subcomm. on Telecommunications & Fin., House Comm. on Energy

& Commerce (Sept. 14, 1994), *reprinted in* 1994-1995 Fed. Sec. L. Rep. (CCH) P 85,433 (1994).

2.

In 1998, the National Association of Securities Dealers proposed qualified immunity for statements made in Forms U-4 and U-5 to address this problem. This proposal was reprinted in Securities Exchange Act Release 39,892, 66 SEC Dock. 2473 (1998). This proposal was limited to arbitration proceedings. It was not acted on by the Securities and Exchange Commission.

3.

An alternative approach would be a standard providing for absolute immunity. See generally Anne Wright, Form U-5 Defamation, 52 Wash. & Lee L. Rev. 1299 (1995); *Acciardo v. Millennium Sec. Corp.*, 83 F. Supp. 2d 413 (S.D.N.Y. 2000) (discussing both New York qualified and absolute immunity cases).

4.

Securities administrators or self-regulatory organizations generally are subject to absolute or qualified immunity for actions of their employees within the course of their official duties. See 10 Louis Loss & Joel Seligman, *Securities Regulation* 4818-4821 (3d ed. rev. 1996).

5.

As is generally the law "truth is a complete defense to a defamation action." *Andrews v. Prudential Sec., Inc.*, 160 F.3d 304, 308 (6th Cir. 1998).

6.

An agent who has been the subject of a Form U-5, Uniform Termination Notice for Securities Industry Registration, may respond to specified adverse disclosures and have her or his responses reprinted on the published version of Form U-5.

7.

Through September 2002 no state had adopted an immunity provision in its securities statute. No state has rejected immunity in this context by judicial decision. A number of states have adopted qualified immunity by judicial decision. See, e.g., *Eaton Vance Distrib., Inc. v. Ulrich*, 692 So.2d 915 (Fla. Dist. Ct. App. 1997); *Bavarati v. Josephal, Lyon & Ross, Inc.*, 28 F.3d 704 (7th Cir. 1994) (Illinois); *Andrews v. Prudential Sec., Inc.*, 160 F.3d 304 (6th Cir. 1998) (Michigan); *Prudential Sec., Inc. v. Dalton*, 929 F. Supp. 1411 (N.D. Okla. 1996) (Oklahoma); *Glennon v. Dean Witter Reynolds Inc.*, 83 F.3d 132 (6th Cir. 1996) (Tennessee).

§ 508. CRIMINAL PENALTIES.

(a) [Criminal penalties.] A person that willfully violates this [Act], or a rule adopted or order issued under this [Act], except Section 504 or the notice filing requirements of Section 302 or 405, or that willfully violates Section 505 knowing the statement made to be false or misleading in a material respect, upon conviction, shall be fined not more than \$[] or imprisoned not more than [] years, or both. An individual convicted of violating a rule or order under this [Act] may be fined, but may not be imprisoned, if the individual did not have knowledge of the rule or order.

(b) [Criminal reference not required.] The [Attorney General or the proper prosecuting attorney] with or without a reference from the administrator, may institute criminal proceedings under this [Act].

(c) [No limitation on other criminal enforcement.] This [Act] does not limit the power of this State to punish a person for conduct that constitutes a crime under other laws of this State.

Official Comments Prior Provisions: 1956 Act Section 409; RUSA Section 604; Securities Exchange Act of 1934 Section 32(a).

1.

This Section follows the 1956 Act and the federal securities laws in imposing criminal penalties for any willful violation of the Act. RUSA Section 604 distinguished between felonies and misdemeanors, limiting willful violations of cease and desist orders to a misdemeanor.

2.

The term "willfully" has the same meaning in Section 508 as it did in the 1956 Act. All that is required is proof that a person acted intentionally in the sense that the person was aware of what he or she was doing. Proof of evil motive or intent to violate the law or knowledge that the law was being violated is not required.

3.

The final sentence of Section 508(a) is based on Section 32(a) of the Securities Exchange Act of 1934, which provides: "[N]o person shall be subject to imprisonment under this section in violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation." The "no knowledge" clause in Section 508(a) is relevant only to sentencing. The person convicted has the burden of persuasion to prove no knowledge at sentencing. Because this does not impose a burden on the defendant to disprove the elements of a crime, Section 32(a) of the Securities Exchange Act of 1934 has been held not to raise a constitutional problem. *United States v. Mandel*, 296 F. Supp. 1038, 1040 (S.D.N.Y. 1969).

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4.

The appropriate state prosecutor under Section 508(b) may decide whether to bring a criminal action under this statute, another statute, or, when applicable, common law. In certain states the administrator has full or limited criminal enforcement powers.

5.

This section does not specify maximum dollar amounts for criminal fines, maximum terms for imprisonment, nor the years of limitation, but does provide for each state to specify appropriate magnitudes for criminal fines or maximum terms for imprisonment.

6.

The definition of willfulness in Comment 2 to Section 508 has been followed by most courts. See, e.g., *State v. Hodge*, 460 P.2d 596, 604 (Kan. 1969) ("No specific intent is necessary to constitute the offense where one violates the securities act except the intent to do the act denounced by the statute"); *State v. Nagel*, 279 N.W.2d 911, 915 (S.D. 1979) ("[I]t is widely understood that the legislature may forbid the doing of an act and make its commission a crime without regard to the intent or knowledge of the doer"); *State v. Fries*, 337 N.W.2d 398, 405 (Neb. 1983) (proof of a specific intent, evil motive, or knowledge that the law was being violated is not required to sustain a criminal conviction under a state's blue sky law); *People v. Riley*, 708 P.2d 1359, 1362 (Colo. 1985) ("A person acts 'knowingly' or 'willfully' with respect to conduct ... when he is aware that his conduct ... exists"); *State v. Larsen*, 865 P.2d 1355, 1358 (Utah 1993) (willful implies a willingness to commit the act, not an intent to violate the law or to injure another or acquire any advantage); *State v. Montgomery*, 17 P.3d 292, 294 (Idaho 2001) (bad faith is not required for a violation of a state securities act; willful implies "simply a purpose or willingness to commit the act or make the omission referred to"); *State v. Dumke*, 901 S.W.2d 100, 102 (Mo. Ct. App. 1995) (*mens rea* not required); *State v. Mueller*, 549 N.W.2d 455, 460 (Wis. Ct. App. 1996) (willfulness does not require proof that the defendant acted with intent to defraud or knowledge that the law was violated); *United States v. Lilley*, 291 F. Supp. 989, 993 (S.D. Tex. 1968) ("no knowledge" clause in federal statute not available to defendant claiming lack of knowledge of particular SEC rule).

§ 509. CIVIL LIABILITY.

(a) [Securities Litigation Uniform Standards Act.] Enforcement of civil liability under this section is subject to the Securities Litigation Uniform Standards Act of 1998.

(b) [Liability of seller to purchaser.] A person is liable to the purchaser if the person sells a security in violation of Section 301 or, by means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statement made, in light of the circumstances under which it is made, not misleading, the purchaser not knowing the untruth or omission and the seller not sustaining the burden of proof that the seller did not know and, in the exercise of reasonable care, could not have known of the untruth or omission. An action under this subsection is governed by the following:

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(1)

The purchaser may maintain an action to recover the consideration paid for the security, less the amount of any income received on the security, and interest [at the legal rate of interest] from the date of the purchase, costs, and reasonable attorneys' fees determined by the court, upon the tender of the security, or for actual damages as provided in paragraph (3).

(2)

The tender referred to in paragraph (1) may be made any time before entry of judgment. Tender requires only notice in a record of ownership of the security and willingness to exchange the security for the amount specified. A purchaser that no longer owns the security may recover actual damages as provided in paragraph (3).

(3)

Actual damages in an action arising under this subsection are the amount that would be recoverable upon a tender less the value of the security when the purchaser disposed of it, and interest [at the legal rate of interest] from the date of the purchase, costs, and reasonable attorneys' fees determined by the court.

(c) [Liability of purchaser to seller.] A person is liable to the seller if the person buys a security by means of an untrue statement of a material fact or omission to state a material fact necessary in order to make the statement made, in light of the circumstances under which it is made, not misleading, the seller not knowing of the untruth or omission, and the purchaser not sustaining the burden of proof that the purchaser did not know, and in the exercise of reasonable care, could not have known of the untruth or omission. An action under this subsection is governed by the following:

(1)

The seller may maintain an action to recover the security, and any income received on the security, costs, and reasonable attorneys' fees determined by the court, upon the tender of the purchase price, or for actual damages as provided in paragraph (3).

(2)

The tender referred to in paragraph (1) may be made any time before entry of judgment. Tender requires only notice in a record of the present ability to pay the amount tendered and willingness to take delivery of the security for the amount specified. If the purchaser no longer owns the security, the seller may recover actual damages as provided in paragraph (3).

(3)

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Actual damages in an action arising under this subsection are the difference between the price at which the security was sold and the value the security would have had at the time of the sale in the absence of the purchaser's conduct causing liability, and interest [at the legal rate of interest] from the date of the sale of the security, costs, and reasonable attorneys' fees determined by the court.

(d) [Liability of unregistered broker-dealer and agent.] A person acting as a broker-dealer or agent that sells or buys a security in violation of Section 401(a), 402(a), or 506 is liable to the customer. The customer, if a purchaser, may maintain an action for recovery of actual damages as specified in subsections (b)(1) through (3), or, if a seller, for a remedy as specified in subsections (c)(1) through (3).

(e) [Liability of unregistered investment adviser and investment adviser representative.] A person acting as an investment adviser or investment adviser representative that provides investment advice for compensation in violation of Section 403(a), 404(a), or 506 is liable to the client. The client may maintain an action to recover the consideration paid for the advice, interest [at the legal rate of interest] from the date of payment, costs, and reasonable attorneys' fees determined by the court.

(f) [Liability for investment advice.] A person that receives directly or indirectly any consideration for providing investment advice to another person and that employs a device, scheme, or artifice to defraud the other person or engages in an act, practice, or course of business that operates or would operate as a fraud or deceit on the other person, is liable to the other person. An action under this subsection is governed by the following:

(1)

The person defrauded may maintain an action to recover the consideration paid for the advice and the amount of any actual damages caused by the fraudulent conduct, interest [at the legal rate of interest] from the date of the fraudulent conduct, costs, and reasonable attorneys' fees determined by the court, less the amount of any income received as a result of the fraudulent conduct.

(2)

This subsection does not apply to a broker-dealer or its agents if the investment advice provided is solely incidental to transacting business as a broker-dealer and no special compensation is received for the investment advice.

(g) [Joint and several liability.] The following persons are liable jointly and severally with and to the same extent as persons liable under subsections (b) through (f):

(1)

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a person that directly or indirectly controls a person liable under subsections (b) through (f), unless the controlling person sustains the burden of proof that the person did not know, and in the exercise of reasonable care could not have known, of the existence of conduct by reason of which the liability is alleged to exist;

(2)

an individual who is a managing partner, executive officer, or director of a person liable under subsections (b) through (f), including an individual having a similar status or performing similar functions, unless the individual sustains the burden of proof that the individual did not know and, in the exercise of reasonable care could not have known, of the existence of conduct by reason of which the liability is alleged to exist;

(3)

an individual who is an employee of or associated with a person liable under subsections (b) through (f) and who materially aids the conduct giving rise to the liability, unless the individual sustains the burden of proof that the individual did not know and, in the exercise of reasonable care could not have known, of the existence of conduct by reason of which the liability is alleged to exist; and

(4)

a person that is a broker-dealer, agent, investment adviser, or investment adviser representative that materially aids the conduct giving rise to the liability under subsections (b) through (f), unless the person sustains the burden of proof that the person did not know and, in the exercise of reasonable care could not have known, of the existence of conduct by reason of which liability is alleged to exist.

(h) [Right of contribution.] A person liable under this section has a right of contribution as in cases of contract against any other person liable under this section for the same conduct.

(i) [Survival of cause of action.] A cause of action under this section survives the death of an individual who might have been a plaintiff or defendant.

(j) [Statute of limitations.] A person may not obtain relief:

(1)

under subsection (b) for violation of Section 301, or under subsection (d) or (e), unless the action is instituted within one year after the violation occurred; or

(2)

under subsection (b), other than for violation of Section 301, or under subsection (c) or (f), unless the action is instituted within the earlier of two years after discovery of the facts constituting the violation and five years after the violation.

(k) [No enforcement of violative contract.] A person that has made, or has engaged in the performance of, a contract in violation of this [Act] or a rule adopted or order issued under this [Act], or that has acquired a purported right under the contract with knowledge of conduct by reason of which its making or performance was in violation of this [Act], may not base an action on the contract.

(l) [No contractual waiver.] A condition, stipulation, or provision binding a person purchasing or selling a security or receiving investment advice to waive compliance with this [Act] or a rule adopted or order issued under this [Act] is void.

(m) [Survival of other rights or remedies.] The rights and remedies provided by this [Act] are in addition to any other rights or remedies that may exist, but this [Act] does not create a cause of action not specified in this section or Section 411(e).

Official Comments Prior Provisions: 1956 Act Section 410; RUSA Sections 605-607, 609, 802.

1.

Under Section 509 violations of two or more sections can be proven, but the remedy is limited either to rescission or actual damages. Actual damages means compensatory damages. Punitive or "double" damages are not provided by this section which also is the standard under Section 28(a) of the Securities Exchange Act of 1934. See 9 Louis Loss & Joel Seligman, Securities Regulation 4408-4427 (3d ed. rev. 1992).

2.

The Securities Litigation Uniform Standards Act of 1998 cited in Section 509(a) modifies the entire Section 509.

3.

As with Section 12(a)(2) of the Securities Act of 1933, Section 509(b) contains a type of privity requirement in that the purchaser is required to bring an action against the seller. Section 509(b) is broader than Section 12(a)(2) in that it will reach all sales in violation of Section 301, not just sales "by means of a prospectus" as is the law under Section 12(a)(2). See *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561 (1995).

4.

Unlike the current standards on implied rights of action under Rule 10b-5, neither causation nor reliance has been held to be an element of a private cause of action under the precursor to Section 509(b). See Gerhard W. Gohler, *IRA v. Wood*, 919 P.2d 561 (Utah 1996); *Ritch v. Robinson-Humphrey Co.*, 748 So. 2d 861 (Ala. 1999); *Kaufman v. I-Stat Corp.*, 754 A.2d 1188 (N.J. 2000).

5.

The measure of damages in Section 509(b)(3) is that contemplated by Section 12 of the Securities of 1933. See 9 Louis Loss and Joel Seligman, *Securities Regulations* 4242-4246 (3d ed. 1992). The measure of damages in Section 509(c)(3), however, is that contemplated by Rule 10b-5. Sec. 9 id. 4408-4427. In providing for damages as an alternative to rescission, Section 509(b)(3) follows the 1956 Act and is an improvement upon many earlier state provisions, which conditioned the plaintiff's right of recovery on his or her being in a position to make a good tender. A plaintiff is not given the right under this type of statutory formula to retain stock and also seek damages.

6.

Sections 509(e) and (f) are based on a proposed NASAA amendment to the Uniform Securities Act adopted in order "to establish civil liability for individuals who willfully violate Section 102 dealing with fraudulent practices pertaining to advisory activities." Neither provision is intended to limit other state law claims for providing investment advice.

7.

Broker-dealer employees, including research analysts, who receive no special compensation from third parties for investment advice would not be liable under Section 509(f).

8.

The control liability provision in Section 509(g)(1) is modeled on that in the 1956 Act. On the meaning of "control," see 4 Louis Loss & Joel Seligman, *Securities Regulations* 1703-1727 (3d ed. rev. 2000).

9.

The defense of lack of knowledge in Sections 509(g) is also modeled on the 1956 Act.

10.

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Under Section 509(g)(2) partners, officers, and directors are liable, subject to the defense afforded by that subsection, without proof that they aided in the sale. In Section 509(g)(2), the term "partner" is intended to be limited to partners with management responsibilities, rather than a partner with a passive investment.

11.

Under 509(g)(4), the performance by a clearing broker of the clearing broker's contractual functions -- even though necessary to the processing of a transaction -- without more would not constitute material aid or result in liability under this subsection. See, e.g., *Ross v. Bolton*, 904 F.2d 819 (2d Cir. 1990).

12.

The "reasonable attorneys' fees" specified in Section 509 are permissive, not mandatory. See, e.g., *Andrews v. Blue*, 489 F.2d 367, 377 (10th Cir. 1973), (Colorado statute).

13.

The contribution provision in Section 509(h) is a safeguard to avoid the common law principle that prohibited contribution among joint tortfeasors.

14.

The statute of limitations in Section 509(j) is a hybrid of the 1956 Act and federal securities law approaches. The 1956 Act Section 410(p) provided that: "No person may sue under this section more than two years after the contract of sale." Under this provision, the state courts generally decline to extend a statute of limitations period on grounds of fraudulent concealment or equitable tolling. Before the July 2002 enactment of the Sarbanes-Oxley Act, Rule 10b-5 of the Securities Exchange Act as construed by the United States Supreme Court in *Lampf, Pleva, Lipkind, Preps & Petigrew v. Gilbertson*, 501 U.S. 350 (1991), prohibited equitable tolling under the federal securities law one year after discovery and three years after the act formula. See generally 10 Louis Loss & Joel Seligman, *Securities Regulation* 4505-4525 (3d. ed. rev. 1996). The Sarbanes-Oxley Act added 28 U.S.C. § 1658(b) which provides

... a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47)), may be brought not later than the earlier of --

(1) 2 years after the discovery of the facts constituting the violation; or

(2) 5 years after such violation.

Section 509(j)(1), as with the 1956 Act, is a unitary statute of repose, requiring an action to be commenced within one year after a violation occurred. It is not intended that equitable tolling be permitted. Section 509(j)(2), in contrast, generally follows the federal securities law model. An action must be brought within the earlier of two years after discovery or five years after the violation. As with federal courts construing the statute of limitations under Rule 10b-5, it is intended that the plaintiff's right to proceed is limited to two years after actual discovery "or after such discovery

should have been made by the exercise of reasonable diligence" (inquiry notice), see, e.g., *Law v. Medco Research, Inc.*, 113 F.3d 781 (7th Cir. 1997), or five years after the violation. The rationale for replicating the basic federal statute of limitations in this Act is to discourage forum shopping. If the statute of limitations applicable to Rule 10b-5 were to be changed in the future, identical changes should be made in Section 509(j)(2).

15.

Section 509(k) is similar to Section 29(b) of the Securities Exchange Act and is intended to apply only to actions to enforce illegal contracts. See Louis Loss, *Commentary on the Uniform Securities Act 150* (1976).

16.

Section 509(m) follows the 1956 Act.

17.

Section 509 and Section 411(e) provide the exclusive private causes of action under this Act.

§ 510. RESCISSION OFFERS.

A purchaser, seller, or recipient of investment advice may not maintain an action under Section 509 if:

(1)

The purchaser, seller, or recipient of investment advice receives in a record, before the action is instituted:

(A)

an offer stating the respect in which liability under Section 509 may have arisen and fairly advising the purchaser, seller, or recipient of investment advice of that person's rights in connection with the offer, and any financial or other information necessary to correct all material misrepresentations or omissions in the information that was required by this [Act] to be furnished to that person at the time of the purchase, sale, or investment advice;

(B)

if the basis for relief under this section may have been a violation of Section 509(b), an offer to repurchase the security for cash, payable on delivery of the security, equal to the consideration paid, and interest [at the legal rate of interest] from the date of the purchase, less the amount of any income received on the security, or, if the purchaser no longer owns the security, an offer to pay the purchaser upon acceptance of the offer damages in an amount that would be recoverable upon a tender, less the value of the security when the purchaser disposed of it, and interest [at the legal

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rate of interest] from the date of the purchase in cash equal to the damages computed in the manner provided in this subsection;

(C)

if the basis for relief under this section may have been a violation of Section 509(c), an offer to tender the security, on payment by the seller of an amount equal to the purchase price paid, less income received on the security by the purchaser and interest [at the legal rate of interest] from the date of the sale; or if the purchaser no longer owns the security, an offer to pay the seller upon acceptance of the offer, in cash, damages in the amount of the difference between the price at which the security was purchased and the value the security would have had at the time of the purchase in the absence of the purchaser's conduct that may have caused liability and interest [at the legal rate of interest] from the date of the sale;

(D)

if the basis for relief under this section may have been a violation of Section 509(d); and if the customer is a purchaser, an offer to pay as specified in subparagraph (B); or, if the customer is a seller, an offer to tender or to pay as specified in subparagraph (C);

(E)

if the basis for relief under this section may have been a violation of Section 509(e), an offer to reimburse in cash the consideration paid for the advice and interest [at the legal rate of interest] from the date of payment; or

(F)

if the basis for relief under this section may have been a violation of Section 509(f), an offer to reimburse in cash the consideration paid for the advice, the amount of any actual damages that may have been caused by the conduct, and interest [at the legal rate of interest] from the date of the violation causing the loss;

(2)

the offer under paragraph 1 states that it must be accepted by the purchaser, seller, or recipient of investment advice within 30 days after the date of its receipt by the purchaser, seller, or recipient of investment advice or any shorter period, of not less than three days, that the administrator, by order, specifies;

(3)

the offeror has the present ability to pay the amount offered or to tender the security under paragraph (1);

(4)

the offer under paragraph (1) is delivered to the purchaser, seller, or recipient of investment advice, or sent in a manner that ensures receipt by the purchaser, seller, or recipient of investment advice; and

(5)

the purchaser, seller, or recipient of investment advice that accepts the offer under paragraph (1) in a record within the period specified under paragraph (2) is paid in accordance with the terms of the offer.

Official Comments Prior Provisions: 1956 Act Section 410(e); RUSA Section 607.

1.

A rescission offer must meet the specific requirements of Section 510 for civil liability under Section 509 to be extinguished. Cf. *Binder v. Gordian Sec., Inc.*, 742 F. Supp. 663, 666 (N.D. Ga. 1990). See generally Rowe, *Rescission Offers under Federal and State Securities Law*, 12 J. Corp. L. 383 (1987).

2.

A rescission offer that does not comply with Section 510 is subject to civil liability, administrative enforcement, or criminal penalties under this Act. A rescission offer, for example, could violate Section 501, the general fraud provision.

3.

The administrator may publish a form that would comply with Section 510, but the form would not be the only one that could be used by the parties.

4.

A valid rescission offer will be exempt from securities registration. See Section 202(19).

5.

If a state chooses to add a notice or filing provision, it could provide this provision in Section 510(6), which would state:

(6) The offer [or a notice] is required to be filed with the administrator 10 business days before the

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offering and conform in form and content with a rule prescribed by the administrator.

§ 601. ADMINISTRATION.

(a) [Administration.] The administrator shall administer this [Act] [insert any related provisions on such matters as method of selection, salary, term of office, selection and remuneration of personnel, and annual reports to the legislature or governor that are appropriate to the particular State].

(b) [Unlawful use of records or information.] It is unlawful for the administrator or an officer, employee, or designee of the administrator to use for personal benefit or the benefit of others records or other information obtained by or filed with the administrator that are not public under Section 607(b). This [Act] does not authorize the administrator or an officer, employee, or designee of the administrator to disclose the record or information, except in accordance with Section 602, 607(c), or 608.

(c) [No privilege or exemption created or diminished.] This [Act] does not create or diminish a privilege or exemption that exists at common law, by statute or rule, or otherwise.

(d) [Investor education.] The administrator may develop and implement investor education initiatives to inform the public about investing in securities, with particular emphasis on the prevention and detection of securities fraud. In developing and implementing these initiatives, the administrator may collaborate with public and nonprofit organizations with an interest in investor education. The administrator may accept a grant or donation from a person that is not affiliated with the securities industry or from a nonprofit organization, regardless of whether the organization is affiliated with the securities industry, to develop and implement investor education initiatives. This subsection does not authorize the administrator to require participation or monetary contributions of a registrant in an investor education program.

(e) [The Securities Investor Education and Training Fund.] The Securities Investor Education and Training Fund is created to provide funds for the purposes specified in subsection (d). [All monies received by the State by reason of civil penalties pursuant to this [Act] shall be deposited in the Securities Investor Education and Training Fund. The State may insert any other provision concerning appropriations to support this fund as well as procedures for its operations.]

Official Comments Prior Provisions: 1956 Act Section 406; RUSA Sections 701-702.

1.

Section 601(b) should be read with Section 607. Section 601(b) prohibits the administrator or the administrator's officers and employees from using for personal benefit records or information that Section 607(b) specifies do not constitute public records. Section 601(b) is not intended to limit the operation of Section 607(a). Neither Section 601(b) nor 607(b) is intended to impede the ability of the agencies specified in Section 608(a) from sharing records or other

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information in connection with an examination or an investigation.

2.

Section 601(c) makes clear that nothing in this Act alters the availability of evidentiary privileges. That question is left to the general law of the particular state.

3.

Sections 601(d) and (e) were adopted in recognition of the importance of investor education. An increasing number of jurisdictions are earmarking specific funds for this purpose. The lack of financial acumen among public investors, seniors, and students continues to be demonstrated in recent industry and regulatory studies. The importance of investor financial literacy is increasingly crucial given the decades long shift from defined benefit retirement plans toward defined contribution plans where employees are left to direct their own retirement accounts.

§ 602. INVESTIGATIONS AND SUBPOENAS.

(a) [Authority to investigate.] The administrator may:

(1)

conduct public or private investigations within or outside of this State which the administrator considers necessary or appropriate to determine whether a person has violated, is violating, or is about to violate this [Act] or a rule adopted or order issued under this [Act], or to aid in the enforcement of this [Act] or in the adoption of rules and forms under this [Act];

(2)

require or permit a person to testify, file a statement, or produce a record, under oath or otherwise as the administrator determines, as to all the facts and circumstances concerning a matter to be investigated or about which an action or proceeding is to be instituted; and

(3)

publish a record concerning an action, proceeding, or an investigation under, or a violation of, this [Act] or a rule adopted or order issued under this [Act] if the administrator determines it is necessary or appropriate in the public interest and for the protection of investors.

(b) [Administrator powers to investigate.] For the purpose of an investigation under this [Act], the administrator or its designated officer may administer oaths and affirmations, subpoena witnesses, seek compulsion of attendance, take

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evidence, require the filing of statements, and require the production of any records that the administrator considers relevant or material to the investigation.

(c) [Procedure and remedies for noncompliance.] If a person does not appear or refuses to testify, file a statement, produce records, or otherwise does not obey a subpoena as required by the administrator under this [Act], the administrator [may refer the matter to the Attorney General or the proper attorney, who] may apply to [insert name of the appropriate court] or a court of another State to enforce compliance. The court may:

(1)

hold the person in contempt;

(2)

order the person to appear before the administrator;

(3)

order the person to testify about the matter under investigation or in question;

(4)

order the production of records;

(5)

grant injunctive relief, including restricting or prohibiting the offer or sale of securities or the providing of investment advice;

(6)

impose a civil penalty of not less than \$[] and not greater than \$[] for each violation; and

(7)

grant any other necessary or appropriate relief.

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(d) [Application for relief.] This section does not preclude a person from applying to [insert name of appropriate court] or a court of another State for relief from a request to appear, testify, file a statement, produce records, or obey a subpoena.

(e) [Use immunity procedure.] An individual is not excused from attending, testifying, filing a statement, producing a record or other evidence, or obeying a subpoena of the administrator under this [Act] or in an action or proceeding instituted by the administrator under this [Act] on the ground that the required testimony, statement, record, or other evidence, directly or indirectly, may tend to incriminate the individual or subject the individual to a criminal fine, penalty, or forfeiture. If the individual refuses to testify, file a statement, or produce a record or other evidence on the basis of the individual's privilege against self-incrimination, the administrator may apply [to the name of the appropriate court] to compel the testimony, the filing of the statement, the production of the record, or the giving of other evidence. The testimony, record, or other evidence compelled under such an order may not be used, directly or indirectly, against the individual in a criminal case, except in a prosecution for perjury or contempt or otherwise failing to comply with the order.

(f) [Assistance to securities regulator of another jurisdiction.] At the request of the securities regulator of another State or a foreign jurisdiction, the administrator may provide assistance if the requesting regulator states that it is conducting an investigation to determine whether a person has violated, is violating, or is about to violate a law or rule of the other State or foreign jurisdiction relating to securities matters that the requesting regulator administers or enforces. The administrator may provide the assistance by using the authority to investigate and the powers conferred by this section as the administrator determines is necessary or appropriate. The assistance may be provided without regard to whether the conduct described in the request would also constitute a violation of this [Act] or other law of this State if occurring in this State. In deciding whether to provide the assistance, the administrator may consider whether the requesting regulator is permitted and has agreed to provide assistance reciprocally within its State or foreign jurisdiction to the administrator on securities matters when requested; whether compliance with the request would violate or prejudice the public policy of this State; and the availability of resources and employees of the administrator to carry out the request for assistance.

Official Comments Prior Provisions: 1956 Act Section 407; RUSA Section 601.

1.

Sections 602 (a) and (b) follow the 1956 Act, which was modeled generally on Sections 21(a) through (d) of the Securities Exchange Act of 1934 as it then read.

2.

Standards for issuance of subpoenas have been generally established in federal and state securities law. See, e.g., 10 Louis Loss & Joel Seligman, *Securities Regulation* 4917-4937 (3d ed. rev. 1996) (discussing *Oklahoma Press Pub. Co. v. Walling*, 327 U.S. 186 (1946) and other cases). The scope of subpoena enforcement in each state is a general matter for judicial determination. Under Section 602, an individual subpoenaed to testify by the administrator is not

compelled to testify within the meaning of these sections simply by service of a subpoena. Under Section 602(b) the individual can be subpoenaed and compelled to attend. Once in attendance an individual can assert an evidentiary privilege or exemption, see Section 601(c), including the Fifth Amendment privilege against self-incrimination. If an individual refuses to testify or give evidence, the administrator may apply (or have the appropriate State attorney apply) to the appropriate court for the relief specified in Section 602(c). If the individual invokes the privilege against self-incrimination, Section 602(d) allows the administrator to apply to the appropriate court to compel testimony under the "use immunity" provision barring the record compelled or other evidence obtained from being used in a criminal case. See *People v. District Co. of Arapahoe County*, 894 P.2d 739 (Colo. 1995). The phrase "directly or indirectly" in Section 602(e) is intended to include testimony, other evidence, or other information derived from immunized testimony, statements, records, or evidence.

3.

Section 602 is intended to apply generally to securities offers and sales under Article 3 and broker-dealer and investment adviser activity under Article 4, when there is noncompliance with the first sentence of Section 602(c). This subsection does not limit the powers of an administrator under other provisions of this Act.

4.

A court may quash a subpoena for good cause under Section 602(d). The court may decline to enforce a subpoena that is arbitrary, capricious, or oppressive.

5.

Where appropriate under Section 602(f), an administrator could move to authorize admission of a requesting state's attorney under existing *pro hac vice* rules.

6.

Section 602(f) is consistent with the Securities Litigation Uniform Standard Act of 1998 which provides in Section 102(e):

The Securities and Exchange Commission, in consultation with State securities commissions (or any agencies or offices performing like functions), shall seek to encourage the adoption of State laws providing for reciprocal enforcement by State securities commissions of subpoenas issued by another State securities commission seeking to compel persons to attend, testify in, or produce documents or records in connection with an action or investigation by a State securities commission of an alleged violation of State securities laws.

7.

There are limitations on financial institutions being subject to visitatorial powers by State officials, such as those

affecting national banks contained in *12 U.S.C. 484* and *12 C.F.R. Sec. 7.4000*. Law outside this Act may place similar limits on state chartered financial institutions being subjected to visitorial powers. This Act does not negate these limitations.

§ 603. CIVIL ENFORCEMENT.

(a) [Civil action instituted by administrator.] If the administrator believes that a person has engaged, is engaging, or is about to engage in an act, practice, or course of business constituting a violation of this [Act] or a rule adopted or order issued under this [Act] or that a person has, is, or is about to engage in an act, practice, or course of business that materially aids a violation of this [Act] or a rule adopted or order issued under this [Act], the administrator may maintain an action in the [insert the name of the court] to enjoin the act, practice, or course of business and to enforce compliance with this [Act] or a rule adopted or order issued under this [Act].

(b) [Relief available.] In an action under this section and on a proper showing, the court may:

(1)

issue a permanent or temporary injunction, restraining order, or declaratory judgment;

(2)

order other appropriate or ancillary relief, which may include:

(A)

an asset freeze, accounting, writ of attachment, writ of general or specific execution, and appointment of a receiver or conservator, that may be the administrator, for the defendant or the defendant's assets;

(B)

ordering the administrator to take charge and control of a defendant's property, including investment accounts and accounts in a depository institution, rents, and profits; to collect debts; and to acquire and dispose of property;

(C)

imposing a civil penalty up to \$[] for a single violation or up to \$[] for more than one violation; an order of rescission, restitution, or disgorgement directed to a person that has engaged in an act, practice, or course of business constituting a violation of this [Act] or the predecessor act or a rule adopted or order issued under this [Act] or the predecessor act; and

(D)

ordering the payment of prejudgment and postjudgment interest; or

(3)

order such other relief as the court considers appropriate.

(c) [No bond required.] The administrator may not be required to post a bond in an action or proceeding under this [Act].

Official Comments Prior Provisions: 1956 Act Section 408; RUSA Section 603

1.

Section 408 of the 1956 Act was limited to injunctions. This Section follows RUSA in broadening the civil remedies available when the administrator believes that a violation has occurred. A primary purpose of a broad range of potential sanctions is to enable administrators to better tailor appropriate sanctions to particular misconduct.

2.

The administrator alternatively may proceed to seek administrative enforcement under Section 604; to deny, suspend, or revoke a securities registration under Section 306; or to deny, suspend, revoke, or take other action against a broker-dealer, agent, investment adviser, or investment adviser representative registration under Section 412.

3.

Constitutional due process considerations can also be addressed by rulemaking or incorporation of the applicable administrative procedure act provisions of each jurisdiction. The term "upon a proper showing" has a settled meaning in the federal securities laws. See, e.g., Securities Act of 1933 Section 20(b).

4.

As with Sections 509(g)(3) and (4), materially aid in Section 603(a) does not include ministerial or clerical acts.

§ 604. ADMINISTRATIVE ENFORCEMENT.

(a) [Issuance of an order or notice.] If the administrator determines that a person has engaged, is engaging, or is about

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to engage in an act, practice, or course of business constituting a violation of this [Act] or a rule adopted or order issued under this [Act] or that a person has materially aided, is materially aiding, or is about to materially aid an act, practice, or course of business constituting a violation of this [Act] or a rule adopted or order issued under this [Act], the administrator may:

(1)

issue an order directing the person to cease and desist from engaging in the act, practice, or course of business or to take other action necessary or appropriate to comply with this [Act];

(2)

issue an order denying, suspending, revoking, or conditioning the exemptions for a broker-dealer under Section 401(b)(1)(D) or (F) or an investment adviser under Section 403(b)(1)(C); or

(3)

issue an order under Section 204.

(b) [Summary process.] An order under subsection (a) is effective on the date of issuance. Upon issuance of the order, the administrator shall promptly serve each person subject to the order with a copy of the order and a notice that the order has been entered. The order must include a statement whether the administrator will seek a civil penalty or costs of the investigation, a statement of the reasons for the order, and notice that, within 15 days after receipt of a request in a record from the person, the matter will be scheduled for a hearing. If a person subject to the order does not request a hearing and none is ordered by the administrator within 30 days after the date of service of the order, the order becomes final as to that person by operation of law. If a hearing is requested or ordered, the administrator, after notice of and opportunity for hearing to each person subject to the order, may modify or vacate the order or extend it until final determination.

(c) [Procedure for final order.] If a hearing is requested or ordered pursuant to subsection (b), a hearing must be held [pursuant to the state administrative procedure act]. A final order may not be issued unless the administrator makes findings of fact and conclusions of law in a record [in accordance with the state administrative procedure act]. The final order may make final, vacate, or modify the order issued under subsection (a).

(d) [Civil penalty.] In a final order under subsection (c), the administrator may impose a civil penalty up to \$[] for a single violation or up to \$[] for more than one violation.

(e) [Costs.] In a final order, the administrator may charge the actual cost of an investigation or proceeding for a

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violation of this [Act] or a rule adopted or order issued under this [Act].

(f) [Filing of certified final order with court; effect of filing.] If a petition for judicial review of a final order is not filed in accordance with Section 609, the administrator may file a certified copy of the final order with the clerk of a court of competent jurisdiction. The order so filed has the same effect as a judgment of the court and may be recorded, enforced, or satisfied in the same manner as a judgment of the court.

(g) [Enforcement by court; further civil penalty.] If a person does not comply with an order under this section, the administrator may petition a court of competent jurisdiction to enforce the order. The court may not require the administrator to post a bond in an action or proceeding under this section. If the court finds, after service and opportunity for hearing, that the person was not in compliance with the order, the court may adjudge the person in civil contempt of the order. The court may impose a further civil penalty against the person for contempt in an amount not less than \$[] but not greater than \$[] for each violation and may grant any other relief the court determines is just and proper in the circumstances.

Official Comments Prior Provisions: RUSA Sections 602, 712.

1.

Section 604, unlike Section 603, may be initiated by the administrator without prior judicial process or a prior hearing. The section, among other matters, empowers the administrator to act summarily in appropriate circumstances.

2.

Sections 603 and 604 are intended to be available to the administrator against persons not subject to stop orders under Section 306 or proceedings against registered broker-dealers, agents, investment advisers, or investment adviser representatives under Section 412. All persons or securities not subject to Section 306 or 412 will be subject to Sections 603 and 604. A person must be covered by either (1) Sections 306 or 412 or (2) Sections 603 or 604.

3.

Service of an order or notice under this Section is not effective unless made in accordance with Section 611.

§ 605. RULES, FORMS, ORDERS, INTERPRETATIVE OPINIONS, AND HEARINGS.

(a) [Issuance and adoption of forms, orders, and rules.] The administrator may:

(1)

issue forms and orders and, after notice and comment, may adopt and amend rules necessary or appropriate to

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carry out this [Act] and may repeal rules, including rules and forms governing registration statements, applications, notice filings, reports, and other records;

(2)

by rule, define terms, whether or not used in this [Act], but those definitions may not be inconsistent with this [Act]; and

(3)

by rule, classify securities, persons, and transactions and adopt different requirements for different classes.

(b) [Findings and cooperation.] Under this [Act], a rule or form may not be adopted or amended, or an order issued or amended, unless the administrator finds that the rule, form, order, or amendment is necessary or appropriate in the public interest or for the protection of investors and is consistent with the purposes intended by this [Act]. In adopting, amending, and repealing rules and forms, Section 608 applies in order to achieve uniformity among the States and coordination with federal laws in the form and content of registration statements, applications, reports, and other records, including the adoption of uniform rules, forms, and procedures.

(c) [Financial statements.] Subject to Section 15(h) of the Securities Exchange Act and Section 222 of the Investment Advisers Act of 1940, the administrator may require that a financial statement filed under this [Act] be prepared in accordance with generally accepted accounting principles in the United States and comply with other requirements specified by rule adopted or order issued under this [Act]. A rule adopted or order issued under this [Act] may establish:

(1)

subject to Section 15(h) of the Securities Exchange Act and Section 222 of the Investment Advisers Act of 1940, the form and content of financial statements required under this [Act];

(2)

whether unconsolidated financial statements must be filed; and

(3)

whether required financial statements must be audited by an independent certified public accountant.

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(d) [Interpretative opinions.] The administrator may provide interpretative opinions or issue determinations that the administrator will not institute a proceeding or an action under this [Act] against a specified person for engaging in a specified act, practice, or course of business if the determination is consistent with this [Act]. A rule adopted or order issued under this [Act] may establish a reasonable charge for interpretative opinions or determinations that the administrator will not institute an action or a proceeding under this [Act].

(e) [Effect of compliance.] A penalty under this [Act] may not be imposed for, and liability does not arise from conduct that is engaged in or omitted in good faith believing it conforms to a rule, form, or order of the administrator under this [Act].

(f) [Presumption for public hearings.] A hearing in an administrative proceeding under this [Act] must be conducted in public unless the administrator for good cause consistent with this [Act] determines that the hearing will not be so conducted.

Official Comments Prior Provisions: 1956 Act Section 412; RUSA Sections 705, 707.

1.

It is anticipated that the administrator will propose amendments or make rules under Section 605(a) to remain coordinate with relevant federal law, as well as appropriate rules of the National Association of Securities Dealers, and to achieve uniformity among the States.

2.

Uniform forms such as Form B-D, U-4, U-5, and NF are today common in the securities industry and are authorized by Section 605(b).

3.

Section 605(c) refers to generally accepted accounting principles in the United States which currently are promulgated by the Financial Accounting Standards Board and the Securities and Exchange Commission.

4.

It is anticipated that the states will employ websites, e-mail or other electronic means to provide notice of proposed rulemaking or adoption of new rules, rule amendments, forms or form amendments, statements of policy or interpretations adopted by the administrator, and issuance of orders to registrants and others who have provided a current e-mail or similar address and expressed an interest in receiving such notice.

5.

Section 605(e) does not apply to staff no action or interpretative opinions, but does apply to rules, forms, orders, statements of policy or interpretations adopted by the administrator.

§ 606. ADMINISTRATIVE FILES AND OPINIONS.

(a) [Public register of filings.] The administrator shall maintain, or designate a person to maintain, a register of applications for registration of securities; registration statements; notice filings; applications for registration of broker-dealers, agents, investment advisers, and investment adviser representatives; notice filings by federal covered investment advisers that are or have been effective under this [Act] or the predecessor act; notices of claims of exemption from registration or notice filing requirements contained in a record; orders issued under this [Act] or the predecessor act; and interpretative opinions or no action determinations issued under this [Act].

(b) [Public availability.] The administrator shall make all rules, forms, interpretative opinions, and orders available to the public.

(c) [Copies of public records.] The administrator shall furnish a copy of a record that is a public record or a certification that the public record does not exist to a person that so requests. A rule adopted under this [Act] may establish a reasonable charge for furnishing the record or certification. A copy of the record certified or a certificate by the administrator of a record's nonexistence is prima facie evidence of a record or its nonexistence.

Official Comments Prior Provisions: 1956 Act Section 413; RUSA Section 709.

1.

"Record" is defined in Section 102(25).

2.

Compliance with a state records law will typically satisfy the requirements of Section 606(a).

§ 607. PUBLIC RECORDS; CONFIDENTIALITY.

(a) [Presumption of public records.] Except as otherwise provided in subsection (b), records obtained by the administrator or filed under this [Act], including a record contained in or filed with a registration statement, application, notice filing, or report, are public records and are available for public examination.

(b) [Nonpublic records.] The following records are not public records and are not available for public examination

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under subsection (a):

(1)

a record obtained by the administrator in connection with an audit or inspection under Section 411(d) or an investigation under Section 602;

(2)

a part of a record filed in connection with a registration statement under Sections 301 and 303 through 305 or a record under Section 411(d) that contains trade secrets or confidential information if the person filing the registration statement or report has asserted a claim of confidentiality or privilege that is authorized by law;

(3)

a record that is not required to be provided to the administrator or filed under this [Act] and is provided to the administrator only on the condition that the record will not be subject to public examination or disclosure;

(4)

a nonpublic record received from a person specified in Section 608(a); [and]

(5)

any social security number, residential address, and residential telephone number contained in a record that is filed[]; and

(6)

a record obtained by the administrator through a designee of the administrator that a rule or order under this [Act] determines has been:

(A)

expunged from the administrator's records by the designee; or

(B)

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determined to be nonpublic or nondisclosable by that designee if the administrator finds the determination to be in the public interest and for the protection of investors].

(c) [Administrator discretion to disclose.] If disclosure is for the purpose of a civil, administrative, or criminal investigation, action, or proceeding or to a person specified in Section 608(a), the administrator may disclose a record obtained in connection with an audit or inspection under Section 411(d) or a record obtained in connection with an investigation under Section 602.

Official Comments Prior Provisions: RUSA Section 703; SEC Rule Section 200.80(b)(4); Securities Exchange Act of 1934 Sections 24(d) and (e).

1.

Section 607(a) reflects the extensive development of freedom of information and open records laws since the 1956 Act was adopted.

2.

Section 607(b) may insulate from public disclosure records or other information that may be available under a state freedom of information or open records act. Unless the state freedom of information or open records act implements a constitutional provision, this Act as the later and more specific enactment should control as a matter of statutory construction. A state may amend its freedom of information act, open records act or this section to eliminate any inconsistencies.

3.

Records and other information obtained by an administrator in connection with an audit or inspection under subsection 411(d) or an investigation under Section 602 may be made public in the enforcement action, even if records and other information would otherwise be subject to subsection 607(b)(1).

4.

An administrator may orally disclose information under Section 607(c) to a person specified in Section 608(a) for the purposes specified in Section 607(c).

§ 608. UNIFORMITY AND COOPERATION WITH OTHER AGENCIES.

(a) [Objective of uniformity.] The administrator shall, in its discretion, cooperate, coordinate, consult, and, subject to Section 607, share records and information with the securities regulator of another State, Canada, a Canadian province or territory, a foreign jurisdiction, the Securities and Exchange Commission, the United States Department of Justice, the Commodity Futures Trading Commission, the Federal Trade Commission, the Securities Investor Protection Corporation, a self-regulatory organization, a national or international organization of securities regulators, a federal or

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state banking and insurance regulator, and a governmental law enforcement agency to effectuate greater uniformity in securities matters among the federal government, self-regulatory organizations, States, and foreign governments.

(b) [Policies to consider.] In cooperating, coordinating, consulting, and sharing records and information under this section and in acting by rule, order, or waiver under this [Act], the administrator shall, in its discretion, take into consideration in carrying out the public interest the following general policies:

(1)

maximizing effectiveness of regulation for the protection of investors;

(2)

maximizing uniformity in federal and state regulatory standards; and

(3)

minimizing burdens on the business of capital formation, without adversely affecting essentials of investor protection.

(c) [Subjects for cooperation.] The cooperation, coordination, consultation, and sharing of records and information authorized by this section includes:

(1)

establishing or employing one or more designees as a central depository for registration and notice filings under this [Act] and for records required or allowed to be maintained under this [Act];

(2)

developing and maintaining uniform forms;

(3)

conducting a joint examination or investigation;

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(4)

holding a joint administrative hearing;

(5)

instituting and prosecuting a joint civil or administrative proceeding;

(6)

sharing and exchanging personnel;

(7)

coordinating registrations under Sections 301 and 401 through 404 and exemptions under Section 203;

(8)

sharing and exchanging records, subject to Section 607;

(9)

formulating rules, statements of policy, guidelines, forms, and interpretative opinions and releases;

(10)

formulating common systems and procedures;

(11)

notifying the public of proposed rules, forms, statements of policy, and guidelines;

(12)

attending conferences and other meetings among securities regulators, which may include representatives of governmental and private sector organizations involved in capital formation, deemed necessary or appropriate to

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promote or achieve uniformity; and

(13)

developing and maintaining a uniform exemption from registration for small issuers, and taking other steps to reduce the burden of raising investment capital by small businesses.

Official Comments Prior Provisions: 1956 Act Section 415; RUSA Sections 704 and 803; 19(c) of the Securities Act of 1933.

1.

Uniformity of regulation among the states and coordination with the Securities and Exchange Commission is a principal objective of this Act. Section 608 is intended to encourage such cooperation to the maximum extent appropriate. Operative phrases such as "shall, in its discretion" in Sections 608(a) and (b) are intended to be precisely coordinate with the directive that Congress gave to the Securities and Exchange Commission in Section 19(c) of the Securities Act of 1933.

2.

The goals of uniformity among the states and coordination with related federal regulation, including self regulatory organizations, may be enhanced by greater use of information technology systems such as the Web-CRD, the Investment Adviser Registration Depository (IARD), or the Securities and Exchange Commission Electronic Data Gathering, Analysis and Retrieval System (EDGAR). These types of techniques are consistent with a potential system of "one stop filing" of all federal and state forms that is encouraged by this Act.

3.

This Act is intended, to the extent practicable, to be revenue neutral in its impact on existing state laws.

4.

Section 608(c) lists some joint or coordinated efforts which might be undertaken. Other appropriate cooperative activities are also encouraged.

5.

Court decisions interpreting the securities laws have construed these acts to achieve "broad protection to investors," a remedial approach that "embodies a flexible rather than a static principle, one that is capable of adaption to meet the countless and variable schemes devised by those who seek to use the money of others on the promise of

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profits." SEC v. W.J. Howey Co, 328 U.S. 293, 299, 301 (1946).

§ 609. JUDICIAL REVIEW.

(a) [Judicial review of orders.] A final order issued by the administrator under this [Act] is subject to judicial review in accordance with [the state administrative procedure act].

[(b) [Judicial review of rules.] A rule adopted under this [Act] is subject to judicial review in accordance with [the state administrative procedure act].]

Official Comments Prior Provisions: 1956 Act Section 411; RUSA Section 711(b).

1.

The 1956 Act Section 411 specified procedures for judicial review of orders, in part modeled on Section 12 of the Model Administrative Procedure Act, 54 Handbook of National Conference of Commissioners on Uniform State Laws 334 (1944) and partly on Section 25 of the Securities Exchange Act.

2.

A rule adopted under this Act may be subject to judicial review in accordance with the state administrative procedure act.

3.

In those states in which judicial review of rules is permitted, a state may choose to add Section 609(b). In those states in which judicial review of rules is not permitted, Section 609(b) should be deleted.

§ 610. JURISDICTION.

(a) [Sales and offers to sell.] Sections 301, 302, 401(a), 402(a), 403(a), 404(a), 501, 506, 509, and 510 do not apply to a person that sells or offers to sell a security unless the offer to sell or the sale is made in this State or the offer to purchase or the purchase is made and accepted in this State.

(b) [Purchases and offers to purchase.] Sections 401(a), 402(a), 403(a), 404(a), 501, 506, 509, and 510 do not apply to a person that purchases or offers to purchase a security unless the offer to purchase or the purchase is made in this State or the offer to sell or the sale is made and accepted in this State.

(c) [Offers in this State.] For the purpose of this section, an offer to sell or to purchase a security is made in this State, whether or not either party is then present in this State, if the offer:

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(1)

originates from within this State; or

(2)

is directed by the offeror to a place in this State and received at the place to which it is directed.

(d) [Acceptances in this State.] For the purpose of this section, an offer to purchase or to sell is accepted in this State, whether or not either party is then present in this State, if the acceptance:

(1)

is communicated to the offeror in this State and the offeree reasonably believes the offeror to be present in this State and the acceptance is received at the place in this State to which it is directed; and

(2)

has not previously been communicated to the offeror, orally or in a record, outside this State.

(e) [Publications, radio, television, or electronic communications.] An offer to sell or to purchase is not made in this State when a publisher circulates or there is circulated on the publisher's behalf in this State a bona fide newspaper or other publication of general, regular, and paid circulation that is not published in this State, or that is published in this State but has had more than two thirds of its circulation outside this State during the previous 12 months or when a radio or television program or other electronic communication originating outside this State is received in this State. A radio or television program, or other electronic communication is considered as having originated in this State if either the broadcast studio or the originating source of transmission is located in this State, unless:

(1)

the program or communication is syndicated and distributed from outside this State for redistribution to the general public in this State;

(2)

the program or communication is supplied by a radio, television, or other electronic network with the electronic

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signal originating from outside this State for redistribution to the general public in this State;

(3)

the program or communication is an electronic communication that originates outside this State and is captured for redistribution to the general public in this State by a community antenna or cable, radio, cable television, or other electronic system; or

(4)

the program or communication consists of an electronic communication that originates in this State, but which is not intended for distribution to the general public in this State.

(f) [Investment advice and misrepresentations.] Sections 403(a), 404(a), 405(a), 502, 505, and 506 apply to a person if the person engages in an act, practice, or course of business instrumental in effecting prohibited or actionable conduct in this State, whether or not either party is then present in this State.

Official Comments Source of Law: 1956 Act Section 414; RUSA Section 801.

1.

Section 610 defines the application of the Act to interstate or international transactions when only some of the elements of a violation occur in this State. This Section applies to all types of proceedings specified by the Act -- administrative, civil, and criminal. The law is now settled that a person may violate the law of a particular state without ever being within the state or performing each act necessary to violate the law within that state.

2.

Section 610 generally follows Section 414 of the 1956 Act, but has been modernized to reflect the development of the Internet and other electronic communications after 1956.

3.

Section 610 can be illustrated in the context of a civil action under Section 509(b) by a purchaser in State A against a seller in State B: Section 610(a) would apply when an "offer to sell is made in this State." Section 610(c) provides that an offer which originates in State B and is directed to State A is made in both states. The securities act of State A would apply under Section 610(c)(2). The act of State B would apply also, under Section 610(c)(1). The intent is to prevent a seller in State B from using that state as a base of operations for defrauding person in other states. Section 610(e) addresses offers made through publications, radio, television, or electronic communications. The subsection provides a series of safe harbors for advertisements in newspapers, magazines, radio, television, or electronic media that

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either originate outside State A or that originate in State A but are directed outside the state to the general public. With respect to bona fide newspapers or other publications of general, regular, and paid circulation, the safe harbor requires that more than two thirds of its circulation be outside State A. With respect to radio, television, or other electronic communications, safe harbors are specified in Sections 610(e)(1) through (4). Section 610(d), however, provides that a person in State A who makes an offer to purchase as a result of communication described in Section 610(e) may cause the act to be applicable if the offeror accepts the offer "in this State." Section 610(d) defines when an offer is accepted "in this State." If a selling broker-dealer in State B solely sends a confirmation into State A, or the purchaser in State A sends a check from within State A, the act will not apply unless, under Section 610(d), the confirmation or delivery constitutes the seller's acceptance of the purchaser's offer to buy in State A. The applicability of the act to purchaser is addressed by Section 610(b) which is the converse of Section 610(a). Under Section 509(c) there can be liability of purchasers to sellers. Section 610(f) is a new provision that specifies jurisdictions in cases involving investment advice and misrepresentations.

4.

Under subsection 202(20) certain out-of-state offers or sales are exempt from securities registration.

5.

The phrase "other electronic means" is coextensive with computer or other information technology permitted by subsections 102(8), 102(25).

6.

Under Section 610 the administrator may adopt interpretative rules or orders to specify when particular uses of new electronic communications, including the Internet, involve an offer to sell or to purchase a security, acceptance of an order to purchase or sell a security, or an act or practice involving prohibited conduct, within a State, whether or not a purchaser, seller, or other party is then present in the State. The NASAA Interpretive Order Concerning Broker-Dealers, Agents, and Investment Adviser Representatives Using the Internet for General Dissemination of Information for Products and Services (Apr. 23, 1997) is an illustration of an interpretative order that would be in compliance with the administrator's authority under Section 610. Under this Order, broker-dealers, agents, investment advisers, and investment adviser representatives who distribute information on available products and services through communications on the Internet generally to anyone having access to the Internet such as postings on a bulletin board or home page shall not be deemed to be transacting business in a State if specified conditions are satisfied including a legend clearly stating that the broker-dealer, agent, investment adviser, or investment adviser representative may transact business in that State only if first registered, excluded or exempted from applicable registration requirements.

§ 611. SERVICE OF PROCESS.

(a) [Signed consent to service of process.] A consent to service of process complying with Section 611 required by this [Act] must be signed and filed in the form required by a rule or order under this [Act]. A consent appointing the administrator the person's agent for service of process in a noncriminal action or proceeding against the person, or the person's successor or personal representative under this [Act] or a rule adopted or order issued under this [Act] after the consent is filed, has the same force and validity as if the service were made personally on the person filing the consent. A person that has filed a consent complying with this subsection in connection with a previous application for

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registration or notice filing need not file an additional consent.

(b) [Conduct constituting appointment of agent for service.] If a person, including a nonresident of this State, engages in an act, practice, or course of business prohibited or made actionable by this [Act] or a rule adopted or order issued under this [Act] and the person has not filed a consent to service of process under subsection (a), the act, practice, or course of business constitutes the appointment of the administrator as the person's agent for service of process in a noncriminal action or proceeding against the person or the person's successor or personal representative.

(c) [Procedure for service of process.] Service under subsection (a) or (b) may be made by providing a copy of the process to the office of the administrator, but it is not effective unless:

(1)

the plaintiff, which may be the administrator, promptly sends notice of the service and a copy of the process, return receipt requested, to the defendant or respondent at the address set forth in the consent to service of process or, if a consent to service of process has not been filed, at the last known address, or takes other reasonable steps to give notice; and

(2)

the plaintiff files an affidavit of compliance with this subsection in the action or proceeding on or before the return day of the process, if any, or within the time that the court, or the administrator in a proceeding before the administrator, allows.

(d) [Service in administrative proceedings or civil actions by administrator.] Service pursuant to subsection (c) may be used in a proceeding before the administrator or by the administrator in a civil action in which the administrator is the moving party.

(e) [Opportunity to defend.] If process is served under subsection (c), the court, or the administrator in a proceeding before the administrator, shall order continuances as are necessary or appropriate to afford the defendant or respondent reasonable opportunity to defend.

Official Comments Prior Provisions: 1956 Act Sections 414(g) and (h); RUSA Section 708.

1.

Section 611 follows the 1956 Act and RUSA in providing for a signed consent to service of process in Section 611(a); a substituted service of process in Section 611(b); and process and opportunity to defend in Sections 611(c)

through (e).

2.

An issuer is not required to file a consent to service of process unless it proposes to offer a security in this State through someone acting on an agency basis. Since the civil liability provisions of Section 509(b) apply only in a suit by a purchaser against a seller, the issuer in a firm commitment underwriting is civilly liable only to the underwriter, who, in turn, may be liable to the dealer, who, in turn, may be liable to the purchaser. In contrast, in a best efforts underwriting, when the security is sold on an agency basis and title passes directly to the purchaser, the issuer can be liable to the purchaser.

3.

Section 611(b) generally follows Section 414(h) of the 1956 Act and Section 708(c) of RUSA. The intent is to provide for substituted service of process when a seller in one state directs an offer into a second state either in violation of the laws of the second state or fraudulently. Under Section 611(b) the purchaser may sue the seller in the purchaser's state and then bring an action on the judgment in the seller's state. The constitutionality of this type of statute has long been sustained.

4.

This section was originally based on the type of nonresident motorist statute whose constitutionality was sustained in *Hess v. Pawlowski*, 274 U.S. 352 (1927) and subsequently in other contexts. See, e.g., *International Shoe Co. v. State of Wash.*, 326 U.S. 310 (1945); *Travelers Health Ass'n v. Commonwealth of Va.*, 339 U.S. 643 (1950).

§ 612. SEVERABILITY CLAUSE.

If any provision of this [Act] or its application to any person or circumstances is held invalid, the invalidity does not affect other provisions or applications of this [Act] that can be given effect without the invalid provision or application, and to this end the provisions of this [Act] are severable.

Official Comments

Prior Provisions: 1956 Act Section 417; RUSA Section 805.

§ 701. EFFECTIVE DATE.

This [Act] takes effect on [insert date, which should be at least 60 days after enactment].

§ 702. REPEALS.

The following act is repealed:

§ 703. APPLICATION OF ACT TO EXISTING PROCEEDING AND EXISTING RIGHTS AND DUTIES.

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(a) [Applicability of predecessor act to pending proceedings and existing rights.] The predecessor act exclusively governs all actions or proceedings that are pending on the effective date of this [Act] or may be instituted on the basis of conduct occurring before the effective date of this [Act], but a civil action may not be maintained to enforce any liability under the predecessor act unless instituted within any period of limitation that applied when the cause of action accrued or within five years after the effective date of this [Act], whichever is earlier.

(b) [Continued effectiveness under predecessor act.] All effective registrations under the predecessor act, all administrative orders relating to the registrations, rules, statements of policy, interpretative opinions, declaratory rulings, no action determinations, and conditions imposed on the registrations under the predecessor act remain in effect while they would have remained in effect if this [Act] had not been enacted. They are considered to have been filed, issued, or imposed under this [Act], but are exclusively governed by the predecessor act.

(c) [Applicability of predecessor act to offers or sales.] The predecessor act exclusively applies to an offer or sale made within one year after the effective date of this [Act] pursuant to an offering made in good faith before the effective date of this [Act] on the basis of an exemption available under the predecessor act.

Official Comments Prior Provisions: 1956 Act Section 418; RUSA Section 807. Prior law governs all suits, actions, prosecutions, or proceedings which are pending or may be initiated on the basis of facts or circumstances occurring before the effective date of a State blue sky statute. See *Hilton v. Mumaw*, 522 F.2d 588, 600 (9th Cir. 1975).



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§ UF.syn Synopsis to Chapter UF: Uniform Forms

Form UF-3 How to Register as an Investment Adviser

Information on Registration and Regulation of Brokers and Dealers

Form U-1 Uniform Application to Register Securities

U-2 Uniform Consent to Service of Process

U-2A Uniform Corporate Resolution

NF Uniform Investment Company Notice Filing

Form U-SB Uniform Surety Bond Form

BD Uniform Application for Broker-Dealer Registration

BDW Uniform Request for Broker-Dealer Withdrawal

U-4 Uniform Application for Securities Industry Registration or Transfer

U-5 Uniform Termination Notice for Securities Industry Registration

ADV Uniform Application for Investment Adviser Registration

ADV Uniform Application for Investment Adviser Registration [New version of form, effective January 1, 2001]

ADV-W Notice of Withdrawal from Registration as Investment Adviser [See Editor's Note]

ADV-W Notice of Withdrawal from Registration as an Investment Adviser [New version of form, effective January 1, 2001]

ADV-E Certificate of Accounting of Client Securities and Funds in Possession or Custody of an Investment Adviser

ADV-H Application for a Temporary or Continuing Hardship Exemption

ADV-NR Appointment of Agent for Service of Process by Non-Resident General Partner and Non-Resident Managing Agent of an Investment Adviser

U-7 Small Corporate Offering Registration Form

D Notice of Sales of Securities Pursuant to Regulation D, Section 4(6), and/or Uniform Limited Offering Exemption

U-10 Uniform Examination Request For Non-NASD Candidates

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Form UF-3 How to Register as an Investment Adviser

How to Register as an Investment Adviser

-by-

United States Securities and Exchange Commission

Division of Investment Management

December 31, 1999

INTRODUCTION

If you are required to register with the SEC as an investment adviser, you must file Form ADV and keep it current by filing periodic amendments, including an annual amendment on Schedule I to Form ADV. You must also, among other things: comply with the "brochure rule," which requires most advisers to provide clients and prospective clients with information about the adviser's business practices and educational and business background; maintain accurate and current books and records, as specified by SEC rules; and be subject to inspection and examination by the SEC staff. You also may be subject to limited forms of state regulation. These requirements are discussed below, and in the document "General Information on the Regulation of Investment Advisers." In addition, please consult the Investment Advisers Act, the rules thereunder, and the instructions to the forms, all of which have been included in this booklet for your convenience.

FORM ADV

Form ADV is the application for registration with the SEC as an investment adviser. Part I asks for information that is used to review the application and is used in the SEC's investment adviser regulatory program. Part II requires disclosure of the background and business practices of the investment adviser, and can be given to clients of the investment adviser to comply with the "brochure rule." There are also several schedules to Form ADV. You must file both parts of Form ADV and the appropriate schedules with the SEC. Schedule I must be filed with the SEC annually, regardless of whether information on the schedule has changed.

How long does it take to process Form ADV?

Within 45 days after you file your Form ADV registration application, the SEC must grant your registration or begin

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proceedings to deny it, assuming that you have fully and properly completed all items of the form and accompanying schedules. The SEC staff will return any Form ADV that is not fully and properly completed. A new 45 day period will begin when the Form ADV is resubmitted.

AMENDING FORM ADV

SEC-registered advisers must update Form ADV annually by amending Schedule I and any information on the form that has become inaccurate. Instruction 10 to Form ADV specifies the type of information that must be corrected promptly, and the type that must be corrected within ninety days of the end of the adviser's fiscal year. Schedule I to Form ADV must be amended every year, within ninety days of the end of the adviser's fiscal year. If an adviser indicates on Schedule I that it is no longer eligible for SEC registration, the adviser must withdraw its registration within 180 days after the end of the adviser's fiscal year.

Amending the form requires completing the execution page (page one of the form) and the entire page(s) containing the updated item(s). Circle the items being amended. Rule 204-1 and the instructions to Form ADV give more complete information on amendments.

CURRENT BOOKS AND RECORDS, BALANCE SHEETS

All SEC-registered investment advisers must maintain true, accurate, and current books and records, as specified in Rule 204-2. Not all SEC-registered investment advisers, however, are required to submit financial statements to the Commission. SEC-registered investment advisers must file a balance sheet for the most recent fiscal year if they have custody or possession of client funds or securities, or if they require prepayment of more than \$500 in fees per client, six months or more in advance. See Form ADV, Part II, Item 14, and Schedule G to Form ADV. If you are required to submit a balance sheet, it must be audited by an independent public accountant. It is filed annually on Schedule G as an amendment to Form ADV. In addition, an adviser that has custody of client funds or securities must arrange for an independent public accountant to perform a "surprise" inspection of the custody property at some time during the calendar year, and the accountant's report of this examination must be filed with the Commission as an attachment to Form ADV-E.

FILING REQUIREMENTS

Obtaining Forms, Copies of SEC forms, including Forms ADV and ADV-W, can be obtained from the SEC's Publication Unit in Washington, D.C. by calling (202) 942-4046, or by sending a written request to: Publications Unit, U.S. Securities and Exchange Commission, 450 5th Street, N.W., Mail Stop C-11, Washington D.C., 20549. There is no charge. Forms ADV, ADV-E and ADV-W also are available on the SEC's website at <<<http://www.sec.gov/offices/invmgmt/advinst.htm>>>.

Where to File, Submit all forms to: U.S. Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549, Attn: Filing Desk.

Instructions, All of the forms, including Forms ADV and ADV-W, contain detailed instructions. Additional inquiries regarding the mechanics of completing and filing the forms should be directed to: Branch of Registrations and Examinations, SEC Operations Center, Mail Stop A-2, 6432 General Green Way Drive, Alexandria, VA 22312 ((202) 942-8980).

Copies, Signatures, Names, All adviser filings must be typed, and submitted in triplicate. Failure to submit three copies will result in the filing being returned. The filing also may be declared delinquent when it is resubmitted. You should retain a fourth copy of all filings for your records. Each copy of an execution page must contain an original, manual signature. Anyone executing a Form ADV or an amendment to Form ADV must use his full name unless the individual legally only has an initial. If the registration application is filed by a sole proprietor, it should be signed by the proprietor, if filed by a partnership, it should be signed in the name of the partnership by a general partner, if filed by a corporation, it should be signed in the corporation's name by an authorized principal officer. The signature to Form

ADV must be notarized, or may be signed without notarization under penalty of perjury.

Fees, There are no fees for registration as an investment adviser, nor are there any fees for amendments or other filings.



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CHAPTER UF Uniform Forms

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Information on Registration and Regulation of Brokers and Dealers

DIVISION OF
MARKET
REGULATION

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

**Information on Registration and Regulation of
BROKERS AND DEALERS**

I. GENERAL REQUIREMENTS

The Securities Exchange Act of 1934 (the "1934 Act") was enacted by the Congress to provide for the regulation of the nation's securities markets and the securities professionals who participate in those markets. The 1934 Act establishes a scheme of regulation with respect to, among other things, the business of being a broker or dealer in securities.

The threshold requirement applied to brokers and dealers is that they register with the Securities and Exchange Commission. The application for registration on Form BD, which is contained in this package, requires information concerning the background of the broker-dealer applicant and its principals, controlling persons, and employees. The application is designed to determine whether the applicant meets the statutory requirements to engage in a business that, at a minimum, involves high professional standards, and quite often, the more rigorous responsibilities of a fiduciary. Accordingly, it is important that a registered broker-dealer acquaint itself with and comply with the provisions of the federal securities laws that govern its business.

II. WHO IS REQUIRED TO REGISTER

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Section 15(a)(1) of the 1934 Act makes it unlawful for any broker or dealer (other than one whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange) "to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce ... the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) unless such broker or dealer is registered in accordance with [Section 15(b)]."

Definitions

"Broker" is defined in Section 3(a)(4) of the 1934 Act to mean any person engages in the business of effecting transactions in securities for the account of others, but does not include a bank.

"Dealer" is defined in Section 3(a)(5) of the 1934 Act to mean any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but it does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business.

"Exempted security" is defined in Section 3(a)(12) and includes, but is not limited to, securities that are direct obligations of, or obligations guaranteed as to principal or interest by, the United States and securities issued or guaranteed by corporations in which the United States has a direct or indirect interest, as designated by the Secretary of the Treasury. A security sold in a transaction that is exempt from registration under the Securities Act of 1933 is not necessarily an "exempted security" under the 1934 Act. Thus, *the fact that a private offering is made pursuant to Regulation D does not necessarily relieve a person selling such securities from the requirement of broker-dealer registration.*

CAUTION:

This information is provided as an introduction to the federal securities laws pertaining to brokers and dealers and is only intended to highlight and summarize some of the significant provisions. It should *not* relied on in lieu of reference to the actual statutes, rules regulations and interpretations.

Intrastate Exemption Limitations

The exemption from registration contained in Section 15(a)(1) of the 1934 Act for a broker or dealer whose business is "exclusively intrastate" is of very limited application. To be available to a broker or dealer, all of its business must be transacted within one state. Both sides of any transaction and all aspects of its securities business must be considered. The exemption would not be available if the broker or dealer effects transaction, or otherwise does business, for or with persons outside the state, whether such persons are public investors, issuers, or other broker-dealers. More specifically, without registering the broker or dealer cannot participate in any transaction executed on a national securities exchange and cannot, as agent, represent an out-of-state issuer or investor even if the transaction is effected with a customer in the broker-dealer's own state. The broker or dealer cannot sell to or buy from a person outside its state and cannot advertise in newspapers or other publications distributed outside its state unless the advertisement clearly states that it is doing an "exclusively intrastate" business and can act only for or with a person within its state in a wholly intrastate transaction.

Interpretations

The staff of the Division of Market Regulation has interpreted the definitions of the terms "broker" and "dealer" in a continuing series of "no-action" letters that are available through the Commission's Public Reference Branch. For example, under certain circumstances, persons selling only the securities of their employer may not be required to register as broker-dealers. Potential registrants may wish to review the "no-action" letters, consult with private counsel,

or request interpretive advice from the Division's staff if they are uncertain about the need to register.

III. APPLICATION FOR REGISTRATION AND INITIAL FINANCIAL STATEMENT

Application for registration as a broker-dealer may be made by filing one executed copy of Form BD with the Commission through the Central Registration Depository (CRD) operated by the National Association of Securities Dealers, Inc. ("NASD"). For detailed filing instructions, see the Special Instructions to Form BD contained in this package. There is no fee for filing. Non-resident applicants must submit an irrevocable appointment of the Commission as agent for service of process pursuant to Rule 15b1-5. An application will be returned to the applicant if all items have not been answered in the manner required, or if it is otherwise not acceptable for filing. Once an application has been accepted for filing, the Commission, within 45 days, will grant registration or institute proceedings to determine whether registration should be denied. **A broker-dealer must not commence doing business until its registration has been granted by the Commission, it has become a member of a self-regulatory organization, and its officer, directors, and other employees have satisfied certain qualification requirements (see "Associated Persons," below).**

IV. POST-REGISTRATION COMPLIANCE REQUIREMENTS

SRO Membership

In addition to registration with the Commission, a broker-dealer is required to become a member of an appropriate self-regulatory organization ("SRO"). If a broker-dealer effects transactions solely on a national securities exchange of which it is a member, that exchange is the appropriate SRO. If a broker-dealer effects transactions in over-the-counter securities, however, it must become a member of a national securities association. Since the NASD currently is the only such association, NASD membership is mandatory for broker-dealers that effect transactions in over-the-counter securities. A broker-dealer that does both an exchange and over-the-counter business must become a member of both the exchange and the NASD. Rule 15b9-1 under the 1934 Act, however, provides a limited exemption from membership with a national securities association for broker-dealers that belong to a national securities exchange and engage in very limited securities activities other than on such exchange. In most cases, initial and periodic membership fees must be paid to the NASD and exchanges. For further information about SRO membership, contact the applicable exchange or NASD district office listed in this package.

A broker-dealer may *not* commence business until its SRO membership has become effective.

SIPC Membership

Every registered broker-dealer must be a member of the Securities Investor Protection Corporation ("SIPC") unless its principal business is conducted outside of the United States or consists exclusively of the sale or distribution of investment company shares, variable annuities, or insurance. Each SIPC member must pay an annual fee to SIPC. For further information, contact SIPC, 805 15th St., N.W., Suite 800, Washington, D.C. 20005.

Associated Persons

"Associated person," as defined in Section 3(a)(18) of the 1934 Act, includes any partner, officer, director, branch manager, or employee of broker-dealer, or any person controlling, controlled by, or under common control with, a broker-dealer. Every associated person of a broker-dealer, other than one whose functions are solely clerical or ministerial, must meet certain specified qualification requirements. These qualifications include having his or her employer file a Form U-4 with the applicable SRO and passing an SRO securities examination. For certain associated persons who engage only in a limited range of securities activities, such as direct participation programs (*i.e.* certain tax shelter limited partnerships), the NASD provides in lieu of the general securities examination, a special examination

focused on the particular type of security involved. Form U-4 is the standardized form for registration of individuals and contains, among other things, information about the prior employment and disciplinary history of the individual. Copies of Form U-4 and information on securities examinations are available from the applicable SRO.

Required Books, Records and Financial Reports

Rules 17a-3, 17a-4, and 17a-5 under the 1934 Act specify certain basic recordkeeping and reporting requirements. Rule 17a-3 requires registered broker-dealers to make and keep current books and records detailing, among other things, securities transactions, money balances, and securities positions. Rule 17a-4 specifies record retention and preservation requirements for registered broker-dealers. Rule 17a-5 requires broker-dealers to file with the Commission periodic reports, including quarterly and annual financial statements. The annual report, called the "FOCUS" report, generally must be certified by an independent public accountant.

Net Capital Requirements

Rule 15c3-1 under the 1934 Act sets forth the "net capital" requirements for broker-dealers. Its object is to require a broker-dealer to have at all times sufficient liquid assets to cover its current indebtedness. In addition to the ratios tests set forth in the rule, Rule 15c3-1 prescribes required minimum net capital levels based upon the type of securities activities a broker-dealer conducts. For example, broker-dealers that clear and carry customer accounts must maintain at least \$250,000 in minimum net capital. Other categories of broker-dealers are permitted to operate with lesser levels of net capital.

Inspections

Broker-dealers are subject to inspections by the Commission and the SROs. Newly-registered broker-dealers generally must be inspected by the appropriate SRO for compliance with applicable financial responsibility rules within six months of registration and for compliance with all other regulatory requirements within twelve months of registration. Thereafter, the Commission and the SROs may inspect on a periodic basis. Under Section 17 of the 1934 Act, the books and records of a broker-dealer must be made available for Commission or SRO inspection without notice at any reasonable time.

Fingerprinting Requirement

Rule 17f-2 under the 1934 Act requires that every partner, officer, director, or employee of a broker-dealer be fingerprinted and submit the fingerprints to the Attorney General of the United States. Paragraph (a)(1)(iii) grants permissive exemptions from the requirements of the fingerprinting rule to registered broker-dealers engaged in the sale of certain securities that are not ordinarily evidenced by the issuance of certificates. The rule also provides that those persons who do not sell securities, have access to securities, money or original books and records, and who do not supervise persons engaged in such activities, are exempt. A registered broker-dealer claiming this exemption must, however, comply with the notice requirements of paragraph (e) of Rule 17f-2. SRO members may obtain fingerprint cards from the applicable SRO and should submit the completed fingerprint cards to the SRO for forwarding to the Attorney General.

Lost and Stolen Securities Program

All registered broker-dealers must register in this program, except those that effect securities transactions exclusively on the floor of a national securities exchange solely for other members of such exchange and do not receive or hold customer securities, and those that are engaged exclusively in the sale of variable contracts or limited partnership interests and do not receive or hold certain securities. Broker-dealers registered in the program must report on Form X-17F-1A securities losses, thefts and instances of counterfeiting to, and make the inquiries regarding securities coming

into their possession of, the Securities Information Center, which operates the program for the Commission. The registration, reporting, inquiry, and recordkeeping requirements generally are set forth in Rule 17f-1 under the 1934 Act. A registration form can be obtained from Securities Information Center, P.O. Box 421, Wellesley Hills, Massachusetts 02181.

Conduct Rule

Registered broker-dealers that are members of the NASD are required to comply with the NASD's Rules of Fair Practice, which govern the conduct of certain aspects of the business of a broker-dealer and generally require that a broker-dealer observe high standards of commercial honor and just and equitable principals of trade in the conduct of business. The exchanges also have rules that govern the conduct of an exchange securities business.

In addition, any broker-dealer effecting transactions in municipal securities must comply with the rules of the Municipal Securities Rulemaking Board. Any broker-dealer effecting transactions in governments securities must file notice of its activities with the Commission and comply with the government securities rules adopted by the Secretary of the Treasury.

Antifraud Provisions

The antifraud provisions of the federal securities laws are contained in Section 17 of the Securities Act of 1933, Sections 10(b) and 15(c) of the 1934 Act, and the rules thereunder. These provisions prohibit misstatements or misleading omissions of material facts, and fraudulent or manipulative acts and practices, in connection with the purchase or sale of securities. There are many specific rules applicable to broker-dealers, such as Rule 10b-10 (customer confirmation rule) that were adopted pursuant to the antifraud provisions.

Responsibility for Compliance--SEC Assistance

Although attention has been directed to selected provisions of the 1934 Act and rules, this is not to be regarded as relieving any broker-dealer from complying with all regulatory provisions applicable to its conduct at any given time. The staff of the Commission is available to broker-dealer applicants and registrants to discuss problems with regard to registration and other provisions of the 1934 Act that may pertain to specific proposed activities. Although the Commission staff is not in a position to act as counsel to an individual or broker-dealer in this regard, interested persons may find it convenient to contact the Office of Chief Counsel of the Division of Market Regulation or the Regional Office of the Commission in their area. It also may be helpful to review these matters with a private attorney familiar with the securities laws.

State Requirements

Many states have their own requirements with respect to persons conducting business as broker-dealers within that state. Information with respect to the requirements of any particular state should be addressed to the appropriate official in that state.



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CHAPTER UF Uniform Forms

*2-UF Blue Sky Regulation Form U-1***Form U-1 Uniform Application to Register Securities**

Uniform Application to Register Securities

Application to _____ of the State of _____ pursuant to Section
 _____ of the _____

1. Name and address of Issuer and principal office in this state:
2. Name, address and telephone number of correspondent to whom notices and communications regarding this application may be sent:
3. Name and address of applicant:
4. Registration or acceptance for filing is sought for the following described securities in the amounts indicated:

Description of Securities	Offering Price or Proposed Offering Price	Total Offering		Offering in this State	
		No. of Shares or Units	Amount	No. of Shares or Units	Amount
			\$		\$
		Totals	\$	\$	

Indicate the maximum commission to be charged: _____%

5. Amount of filing and examination fees which are enclosed: \$ _____ \$

6. A Registration Statement was filed with the Securities and Exchange Commission on

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_____ (date) and (became) (will become) effective on _____ (date)

7.

- (a) List the states in which it is proposed to offer the securities for sale to the public.
- (b) List the states, if any, in which the securities are eligible for sale to the public.
- (c) List the states, if any, which have refused, by order or otherwise, to authorize sale of the securities to the public, or have revoked or suspended the right to sell the securities or in which an application has been withdrawn.

8. Submitted herewith as a part of this application are the following documents (documents on file may be incorporated by reference):

- (a) One copy of the Registration Statement and two copies of the Prospectus in the latest form on file under the Securities Act of 1933.
- (b) Underwriting Agreement, Agreement among Underwriters, and Selected Dealers Agreement.
- (c) Indenture.
- (d) Issuer's charter or articles of incorporation as amended to date.
- (e) Issuer's by-laws as amended to date.
- (f) Signed copy of opinion of counsel filed with Registration Statement pursuant to the Securities Act of 1933.
- (g) Specimen (type of security) _____
- (h) Consent to service of process accompanied by appropriate corporate resolution.
- (i) If an earning computation or similar requirement is required to be met in this state, attach a separate sheet as an exhibit showing compliance.
- (j) One copy of all advertising matter to be used in connection with the offering.
- (k) Others (list each):

9. The applicant hereby applies for registration or acceptance for filing of the above described securities under the law cited above and in consideration thereof agrees so long as the registration remains in effect that it will:

- (a) Advise the above named state authority of any change prior to registration in this state in any of the information contained herein or in any of the documents submitted with or as a part of this application.
- (b) File with the above named state authority within two business days after filing with

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the Securities and Exchange Commission (i) any amendments other than delaying amendments to the federal registration statement, designating the changed, revised or added material or information by underlining the same; and (ii) the final prospectus, or any further amendments or supplements thereto.

(c) Notify the above named state authority within two business days (i) upon the receipt of any stop order, denial, order to show cause, suspension or revocation order, injunction or restraining order, or similar order entered or issued by any state or other regulatory authority or by any court, concerning the securities covered by this application or other securities of the issuer currently being offered to the public; and (ii) upon the receipt of any notice of effectiveness of said registration by the Securities and Exchange Commission.

(d) Notify the above named state authority at least two business days prior to the effectiveness of said registration with the Securities and Exchange Commission of (i) any request by the issuer or applicant to any other state or regulatory authority for permission to withdraw any application to register the securities described herein; and (ii) a list of all states in which applications have been filed where the issuer or applicant has received notice from the state authority that the application does not comply with state requirements and cannot or does not intend to comply with such requirements.

(e) Furnish promptly all such additional information and documents in respect to the issuer or the securities covered by this application as may be requested by the above named state authority prior to registration or acceptance for filing.

Date: _____

(Name of Applicant)

By: _____

(Name and Title)

STATE OF _____
COUNTY OF _____

The undersigned, _____, being first duly sworn, deposes and says:

That he has executed the foregoing application for and on behalf of the applicant named therein; that he is _____ of such applicant and is fully authorized to execute and file such application; that he is familiar with such application; and that to the best of his knowledge, information and belief the statements made in such application are true and the documents submitted therewith are true copies of the originals thereof.

(Name of Applicant)

2-UF Blue Sky Regulation Form U-1

Subscribed and sworn to before me
this _____ day of _____

NOTARY PUBLIC

In and for the County of _____

State of _____

My Commission Expires: _____

(Notarial Seal)

**FOR AN ACKNOWLEDGEMENT OF THE FILING OF THIS
APPLICATION COMPLETE THE LEFT COLUMN BELOW**

Name and address of correspondent

State of _____

File Number _____

Applicant

Date _____

Examiner

Issuer

Telephone _____

Date: _____

(Name of Applicant)

By: _____

(Name and Title)

STATE OF _____

COUNTY OF _____

The undersigned, _____, being first duly sworn, deposes and says:

That he has executed the foregoing application for and on behalf of the applicant named therein; that he is _____ of such applicant and is fully authorized to execute and file such application; that he is familiar with such application; and that to the best of his knowledge, information and belief the statements made in such application are true and the documents submitted therewith are true copies of the originals thereof.

(Name of Applicant)

2-UF Blue Sky Regulation Form U-1

Subscribed and sworn to before me
this _____ day of _____

NOTARY PUBLIC
In and for the County of _____
State of _____
My Commission Expires: _____
(Notarial Seal)

**FOR AN ACKNOWLEDGEMENT OF THE FILING OF THIS
APPLICATION COMPLETE THE LEFT COLUMN BELOW**

Name and address of correspondent	State of _____
_____	File Number _____

Applicant	Date _____
_____	Examiner
Issuer	
_____	Telephone _____



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CHAPTER UF Uniform Forms

2-UF Blue Sky Regulation U-2

U-2 Uniform Consent to Service of Process

Uniform Consent to Service of Process

Know all men by these presents:

That the undersigned _____ (a corporation), (a partnership), a () organized under the laws of _____ or (an individual), [strike out inapplicable nomenclature] for purposes of complying with the laws of the States indicated hereunder relating to either the registration or sale of securities, hereby irrevocably appoints the officers of the States so designated hereunder and their successors in such offices, its attorney in those States so designated upon whom may be served any notice, process or pleading in any action or proceeding against it arising out of, or in connection with, the sale of securities or out of violation of the aforesaid laws of the States so designated; and the undersigned does hereby consent that any such action or proceeding against it may be commenced in any court of competent jurisdiction and proper venue within the States so designated hereunder by service of process upon the officers so designated with the same effect as if the undersigned was organized or created under the laws of that State and have been served lawfully with process in that State.

It is requested that a copy of any notice, process or pleading served hereunder be mailed to:

(Name)

(Address)

Place an "X" before the names of all the States for which the person executing this form is appointing the designated Officer of each State as its attorney in that State for receipt of service of process:

_____ Secretary of State
AL

_____ Administrator of the Division of Banking and Corporations, Department

2-UF Blue Sky Regulation U-2

AK	of Commerce and Economic Development
_____	The Corporation Commission
AZ	
_____	The Securities Commissioner
AR	
_____	Commissioner of Corporations
CA	
_____	Securities Commissioner
CO	
_____	Banking Commissioner
CT	
_____	Securities Commissioner
DE	
_____	Public Service Commission
DC	
_____	Dept. of Banking and Finance
FL	
_____	Commissioner of Securities
GA	
_____	Administrator, Department of Finance
GUAM	
_____	Commissioner of Securities
HI	
_____	Director, Department of Finance
ID	
_____	Secretary of State
IL	
_____	Secretary of State
IN	
_____	Commissioner of Insurance
IA	
_____	Secretary of State
KS	
_____	Director, Division of Securities
KY	
_____	Commissioner of Securities
LA	
_____	Administrator, Securities Division
ME	
_____	Commissioner of the Division of Securities
MD	
_____	Secretary of State
MA	

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_____	Administrator, Corporation and Securities Bureau, Department of Commerce
MI	
_____	Commissioner of Commerce
MN	
_____	Secretary of State
MS	
_____	Securities Commissioner
MO	
_____	State Auditor and Commissioner of Insurance
MT	
_____	Director of Banking and Finance
NE	
_____	Secretary of State
NV	
_____	Secretary of State
NH	
_____	Chief, Securities Bureau
NJ	
_____	Director, Securities Division
NM	
_____	Secretary of State
NY	
_____	Secretary of State
NC	
_____	Securities Commissioner
ND	
_____	Secretary of State
OH	
_____	Director, Department of Insurance and Finance
OR	
_____	Securities Administrator
OK	
_____	Pennsylvania does not require filing of a Consent to Service of Process
PA	
_____	Commissioner of Financial Institutions
PR	
_____	Director of Business Regulation
RI	
_____	Director of the Division of Securities
SD	
_____	Securities Commissioner
SC	
_____	Commissioner of Commerce and Insurance

2-UF Blue Sky Regulation U-2

TN

Securities Commissioner

TX

Director, Division of Securities

UT

Clerk, State Corporation Commission

VA

Commissioner of Banking, Insurance, Securities & Health Administra-
tion

VT

Director of the Department of Licensing

WA

Commissioner of Securities

WV

Commissioner of Securities

WI

Secretary of State

WY

Dated this _____ day of _____, 20__

(SEAL)

By _____

Title**CORPORATE ACKNOWLEDGMENT**

State or Province of _____)

County of _____) ss.

On this _____ day of _____, 20____ before me
 _____ the undersigned officer, personally appeared _____ known personally to me to be
 the _____ (Title) of the above named corporation and acknowledged that he, as an officer being
 authorized so to do, executed the foregoing instrument for the purposes therein contained, by signing the name of the
 corporation by himself as an officer.

IN WITNESS WHEREOF I have hereunto set my hand and official seal.

Notary Public/Commissioner of Oaths
My Commission Expires_____

(SEAL)

INDIVIDUAL OR PARTNERSHIP ACKNOWLEDGMENT

State or Province of _____)

County of _____) ss.

On this _____ day of _____, 20 _____, before me,
_____, the undersigned officer, personally appeared _____ to me personally known and
known to me to be the same person(s) whose name(s) is (are) signed to the foregoing instrument, and acknowledged the
execution thereof for the uses and purposes therein set forth.

In WITNESS WHEREOF I have hereunto set my hand and official seal.

Notary Public/Commissioner of Oaths
My Commission Expires_____

(SEAL)



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CHAPTER UF Uniform Forms

2-UF Blue Sky Regulation U-2A

U-2A Uniform Corporate Resolution

Form U-2A
Uniform Corporate Resolution
Uniform Form of Corporate Resolution of

(Name of Corporation)

RESOLVED, that it is desirable and in the best interest of this Corporation that its securities be qualified or registered for sale in various states; that the President or any Vice President and the Secretary or any Assistant Secretary hereby are authorized to determine the states in which appropriate action shall be taken to qualify or register for sale all or such part of the securities of this Corporation as said officers may deem advisable; that said officers are hereby authorized to perform on behalf of this Corporation any and all such acts as they deem necessary or advisable in order to comply with the applicable laws of any such states, and in connection therewith to execute and file all requisite papers and documents, including, but not limited to, applications, reports, surety bonds, irrevocable consents and appointments of attorneys for service of process; and the execution by such officers of any such paper or document or the doing by them of any act in connection with the foregoing matters shall conclusively establish their authority from this Corporation and the approval and ratification by this Corporation of the papers and documents so executed and the action so taken.

CERTIFICATE

The undersigned hereby certifies that he is the _____ Secretary of _____, a corporation organized and existing under the laws of the State of _____; that the foregoing is a true and correct copy of a resolution duly adopted at a meeting of the Board of Directors of said corporation held on the _____ day of _____, 20 _____, at which meeting a quorum was at all times present and acting; that the passage of said resolution was in all respects legal; and that said resolution is in full

force and effect.

Dated this _____ day of _____, 20_____.

Secretary

(CORPORATE SEAL)



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CHAPTER UF Uniform Forms

2-UF Blue Sky Regulation NF

NF Uniform Investment Company Notice Filing

Uniform Investment Company Notice Filing

Please Read Instructions Prior To Filling Out Form State File No. _____

Notice to the State/Commonwealth of _____

1. Name of Issuer _____

2. Address _____

3. Type of Filing: (check all that apply)

☐ Open-end Mutual Fund	☐ Unit Investment Trust	☐ Closed-end Mutual Fund
☐ Initial Filing	☐ Renewal Filing	☐ Amendments
☐ Exemption Filing	☐ Termination	☐ Withdrawal
☐ Sales Report	☐ Increase Dollar Amount	

☐ Other (specify) _____

For name changes, provide former name: _____

For amendments, specify nature of the change(s): _____

4. Description of Securities(e.g. Shares of beneficial interest): _____

2-UF Blue Sky Regulation NF

Name of Fund _____

Portfolio(s) _____

Class(es) _____

Fiscal Year End of the issuer (if applicable) _____

Are all of the securities described on this form offered in one prospectus? Yes ☐ No ☐

5. Contact Person:

Name _____ Firm _____

Address _____

City _____ State _____

ZIP _____ Telephone _____

FAX: _____ E-Mail _____

6. CIK# (EDGAR) _____ Federal ID# (if applicable) _____

Broker-Dealer: _____ SEC Registration No.(if applicable) _____

Broker Dealer[]s CRD No. _____ State of Incorporation/Charter _____

Portfolio _____

Class _____

7. ☐ Notice Period: Beginning Date: _____/_____/____ Ending Date:
_____/_____/_____☐ The issuer elects to have its notice filing made effective upon filing. _____☐ The issuer elects to have its notice filing period begin with SEC effectiveness and
thereby agrees to provide the above state prompt notice of such effectiveness.8. Notice Fee: \$ _____ ☐ No Filing Fee Required

2-UF Blue Sky Regulation NF

Sales Report Fee (if applicable) \$ _____

Other Fee \$ _____ Explain _____

9. To determine the basis used for calculating the filing fee, provide the following:

☐ Indefinite Amount ☐ Definite Amount \$ _____

☐ _____ Exemption Filing ☐ Net Assets: \$ _____

10. For filings to increase the dollar amount of securities reported during the notice period, provide the following:

(1) Previous Amount of Securities _____

(2) Amount of Increase _____

(3) Cumulative Amount of Securities _____

11. SALES REPORT [To the extent not applicable, place N/A in the blank(s)]

Period Covered: Beginning date: _____ / _____ / _____ Ending:
_____ / _____ / _____

Balance at beginning of period \$ _____

Additional Increases during period \$ _____

Amount available for sale \$ _____

Sales during the period \$ _____

Unsold balance at end of period \$ _____

12. UNIFORM CONSENT TO SERVICE OF PROCESS (select one)

1. ☐ Was previously filed with this state with respect to the issuer of the securities covered for the securities covered by this notice and is incorporated by reference

2. ☐ Is attached.

3. ☐ Not Applicable (explain): _____

13. SIGNATURES

The undersigned under penalties of perjury certifies that s/he has executed this Uniform Investment Company notice on behalf of, and with the authority of the issuer. The undersigned and the issuer represent that the information and statements contained in the notice filed, are current, true and complete to the best of his or her knowledge, information and belief and that any documents submitted with the notice are true copies of the originals, and that the securities covered by this Notice are Covered Securities as defined by Section 18(b)(2) of the Securities Act of 1933.

2-UF Blue Sky Regulation NF

Dated this _____ day of _____, _____

Month Year

For: _____ By: _____

Name of Issuer Signature of Authorized Agent of Issuer

Print Name Title of Agent for Issuer

The filing of this notice constitutes a binding agreement by the above-named issuer and under the laws of the jurisdiction in which this Form is filed, that upon receipt of a request from such jurisdiction, the issuer will promptly provide a copy of its current prospectus, and/or statement of additional information, and/or any other document, if any, as filed with the Securities and Exchange Commission.



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CHAPTER UF Uniform Forms

2-UF Blue Sky Regulation Form U-SB

Form U-SB Uniform Surety Bond Form

Uniform Surety Bond Form
State/Commonwealth/Territory of

Name of Agency

Address of Agency

Bond No. _____

KNOW ALL PERSONS BY THESE PRESENTS:

That,

Name and address of broker-dealer or investment adviser

as Principal, having filed with the office of the

Name of agency requiring bond

on or about the _____ day of _____, 20____, an application to transact business in this State/Commonwealth/Territory as a

and

Designate whether principal is B/D or I/A

_____ as Surety, a corporation organized *Name and address of Surety*

under the laws of the State/Commonwealth/Territory of _____ and being duly authorized to transact the business of indemnity and suretyship in this State/Commonwealth/Territory, do hereby acknowledge our indebtedness to the State/Commonwealth/ Territory of _____ for the use and benefit of any person(s) having a claim under the conditions of this obligation, in the sum of _____, Dollars (\$ _____), as required by _____ provided, however, that the

2-UF Blue Sky Regulation Form U-SB

Statute Requiring Bond

aggregate liability hereunder shall not exceed the sum of _____ Dollars, (\$ _____) regardless of the number of claimants, and shall not be construed as individual liability.

LIABILITY for the payment of this sum, to which we hereby obligate and bind ourselves, our heirs, executors, administrators, successors and assigns, jointly and severally, becomes effective upon the following conditions:

1. Registration/Licensing of the Principal to transact business in this State/Commonwealth/Territory as a _____ *Designate whether principal is a broker-dealer or investment adviser and*
2. Failure by the Principal to strictly comply with all applicable provisions of, and orders, rules and regulations issued pursuant to, the applicable securities statutes of the particular state, commonwealth or territory in which such Principal is registered.

THIS Bond shall expire at such time as the Principal's registration is withdrawn, terminates through non-renewal or issue revoked by the

Name of Agency

except as to liability for acts or omissions which occur prior to such time. This Bond may also be canceled by the Surety upon _____ days written notice by registered mail to the Principal and to the _____ in which case this Bond shall

Name of Agency

be considered canceled upon the expiration of _____ said days period except as to liability for acts or omissions which occur prior to the date of cancellation. Notice shall be deemed effective upon receipt by the applicable state agency of said written notice along with sufficient proof of notice to the Principal.

NO suit may be maintained to enforce any liability arising under this Bond unless brought within _____ years after discovery of the act or omission upon which liability is based. IT is understood and agreed that any person(s) having a claim under the conditions of this obligation may initiate suit in any court of competent jurisdiction against the Principal and/or the Surety upon this Bond.

WITNESS OUR SIGNATURES, this the _____ day of _____, 20____.

PRINCIPAL

BY
(corporate seal, if applicable)

SURETY

BY

Counter Signature of

Agent of Surety resident

ACKNOWLEDGMENT OF INDIVIDUAL

2-UF Blue Sky Regulation Form U-SB

STATE OF _____	)	
COUNTY OF _____	)	ss.
	)	
	)	

On this _____ 20____, before me personally appeared _____, to me known to be the person described who executed the foregoing instrument, as Principal, an acknowledged to me that he executed the same as his free act and deed.

(NOTARIAL SEAL)

NOTARY PUBLIC,

COUNTY,

MY COMMISSION EXPIRES

ACKNOWLEDGMENT OF PARTNERSHIP

STATE OF _____	)	
COUNTY OF _____	)	ss.
	)	
	)	

On this _____, 19____, before me personally appeared _____, to me known to be a member of the firm who executed the foregoing instrument, and he duly acknowledged to me that he executed the same as and for the act and deed of said firm.

(NOTARIAL SEAL)

NOTARY PUBLIC,

COUNTY,

NOTE: A true and correct copy of the applicable "Power of Attorney" must be attached hereto where the Bond is subscribed to by an "Attorney in Fact."



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CHAPTER UF Uniform Forms

2-UF Blue Sky Regulation BD

BD Uniform Application for Broker-Dealer Registration

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CHAPTER UF Uniform Forms

2-UF Blue Sky Regulation BDW

BDW Uniform Request for Broker-Dealer Withdrawal

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CHAPTER UF Uniform Forms

2-UF Blue Sky Regulation U-4

U-4 Uniform Application for Securities Industry Registration or Transfer

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FOOTNOTES:

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CHAPTER UF Uniform Forms

2-UF Blue Sky Regulation U-5

U-5 Uniform Termination Notice for Securities Industry Registration

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FOOTNOTES:

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CHAPTER UF Uniform Forms

2-UF Blue Sky Regulation ADV

ADV Uniform Application for Investment Adviser Registration

[Editor's Note: Please note that the following version of Form ADV is no longer used by the SEC. An IARD-compatible version of Form ADV was adopted by the SEC in Release No. IA-1897, Sept. 12, 2000, effective Oct. 10, 2000, and amended in Release No. IA-1916, Dec. 21, 2000, effective Jan. 1, 2001. The new version of the form is printed immediately after the end of this version. Please note, however, that it is not yet clear which of the states will mandate the use of the IARD *or* the new form for those investment advisers that are not federally registered. Therefore, this version of the uniform form may remain useful in certain states. For information on the status of investment adviser forms in specific states, consult the web site of that state's securities administration or contact the state's securities administrator.]

[Click here to view image.](#)



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CHAPTER UF Uniform Forms

2-UF Blue Sky Regulation ADV

ADV Uniform Application for Investment Adviser Registration [New version of form, effective January 1, 2001]

[**Editor's Note:** Please note that the following is the new version of Form ADV. An IARD-compatible version of Form ADV was initially adopted by the SEC in Release No. IA-1897, Sept. 12, 2000, effective Oct. 10, 2000. The version printed below contains further amendments, namely technical amendments made in Release No. IA-1916, Dec. 21, 2000, effective Jan. 1, 2001.]

FORM ADV (Paper Version)

UNIFORM APPLICATION FOR INVESTMENT ADVISER REGISTRATION

Form ADV: General Instructions

Read these instructions carefully before filing Form ADV. Failure to follow these instructions, properly complete the form, and pay all required fees may result in your filing being returned to you. Electronic filers should follow the instructions available on-line, which are different.

In these instructions and in the form, "you" means the investment adviser (i.e., the advisory firm) applying for registration or amending its registration. If you are a "separately identifiable department or division" (SID) of a bank, "you" means the SID, rather than your bank, unless the instructions or the form provide otherwise. Terms that appear in *italics* are defined in the Glossary of Terms to Form ADV.

1. Where can I get more information on Form ADV, electronic filing, and the IARD?

The SEC provides information about its rules and the Advisers Act on its website: <<www.sec.gov/iard>>.

NASAA provides information about state investment adviser laws and state rules, and how to contact a *state securities*

authority, on its website: <<www.nasaa.org>>.

NASD provides information about the IARD and electronic filing on the IARD website: <<www.iard.com>>.

2. What is Form ADV used for?

Investment advisers use Form ADV to:

- Register with the Securities and Exchange Commission
- Register with one or more *state securities authorities*
- Amend those registrations

3. How is Form ADV organized?

Form ADV contains three parts:

- Part 1A asks a number of questions about you, your business practices, the *persons* who own and *control* you, and the *persons* who provide investment advice on your behalf. All advisers registering with the SEC or any of the *state securities authorities* must complete Part 1A.

Part 1 A also contains several schedules that supplement Part 1A. The items of Part 1A let you know which schedules you must complete.

- ☐ Schedule A asks for information about your direct owners and executive officers.
- ☐ Schedule B asks for information about your indirect owners.
- ☐ Schedule C is used by paper filers to update the information required by Schedules A and B (see Instruction 14).
- ☐ Schedule D asks for additional information for certain items in Part 1A.
- ☐ Disclosure Reporting Pages (or "DRPs") ask for details about disciplinary events involving you or *persons* affiliated with you. (These are considered schedules too.)

- Part 1B asks additional questions required by *state securities authorities*. Part 1B contains three DRPs. If you are applying for registration or are registered only with the SEC, you do not have to complete Part 1B. (If you are filing electronically and you do not have to complete Part 1B, you will not see Part 1B.)

- Part II is your current brochure. You must continue to amend your brochure, deliver it to prospective *clients*, and annually offer it to current *clients*. See rule 204-3. You are not required to file amendments to Part II with the SEC.

Note:

The SEC has proposed to amend Part II of Form ADV. These changes, proposed as Part 2, have not been

2-UF Blue Sky Regulation ADV

adopted at this time. Until the Commission adopts Part 2, the current brochure requirements are in effect, except that you are no longer required to file amendments to Part II with the Commission. See rule 204-3.

4. When am I required to update my Form ADV?

You must amend your Form ADV each year by filing an *annual updating amendment* within 90 days after the end of your fiscal year. When you submit your *annual updating amendment*, you must update your responses to all items.

In addition to your *annual updating amendment*, you must amend your Form ADV by filing additional amendments (other-than-annual amendments) promptly if:

- information you provided in response to Items 1, 3, 9, or 11 of Part 1A or Items 1, 2.A. through 2.F., or 2.I. of Part 1B become inaccurate in any way;
- information you provided in response to Items 4, 8, or 10 of Part 1A or Item 2.G. of Part 1B become materially inaccurate; or
- information you provided in your brochure becomes materially inaccurate.

If you are submitting an other-than-annual amendment, you are not required to update your responses to Items 2, 5, 6, 7, or 12 of Part 1A or Items 2.H. or 2.J. of Part 1B even if your responses to those items have become inaccurate. If you are amending Part II, do not file the amendment with the SEC.

Failure to update your Form ADV, as required by this instruction, is a violation of SEC rule 204-1 and similar state rules and could lead to your registration being revoked.

5. Are there changes to the Part II requirements?

The rules for preparing, delivering and offering Part II have not changed. You can still satisfy these requirements by delivering Part II or a brochure containing at least the information contained in Part II. If you are using Part II, you can continue to use Schedule F as a continuation sheet. If you check "yes" to Item 14 of Part II, prepare and file a balance sheet following instructions in Schedule G. The balance sheet information must be distributed to *clients* as part of your written disclosure statement (regardless of whether you use Part II or a brochure).

If you are an SEC-registered adviser, however, you no longer have to file Part II with the SEC. Instead, you must keep a copy in your files, and provide it to SEC staff upon request. You must update the information in your Part II whenever it becomes materially inaccurate. You can do this by substituting pages, or by affixing a "sticker" replacing the stale information.

If you are a state-registered adviser, you must continue to file Part II with the appropriate *state securities authority* on paper, regardless of whether you are filing Part 1 on paper or electronically through the IARD.

Note:

The SEC has proposed, but not adopted, substantial changes to Part II.

6. Where do I sign my Form ADV application or amendment?

You must sign the appropriate Execution Page. There are three Execution Pages at the end of the form. Your initial application and all amendments to Form ADV must include at least one Execution Page.

2-UF Blue Sky Regulation ADV

- If you are applying for or amending your SEC registration, you must sign and submit either a:

☐ Domestic Investment Adviser Execution Page, if you (the advisory firm) are a resident of the United States; or

☐ *Non-Resident* Investment Adviser Execution Page, if you (the advisory firm) are not a resident of the United States.

- If you are applying for or amending your registration with a *state securities authority*, you must sign and submit the State-Registered Investment Adviser Execution Page.

7. Who must sign my Form ADV or amendment?

The individual who signs the form depends upon your form of organization:

- For a sole proprietorship, the sole proprietor.
- For a partnership, a general partner.
- For a corporation, an authorized principal officer.
- For a "separately identifiable department or division" (SID) of a bank, a principal officer of your bank who is directly engaged in the management, direction or supervision of your investment advisory activities.
- For all others, an authorized individual who participates in managing or directing your affairs.

The signature does not have to be notarized, and in the case of an electronic filing, should be a typed name.

8. How do I file my Form ADV?

Note:

Until May 1, 2001, you must also consult the Form ADV Supplemental Instructions for Transition to Electronic Filing.

Complete Form ADV electronically using the Investment Adviser Registration Depository (IARD) if:

- You are filing with the SEC (and submitting *notice filings* to any of the *state securities authorities*), or
- You are filing with a *state securities authority* that requires or permits advisers to submit Form ADV through the IARD.

To file electronically, go the IARD website (<<www.iard.com>>), which contains detailed instructions for advisers to follow when filing through the IARD.

Complete Form ADV (Paper Version) on paper if:

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- You are filing with the SEC or a *state securities authority* that requires electronic filing, but you have been granted a continuing hardship exemption. Hardship exemptions are described in Instruction 13.
- You are filing with a *state securities authority* that permits (but does not require) electronic filing and you do not file electronically.

9. How do I get started filing electronically?

- First, get a copy of the IARD Entitlement Package from the following web site: <<www.iard.com>>. Second, request access to the IARD system for your firm by completing and submitting the IARD Entitlement Package. The IARD Entitlement Package must be submitted on paper. Mail the forms to: IARD Entitlement Requests, NASD, P.O. Box 9495, Gaithersburg, MD 20898-9495.
- When NASD receives your Entitlement Package, they will assign a *CRD* number (identification number for your firm) and a user I.D. code and password (identification number and system password for the individual(s) who will submit Form ADV filings for your firm). Your firm may request an I.D. code and password for more than one individual. The NASD also will create a financial account for you from which the IARD will deduct filing fees and any *state* fees you are required to pay. If you already have a *CRD* account with NASD, it will also serve as your IARD account; a separate account will not be established.
- Once you receive your *CRD* number, user I.D. code and password, and you have funded your account, you are ready to file electronically.
- Questions regarding the Entitlement Process should be addressed to NASD at 240.386.4848.

10. If I am applying for registration with the SEC, or amending my SEC registration, how do I make notice filings with the *state securities authorities*?

If you are applying for registration with the SEC or amending your SEC registration, one or more *state securities authorities* may require you to provide them with copies of your SEC filings. We call these filings "*notice filings*." Your *notice filings* will be sent electronically to the *states* that you check on Item 2.B. of Part 1A. The *state securities authorities* to which you send *notice filings* may charge fees, which will be deducted from the account you establish with NASD. To determine which *state securities authorities* require SEC-registered advisers to submit *notice filings* and to pay fees, consult the relevant state investment adviser law or *state securities authority*. See General Instruction 1.

If you are granted a continuing hardship exemption to file Form ADV on paper, NASD will enter your filing into the IARD and your *notice filings* will be sent electronically to the *state securities authorities* that you check on Item 2.B. of Part 1A.

11. I am registered with a *state*. When must I switch to SEC registration?

If you report on your *annual updating amendment* that your assets under management have increased to \$30 million or more, you must register with the SEC within 90 days after you file that *annual updating amendment*. If your assets under management increase to \$25 million or more but not \$30 million, you may, but are not required to, register with the SEC (assuming you are not otherwise required to register with the SEC). Once you register with the SEC, you are subject to SEC regulation, regardless of whether you remain registered with one or more *states*. Each of your *investment adviser representatives*, however, may be subject to registration in those *states* in which the representative has a place of business. See SEC rule 203A-1(b). For additional information, consult the investment adviser laws or the *state*

securities authority for the particular state in which you are "doing business." See General Instruction 1.

12. I am registered with the SEC. When must I switch to registration with a *state securities authority*?

If you report on your *annual updating amendment* that you have assets under management of less than \$25 million and you are not otherwise eligible to register with the SEC, you must withdraw from SEC registration within 180 days after the end of your fiscal year by filing Form ADV-W. You should consult state law in the states that you are doing business to determine if you are required to register in these states. See General Instruction 1. Until you file your Form ADV-W with the SEC, you will remain subject to SEC regulation, and you also will be subject to regulation in any states where you register. See SEC rule 203A-1(b).

13. Are there filing fees?

Yes. These fees go to support and maintain the IARD. The IARD filing fees are in addition to any registration or other fee that may be required by state law. You must pay an IARD filing fee for your initial application and each *annual updating amendment*. There is no filing fee for an other-than-annual amendment or Form ADV-W. The IARD filing fee schedule is published at <<www.sec.gov/iard>>; <<www.nasaa.org>>; and <<www.iard.com>>.

If you are submitting a paper filing under a continuing hardship exemption (see Instruction 14), you are required to pay an additional fee. The amount of the additional fee depends on whether you are filing Form ADV or Form ADV-W. (There is no additional fee for filings made on Form ADV-W.) The hardship filing fee schedule is available at 240.386.4848.

14. What if I am not able to file electronically?

If you are required to file electronically but cannot do so, you may be eligible for one of two types of hardship exemptions from the electronic filing requirements.

- **A temporary hardship exemption** is available if you file electronically, but you encounter unexpected difficulties that prevent you from making a timely filing with the IARD, such as a computer malfunction or electrical outage. This exemption does not permit you to file on paper; instead, it extends the deadline for an electronic filing for seven business days. See SEC rule 203-3(a).

- **A continuing hardship exemption** may be granted if you are a small business and you can demonstrate that filing electronically would impose an undue hardship. You are a small business, and may be eligible for a continuing hardship exemption, if you are required to answer Item 12 of Part 1A (because you have assets under management of less than \$25 million) and you are able to respond "no" to each question in Item 12. See SEC rule 0-7.

If you have been granted a continuing hardship exemption, you must complete and submit the paper version of Form ADV to NASD. NASD will enter your responses into the IARD. As discussed in General Instruction 13, NASD will charge you a fee to reimburse it for the expense of data entry.

Before applying for a continuing hardship exemption, consider engaging a firm that assists investment advisers in making filings with the IARD. Check the SEC's web site (<<www.sec.gov/iard>>) to obtain a list of firms that provide these services.

15. I am eligible to file on paper. How do I make a paper filing?

When filing on paper, you must:

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- Type all of your responses.
- Include your name (the same name you provide in response to Item 1.A. of Part 1A) and the date on every page.
- If you are amending your Form ADV:
 - ☐ complete page 1 and circle the number of any item for which you are changing your response.
 - ☐ include your SEC 801-number (if you have one) and your *CRD* number (if you have one) on every page.
 - ☐ complete the amended item in full and circle the number of the item for which you are changing your response.
 - ☐ to amend Schedule A or Schedule B, complete and submit Schedule C.

Where you submit your paper filing depends on why you are eligible to file on paper:

- If you are filing on paper because you have been granted a continuing hardship exemption, submit one manually signed Form ADV and one copy to: IARD Document Processing, NASD, P.O. Box 9495, Gaithersburg, MD 20898-9495.

If you complete Form ADV on paper and submit it to NASD but you do not have a continuing hardship exemption, the submission will be returned to you.

- If you are filing on paper because a *state* in which you are registered or applying for registration allows you to submit paper instead of electronic filings, submit one manually signed Form ADV and one copy to the appropriate *state securities authorities*.

16. Who is required to file Form ADV-NR?

Every *non-resident* general partner and *managing agent* of all SEC-registered advisers, whether or not the adviser is resident in the United States, must file Form ADV-NR in connection with the adviser's initial application. A general partner or *managing agent* of an SEC-registered adviser who becomes a *non-resident* after the adviser's initial application has been submitted must file Form ADV-NR within 30 days. Form ADV-NR must be filed on paper (it cannot be filed electronically).

Submit Form ADV-NR to the SEC at the following address:

Securities and Exchange Commission, 450 5th Street, N.W., Mail Stop A-2, Washington, DC 20549; Attn: Branch of Registrations & Examinations

Failure to file Form ADV-NR promptly may delay SEC consideration of your initial application.

Federal Information Law and Requirements

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Sections 203(c) and 204 of the Advisers Act [*15 U.S.C. §§ 80b-3(c) and 80b-4*] authorize the SEC to collect the information required by Form ADV. The SEC collects the information for regulatory purposes, such as deciding whether to grant registration. Filing Form ADV is mandatory for advisers who are required to register with the SEC. The SEC maintains the information submitted on this form and makes it publicly available. The SEC may return forms that do not include required information. Intentional misstatements or omissions constitute federal criminal violations under *18 U.S.C. § 1001* and *15 U.S.C. § 80b-17*.

SEC's Collection of Information

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number. The Advisers Act authorizes the SEC to collect the information on Form ADV from applicants. See *15 U.S.C. §§ 80b-3(c)(1) and 80b-4*. Filing the form is mandatory.

The main purpose of this form is to enable the SEC to register investment advisers. Every applicant for registration with the SEC as an adviser must file the form. See *17 C.F.R. § 275.203-1*. By accepting a form, however, the SEC does not make a finding that it has been completed or submitted correctly. The form is filed annually by every adviser, no later than 90 days after the end of its fiscal year, to amend its registration. It is also filed promptly during the year to reflect material changes. See *17 C.F.R. § 275.204-1*. The SEC maintains the information on the form and makes it publicly available through the IARD.

Anyone may send the SEC comments on the accuracy of the burden estimate on page 1 of the form, as well as suggestions for reducing the burden. The Office of Management and Budget has reviewed this collection of information under *44 U.S.C. § 3507*.

The information contained in the form is part of a system of records subject to the Privacy Act of 1974, as amended. The SEC has published in the Federal Register the Privacy Act System of Records Notice for these records.

FORM ADV (Paper Version)**UNIFORM APPLICATION FOR INVESTMENT ADVISER REGISTRATION****Form ADV: Supplemental Instructions for Electronic Filing****SEC Requirements**

SEC rules require advisers that are registered or applying for registration with the SEC to file electronically. All applications for registration filed after December 31, 2000 must be filed electronically through the IARD system. See SEC rule 203-1.

State Requirements

Check with the *state securities authorities* of the states in which you have a filing obligation to determine whether you

can or must file Form ADV electronically through the IARD. NASAA provides information about state investment adviser laws and state rules, and how to contact a *state securities authority*, on its website: www.nasaa.org.

FORM ADV (Paper Version)

UNIFORM APPLICATION FOR INVESTMENT ADVISER REGISTRATION

Form ADV: Instructions for Part 1A

These instructions explain how to complete certain items in Part 1A of Form ADV.

1 . Item 1: Identifying Information

If you are a "separately identifiable department or division" (SID) of a bank, answer Item 1.A. with the full legal name of your bank, and answer Item 1.B. with your own name (the name of the department or division) and all names under which you conduct your advisory business. In addition, your *principal office and place of business* in Item 1.F. should be the principal office at which you conduct your advisory business. In response to Item 1.I., the World Wide Web site addresses you list on Schedule D should be sites that provide information about your own activities, rather than general information about your bank.

2 . Item 2: SEC Registration

If you are registered or applying for registration with the SEC, you must indicate in Item 2.A. why you are eligible to register with the SEC by checking one or more boxes.

a. Item 2.A(1): Adviser with Assets Under Management of \$25 Million or More. You may check box 1 only if your response to Item 5.F(2)(c) is \$25 million or more. While you may register with the SEC if your assets under management are at least \$25 million but less than \$30 million, you must register with the SEC if your assets under management are \$30 million or more. Part 1A Instruction 5.b. explains how to calculate your assets under management.

If you are a state-registered adviser and you report on your *annual updating amendment* that your assets under management increased to \$25 million or more, you may register with the SEC. If your assets under management increased to \$30 million or more, you must register with the SEC within 90 days after you file that *annual updating amendment*. See SEC rule 203A-1(b) and Form ADV General Instruction 10.

b. Item 2.A(4): Adviser to an Investment Company. You may check box 4 only if you currently provide advisory services under an investment advisory contract to an investment company registered under the Investment Company Act of 1940 and the investment company is operational (i.e., has assets and shareholders, other than just the organizing shareholders). See section 203A(a)(1)(B) of the Advisers Act. Advising investors about the merits of investing in mutual funds or recommending particular mutual funds does not make you eligible to check this box.

c. Item 2.A(5): Nationally Recognized Statistical Rating Organization. You may check box 5 only if you are designated as a nationally recognized statistical rating organization pursuant to an application filed under paragraph (c)(13)(i) of SEC rule 15c3-1 under the Securities Exchange Act of 1934. See SEC

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rule 203A-2(a). This designation generally is limited to rating agencies, such as Moody's and Standard & Poor's.

d. **Item 2.A(6): Pension Consultant.** You may check box 6 only if you are eligible for the pension consultant exemption from the prohibition on SEC registration.

- You are eligible for this exemption if you provided investment advice to employee benefit plans, governmental plans, or church plans with respect to assets having an aggregate value of \$50 million or more during the 12-month period that ended within 90 days of filing this Form ADV. You are not eligible for this exemption if you only advise plan participants on allocating their investments within their pension plans. See SEC rule 203A-2(b).

- To calculate the value of assets for purposes of this exemption, aggregate the assets of the plans for which you provided advisory services at the end of the 12-month period. If you provided advisory services to other plans during the 12-month period, but your employment or contract terminated before the end of the 12-month period, you also may include the value of those assets.

e. **Item 2.A(7): Affiliated Adviser.** You may check box 7 only if you are eligible for the affiliated adviser exemption from the prohibition on SEC registration. See SEC rule 203A-2(c). You are eligible for this exemption if you *control*, are *controlled by*, or *are under common control with* an investment adviser that is registered with the SEC, and you have the same *principal office and place of business* as that other investment adviser. Note that you may not rely on the SEC registration of an Internet investment adviser under rule 203A-2(f) in establishing eligibility for this exemption. See SEC rule 203A-2(f)(iii). If you check box 7, you also must complete Section 2.A(7) of Schedule D.

f. **Item 2.A(8): Newly-Formed Adviser.** You may check box 8 only if you are eligible for the newly-formed-adviser exemption from the prohibition on SEC registration. See SEC rule 203A-2(d). You are eligible for this exemption if:

- immediately before you file your application for registration with the SEC, you were not registered or required to be registered with the SEC or a *state securities authority*; and
- at the time of your formation, you have a reasonable expectation that within 120 days of registration you will be eligible for SEC registration.

If you check box 8, you also must complete Section 2.A(8) of Schedule D.

You must file an amendment to Part 1A of your Form ADV that updates your response to Item 2.A. within 120 days after the SEC declares your registration effective. You may not check box 8 on your amendment; since this exemption is available only if you are not registered, you may not "re-rely" on this exemption. If you indicate on that amendment (by checking box 12) that you are not eligible to register with the SEC, you also must at that same time file a Form ADV-W to withdraw your SEC registration.

g. **Item 2.A(9): Multi-State Adviser.** You may check box 9 only if you are eligible for the multi-state adviser exemption from the prohibition on SEC registration. See SEC rule 203A-2(e). You are eligible for this exemption if you are required to register as an investment adviser with the securities authorities of 30 or more *states*. If you check box 9, you must complete Section 2.A(9) of Schedule D. You must

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complete Section 2.A(9) of Schedule D in each *annual updating amendment* you submit.

If you check box 9, you also must:

- create and maintain a list of the *states* in which, but for this exemption, you would be required to register;
- update this list each time you submit an *annual updating amendment* in which you continue to represent that you are eligible for this exemption; and
- maintain the list in an easily accessible place for a period of not less than five years from each date on which you indicate that you are eligible for the exemption.

If, at the time you file your *annual updating amendment*, you are required to register in less than 25 *states* and you are not otherwise eligible to register with the SEC, you must check box 12 in Item 2.A. You also must file a Form ADV-W to withdraw your SEC registration. See Part 1A Instruction 2.i.

h. Item 2.A (10): Internet Investment Adviser. You may check box 10 only if you are eligible for the Internet adviser exemption from the prohibition on SEC registration. See SEC rule 203A-2(f). You are eligible for this exemption if:

- you provide investment advice to your *clients* through an interactive website. An interactive website means a website in which computer software-based models or applications provide investment advice based on personal information each *client* submits through the website. Other forms of online or Internet investment advice do not qualify for this exemption;
- you provide investment advice to all of your *clients* exclusively through the interactive website, except that you may provide investment advice to fewer than 15 *clients* through other means during the previous 12 months; and
- you maintain a record demonstrating that you provide investment advice to your *clients* exclusively through an interactive website in accordance with these limits.

i. Item 2.A(12): Adviser No Longer Eligible to Remain Registered with the SEC. You must check box 12 if:

- you are registered with the SEC;
- you are filing an *annual updating amendment* to Form ADV in which you indicate in response to Item 5.F(2)(c) that you have assets under management of less than \$25 million; and
- you are not eligible to check any other box (other than box 12) in Item 2.A. (and are therefore no longer eligible to remain registered with the SEC).

You must withdraw from SEC registration within 180 days after the end of your fiscal year by filing Form ADV-W. Until you file your Form ADV-W, you will remain subject to SEC regulation, and you also will be subject to regulation in the *states* in which you

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register. See SEC rule 203A-1(b).

3 . Item 3: Form of Organization

If you are a "separately identifiable department or division" (SID) of a bank, answer Item 3.A. by checking "other." In the space provided, specify that you are a "SID of" and indicate the form of organization of your bank. Answer Items 3.B. and 3.C. with information about your bank.

4 . Item 4: Successions

a. **Succession of an SEC-Registered Adviser.** If you (1) have taken over the business of an investment adviser or (2) have changed your structure or legal status (e.g., form of organization or state of incorporation), a new organization has been created, which has registration obligations under the Advisers Act. There are different ways to fulfill these obligations. You may rely on the registration provisions discussed in the General Instructions, or you may be able to rely on special registration provisions for "successors" to SEC-registered advisers, which may ease the transition to the successor adviser's registration.

To determine if you may rely on these provisions, review "Registration of Successors to Broker-Dealers and Investment Advisers," Investment Advisers Act Release No. 1357 (Dec. 28, 1992). If you have taken over an adviser, follow Part 1A Instruction 4.a(1), Succession by Application. If you have changed your structure or legal status, follow Part 1A Instruction 4.a(2), Succession by Amendment. If either (1) you are a "separately identifiable department or division" (SID) of a bank that is currently registered as an investment adviser, and you are taking over your bank's advisory business; or (2) you are a SID currently registered as an investment adviser, and your bank is taking over your advisory business, then follow Part 1A Instruction 4.a(1), Succession by Application.

(1) **Succession by Application.** If you are not registered with the SEC as an adviser, and you are acquiring or assuming substantially all of the assets and liabilities of the advisory business of an SEC-registered adviser, file a new application for registration on Form ADV. You will receive new registration numbers. You must file the new application within 30 days after the succession. On the application, make sure you check "yes" to Item 4.A., enter the date of the succession in Item 4.B., and complete Section 4 of Schedule D.

Until the SEC declares your new registration effective, you may rely on the registration of the adviser you are acquiring, but only if the adviser you are acquiring is no longer conducting advisory activities. Once your new registration is effective, a Form ADV-W must be filed with the SEC to withdraw the registration of the acquired adviser.

(2) **Succession by Amendment.** If you are a new investment adviser formed solely as a result of a change in form of organization, a reorganization, or a change in the composition of a partnership, and there has been no practical change in *control* or management, you may amend the registration of the registered investment adviser to reflect these changes rather than file a new application. You will keep the same registration numbers, and you should not file a Form ADV-W. On the amendment, make sure you check "yes" to Item 4.A., enter the date of the succession in Item 4.B., and complete Section 4 of Schedule D. You must submit the amendment within 30 days after the change or reorganization.

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b. **Succession of a State-Registered Adviser.** If you (1) have taken over the business of an investment adviser or (2) have changed your structure or legal status (e.g., form of organization or state of incorporation), a new organization has been created, which has registration obligations under state investment adviser laws. There may be different ways to fulfill these obligations. You should contact each state in which you are registered to determine that state's requirements for successor registration. See Form ADV General Instruction 1.

5 . Item 5: Information About Your Advisory Business

a. **Newly-Formed Advisers:** Several questions in Item 5 that ask about your advisory business assume that you have been operating your advisory business for some time. Your response to these questions should reflect your current advisory business (i.e., at the time you file your Form ADV), with the following exceptions:

- base your response to Item 5.E. on the types of compensation you expect to accept;
- base your response to Item 5.G. on the types of advisory services you expect to provide during the next year; and
- skip Item 5.H.

b. **Item 5.F: Calculating Your Assets Under Management.** In determining the amount of your assets under management, include the securities portfolios for which you provide continuous and regular supervisory or management services as of the date of filing this Form ADV.

(1) **Securities Portfolios.** An account is a securities portfolio if at least 50% of the total value of the account consists of securities. For purposes of this 50% test, you may treat cash and cash equivalents (i.e., bank deposits, certificates of deposit, bankers acceptances, and similar bank instruments) as securities. You may include securities portfolios that are:

- (a) your family or proprietary accounts (unless you are a sole proprietor, in which case your personal assets must be excluded);
- (b) accounts for which you receive no compensation for your services; and
- (c) accounts of *clients* who are not U.S. residents.

(2) **Value of Portfolio.** Include the entire value of each securities portfolio for which you provide continuous and regular supervisory or management services. If you provide continuous and regular supervisory or management services for only a portion of a securities portfolio, include as assets under management only that portion of the securities portfolio for which you provide such services. Exclude, for example, the portion of an account:

- (a) under management by another *person*; or
- (b) that consists of real estate or businesses whose operations you "manage" on behalf of a *client* but not as an investment.

Do not deduct securities purchased on margin.

(3) Continuous and Regular Supervisory or Management Services.

General Criteria. You provide continuous and regular supervisory or management services with respect to an account if:

(a) you have *discretionary authority* over and provide ongoing supervisory or management services with respect to the account; or

(b) you do not have *discretionary authority* over the account, but you have ongoing responsibility to select or make recommendations, based upon the needs of the *client*, as to specific securities or other investments the account may purchase or sell and, if such recommendations are accepted by the *client*, you are responsible for arranging or effecting the purchase or sale.

Factors. You should consider the following factors in evaluating whether you provide continuous and regular supervisory or management services to an account.

(a) **Terms of the advisory contract.** If you agree in an advisory contract to provide ongoing management services, this suggests that you provide these services for the account. Other provisions in the contract, or your actual management practices, however, may suggest otherwise.

(b) **Form of compensation.** If you are compensated based on the average value of the *client's* assets you manage over a specified period of time, that suggests that you provide continuous and regular supervisory or management services for the account. If you receive compensation in a manner similar to either of the following, that suggests you do not provide continuous and regular supervisory or management services for the account

--

(i) you are compensated based upon the time spent with a *client* during a *client* visit; or

(ii) you are paid a retainer based on a percentage of assets covered by a financial plan.

(c) **Management practices.** The extent to which you actively manage assets or provide advice bears on whether the services you provide are continuous and regular supervisory or management services. The fact that you make infrequent trades (e.g., based on a "buy and hold" strategy) does not mean your services are not "continuous and regular."

Examples. You may provide continuous and regular supervisory or management services for an account if you:

(a) have *discretionary authority* to allocate *client* assets among various mutual funds;

(b) do not have *discretionary authority*, but provide the same allocation services, and satisfy the criteria set forth in Instruction 5.b(3);

(c) allocate assets among other managers (a "manager of managers"), but only if you have *discretionary authority* to hire and fire managers and reallocate assets among them; or

(d) you are a broker-dealer and treat the account as a brokerage account, but only if you have *discretionary authority* over the account.

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You do not provide continuous and regular supervisory or management services for an account if you:

- (a) provide market timing recommendations (i.e., to buy or sell), but have no ongoing management responsibilities;
- (b) provide only *impersonal investment advice* (e.g., market newsletters);
- (c) make an initial asset allocation, without continuous and regular monitoring and reallocation; or
- (d) provide advice on an intermittent or periodic basis (such as upon *client* request, in response to a market event, or on a specific date (e.g., the account is reviewed and adjusted quarterly)).

(4) **Value of Assets Under Management.** Determine your assets under management based on the current market value of the assets as determined within 90 days prior to the date of filing this Form ADV. Determine market value using the same method you used to report account values to *clients* or to calculate fees for investment advisory services.

(5) **Example.** This is an example of the method of determining whether a *client* account may be included as assets under management.

A *client's* portfolio consists of the following:

\$ 6,000,000 stocks and bonds

\$ 1,000,000 cash and cash equivalents

\$ 3,000,000 non-securities (collectibles, commodities, real estate, etc.)

\$10,000,000 Total Assets

First, is the account a securities portfolio? The account is a securities portfolio because securities as well as cash and cash equivalents (which you have chosen to include as securities) (\$6,000,000 + \$1,000,000 = \$7,000,000) comprise at least 50% of the value of the account (here, 70%). (See Instruction 5.b(1)).

Second, does the account receive continuous and regular supervisory or management services? The entire account is managed on a *discretionary* basis and is provided ongoing supervisory and management services, and therefore receives continuous and regular supervisory or management services. (See Instruction 5.b(3)).

Third, what is the entire value of the account? The entire value of the account (\$10,000,000) is included in the calculation of the adviser's total assets under management.

6 . Item 10: **Control Persons**

If you are a "separately identifiable department or division" (SID) of a bank, identify on Schedule A your bank's executive officers who are directly engaged in managing, directing, or supervising your investment advisory activities, and list any other *persons* designated by your bank's board of directors as responsible for the day-to-day conduct of your

investment advisory activities, including supervising *employees* performing investment advisory activities.

7 . Additional Information.

If you believe your response to an item in Form ADV Part 1A requires further explanation, or if you wish to provide additional information, you may do so on Schedule D, in the Miscellaneous section. Completion of this section is optional

GLOSSARY OF TERMS

1. **Advisory Affiliate:** Your advisory affiliates are (1) all of your officers, partners, or directors (or any *person* performing similar functions); (2) all *persons* directly or indirectly **controlling** or **controlled** by you; and (3) all of your current *employees* (other than *employees* performing only clerical, administrative, support or similar functions).

If you are a "separately identifiable department or division" (SID) of a bank, your *advisory affiliates* are: (1) all of your bank's *employees* who perform your investment advisory activities (other than clerical or administrative *employees*); (2) all *persons* designated by your bank's board of directors as responsible for the day-to-day conduct of your investment advisory activities (including supervising the *employees* who perform investment advisory activities); (3) all *persons* who directly or indirectly control your bank, and all *persons* whom you **control** in connection with your investment advisory activities; and (4) all other *persons* who directly manage any of your investment advisory activities (including directing, supervising or performing your advisory activities), all *persons* who directly or indirectly **control** those management functions, and all *persons* whom you **control** in connection with those management functions. *[Used in: Part 1A, Item 11; Part 1B, Item 2]*

2. **Annual Updating Amendment:** Within 90 days after your firm's fiscal year end, your firm must file an "annual updating amendment," which is an amendment to your firm's Form ADV that reaffirms the eligibility information contained in Item 2 of Part 1A and updates the responses to any other item for which the information is no longer accurate. *[Used in: General Instructions; Part 1A Instructions, Introductory Text, Item 2]*

3. **Charged:** Being accused of a crime in a formal complaint, information, or indictment (or equivalent formal charge). *[Used in: Part 1A, Item 11; DRPs]*

4. **Client:** Any of your firm's investment advisory clients. This term includes clients from which your firm receives no compensation, such as members of your family. If your firm also provides other services (e.g., accounting services), this term does not include clients that are not investment advisory clients. *[Used throughout Form ADV and Form ADV-W]*

5. **Control:** Control means the power, directly or indirectly, to direct the management or policies of a *person*, whether through ownership of securities, by contract, or otherwise.

- Each of your firm's officers, partners, or directors exercising executive responsibility (or *persons* having similar status or functions) is presumed to control your firm.

- A *person* is presumed to control a corporation if the *person*: (i) directly or indirectly has the right to vote 25 percent or more of a class of the corporation's voting securities; or (ii) has the power to sell or direct the sale of 25 percent or more of a class of the

corporation's voting securities.

- A **person** is presumed to control a partnership if the **person** has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital of the partnership.

- A **person** is presumed to control a limited liability company ("LLC") if the **person**: (i) directly or indirectly has the right to vote 25 percent or more of a class of the interests of the LLC; (ii) has the right to receive upon dissolution, or has contributed, 25 percent or more of the capital of the LLC; or (iii) is an elected manager of the LLC.

- A **person** is presumed to control a trust if the **person** is a trustee or **managing agent** of the trust.

[Used in: General Instructions; Part 1A, Instructions, Items 2, 7, 10, 11, 12, Schedules A, B, C, D; Regulatory DRP]

6. **Custody:** Your firm has custody if it directly or indirectly holds **client** funds or securities, has any authority to obtain possession of them, or has the ability to appropriate them. Your firm has custody, for example, if it has a general power of attorney over a **client's** account or signatory power over a **client's** checking account. See Advisers Act rule 206(4)-2. *[Used in: Part 1A, Item 9; Part 1B, Instructions, Item 2]*

7. **Discretionary Authority:** Your firm has discretionary authority if it has the authority to decide which securities to purchase and sell for the **client**. Your firm also has discretionary authority if it has the authority to decide which investment advisers to retain on behalf of the **client**. *[Used in: Part 1A, Instructions, Item 8; Part 1B, Instructions]*

8. **Employee:** This term includes an independent contractor who performs advisory functions on your behalf. *[Used in: Part 1A, Instructions, Items 1, 5, 7, 11]*

9. **Enjoined:** This term includes being subject to a mandatory injunction, prohibitory injunction, preliminary injunction, or a temporary restraining **order**. *[Used in: Part 1A, Item 11; DRPs]*

10. **Felony:** For jurisdictions that do not differentiate between a felony and a **misdemeanor**, a felony is an offense punishable by a sentence of at least one year imprisonment and/or a fine of at least \$1,000. The term also includes a general court martial. *[Used in: Part 1A, Item 11; DRPs]*

11. **Foreign Financial Regulatory Authority:** This term includes (1) a foreign securities authority; (2) another governmental body or foreign equivalent of a **self-regulatory organization** empowered by a foreign government to administer or enforce its laws relating to the regulation of **investment-related** activities; and (3) a foreign membership organization, a function of which is to regulate the participation of its members in the activities listed above.

[Used in: Part 1A, Items 1, 11; DRPs]

12. **Found:** This term includes adverse final actions, including consent decrees in which the respondent has neither admitted nor denied the findings, but does not include agreements, deficiency letters, examination reports, memoranda of understanding, letters of caution, admonishments, and similar informal resolutions of matters. *[Used in: Part 1A, Item 11; Part 1B, Item 2]*

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13. **Government Entity:** Any state or political subdivision of a state, including (i) any agency, authority, or instrumentality of the state or political subdivision; (ii) a plan or pool of assets **controlled** by the state or political subdivision or any agency, authority or instrumentality thereof; and (iii) any officer, agent, or **employee** of the state or political subdivision or any agency, authority or instrumentality thereof, acting in their official capacity. *[Used in: Part 1A, Item 5]*

14. **High Net Worth Individual:** An individual with at least \$750,000 managed by you, or whose net worth your firm reasonably believes exceeds \$1,500,000, or who is a "qualified purchaser" as defined in section 2(a)(51)(A) of the Investment Company Act of 1940. The net worth of an individual may include assets held jointly with his or her spouse. *[Used in: Part 1A, Item 5]*

15. **Home State:** If your firm is registered with a **state securities authority**, your firm's "home state" is the state where it maintains its **principal office and place of business**. *[Used in: Part 1B, Instructions]*

16. **Impersonal Investment Advice:** Investment advisory services that do not purport to meet the objectives or needs of specific individuals or accounts. *[Used in: Part 1A, Instructions]*

17. **Investment-Related:** Activities that pertain to securities, commodities, banking, insurance, or real estate (including, but not limited to, acting as or being associated with an investment adviser, broker-dealer, municipal securities dealer, government securities broker or dealer, issuer, investment company, futures sponsor, bank, or savings association). *[Used in: Part 1A, Item 11; DRPs; Part 1B, Item 2]*

18. **Involved:** Engaging in any act or omission, aiding, abetting, counseling, commanding, inducing, conspiring with or failing reasonably to supervise another in doing an act. *[Used in: Part 1A, Item 11]*

19. **Management Persons:** Anyone with the power to exercise, directly or indirectly, a **controlling** influence over your firm's management or policies, or to determine the general investment advice given to the **clients** of your firm.

Generally, all of the following are management persons:

- Your firm's principal executive officers, such as your chief executive officer, chief financial officer, chief operations officer, chief legal officer, and chief compliance officer; your directors, general partners, or trustees; and other individuals with similar status or performing similar functions;
- The members of your firm's investment committee or group that determines general investment advice to be given to **clients**; and
- If your firm does not have an investment committee or group, the individuals who determine general investment advice provided to **clients** (if there are more than five people, you may limit your firm's response to their supervisors).

[Used in: Part 1B, Item 2]

20. **Managing Agent:** A managing agent of an investment adviser is any **person**, including a trustee, who directs or manages (or who participates in directing or managing) the affairs of any unincorporated organization or association that is not a partnership. *[Used in: General Instructions; Form ADV-NR]*

21. **Minor Rule Violation:** A violation of a **self-regulatory organization** rule that has been designated as "minor" pursuant to a plan approved by the SEC. A rule violation may be designated as "minor" under a plan if the sanction imposed consists of a fine of \$2,500 or less, and if the sanctioned **person** does not contest the fine. (Check with the appropriate **self-regulatory organization** to determine if a particular rule violation has been designated as "minor" for these purposes.) *[Used in: Part 1A, Item 11]*

22. **Misdemeanor:** For jurisdictions that do not differentiate between a **felony** and a misdemeanor, a misdemeanor is an offense punishable by a sentence of less than one year imprisonment and/or a fine of less than \$1,000. The term also includes a special court martial. *[Used in: General Instructions; Part 1A, Item 11; DRPs]*

23. **NASD CRD** or **CRD:** The Web Central Registration Depository ("CRD") system operated by the NASD for the registration of broker-dealers and broker-dealer representatives. *[Used in: Part 1A, Item 1; Form ADV-W, Item 1]*

24. **Non-Resident:** (a) an individual who resides in any place not subject to the jurisdiction of the United States; (b) a corporation incorporated in and having its **principal office and place of business** in any place not subject to the jurisdiction of the United States; and (c) a partnership or other unincorporated organization or association that has its **principal office and place of business** in any place not subject to the jurisdiction of the United States. *[Used in: General Instructions; Form ADV-NR]*

25. **Notice Filing:** SEC-registered advisers may have to provide **state securities authorities** with copies of documents that are filed with the SEC. These filings are referred to as "notice filings." *[Used in: General Instructions; Part 1A, Item 2; Execution Page(s); Form ADV-W]*

26. **Order:** A written directive issued pursuant to statutory authority and procedures, including an order of denial, exemption, suspension, or revocation. Unless included in an order, this term does not include special stipulations, undertakings, or agreements relating to payments, limitations on activity or other restrictions. *[Used in: Part 1A, Items 2 and 11; Schedule D; DRPs]*

27. **Performance-Based Fee:** An investment advisory fee based on a share of capital gains on, or capital appreciation of, **client** assets. A fee that is based upon a percentage of assets that you manage is not a performance-based fee. *[Used in: Part 1A, Item 5]*

28. **Person:** A natural person (an individual) or a company. A company includes any partnership, corporation, trust, limited liability company ("LLC"), limited liability partnership ("LLP"), or other organization. *[Used throughout Form ADV and Form ADV-W]*

29. **Principal Place of Business** or **Principal Office and Place of Business:** Your firm's executive office from which your firm's officers, partners, or managers direct, **control**, and coordinate the activities of your firm. *[Used in: Part 1A, Instructions, Items 1 and 2; Schedule D; Form ADV-W, Item 1]*

30. **Proceeding:** This term includes a formal administrative or civil action initiated by a governmental agency, **self-regulatory organization** or **foreign financial regulatory authority**; a **felony** criminal indictment or information (or equivalent formal charge); or a **misdemeanor** criminal information (or equivalent formal charge). This term does not include other civil litigation, investigations, or arrests or similar charges effected in the absence of a formal criminal indictment or information (or equivalent formal charge). *[Used in: Part 1A, Item 11; DRPs; Part 1B, Item 2]*

31. **Related Person:** Any **advisory affiliate** and any **person** that is under common **control** with your

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firm. *[Used in: Part 1A, Items 7, 8, 9; Schedule D; Form ADV-W, Item 3]*

32. **Self-Regulatory Organization or SRO:** Any national securities or commodities exchange, registered securities association, or registered clearing agency. For example, the Chicago Board of Trade ("CBOT"), NASD and New York Stock Exchange ("NYSE") are self-regulatory organizations. *[Used in: Part 1A, Item 11; DRPs; Part 1B, Item 2]*

33. **Sponsor:** A sponsor of a **wrap fee program** sponsors, organizes, or administers the program or selects, or provides advice to **clients** regarding the selection of, other investment advisers in the program. *[Used in: Part 1A, Item 5; Schedule D]*

34. **State Securities Authority:** The securities commission (or any agency or office performing like functions) of any state of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other possession of the United States. *[Used throughout Form ADV]*

35. **Wrap Fee Program:** Any advisory program under which a specified fee or fees not based directly upon transactions in a **client's** account is charged for investment advisory services (which may include portfolio management or advice concerning the selection of other investment advisers) and the execution of **client** transactions. *[Used in: Part 1, Item 5; Schedule D]*

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CHAPTER UF Uniform Forms

2-UF Blue Sky Regulation ADV-W

ADV-W Notice of Withdrawal from Registration as Investment Adviser [See Editor's Note]

[Editor's Note: Please note that the following version of Form ADV-W is no longer used by the SEC. An IARD-compatible version of Form ADV-W was adopted by the SEC in Release No. IA-1897, Sept. 12, 2000, effective Oct. 10, 2000, and amended in Release No. IA-1916, Dec. 21, 2000, effective Jan. 1, 2001. The new version of the form is printed immediately after the end of this version. Please note, however, that it is not yet clear which of the states will mandate the use of the IARD or the new form for those investment advisers that are not federally registered. Therefore, this version of the uniform form may remain useful in certain states. For information on the status of investment adviser forms in specific states, consult the web site of that state's securities administration or contact the state's securities administrator.]

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ADV-W Notice of Withdrawal from Registration as an Investment Adviser [*New version of form, effective January 1, 2001*]

[**Editor's Note:** Please note that the following is the new version of Form ADV-W. An IARD-compatible version of Form ADV-W was initially adopted by the SEC in Release No. IA-1897, Sept. 12, 2000, effective Oct. 10, 2000. The version printed below contains further amendments, namely technical amendments made in Release No. IA-1916, Dec. 21, 2000, effective Jan. 1, 2001.]

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ADV-E Certificate of Accounting of Client Securities and Funds in Possession or Custody of an Investment Adviser

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ADV-H Application for a Temporary or Continuing Hardship Exemption

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ADV-NR Appointment of Agent for Service of Process by Non-Resident General Partner and Non-Resident Managing Agent of an Investment Adviser

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U-7 Small Corporate Offering Registration Form

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CHAPTER UF Uniform Forms

2-UF Blue Sky Regulation D

D Notice of Sales of Securities Pursuant to Regulation D, Section 4(6), and/or Uniform Limited Offering Exemption

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2-UF Blue Sky Regulation U-10

U-10 Uniform Examination Request For Non-NASD Candidates

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UNIFORM FORMS

Uniform Branch Office Form Instructions

INSTRUCTIONS

Rev. Form BR (10/2005)

UNIFORM BRANCH OFFICE FORM

Form BR

Uniform Branch Office
Registration Form

GENERAL INSTRUCTIONS

The Uniform Branch Office Registration Form (Form BR) is the form used for branch office registration, notification, *closing* or *withdrawal*. Broker-dealers and investment advisers must use this form to register or notice file their branch offices in the appropriate *jurisdictions* and/or with *SROs*. These instructions apply to the filing of Form BR electronically with the Central Registration Depository ("CRD®"). Filers submitting paper filings should read the Special Instructions For Paper Filers (*Jurisdictions Only*) in conjunction with the other instructions to the form. In addition, paper filers should contact the appropriate *jurisdiction* for specific filing instructions or requirements.

Filers must answer all questions and submit all requested information, unless otherwise directed in the Specific Instructions. The questions in Section 6 (NYSE Branch Information) are required to be completed only by applicants that are seeking registration, or are currently registered, with the New York Stock Exchange (NYSE).

Upon request, you may be required to provide documents to clarify or support responses to the form.

An *applicant* is under a continuing obligation to promptly update Form BR whenever the information becomes inaccurate or incomplete. Amendments must be filed electronically (unless the filer is an approved paper filer) by promptly updating the appropriate section of Form BR. **Note: The SROs and most jurisdictions require that an amendment be filed not later than 30 days after the applicant learns of the facts and circumstances giving rise to the amendment.**

NYSE and some jurisdictions require approval of a branch office before business can be conducted at a branch location.

Contact the appropriate SRO or jurisdiction, if you have questions about Form BR.

Electronic Filing Instructions

A complete Form BR is required when the *applicant* is registering or notice filing a branch office with the CRD system for the first time. All questions must be answered and all sections/fields requiring a response must be completed before the filing will be accepted. Section 6 (NYSE Branch Information) is required to be completed only by *applicants* that are seeking registration, or are currently registered, with NYSE. The *applicant* must complete Section 9 (Signature) to certify that Form BR and amendments thereto have been executed properly and that the information contained therein is accurate and complete. To amend information, the *applicant* must update the appropriate Form BR sections. A signed copy, with original signatures, of the initial Form BR filing and amendments thereto must be retained by the *applicant* and be made available for inspection upon a regulatory request.

Special Instructions For Paper Filers (Jurisdictions Only)

Some *jurisdictions* may require a separate paper filing of Form BR. The *applicant* should contact the appropriate *jurisdiction(s)* for specific filing requirements. Attach Section 9 (Signature) with original manual signatures to an initial Form BR filing. Type applicable information. Provide the name of the *applicant* and the date on each page. Use only the current version of Form BR, or a reproduction of the form. For an amendment to Form BR, circle the number of any item for which you are changing your response. Complete Section 9 (Signature) for all amendment filings.

The Sections of Form BR are as follows:

1. GENERAL INFORMATION
2. REGISTRATION/NOTICE FILING/TYPE OF OFFICE
3. TYPES OF ACTIVITIES/OTHER BUSINESS NAMES/WEBSITES
4. BRANCH OFFICE ARRANGEMENTS
5. ASSOCIATED INDIVIDUALS

6. NYSE BRANCH INFORMATION

7. BRANCH CLOSING

8. BRANCH WITHDRAWAL (PENDING APPLICATION)

9. SIGNATURE

EXPLANATION OF TERMS

The following definitions apply to terms that are italicized in Form BR.

APPLICANT - The broker-dealer or state registered investment adviser filing or amending this form.

APPROPRIATE SIGNATORY - The individual the *applicant* authorizes to execute the *applicant's* Form BR on the *applicant's* behalf. The *appropriate signatory* must meet the criteria established, if any, by the appropriate *self-regulatory organization* and/or *jurisdiction*.

CLOSING - An *applicant's* request to terminate a branch office registration when an *applicant* intends to cease, or has ceased, operations at a branch office.

INVESTMENT-RELATED - Pertains to securities, commodities, banking, insurance, or real estate (including, but not limited to, acting as or being associated with a broker-dealer, issuer, investment company, investment adviser, futures sponsor, bank, or savings association).

JURISDICTION - A state, the District of Columbia, the Commonwealth of Puerto Rico, the U.S. Virgin Islands, or any subdivision or regulatory body thereof.

OFFICE OF SUPERVISORY JURISDICTION (OSJ) - A location as defined by NASD Rule 3010.

PERSON - An individual, partnership, corporation, trust, or other organization.

PERSON-IN-CHARGE - A natural person registered with an *SRO* who is physically located at the branch office and who has been designated by the *applicant* to supervise the activities of the individuals working at the branch office. The *person-in-charge* is not required to be registered in a principal capacity.

REGULAR BRANCH - For purposes of registering with the New York Stock Exchange (NYSE) as a branch office, a location that has an NYSE-properly approved, exam-qualified manager at that location.

SELF-REGULATORY ORGANIZATION (SRO) - Any national securities or commodities exchange or registered securities association, or registered clearing agency.

SMALL BRANCH - For purposes of registering with the NYSE as a branch office, a location that does not have an NYSE- properly approved, exam-qualified manager at that location.

SUPERVISOR - A natural person registered in a principal capacity with an *SRO* who is physically located at an *OSJ* or who, for purposes of registering with the NYSE as a branch office, meets the requirements in NYSE Rule 342.

WITHDRAWAL - An *applicant's* request to withdraw an initial Form BR filing prior to approval of the branch office

identified in that filing. *Withdrawal* applies only for *jurisdictions/SROs* that register branches.

SPECIFIC INSTRUCTIONS

Completing the Form BR

1. GENERAL INFORMATION

Applicant CRD Number The *applicant's* CRD Number will be prepopulated based on the information filed by the *applicant* on the Form BD or the Form ADV.

***Applicant* Name**

The *applicant's* name will be prepopulated based on the information filed by the *applicant* on the Form BD or the Form ADV.

Address Street 1/Street 2

The address where the *applicant's* principal place of business is physically located. This information will be prepopulated based on the information filed by the *applicant* on the Form BD or the Form ADV.

City

The name of the city where the *applicant's* principal place of business is physically located. This information will be prepopulated based on the information filed by the *applicant* on the Form BD or the Form ADV.

State

The name of the state where the *applicant's* principal place of business is physically located. This information will be prepopulated based on the information filed by the *applicant* on the Form BD or the Form ADV.

Country

The country where the *applicant's* principal place of business is physically located. This information will be prepopulated based on the information filed by the *applicant* on the Form BD or the Form ADV.

Postal Code

The postal code where the *applicant's* principal place of business is physically located. This information will be prepopulated based on the information filed by the *applicant* on the Form BD or the Form ADV.

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Firm Billing Code

Enter an optional firm branch designation established by the *applicant*. A firm billing code consists of up to eight alpha/numeric characters. If the *applicant* does not use billing codes, leave this field blank.

NYSE Branch Code Number

A mandatory number selected by the *applicant*, unique to each of its locations, to identify an *applicant's* branch office. The NYSE Branch Code Number can be up to fifteen alpha/numeric characters, and may be the same as the Firm Billing Code.

CRD Branch Number

The CRD branch number is assigned by the CRD system to identify an *applicant's* branch office. If your branch office or office of employment does not have a CRD branch number, leave this field blank.

Branch Address Street 1/Street 2

Enter the address where the branch office is physically located. A complete address must be furnished. Post office boxes are not acceptable. You may enter additional identifying information in Branch Address Street 2, if necessary. Note: If *applicant* files a Form BR amendment to relocate this branch to another state, the amendment filing represents *applicant's* acknowledgement that it is *closing* the branch in the current state. In addition, if *applicant* is relocating this branch to a state that requires branch registration or notice filing, the amendment filing represents *applicant's* acknowledgement that it is requesting branch registration or notice filing in that state.

City

Enter the name of the city where the branch office is physically located.

State

Enter the state where the branch office is physically located.

Country

Enter the name of the country where the branch office is physically located.

Postal Code

Enter the postal code where the branch office is physically located.

Branch Telephone Number

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Enter the telephone number of the branch office.

Branch Facsimile Number

Enter the facsimile number of the branch office.

Private Residence Check Box

Check this box if the Branch Address is a private residence.

2. REGISTRATION/NOTICE FILING/TYPE OF OFFICE**Register/Notice File Branch with SRO/Jurisdiction**

The CRD system will populate the applicable *SRO* and/or *jurisdiction* with which you may be required to register or notice file the branch office based on the *applicant's* current registrations. If *applicant* is not required to register or notice file the branch office with an *SRO* and/or *jurisdiction* that has been populated, you may remove that registration request. If you remove the NYSE registration request, you must also select the box to acknowledge there is no registration requirement for this branch under NYSE rules. Note: If *applicant* files a Form BR amendment to relocate this branch to another state, the amendment filing represents *applicant's* acknowledgement that it is *closing* the branch in the current state. In addition, if *applicant* is relocating this branch to a state that requires branch registration or notice filing, the amendment filing represents *applicant's* acknowledgement that it is requesting branch registration or notice filing in that state.

Type of Branch Office

If you are registering or notice filing this branch with a *jurisdiction*, select the type of registration/notification you are seeking: Broker-dealer and/or Investment Adviser.

NASD Office of Supervisory Jurisdiction

Answer "yes" if this branch office is an NASD *Office of Supervisory Jurisdiction (OSJ)*. If this branch office is not an NASD *OSJ*, indicate the CRD branch number, or firm billing code, for the *OSJ* that has supervisory responsibility for this branch, and the CRD Number for the supervisor in charge of that *OSJ*.

NYSE Type of Office

Select the type of office as required by NYSE Rule 342. If *small branch* is selected, indicate the CRD branch number, NYSE branch code number or firm billing code of the location from which the branch is supervised, and the supervisor's CRD number.

Supervisor/Person-in-Charge

Select the *supervisor(s)* or *person(s)-in-charge* who will supervise the activities at the branch office. Enter the name and/or CRD# of all *supervisors/persons-in-charge* of the branch office.

3. TYPES OF ACTIVITIES/OTHER BUSINESS NAMES/WEBSITES**Types of Activities**

Indicate at least one type of financial industry activity conducted by the *applicant* at this office. Indicate whether any associated person conducts, at this branch, *investment-related* activities in addition to the activities indicated by the *applicant* in the above question.

Other Business Names

Enter all other names under which *investment-related* activities will be conducted by associated persons at this branch, other than those names disclosed on *applicant's* Form BD and/or Form ADV.

Website Addresses

Enter all website addresses used by this branch, other than the primary website address used by the *applicant*.

4. BRANCH OFFICE ARRANGEMENTS

Indicate whether the branch office will have an office sharing arrangement by answering the questions and providing any details if necessary in this section.

5. ASSOCIATED INDIVIDUALS

Initial Filings Only: Enter the name and/or CRD# of all registered individuals, other than the *supervisor(s)/person(s)-in-charge* listed in Section 2 (Registration/Notice Filing/Type of Office), who will be associated with the branch office upon the opening of the branch office.

Note: This section will appear and be required to be completed only for initial branch office filings. To associate a registered individual with a branch office after the initial branch office filing, update the office of employment address on that individual's Form U4.

6. NYSE BRANCH INFORMATION

THIS SECTION SHOULD BE COMPLETED ONLY FOR NYSE BRANCH REGISTRATION

Anticipated Date of Opening

This item will only be completed for initial filings. Enter the month, day, and year the branch office is anticipated to open and provide an explanation if the date is prior to the date of application for registration.

Estimated Cost of Opening and Equipping Office

This item will only be completed for initial filings. Indicate whether or not the estimated cost of opening and equipping this office is over 10% of the *applicant's* most recent excess net capital. The *applicant's* most recent excess net capital should be based on the most recently filed FOCUS report. If "yes", enter the estimated cost of opening and equipping this office.

Estimated Number of Active Accounts

This item will only be completed for initial filings. Enter the estimated number of active accounts.

Branch Office Acquired from Another Broker-dealer or Other Financial Institution

This item will only be completed for initial filings. Indicate whether this branch office was acquired from another broker- dealer or other financial institution. If "yes", enter the name of the organization and date of the transaction.

On-Site Supervisor/Person-In-Charge**Options Business**

Indicate whether options business will be conducted from this location. If "yes", enter the CRD# of the individual who is responsible for the supervision of options business at this location.

Research and Investment Banking Business

If both research and investment banking activities are selected under Section 3 (Types of Activities/Other Business Names/Websites), indicate whether the *applicant* has information barriers in place.

Location of Books and Records (if maintained elsewhere)

Enter the address of the location where the books and records for this branch office will be maintained, if other than the branch or the main office.

Address Street 1/Street 2 where NYSE Certificate should be sent

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Enter the name and address where the certificate for the branch office should be sent, if different from the branch office address. You may enter additional identifying information in Office of Employment Address Street 2, if necessary.

City

Enter the name of the city where the certificate for the branch office should be sent.

State

Enter the state where the certificate for the branch office should be sent.

Country

Enter the country where the certificate for the branch office should be sent.

Postal Code

Enter the postal code where the certificate for the branch office should be sent.

NYSE Bulletin

Indicate whether the branch office should be listed in the NYSE Bulletin.

NYSE Space Sharing

Enter the name of the entity and CRD number, if applicable, with whom the NYSE member or member organization *applicant* intends to share space. Select the type of arrangement, related to the specific entity, under which the *applicant* is seeking approval by checking the applicable box(es). Enter the floor number on which the proposed office sharing arrangement will be located. Comments are required to be entered in the available comment field when at least one of the available arrangement sections are incomplete. Comments will not be allowed when any of the arrangement sections are complete. If multiple space sharing arrangements are intended by the *applicant*, this section is to be answered for each separate entity with information specific to each arrangement.

7. BRANCH CLOSING

If you are *closing* a branch office registered with an *SRO* or *jurisdiction*, complete the following information.
Select the type of registration you are terminating: Broker- dealer and/or Investment Adviser.

Date operations ceased, or will cease, at the branch office

Enter the month, day, and year the branch closed or intends to close.

Location of Books and Records**Address Street 1/Street 2**

Enter the address of the location (or locations, if more than one) of the books and records for the branch office.

City

Enter the name of the city of the location (or locations, if more than one) of the books and records for the branch office.

State

Enter the state of the location (or locations, if more than one) of the books and records for the branch office.

Country

Enter the country of the location (or locations, if more than one) of the books and records for the branch office.

Postal Code

Enter the postal code of the location (or locations, if more than one) of the books and records for the branch office.

Contact Name and Telephone Number**Name**

Enter the name of the individual that can be contacted regarding information on the books and records for the branch office.

Daytime Telephone Number

Enter the daytime telephone number of the individual that can be contacted regarding information on the books and records for the branch office.

8. BRANCH WITHDRAWAL

If you are withdrawing a pending application, complete the following information:

Date of *Withdrawal*

Enter the month, day, and year of *withdrawal*.

Reason for *Withdrawal*

Enter the reason for *withdrawal*.

Contact Name and Telephone Number

Name

Enter the name of the natural person that can be contacted regarding information on the *withdrawal* of this branch office.

Daytime Telephone Number

Enter the daytime telephone number of the individual that can be contacted regarding information on the *withdrawal* of this branch office.

9. SIGNATURE

Please Read Carefully

All signatures required on this Form BR filing must be made in this section. A "signature" includes a manual signature or an electronically transmitted equivalent. For purposes of an electronic form filing, a signature is affected by typing a name in the designated signature field. By typing a name in this field, the signatory acknowledges and represents that the entry constitutes in every way, use, or aspect, his or her legally binding signature.

Signature of Appropriate Signatory. Enter the name of the *Appropriate Signatory*. The name must be typed or printed (if paper filing) as it appears in signature form. By typing a name in this field, the signatory acknowledges that this entry constitutes in every way, use, or aspect, his or her legally binding signature.

Name/Title/Telephone Number of Person Filing the Form. Enter the name, title, and telephone number of the person filing the form.

Date. Enter the month, day, and year that the application or amendment is being signed. Future dates may not be entered in this section.

Uniform Branch Office Form

FIRM NAME:

CRD #:

1. GENERAL INFORMATION

2-UF Blue Sky Regulation

WARNING: Failure to keep this form current and to file accurate supplementary information on a timely basis, or the failure to keep accurate books and records or otherwise to comply with the provisions of law applying to the conduct of business as a broker-dealer or investment adviser would violate the federal securities laws, *self-regulatory organization* rules, and the laws of the *jurisdictions*, and may result in disciplinary, administrative, injunctive, or criminal action.

Applicant CRD #:

Name and principal place of business of firm filing this form:

Applicant Name:

Address Street 1:

Address Street 2:

City:

State:

Country:

Postal Code:

Firm Billing Code (Firm
Branch Designation):

NYSE Branch Code Number: CRD Branch Number:

Branch Office Location:

Branch Address Street 1:

Branch Address Street 2:

City:

State:

Country:

Postal Code:

By filing this amendment to relocate this branch from, and/or to, a state that requires registration or notice filing of branch offices, *applicant* acknowledges that it is *closing* the branch in _____ [and requesting branch registration or notice filing in _____].

Private Residence Check Box: If this address is a private residence, check this box. ☐

Branch Telephone Number:

Branch Facsimile Number:

FIRM NAME:

CRD #:

2. REGISTRATION/NOTICE FILING/TYPE OF OFFICE

Register/Notice File Branch with SRO/Jurisdiction:

☐ NASD NYSE Jurisdiction:

By filing an amendment to relocate this branch to another state, *applicant* acknowledges that submission of this amendment closes this branch in _____ [and requests branch registration in _____]
[and requests notice filing in _____].

2-UF Blue Sky Regulation

☐ By unchecking NYSE registration and checking this box, *applicant* attests that it is not required under NYSE rules to register this branch location with the NYSE.

Type of Branch Office Registration: ☐ Broker-Dealer ☐ Investment Adviser

Is this an NASD *Office of Supervisory Jurisdiction (OSJ)*?: ☐ Yes ☐ No

If not, indicate the CRD branch number, or firm billing code, for the *OSJ* that has supervisory responsibility for this branch, and the CRD Number of the supervisor in charge of that *OSJ*:

CRD Branch Number: Firm Billing Code (Firm OSJ Supervisor CRD Num-
Branch Designation): ber:

NYSE Type of Office: ☐ Small Branch ☐ Regular Branch

If this is an NYSE *Small Branch*, indicate the CRD branch number, NYSE branch code number or firm billing code of the location from which this branch is supervised, and the supervisor's CRD number:

CRD Branch Number: NYSE Branch Code Number:

Firm Billing Code (Firm Branch Designa- Supervisor CRD Number:
tion):

Enter the name and/or CRD# of each *supervisor(s)/person(s)-in-charge*:

Name: CRD Number: ☐ Person- ☐ Delete
In-Charge

☐ Supervisor

Name: CRD Number: ☐ Person- ☐ Delete
In-Charge

☐ Supervisor

Name: CRD Number: ☐ Person- ☐ Delete
In-Charge

☐ Supervisor

FIRM NAME: CRD #:

3. TYPES OF ACTIVITIES/OTHER BUSINESS NAMES/WEBSITES

Indicate the types of financial industry activities conducted by the *applicant* at this branch (Check all that apply):

2-UF Blue Sky Regulation

- ☐ Sales
- ☐ Investment Advisory Services
- ☐ Investment Banking
- ☐ Research
- ☐ Market Making
- ☐ Back Office Operations
- ☐ Underwriting

Does any associated person conduct, at this branch, *investment-related* activities in addition to the activities indicated above?: ☐ Yes ☐ No

If yes, provide description:

Will any associated person of this branch office conduct any *investment-related* activities at this branch office under any name other than those names disclosed on the *applicant's* Form BD or Form ADV?: ☐ Yes ☐ No

If yes, provide all other business names for this location:

Name: ☐ Delete

Name: ☐ Delete

Name: ☐ Delete

Does this branch office use a website other than the primary website address used by the *applicant*?: ☐ Yes ☐ No

If yes, provide the website address(es):

Website Address: ☐ Delete

Website Address: ☐ Delete

Website Address: ☐ Delete

FIRM NAME:

CRD #:

2-UF Blue Sky Regulation

4. BRANCH OFFICE ARRANGEMENTS

Does the branch office occupy or share space with or jointly market with a bank, savings bank, savings association, credit union, or other federally insured depository institution?: ☐ Yes ☐ No

If yes, enter the name of the institution(s):

Name:

Name:

Name:

Is this a business location that will operate pursuant to a written agreement or contract (other than an insurance agency agreement) with the main office?: ☐ Yes ☐ No

If yes, provide the name(s) of the entity(ies) and/ or *person(s)* with whom the agreement or contract was entered:

Entity:

Entity:

Entity:

Will the branch office have primary responsibility for decisions relating to the employment and remuneration of its registered representatives?:

☐ Yes ☐ No

Does the branch office assume liability for its own expenses?: ☐ Yes ☐ No

Does any *person* other than the *applicant* have responsibility, directly or indirectly, for paying the expenses of this branch office or otherwise have a financial interest in this branch office or its activities?: ☐ Yes ☐ No

If yes:

(1) Provide the following information for each entity or *person* responsible for expenses or with a financial interest:

Name: ☐ Firm CRD #: Registered: EIN: ☐ Delete

☐ Individu-
al ☐ Yes
☐ No

Name: ☐ Firm CRD #: Registered: EIN: ☐ Delete

☐ Individu-
al ☐ Yes

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al

☐ No

Name:

☐ Firm

 CRD #: Registered: EIN:

☐ Delete

☐ Individu-

☐ Yes

al

☐ No

(2) Provide an explanation of the expense payment/financial interest arrangement:
FIRM NAME: **CRD #:**

5. ASSOCIATED INDIVIDUALS

Complete this section for initial filings only.

List all registered individuals other than the *supervisor(s)/person(s)-in-charge* that will be associated with this branch:

Individual Name: CRD #:

Individual Name: CRD #:

Individual Name: CRD #:

Individual Name: CRD #:

Individual Name: CRD #:

Individual Name: CRD #:

Individual Name: CRD #:

Individual Name: CRD #:

Individual Name: CRD #:

Individual Name: CRD #:

Individual Name: CRD #:

Individual Name: CRD #:

Individual Name: CRD #:

Individual Name: CRD #:

Individual Name: CRD #:

Individual Name: CRD #:

Individual Name: CRD #:

Individual Name: CRD #:

Individual Name: CRD #:

Individual Name: CRD #:

FIRM NAME: **CRD #:**

6. NYSE BRANCH INFORMATION

NYSE Rule 342(c) requires prior consent of each branch office location with each such location having a qualified person-in-charge acceptable to the NYSE.

Complete the items in this section for initial filings only.

1. Anticipated Date of Opening (MM/DD/YYYY):

If Anticipated Date of Opening is prior to the date the application is filed, explain:

2. Is the estimated cost of opening and equipping this branch office greater than 10% of the *applicant's* most recent excess net capital?:

☐ Yes ☐ No

If yes, enter the cost of opening and equipping the office: \$

3. What is the estimated number of active accounts to be serviced (if applicable)?:

4. Has this branch office been acquired from another broker/dealer or other financial institution?: ☐ Yes ☐ No

If yes, state the name of the organization: Date of transaction (MM/DD/YYYY):

Complete the following items on all filings:

5. Enter the CRD number of the on-site *Supervisor/Person-in-Charge* who is responsible for the supervision at this location:

6. Will Options Business be conducted from this location?: ☐ Yes ☐ No

If yes, enter the CRD number of the registered Options Principal (OP) or Branch Office Manager (BM) who is responsible for the supervision of the Options business:

7. If both the Research and Investment Banking activities are indicated on the activity section of this form answer the following question:

Does the *applicant* have information barriers in place?: ☐ Yes ☐ No

8. Other than the main office, are any of the records pertaining to this office maintained at any other location?: ☐

Yes ☐ No

If yes, provide the location(s):

Address:

Telephone Number:

☐ Delete

2-UF Blue Sky Regulation

Address: Telephone Number: ☐ Delete

Address: Telephone Number: ☐ Delete

9. Name and address where branch office certificates will be sent, if different from this branch office address:

Name:

Certificate Address Street 1:

Certificate Address Street 2:

City:

State:

Country:

Postal Code:

10. Is this office to be listed in the NYSE Bulletin?: ☐ Yes ☐ No

11. Will the office be shared with any other organization?: ☐ Yes ☐ No

If Yes, complete the "NYSE Office Space Sharing Form" to enter a description of how the arrangement will comply with NYSE Rule 343.

NYSE Office Space Sharing Form - Rule 343

FIRM NAME:

CRD #:

NYSE Office Space Sharing Form - Rule 343

6. NYSE BRANCH INFORMATION - OFFICE SHARING

Name of Entity with whom the member or member organization *applicant* intends to share space:

Name:

CRD #:

A space sharing arrangement is permissible if it completely conforms to at least one of the four descriptions outlined in the sections listed below. If the arrangement does not comply with all provisions of any given section, check all applicable representations and include any additional extenuating circumstances which may warrant approval of the arrangement in the 'comments' dialogue box provided.

Select the type of arrangement under which the *applicant* is seeking approval by checking the applicable box(es).

1. ☐ As a clearing member organization we intend to furnish office space, telephone or other facilities to our introducing non-clearing member organization.

-or-

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2. We understand that a member or member organization may share office space with a broker or dealer, investment advisor or other person who conducts a securities or commodities business with the public if certain conditions are met. Accordingly, we attest that:

- ☐ the arrangement is not contrary to the rules of any *self-regulatory organization*; and
- ☐ there is little or no customer traffic in the office of either organization; and
- ☐ sufficient separation exists to enable customers who do visit to identify the individual or organization with which they are transacting business; and
- ☐ employees can be clearly identified as to their respective employer; and
- ☐ clearance has been obtained from the member organization's fidelity insurance carrier and auditors.

-or-

3. We understand that a member or member organization may share office space with another broker or dealer, investment advisor or other person who conducts a securities or commodities business with the public if certain conditions are met. Accordingly, we attest that:

- ☐ such space is separated by ceiling-high solid walls; and
- ☐ such space has direct access to a public hall, main corridor or street; and
- ☐ the name of each organization is placed on the door to such space; and
- ☐ there are no connecting doors or windows between the space to be jointly occupied; and
- ☐ the names are not listed under the same telephone number, and the telephone number of the member is not used on the letterhead or on any advertising of any other member or non-member. (Also see Rule 36.60)

-or-

4. ☐ We intend to share office space with a person who is neither a broker nor a dealer, nor an investment advisor, nor a person who otherwise conducts securities or commodities business with the public.

The proposed office space-sharing arrangement will be located on floor #:

Additional Comments:

FIRM NAME:

CRD #:

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7. BRANCH CLOSING

Date operations ceased or will cease at the branch office (MM/DD/YYYY):

Location of Books and Records:

Address Street 1:

Address Street 2:

City:

State:

Country:

Postal Code:

Address Street 1:

Address Street 2:

City:

State:

Country:

Postal Code:

Address Street 1:

Address Street 2:

City:

State:

Country:

Postal Code:

Contact Name and Telephone Number:

First Name:

Last Name:

Daytime Telephone Number:

8. BRANCH WITHDRAWAL

Date of *Withdrawal* (MM/DD/YYYY):

Reason for *Withdrawal*:

Contact Name and Telephone Number:

First Name:

Last Name:

Daytime Telephone Number:

9. SIGNATURE

The undersigned certifies that he/she has executed this form on behalf of, and with the authority of, the *applicant*. The undersigned and the *applicant* represent that the information and statements contained herein, and all materials filed in connection with this form, are current, true and complete. The undersigned and the *applicant* further represent that to the extent any information previously submitted is not amended, such information is accurate and complete. False statements on this application or any amendment thereto shall constitute a violation of the rules of the applicable *SRO(s)* and/or *jurisdiction(s)*.

A "signature" includes a manual signature or an electronically transmitted equivalent. For purposes of an electronic form filing, a signature is effected by typing a name in the designated signature field. The *applicant* or *applicant's* agent has typed the *applicant's* name under this section to attest to the completeness and accuracy of this record. By typing a name in this field, the signatory acknowledges and represents that the entry constitutes in every way, use, or aspect, his

or her legally binding signature.

—
Date (MM/DD/YYYY)

—
Name of Person Filing
Form

_____ *Signature of Appropriate Signatory*

—
Title of Person Filing
Form

_____ Telephone Number of Person Filing Form



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Blue Sky Regulation

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III STATE FORMS (A-F)
California

3-06CA Blue Sky Regulation 06CA.syn

§ 06CA.syn Synopsis to Chapter 06CA: California

Scope

§ I. Blue Sky Laws and Regulations

§ II. California Forms

§ III. Registration ("Qualification") of Securities

§ IV. Exempt Securities and Transactions

§ V. Intermediary Licensing/Registration

§ VI. Administration and Enforcement

§ VII. Civil Liability/Private Remedies



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Blue Sky Regulation

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III STATE FORMS (A-F)
California

3-06CA Blue Sky Regulation Scope

Scope

SCOPE

**Department of Corporationsⁿ¹
Securities Regulation Division
1515 K Street, Suite 200
Sacramento, CA 94102-4052
(916) 445-7205**

www.corp.ca.gov/srd/security.htm

FOOTNOTES:

(n1)Footnote 1. The Department of Corporations also maintains offices at: 320 West 4th Street, Suite 570, Los Angeles, CA 90013-2344; 1390 Market Street, Suite 810, San Francisco, CA 94102-5503; and 1350 Front Street, Room 2034, San Diego, CA 92101-3697. Applications and notices required by the California Corporate Securities Law are validly filed when received at any of the offices of the Department.



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Blue Sky Regulation

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III STATE FORMS (A-F)

California

3-06CA Blue Sky Regulation

The California Corporate Securities Law provides for registration of securities, for registration of broker-dealers and agents, and for licensing of investment advisers and investment adviser representatives. Subject to statutory exemptions or exceptions, offers and sales of securities in California must be registered by coordination, notification or by permit, as applicable, on prescribed forms. Offerings registered by permit are subject to merit review through application of various guidelines and requirements. California participates in the NASAA Coordinated Equity Review (CER). In addition to prescribing registration requirements generally, California separately addresses requirements for "non-issuer" transactions, making clear that unless the securities involved or the transaction itself is exempted or otherwise excluded, non-issuer transactions are subject to qualification by notification.

The California Corporate Securities Law is administered overall by the Department of Corporations, and the Commissioner of Corporations, who is appointed by the governor. Direct administration carried out by the Securities Regulation Division, one of three operating divisions under the Corporations Commissioner. The Securities Regulation Division is headed by an Assistant Commissioner, and is responsible for the qualification of offers and sales of securities and the licensing and regulation of broker-dealers, agents, investment advisers and investment adviser representatives. The Division also registers the sale of franchises under the Franchise Investment Law, and licenses "capital access companies" under the Capital Access Company Law.ⁿ²

Requests for interpretive opinions, determinations and specific rulings may be made in California, by which interested persons may obtain interpretive advice on particular questions and facts presented to the Commissioner. Requests for interpretive opinions, determinations and rulings must be submitted in writing, and issuance is discretionary with the Commissioner. When issued, an interpretive opinion, determination or ruling is applicable only to the transaction identified in the request and may not be relied upon in connection with any other transaction.

FOOTNOTES:

(n1)Footnote 2. The Capital Access Company Law, Cal. Codes §§ 28000-28958, establishes a licensing and particular regulatory scheme for certain companies organized in reliance on an exemption from the federal Investment Company Act of 1940, that are not in the business of issuing redeemable, but which provide financial or managerial assistance to enterprises doing business or proposing to do business in the state. The federal exemption turns on the application of state regulation of such companies. Accordingly, in order to permit them to operate in reliance on the federal

exemption, California provides for licensing and regulation of those companies that will provide risk capital and management assistance, primarily to small business firms in the state.



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Blue Sky Regulation

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III STATE FORMS (A-F)
California

3-06CA Blue Sky Regulation § I

§ I. Blue Sky Laws and Regulationsn1

The California Corporate Securities Law of 1968, as amended

California Codes §§ 25000, *et seq.*

Part 1: Definitions

Part 2: Qualification of the Sales of Securities:

Exemptions

Issuer Transactions

Recapitalizations and Reorganizations

Nonissuer Transactions

Authority of the Commissioner

General Provisions

Part 3: Regulation of Agents, Broker-Dealers and Investment Advisers

Exemptions

Licensing of Agents and Broker-Dealers

Licensing and Notice Filing Requirements of Investment Adviser
Representatives and Investment Advisers

General Provisions

Part 4: Advertising Securities

Part 5: Fraudulent and Prohibited Practices

Part 6: Enforcement

Civil Liability

Powers of the Commissioner

Crimes

Service of Process

Part 7: Administration

Part 8: General Provisions

Division 2: Security Owners Protection n2

(California Codes § 28000 *et seq.*)

Ch. 1: Definitions and General Provisions

Ch. 2: Unlawful and Fraudulent Conduct

Ch. 3: Civil Liability and Crimes

Division 3: Capital Access Company Law

(California Codes § 28000 *et seq.*)

Ch. 1: General Provisions

Ch. 2: Administration

Ch. 3: Licensing

Ch. 4: Organizational Matters

Ch. 5: Offices

Ch. 6: Transaction of Business

Ch. 7: Records, Reports, and Examinations

Ch. 8: Acquisition of Control

Ch. 9: Merger and Purchase or Sale of Business

Ch. 10: Voluntary Surrender of License

Ch. 11: Enforcement

Ch. 12: Crimes and Criminal Penalties

Ch. 13: Civil Penalties

Ch. 14: Miscellaneous Provisions

The California Franchise Investment Law n3

California Codes §§ 31000-31516

Regulations under the California Corporate Securities Law

Cal. Code Reg., Title 10, Ch. 3

Subch. 1: General Provisions

Administration

Hearings

Conflict of Interest Code

3-06CA Blue Sky Regulation § I

Permit Reform Act

Limitations on Licenses and Certificates to Aliens

Subch. 2: Corporate Securities

- (1) Definitions
- (2) Exemptions from Qualifications
- (3) Procedure for Qualification
- (4) Standards for the Exercise of the Commissioner's Authority
- (5) Conditions of Qualification
- (6) Other Provisions Concerning Exercise of the Commissioner's Authority
- (7) General Provisions Relating to Qualification
- (8) Licensing of Broker-Dealers and Agents
- (9) Regulation of Broker-Dealers and Agents
- (10) Licensing and Regulation of Investment Advisers
- (11) General Provisions Relating to Agents, Broker-Dealers and Investment Advisers
- (12) Advertising Securities
- (13) General Provisions

Regulations under the Capital Access Company Law

Cal. Code Reg., Title 10, Ch. 3, Subch. 2.3

- Art. 1: Definitions
- Art. 2: Application for Licensure and Related Forms
- Art. 3: Application Requesting Approval to Surrender License
- Art. 4: Application for Approval to Acquire Control, Merge With, or Purchase or Sell All or Substantially All of the Licensee's Business
- Art. 5: Advertising
- Art. 6: Fees
- Art. 7: Bonding
- Art. 8: Unsafe and Unsound Practices
- Art. 9: Legend Requirement
- Art. 10: Reports to the Commissioner
- Art. 11: Books and Records
- Art. 12: Custody

FOOTNOTES:

(n1)Footnote 1. *See also* "Legislative Developments," § VI (A), *below*.

(n2)Footnote 2. The separate "Security Owners Protection" provisions of the California Corporate Securities Law make it unlawful for any individual (not otherwise excluded from the definition) to engage in certain fraudulent and other conduct in connection with soliciting, receiving, collecting, or soliciting any subscription or contract to pay any contribution, fees, funds, or compensation of any kind from the owner or holder of a security for the purposes of protecting, enforcing, or representing the rights of the owner or holder. These provisions make violators civilly liable for return of the full amount paid by a holder or owner, along with attorneys fees, and also make willful violations a crime.

(n3)Footnote 3. The Franchise Investment Law comprises Division 5 of Title 4 of the California Corporations Code. It requires all franchisors to make a full written disclosure to prospective franchisees of all material terms of the franchise arrangement, and further requires, subject to a narrow exemption, that the sale of franchises be registered with the Commissioner of Corporations.

The California Corporations Code also includes the California Commodity Law of 1990, Cal. Code § 29500 *et seq.* The Commodity Law is an antifraud statute based on the NASAA Model Commodity Code, and includes extensive provisions relating to enforcement, investigative and administrative powers, and civil and criminal liability in connection with commodity transactions in the state.



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III STATE FORMS (A-F)
California

3-06CA Blue Sky Regulation § II

§ II. California Forms

Uniform, federal and particular state forms adopted or prescribed for use in the administration of the California Corporate Securities Law are as follows:

Uniform and Federal Forms Adopted:

- 1-A: Regulation A Offering Statement under the Securities Act of 1933
- ADV: Uniform Application for Investment Adviser Registration
- ADV-W: Notice of Withdrawal of Registration as Investment Adviser
- BD: Uniform Application for Broker-Dealer Registration
- D: Notice of Sale of Securities Pursuant to Regulation D
- NF: Uniform Investment Company Notice Filing
- U-1: Uniform Application to Register Securities
- U-4: Uniform Application for Securities Industry Registration or Transfer
- U-5: Uniform Termination Notice for Securities Industry Registration
- U-7: Small Corporate Offering Registration (SCOR) Form
- U-10: Uniform Examination Request for Non-NASD Candidates

California State Forms:

- 250.61: Statement of Citizenship, Alienage, and Immigration Status
- 260.100.1: Request for Designation as an Exempt Organization Pursuant to Section 25100(k)
- 260.100.3: Request for Order of Exemption Pursuant to Section 25100(1)
- 260.102.8(a): Notice of Issuance of Shares Pursuant to Subsection (h) of Section 25102
- 260.102.19: Notice of Issuance of Securities Pursuant to Subdivision (o) of Section 25102

3-06CA Blue Sky Regulation § II

- 260.103.6: Notice of Exchange Transaction Pursuant to Section 25103(h)
- 260.105.33/34: Notice of Transaction under Rule 260.105.33/34
 - 260.110: Application for Qualification of the Offer and Sale of Securities
 - 260.111: Application for Qualification by Coordination
 - 260.111.2: Application for Qualification of Securities Pursuant to Section 25111(d)(1) or (2)
 - 260.112: Instructions for Application for Qualification of Issuer Transactions by Notification
 - 260.113: Instructions for Application by Qualification by Permit
 - 260.121: Instructions for Application for Qualification of Recapitalizations and Reorganizations
 - 260.131: Facing Page for Qualification of Recapitalizations and Reorganizations
- 260.141.13: Notice of Release of Securities from Escrow
- 260.141.50: Application for Removal of Conditions
 - 260.146: Semi-annual Report Pursuant to Section 25146
- 260.151(a): Application for Consent to Transfer Securities Pursuant to Section 25151
- 260.151(b): Statement of Transferee to Accompany Application for Consent to Transfer Securities Subject to Legend or Escrow Condition
- 260.165: Consent to Service of Process
- 260.211: Instructions for Completing Form BD
 - 260.211.1: Application for Notification Pursuant to Section 25211(b) for Broker-Dealer Certificate
 - 260.231: Instructions for Completing and Filing Application for Investment Adviser Certificate on Form ADV
- 260.231(INFO): Information to Assist Persons Applying for Investment Adviser Certificate
 - 260.241.2(I): Annual Financial Report-Part I
 - 260.241.2(II): Annual Financial Report-Part II
 - 260.241.2(III): Annual Financial Report-Part III
 - 260.241.2(b): Verification Form Pursuant to Rule 260.241.2(b)
 - 260.241.2(d): Interim Report Form for Broker-Dealer/Investment Adviser
 - 260.242: Application to Surrender Certificate as an Investment Adviser
- 260.25216(E)I: Issuer's Bond
 - 260.507: Application for Approval as to Form of an Offer to Repurchase a Security

Forms under the Capital Access Company Law and Regulations:

- 280.151: Application for a License
- 280.152: Consent to Service of Process

3-06CA Blue Sky Regulation § II

- 280.153: Notice of Officers, Directors, Partners, Control Persons, Managers, Trustees and Employees of a Capital Access Company
- 280.200: Application for Approval to Surrender Capital Access Company License
- 280.250: Application for Approval to Acquire Control, Merge With or Purchase or Sell All or Substantially All of the Licensee's Business or of the Business of Any of the Licensee's Offices to Another Licensee

Other California State Forms:

- 25102(f): Notice of Transaction Pursuant to Section 25102(f)
- 25102(n)(1): First Notice of Transaction Pursuant to Section 25102(n)
- 25102(n)(2): Second Notice of Transaction Pursuant to Section 25102(n)
- 25102(o): Notice of Issuance of Securities Pursuant to Section 25102(o)
- 25103(h): Notice of Exchange Transaction Pursuant to Section 25103(h)
- BID-7: Fingerprint Cards
- CA: Customer Authorization of Disclosure of Financial Records
- QR 500.259: Customer Authorization of Disclosure of Financial Records under the Corporate Securities Law
- QR 500.261: Customer Authorization of Disclosure of Financial Records (Broker-Dealers and Investment Advisers)
- QR 500.265: Customer Authorization of Disclosure of Financial Records (Franchises)
- SIQ: Statement of Identity and Questionnaire



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Blue Sky Regulation

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III STATE FORMS (A-F)

California

3-06CA Blue Sky Regulation § III

§ III. Registration ("Qualification") of Securities

(California Codes §§ 25110-25166)

"Testing the Waters." By rule (Rule 260.105) California exempts offers of securities prior to sale if the securities are exempt from qualification under the law. Otherwise, offers prior to sale are exempted for both issuers and non-issuers only for securities actually sold only in transactions with a bank, savings and loan association, trust company, insurance company, registered investment company, pension or profit-sharing trust, individual retirement account or other institutional investor or governmental agency the Commissioner may designate. The latter category includes sales of securities to the federal government or any agency thereof, or to any corporation wholly owned by a federal, state or local government, and state university or state college, and any public employee retirement system (Rule 260.105.14).

Internet Offerings. n1 An offer on the Internet by an issuer is exempt from qualification requirements in California if:

- The Internet offer originates from outside the state and indicates directly or indirectly that the securities are not being offered to persons in the state;
- The offer is not directed to a person in the state by or on behalf of the issuer; and
- No sales of the securities will be made in the state as a result of the Internet offer until such time as the sale of the securities being offered has been qualified, and a final prospectus is delivered to residents of the state prior to such sale, or the security or sale is otherwise exempt from qualification. Corp. Comm. Rel. No. 100-C (Nov. 5, 1996).

Forms of Registration/Qualification

Unless a security or transaction is exempt under provisions of the Law, it is unlawful to offer or sell in California any security in an issuer transaction unless the sale is "qualified." Of particular note in California is the further provision that an offer or sale of 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 a permit or qualification order, or as to which a material misrepresentation is made in an application regarding the manner of the offering, is deemed an

unqualified offer or sale.

Issuer Transactions

Qualification by Coordination (Cal. Codes § 25111; Rule 260.111). Any security for which a registration statement has been filed under the federal Securities Act of 1933 in connection with the same offering may be qualified in California by coordination. An application for qualification by coordination is comprised primarily of the registration statement filed with the SEC, along with certain undertakings in regard to amendments, consent to service of process, and certain other information. Alternatively, an application for qualification by coordination may be made on Form U-1. However, if Form U-1 is utilized, the same additional information is required. Qualification of the sales of securities by coordination automatically becomes effective at the moment the federal registration statement becomes effective, provided:

- There is no stop order in effect;
- The application has been on file with the Commissioner for at least ten days, although the actual time is by rule extended to permit filing of the application on or before the twentieth business day following filing of the registration statement with the SEC, provided that the application is on file with the Commissioner at least ten business days; and
- A statement of the maximum and minimum proposed offering prices and the maximum underwriting commissions and discounts has been on file for two business days (unless the time is shortened by the Commissioner).n2

If the issuer employs agents in connection with the offering, there is a \$10,000 surety bond requirement for qualification by coordination (Rule 260.216.15), although cash may be deposited in lieu of a surety bond.

Qualification by Notification (Cal. Codes § 25112; Rule 260.112). Securities of an issuer that has outstanding securities registered under Section 12 of the federal Securities Exchange Act of 1934, or by an Investment Company registered under the Investment Company Act of 1940, which are not eligible for qualification by coordination may be qualified in California by notification. In the absence of a stop order, a qualification by notification automatically becomes effective on the tenth business day after filing of the application or the last amendment, or at such earlier time as the Commissioner may order. Instructions for an application for qualification by notification are provided in California Form 260.112 and, in addition to a prescribed facing page, the application includes information describing the business of the issuer, the use of proceeds, the plan of distribution, director and executive officer information, affiliate transaction information and several other categories of information. As with other forms of qualification, a surety bond is required if agents are employed in the distribution of the securities.

Qualification by Permit (Cal. Codes § 25113; Rule 260.113). All securities, whether or not eligible for qualification by coordination or notification, may be qualified by "permit" in California. An application for qualification by permit must include all of the information required for qualification by notification, and additional information prescribed by rule that, among other things, pertains to particular types of offerings. Instructions for an application for qualification by permit are set out in California Form 260.113. For qualifying small business issuers, Form U-7 (SCOR) is permitted, but subject to certain further requirements applicable to the offering.

Applications for qualification by permit in California are reviewed pursuant to "Standards for the Exercise of the Commissioner's Authority" set forth in rules, and intended to furnish guidelines for the exercise of the Commissioner's discretion relating to the qualification of securities, based upon the usual or typical circumstances encountered. The stated standards do not preclude application of different standards justified by the circumstances. Enumerated standards (and requirements) address the following:

- Suitability of investors
- Securities of speculative businesses
- Rights of security holders
- Selling expenses and options to underwriters
- Rights, warrants and options generally
- Promotional shares
- Recapitalizations and Reorganization
- Stock Dividends and stock splits
- Securities of particular issuers including, for example, debt offerings by churches
- Investment company securities
- Real estate program securities
- Oil and gas interests

The Commissioner is authorized to impose conditions of qualification including escrows and legends, restrictions on transfer, impound conditions and employment of licensed agents. In all of this process, California participates in the NASAA Coordinated Equity Review (CER) Program, and thus has agreed to adhere to applicable NASAA guidelines to the extent they do not otherwise conflict with California law, rules or orders. Comm. Rel. No.111-C (Apr. 16, 1998).

Non-Issuer Transactions n3

The Law specifically addresses sales of securities by a non-issuer in California, requiring qualification of all such transactions unless the security involved or the transaction is otherwise exempt. Qualification by notification is expressly made available for non-issuer sales, unless the securities are offered pursuant to an exemption under Regulation A of the Securities Act of 1933, in which case the sale must be qualified by permit. To the extent a non-issuer is unable to provide information that would otherwise be required by an application for qualification by notification, the person must only supply that information that is known to him/her, or which can be furnished without unreasonable effort or expense. Securities previously subject to an escrow condition may not be sold or transferred by a non-issuer without release of the escrow by the Commissioner. Applications to qualify securities for non-issuer transactions must further demonstrate that the issuer is engaged in an ongoing business. As a guideline, an issuer showing annual gross receipts from operations of not less than \$500,000 will ordinarily be deemed to meet the requirement. *See* Rule 260.140.137 ("Shell companies").

Applications to qualify non-issuer transactions are subjected to the same standards that are applied to issuer transactions when:

- A non-issuer application is filed in connection with a proposed offering of the securities pursuant to a registration statement under the Securities Act of 1933, or pursuant to an exemption under Regulation A of the 1933 Act;

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- The issuer of the securities has within 24 months immediately preceding the date of the filing made a public offering which was not qualified in California, or which was qualified as a limited offering; or
- A significant market for the securities proposed to be offered by the non-issuer does not exist in California. For purposes of this provision a "significant market" means that the securities are held by not less than 100 persons in the state and are subject to regular quotations by at least one market-maker.

Shelf Registration. To accommodate SEC Rule 415 under the Securities Act of 1933, California permits shelf registration through a short form qualification by coordination. The abbreviated procedure is available only for those issuers eligible to file with the SEC on Forms S-3 or F-3. After review of the application and resolution of any issues raised by application of qualification standards, on notice of effectiveness from the Commissioner the qualification will be effective for twelve months from the date of notification. Specific transactions involve additional requirements. Comm. Rel. No. 70-C (June 24, 1982, as revised).

Multijurisdictional Disclosure System (MJDS). California accommodates the MJDS through qualification by coordination, and with a waiver of the normal ten day review period in favor of the MJDS seven day period provided that the application in California is filed on the same day as the SEC filing. An MJDS application for qualification may be made on Form U-1, but will be granted expedited review only if clearly identified as an MJDS application.

Qualification of Small Corporate Offerings (Cal. Codes § 25113(b)(2)). Small company applicants in California may utilize Form U-7, the Small Corporate Offering Registration (SCOR) form for qualification of an offering by permit. The total offering of voting common stock and preferred stock by an applicant is limited to \$1 million during a 12 month period, adjusted by the amounts, if any, of securities offered in certain exempt transactions under the Securities Act of 1933. A qualifying small company offering is subject to a minimum offering price per share, and the applicant must also undertake that there will be no stock splits, stock dividends, spinoffs or mergers for a period of two years from the close of the offering except as may be authorized by the Commissioner. The net proceeds of the offering must be expended in the operations of the business.

Application Fees:

Qualification by Coordination: \$200 plus one-fifth of one per cent of the aggregate value of securities being offered, but subject to a maximum fee of \$2500.

Qualification by Notification: \$200 plus one-fifth of one per cent of the aggregate value of securities being offered, but subject to a maximum fee of \$2500.

Non-issuer Qualification by Notification: \$100.

Qualification by Permit: \$200 plus one-fifth of one per cent of the aggregate value of securities being offered, but subject to a maximum fee of \$2500. For an application for qualification by permit in a recapitalization or reorganization:

- For any change in the rights, preferences, privileges or restrictions of or on outstanding securities: \$200.
- For an exchange of securities by an issuer with its existing security holders exclusively, or in an exchange in connection with a merger, consolidation or purchase of assets in consideration of the issuance of securities: \$200 plus one-fifth of one per cent of the value as alleged in the application or the actual value as determined by the Commissioner of the consideration to be received in exchange, but

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subject to a maximum fee of \$2500.

Small Company Qualification by Permit: \$2500, subject to an additional fee of up to \$1000 to cover actual costs of processing the application that exceed the base application fee.

Amendment to an Application after Effective Date of Qualification: \$50 plus any additional fee that would have been required for the original application if the matters set forth in the amendment had been included in the original application.

FOOTNOTES:

(n1)Footnote 1. *Advertising* on the Internet by intermediaries is a separate topic, addressed by Policy Statement in California. The California policy on the use of the Internet by broker-dealers and investment advisers for the dissemination of information on products and services is discussed in Part V below.

(n2)Footnote 2. The procedure for automatic effectiveness of a qualification for an open-ended investment company or a unit investment trust which has previously qualified the sale of securities is slightly different, turning primarily on submission of a statement of no material changes in the offering, *see* Cal. Codes § 25111(d).

(n3)Footnote 3. A "non-issuer transaction" means any transaction not directly or indirectly for the benefit of the issuer. A transaction is indirectly for the benefit of the issuer if any portion of the proceeds will be received indirectly by the issuer, *see* Cal. Code § 25011.



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III STATE FORMS (A-F)

California

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§ IV. Exempt Securities and Transactions

(California Codes §§ 25100-25105)

A. The registration provisions of the California Corporate Securities Law do not apply to any of the following securities:

- Any security issued or guaranteed by the United States, any state, city, county, public district, public authority, public entity, or any political subdivision of a state or any agency or corporate or other instrumentality thereof, or any certificate of deposit for such a security.
- Any security issued or guaranteed by Canada, any Canadian province, any political subdivision or municipality of a Canadian province, or any other foreign government with which the United States currently maintains diplomatic relations if the security is recognized as a valid obligation by the issuer or guarantor, or any certificate of deposit for such a security.
- Securities of world-class foreign issuers meeting certain criteria. (Rule 260.105.11)
- Any security issued or guaranteed by and representing an interest in or a direct obligation of a national bank, or a bank or trust company incorporated under the laws of California, and any security issued by a bank to one or more other banks and representing an interest in an asset of the issuing bank.
- Any security issued or guaranteed by a federal savings association, federal savings bank, federal land bank, joint land bank, national farm loan association, or by any savings association subject to California supervision and regulation.
- Any security (with certain exceptions relating to real estate) the issuance of which is subject to authorization by the California Insurance Commissioner, the Public Utilities Commission, or the Real Estate Commissioner.
- Any security consisting of any interest in all or portions of a parcel or parcels of real property which

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are subdivided lands or a subdivision or in a real estate development, provided that there is no investment contract offered or sold with the interest and certain other conditions are met.

- Mutual capital certificates or savings accounts issued by a savings association holding a license or certificate of authority in the state.

- A security issued or guaranteed by a federal credit union, or by a credit union organized and supervised, or regulated, under the state credit union law.

- Any security issued or guaranteed by any railroad, other common carrier, public utility or public utility holding company that meets certain qualifications or is otherwise regulated in regard to issuance or guarantee of the security by the federal or a state government, or Canada or any Canadian province.

- Any security (other than an evidence of indebtedness) of (1) an issuer organized exclusively for religious, educational, benevolent, charitable, fraternal or reformatory purposes and not for pecuniary profit, if no part of the net earnings of the issuer inures to the benefit of any private shareholder or individual; or (2) a chamber of commerce or a trade or professional association. By rule, the exemption extends to non-profit organizations which expect or intend to make some profit, directly or indirectly, from any business or activity associated with the organization or operation of the organization if certain conditions are met. (Rule 260.105.20)

- An offer or sale of certain guarantees, letters of credit, standby purchase agreements or other similar securities obligating the issuer to pay the principal of and/or interest on certain exempt securities or securities meeting qualifications in regard to the issuer. (Rule 260.105.38)

- Agreements commonly known as "life income contracts" of an issuer organized exclusively for religious, educational, benevolent, charitable, fraternal or reformatory purposes and not for pecuniary profit, if no part of the net earnings of the issuer inures to the benefit of any private shareholder or individual; and which the Commissioner designates by rule or order.

- Commercial paper arising out of a current transaction, or the proceeds of which have been or are to be used for a current transaction, and which evidences an obligation to pay cash within nine months of the date of issuance, and subject to certain other conditions.

- Checks, drafts or money orders offered and sold by a person licensed to engage in such activity under the provisions of the state banking law. (Rule 260.105.16)

- Securities issued by a non-profit cooperative association organized under applicable state law.

- Beneficial interests in an employee pension, profit-sharing, stock bonus or similar benefit plan meeting certain requirements for qualification.

- Any security listed or approved upon issuance for listing upon notice of issuance on a national securities exchange registered under the Securities Exchange Act of 1934 or on the National Market System tier of the Nasdaq Stock Market if the exchange or Nasdaq market has been certified by the Commissioner as to certain qualifying criteria, and when the security meets certain criteria. Securities senior to listed or designated securities are also exempt by rule, but are subject to a notice requirement. (Rule 260.105.33)

- Publicly traded common shares by an issuer with securities registered under section 12 of the

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Securities Exchange Act of 1934, listed or approved for listing on a national securities exchange, and which meet certain further criteria. (Rule 260.105.17)

- Exchange-traded options on stock indices and foreign currencies, provided certain conditions are met. (Rule 260.105.35-.36)
- Promissory notes secured by a lien on real property, provided the note is not one of a series secured by the same property, and does not involve beneficial interests sold to more than one person.
- Investment grade rated debt securities. (Rule 260.105.34)
- Qualifying unincorporated inter-indemnity, reciprocal or inter-insurance contracts.
- Shares or memberships issued by qualifying cooperative corporations organized under California law.
- Any security consisting of or representing an interest in a pool of mortgages meeting certain qualifying conditions.
- Any NSMIA "covered security, including any security issued by an investment company registered under the federal Investment Company Act of 1940 that is defined as a covered security under NSMIA and meets certain further requirements.
- Securities of an issuer that is a reporting company under sections 13 or 15(d) of the Securities Exchange Act of 1934, and which are offered or sold in a transaction exempt under section 4(1) of the Securities Act of 1933 in which the seller is not an issuer, underwriter or dealer; or in a transaction by a dealer exempt under section 4(3) of that Act.

B. The qualification provisions of the California Corporate Securities Law do not apply to any of the following transactions:

- An offer (but not a sale) not involving any public offering, and the execution and delivery of any agreement for the sale of securities pursuant to the offer if the agreement meets certain conditions.
- An offer (but not a sale) of a security for which a registration statement has been filed under the Securities Act of 1933 but has not yet become effective, or for which an offering statement under Regulation A of that Act has been filed but has not yet been qualified, so long as no stop order is in effect and no other proceedings are pending.
- An offer (but not a sale) and the execution and delivery of any agreement for the sale of securities pursuant to the offer as may be permitted by the Commissioner upon application ("Negotiating Permit").
- Any transaction or agreement between the issuer and an underwriter, or among underwriters, if the sale of the securities is qualified or exempt from qualification at the time of distribution in the state.
- An offer or sale of an evidence of indebtedness, or guarantee thereof, in a transaction not involving a public offering.ⁿ¹
- An offer or sale of a security by the bona fide owner for his or her own account, provided there is no advertising and the transaction is not effected through a broker-dealer in a public offering.

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- An offer or sale effected through a licensed broker-dealer pursuant to an unsolicited offer to buy.
- An offer or sale of a security in a bona fide brokerage transaction that is exempt from registration under section 4(4) of the federal Securities Act of 1933.
- An offer or sale to a bank, savings and loan association, trust company, insurance company, registered investment company, pension or profit-sharing trust, individual retirement plan, or such other institutional investor or governmental agency or instrumentality as the Commissioner may designate by rule, provided that the purchaser represents that it is purchasing for its own account for investment and not with a view to or for sale in connection with any distribution of the security.
- Any transaction or agreement between a person on whose behalf an offering is made and an underwriter, or among underwriters, if the sale of the securities is exempt from qualification at the time of or qualified prior to distribution in the state.
- An offer or sale by or for the account of a bona fide secured party selling the security in the ordinary course of business to liquidate a debt.
- Any transaction by an executor, administrator, sheriff, marshal, receiver, trustee in bankruptcy, guardian, or conservator.
- Any offer or sale of a security for which any security of the same class has been qualified under the Law within prescribed time limits and when certain other conditions are met.
- Any offer or sale of conditional sale agreements, equipment trust certificates, or certificates of interest or participation therein or partial assignments thereof, covering the purchase of railroad rolling stock or equipment, or the purchase of motor vehicles, aircraft, or parts thereof, in a transaction not involving a public offering.
- Offers or sales to banks and other financial institutions, pension or profit-sharing trusts, retirement plan accounts and other institutional investors or government agencies or instrumentalities that the Commissioner may designate by rule, or to a corporation that has outstanding securities registered under section 12 of the Securities Exchange Act of 1934, or a qualifying subsidiary of the corporation.
- An offer or sale of any certificate of interest or participation in an oil or gas title or lease meeting certain requirements.
- An offer or sale of any security under or pursuant to a plan of reorganization under Chapter 11 of the federal bankruptcy law that has been confirmed or is subject to confirmation.
- Qualifying offers or sales of an option, warrant, put, call, straddle, and any guarantee of such a security, by a person who is not the issuer of the underlying security and which meets certain other conditions.
- An offer or sale of a security issued by a corporation or limited liability company pursuant to a purchase plan or agreement, or issued pursuant to an option plan or agreement, when the security at the time of issuance or grant is exempt from registration under the Securities Act of 1933 and certain other conditions are satisfied.

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- An offer or sale of non-redeemable securities to accredited investors by a person licensed under the Capital Access Company Law.
- An offer or sale of any viatical or life settlement contract or fractionalized or pooled interest therein in a transaction meeting certain conditions.
- Sales of a series of notes secured directly by an interest in the same property, or the sale of undivided interests in a note secured directly by real property equivalent to a series transaction, that complies with provisions of the California Business and Professions Code.
- Negotiations or agreements prior to general solicitation of approval by the holders of equity securities regarding (1) a change in the rights, preferences, privileges or restrictions of or on outstanding securities; (2) a merger, consolidation or sale of assets in consideration of the issuance of securities; or (3) an entity conversion transaction.
- A change in the rights, preferences, privileges or restrictions of or on outstanding securities, or any entity conversion transaction, involving an issuer in which less than 25% of affected holders have addresses in the state.
- Any exchange incident to a merger, consolidation, or sale of assets in consideration of the issuance of securities of another issuer when less than 25% of holders who are to receive securities have addresses in the state, and certain other conditions are met.
- Any change (other than a stock split or reverse stock split) in the rights, preferences, privileges or restrictions of or on outstanding equity securities, except for certain changes to the extent they materially and adversely affect any class of equity securities.
- A stock split or reverse stock split, except in certain circumstances in which the split would have a material effect on the proportionate interests of the respective classes of shares outstanding as to voting, dividends, or distributions, or certain other circumstances apply.
- Any change in the rights of outstanding debt securities, except in certain circumstances if there is a material and adverse effect on any class of securities.
- An exchange incident to a merger, consolidation, or sale of assets which meets certain criteria.
- An exchange of securities in connection with a merger, consolidation or sale of corporate assets in consideration wholly or in part of the issuance of securities, or an entity conversion transaction, pursuant to a plan of reorganization or arrangement confirmed or subject to confirmation under the United States Bankruptcy Code.
- Any transaction in which money is advanced or loaned to a corporate issuer with an agreement or expectation that shares of the issuer will be issued in exchange for cancellation of, or conversion of such advances or loans, provided certain requirements are met. (Rule 260.105.23)
- An offer or sale of a beneficial interest in an inter vivos pre-need funeral trust meeting certain qualifications. (Rule 260.105.26)

Exemption Fees

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Offers and Sales Under a Stock Purchase or Stock Option Plan (Cal. Codes § 25102(o)): \$200 plus one-fifth of 1% of the aggregate value of the securities proposed to be sold, but subject to a maximum \$2500 total fee.

Exchange Incident to a Merger, Consolidation or Sale of Assets (Cal. Codes § 25103(h)): \$600.

Negotiating Permit: \$50.

Application Fee for Exemptions Relating to Certain Notes and Commercial Paper: \$250.

Investment Companies (Cal. Codes § 25100.1(b)): For federally registered investment companies and unit investment trusts claiming exemption, the notice filing fee is \$200, plus one-fifth of 1% of the aggregate value of the securities to be sold, subject to a maximum \$2500 fee.

California Limited Offering Exemptions

The California Corporate Securities Law includes several limited offering exemptions, as follows:

- *Limited Public Offering.* An offering of securities (other than a "roll up" or blind pool) by a California corporation or a foreign corporation that is subject to the general corporation law of California, or other issuer organized under California law in which sales are made only to qualified purchasers or other persons the issuer reasonably believes to be qualified purchasers. Qualified purchasers include various institutional investors as well as natural persons who meet income and net worth criteria, and who purchase for their own account and not with a view to distribution. Use of a written offering disclosure statement meeting the requirements of Regulation D under the Securities Act of 1933 is required. Subject to restrictions, a general announcement of the proposed offering is permitted. There staged notice of transaction filing requirements and prescribed forms of notice. (Cal. Codes § 25102(n); Rule 260.102.16)

- *Limited Offering Exemption.* An offering involving sales to no more than 35 purchasers who meet certain requirements and who purchase for their own accounts without a view to distribution is exempt. Certain purchasers are excluded from the count, including any person who meets "accredited investor" criteria as set forth in Regulation D under the federal Securities Act of 1933. There are limitations on the manner of the offering, and a notice filing requirement is included by rule. (Cal. Codes § 25102(f); Rules 260.102.12-.14)

- *Qualified Purchaser Exemption.* Offers and sales only to "qualified purchasers" as defined under NSMIA, or in transactions otherwise exempt by NSMIA from registration under the federal Securities Act of 1933, but subject to notice filing and fee requirements. Cal. Codes § 25102.1(a), (c), (d).

- *Limited Offering of Common Stock by a Corporation.* The offer and sale of voting common stock by a corporation (incorporated in any state) is exempt if immediately after the proposed sale and issuance there will be only one class of stock outstanding that is owned beneficially by no more than 35 persons, provided certain additional conditions are met. Restrictions include no advertising or selling expenses, they type of consideration paid for the stock, no intent to distribute, and a prescribed notice filing and fee requirement. Cal Codes § 25102(h).

Limited Offering Exemption Fees:

Qualified Purchaser Exemption (Cal. Codes § 25102(a)): The notice filing fee requirement is \$600.

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NSMIA Exempt Offerings (Regulation D, Rule 506; Cal Codes § 25102.1(d)): The notice filing fee is \$150.

Limited Offering Exemption (Cal. Codes § 25102(f)): The fee requirement for this limited offering is established on the basis of the total value of the securities to be sold, and ranges from \$25 for offerings valued at \$25,000 or less, to \$150 for offerings in excess of \$1 million. The filing fee for an SEC Rule 506 offering is \$150.

Limited Corporate Offering (Cal. Codes § 25102(h)): The fee requirement for this limited offering is established on the basis of the value of the securities proposed to be sold, and ranges from \$25 for sales of \$25,000 or less to \$300 for sales in excess of \$1 million.

Offerings by Capital Access Companies

Capital access companies provide financial or managerial assistance to small businesses that meet specified requirements, including the requirement that the small business receiving the assistance have a significant connection to California. Requirements applicable to the offer and sale of securities by a capital access company include the following:²

- The securities can be sold only to accredited investors.
- Not less than 80% of the capital access company's securities must be held by California residents or by investors with a substantial business presence in the state.
- The capital access company may not issue redeemable securities.
- The capital access company must meet certain requirements as to tangible net worth, funds available to invest, financial resources to cover expenses, and qualified management.

FOOTNOTES:

(n1)Footnote 1. A "non-public" offering for purposes of these provisions means that offers are not made to more than 25 persons and sales are not consummated to more than 10 of such persons, and who meet certain further criteria regarding the ability to protect their own interests. Rule 260.102.2.

(n2)Footnote 2. See Comm. Rel. No. 1-CACL (Aug. 9, 1999). Capital access companies must be licensed by the Department of Corporations. Particular licensing requirements and procedures are addressed in Part V below.



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III STATE FORMS (A-F)

California

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§ V. Intermediary Licensing/Registration

(California Codes §§ 25200-25403)

A. Securities Broker-Dealers. Unless exempted, any person who transacts business in the state as a broker-dealer or agent must be licensed under the Corporate Securities Law.ⁿ¹ For purposes of the California licensing ("certificate") provisions, broker-dealer means any person engaged in the business of effecting transactions in securities in the state for the account of others or for his/her own account. Broker-dealer does *not* include: (a) any other issuer; (b) an agent employed by a broker-dealer or issuer; (c) a bank, trust company or savings and loan association; or (d) any person insofar as he or she buys or sells securities for his or her own account, either individually or in some fiduciary capacity, but not as part of a regular business; (e) a person who has no place of business in the state and who effects transactions exclusively with (1) issuers of the securities involved in the transactions or (2) other broker-dealers; (f) a licensed real estate broker engaged in the sale of certain exempt securities; and (g) an exchange certified by the Commissioner when it is issuing or guaranteeing options.

Exemptions from broker-dealer licensing requirements. The following broker-dealers are exempt from licensing in California:

- A broker-dealer registered under the Securities Exchange Act of 1934, having no place of business in California, and who does not direct offers to sell or buy into the state in any manner to persons other than broker-dealers, banks, savings and loan associations, trust companies, insurance companies, registered investment companies, pension or profit-sharing trusts, or other institutional investors or government agencies designated by rule, or to more than 15 other customers having an existing account with the broker-dealer prior to any offer made to them in the state, during any period of 12 consecutive months.
- A person whose only clients are insurance companies.
- A real estate broker licensed by the state Real Estate Commissioner, when engaged in transactions in any general or limited partnership, joint venture, unincorporated association, or similar organization (but not a corporation) owned beneficially by no more than 100 persons and formed for the sole purpose of, and engaged solely in, investment in an interest in real property.

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- A licensed real estate broker whose business as a broker-dealer is limited to (a) transactions involving all of the outstanding securities of an existing business as part of a negotiated transaction for the purchase and sale of real estate or substantially all of the assets of the business; (b) transactions in shares or memberships of mutual water companies in connection with a sale of an interest in real property; (c) transactions in investment contracts sold or offered for sale with, or as part of, residential condominium units or time shares if the sale is qualified under applicable law; and (d) transactions in a series of notes secured by interests in the same real property in transactions qualified or exempt from qualification under the Corporate Securities Law. (Rule 260.204.1)

- A financial institution which undertakes activities with respect to the operation of an investment company.

- Persons who effect securities transactions only in connection with mergers, consolidations or purchase of corporate assets, and who does not receive, transmit or hold for customers any funds or securities in connection with such transactions. (Rule 260.204.5)

- Certain licensed lenders. (Rule 260.204.6)

- A Canadian broker-dealer registered in good standing in the Canadian jurisdiction from which it is effecting transactions, and which is a member of a Canadian stock exchange or self-regulatory organization, with no office or physical presence in the state, who (a) effects transactions for Canadian residents temporarily resident in or visiting the state, with whom the Canadian broker-dealer had a bona fide client relationship before the Canadian resident entered the United States; or (b) effects transactions for a Canadian retirement account of which the holder or contributor is a permanent or temporary resident or visitor in the state. (Rule 260.204.10)

- A person licensed as a capital access company when engaged in the transaction of business pursuant to the requirements of the Capital Access Company Law and regulations.

A broker-dealer registered under the Securities Exchange Act of 1934, and who is a member of a designated securities exchange or the NASD, and who has not had a certificate previously revoked or denied, may be licensed in California by "notification." A form of application by notification is prescribed by rule (Rule 260.211.1(b)). An application for broker-dealer licensing other than by notification is made on Form BD-the Uniform Application for Broker-Dealer Registration. Instructions for filing in California are prescribed by rule (Rule 260.211(b)). Unless a denial proceeding is initiated by the Commissioner, an application for licensing becomes effective on the third business day after the application is filed, or on the day a certificate is issued, whichever comes first. The Commissioner may delay the effectiveness of an application for up to 15 days (or longer by consent of the applicant) if the delay is necessary to determine whether a denial proceeding should be instituted.

Further requirements for all broker-dealer licenses include:

Minimum net capital. The applicable minimum net capital is that set by SEC Rule 15c3-1 under the Securities Exchange Act of 1934 (Rule 260.216.12).n2

Broker-dealers and their compliance supervisors must pass either the Uniform Securities Agent State Law Examination (Series 63) or the Uniform Combined Law Examination (Series 66), in addition to whatever further examination may be required for principals and other associated persons of a firm by any self-regulatory organization of which the broker-dealer is a member.

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B. Agents. "Agent" means any individual other than a dealer or a partner of a broker-dealer, who represents a broker-dealer or who, for compensation, represents an issuer in effecting or attempting to effect purchases or sales of securities in the state. The definition of agent in California does *not* include any of the following:

An individual who only represents an issuer in effecting transactions in exempt securities or in exempt transactions.

An individual who has no place of business in the state if he or she effects transactions in the state exclusively with broker-dealers.

An associated person of a broker or dealer effecting *de minimis* transactions in accordance with § 15(h)(2) of the Securities Exchange Act of 1934, namely, transactions by an associated person or broker-dealer registered in another state on behalf of an existing customer present in California for less than 30 days.

An officer or director of a broker-dealer or issuer, or a person occupying a similar status or performing similar functions who does not receive compensation specifically related to purchases and sales of securities.

A licensed "life agent" of an issuer selling viatical settlement contracts in transactions qualified for the applicable exemption.

Applications for licensing ("certificate") as a broker-dealer or agent in California are made by means of Form BD and Form U-4, respectively. Form BD is subject to separate instructions in California that prescribe certain additional categories of information, and modify that part of Form BD which requires certain criminal history disclosures, *see* Rule 260.211(b). Additional information required includes certain financial information, net capital computation, fingerprint cards and other exhibits. For broker-dealers eligible to use the Central Registration Depository system, application filings for agents on Form U-4 may be submitted through that system. However, no agent application is effective until specifically approved by the Commissioner, who may request submission of additional documentation or information in connection with the application.

Agents are subject to qualification requirements. Each agent applicant must, within two years prior to making the application, have passed the Series 63 (Uniform Securities Agent State Law Examination) or the Series 66 (Uniform Combined State Law Examination). Dual employment of an agent is permitted in California provided certain conditions are satisfied and required notice is given to the Commissioner. Rule 260.216.16.

Applications for broker-dealer and agent licensing are reviewed in accordance with conduct standards, and once licensed broker-dealers and agents are subject to numerous conduct rules adopted under a general prohibition against manipulative, deceptive, or other fraudulent schemes, devices or contrivances or as independent conduct rules, as, for example, rules relating to suitability of recommendations. As a general standard applicable to all broker-dealers and agents, California mandates that each must observe high standards of commercial honor and just and equitable principles of trade in the conduct of business.

Other requirements applicable to broker-dealers in California include:

Record keeping requirements (Rule 260.241). Every broker-dealer must make, maintain, and preserve books and records in compliance with U.S. Securities and Exchange Commission Rules 15c2-11 (17 C.F.R. 240.15c2-11), 15g-2(c) (17 C.F.R. 240.15g-2(c)), 15g-4(b)(2) (17 C.F.R. 240.15g-4(b)(2)), 15g-5(b)(2) (17 C.F.R. 240.15g-5(b)(2)), 15g-6(f) (17 C.F.R. 240.15g-6(f)), 17a-3 (17 C.F.R. 240.17a-3), and 17a-4 (17 C.F.R. 240.17a-4), all of which are incorporated by reference.

- Specific record keeping requirements (Rule 260.218.5).

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- On-going compliance with reserve and custody of security requirements (Rule 260.216.12.1).
- Disclosure of compensation from financial planning activities.
- Timely amendments to Forms BD or U-4 when there are changes to the information contained in the original forms.
- Special filing requirements for terminations of agents by a broker-dealer for cause.
- Usury restrictions on margin loans.

Broker-dealers are also obligated to exercise diligent supervision over the securities activities of agents, and must establish, maintain and enforce written supervisory procedures designed to comply with specified duties, and records of which must be maintained as part of general record-keeping requirements (Rule 260.218.4).

Use of the Internet. California has adopted a modified version of the NASAA "Interpretive Order Concerning Broker-Dealers, Investment Advisers, Broker-Dealer Agents and Investment Adviser Representatives Using the Internet for General Dissemination of Information on Products and Services." Comm. Rel No. 107-C (Aug. 19, 1997). Use of the Internet by these intermediaries does not constitute "transacting business" in the state if specific conditions are met, including:

- A written legend requirement on the Internet communication disclosing that the intermediary may only transact business in a particular state after licensure or satisfying qualification requirements, unless excluded or exempted, and that individualized follow-up responses may not be made without the intermediary first complying the state's licensing requirements, or pursuant to an applicable exemption.
- The Internet communication contains a "firewall" or other mechanism designed to ensure that prior to any subsequent direct communication with prospective customers or clients the intermediary is first licensed in the state or has an available exemption.
- The Internet communication is limited to the dissemination of general information on products and services, and does not involve either effecting or attempting to effect transactions or the rendering of personalized investment advice for compensation in the state.

Advertising Generally. The Corporate Securities Act requires that a copy of any advertisement to be published in the state concerning any security sold or offered for sale must be filed with the Commissioner at least three days prior to publication. Certain advertisements are excluded, including those published by a licensed broker-dealer who is not effecting transactions in the security as an underwriter or other participant in a distribution for the issuer (Cal. Codes § 25300).

Broker-Dealer and Agent Filing Fees: The application and annual fee for licensing as a dealer in California is \$300, and \$25 for each agent (plus reimbursement of the processing fee for applicant fingerprints).

C. Investment Advisers/Investment Adviser Representatives. California has adopted the federal definition (and exclusions) of 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. Cal. Codes § 25009. By rule, California also exempts the following persons from licensing requirements:

- (1) Any person who does not hold itself out generally to the public as an investment adviser;

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- (2) Has fewer than 15 clients;
- (3) Is exempt from federal registration; and
- (4) Either has assets under management of at least \$25 million, or provides investment advice solely to qualifying venture capital companies. (Rule 260.204.9)

Otherwise, any person, other than a federal covered adviser, who transacts business as an investment adviser must be licensed under the Corporate Securities Law unless the adviser has no place of business in the state, and during the preceding twelve months had no more than six non-institutional clients who are residents of the state. The "client" definition used in this provision excludes advisers who, for example, provide investment advice only to investment companies registered under the Investment Company Act of 1940, banks and other financial institutions, and other institutional investors. Cal. Codes § 25202.

A federal covered adviser is subject to notice filing requirements in California if the adviser has more than six non-institutional clients. Federal covered advisers subject to notice filing must file an annual report with the Commissioner comprised of SEC-filed documents, and payment of a fee. Cal. Codes § 25230.1.

Financial Planners. In California, the definition of investment adviser also expressly includes an 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 in regard to securities, or who publishes analyses or reports regarding securities. The same exclusions and exemptions that apply generally to the definition of investment adviser are incorporated into the "financial planner" provision as well. Cal. Codes § 25009(b). Specific disclosure requirements related to compensation for financial planning³ are applicable to all advisers and associated persons (Rule 260.235.2).

Investment adviser representatives subject to licensing in California include any individual who is a principal or associated person of an adviser subject to supervision and control of the adviser, and who engages in any of the following activities:

- Makes any recommendations or otherwise renders advice regarding securities.
- Manages accounts or portfolios of clients.
- Determines which recommendations or advice regarding securities should be given.
- Solicits, offers, or negotiates for the sale or sells investment advisory services.
- Supervises employees or perform any of the foregoing. Cal. Codes § 25009.5.

Investment adviser representatives of federal covered advisers are subject to licensing in California regardless of the exempt status of the adviser itself if the investment adviser representative maintains a place of business in the state. Comm. Rel. No. 105-C (July 3, 1997).

Investment Adviser and Investment Adviser Representative licensing applications are subjected to the same standards and criteria for review as apply to broker-dealers and agents. Application requirements for investment advisers include:

- Filing Form ADV (modified in regard to criminal background, and to include certain additional information),ⁿ⁴ and a complete, current Form U-4 for each investment adviser representative. Both may be filed through the Investment Adviser Registration Depository system (IARD) by participating

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applicants, except that Part II of Form ADV must be filed directly with the Commissioner;

- Subject to some exemptions, proof of compliance with written examination requirements or certain professional qualification requirements (Rule 260.236);
- Such financial reports or information that may be required; and
- Applicable fee(s).

Capital Requirements. For investment advisers who have custody of their clients' funds (including prepaid fees) or securities, or who have any power-of-attorney or trading authority from an advisory client to execute transactions, must meet certain capital requirements. Such an adviser may not permit its total aggregate indebtedness to exceed 500% of its tangible net capital, or permit its current aggregate indebtedness to exceed its current net capital, and must maintain net capital as follows:

- Tangible net capital of not less than \$25,000; or
- For advisers that have power-of-attorney or trading authority, but that do not have regular or periodic custody or possession of client funds or securities, but receive prepaid subscriptions or fees, tangible net capital of at least \$5000; or
- For advisers that receive fees for periodic publications or services paid six months or more in advance, but that do not have any trading authority and do not otherwise have possession or custody of client funds or assets, tangible net capital of at least \$1000.

There is no bonding requirement applicable to investment advisers or investment adviser representatives, although the Commissioner has the statutory authority to establish a fidelity bond requirement by rule for those advisers having custody of client funds or securities, or who have trading authority.

All Investment advisers in California are subject to books and records requirements that generally track the requirements imposed on federal covered advisers under SEC Rule 204-2 under the Investment Advisers Act of 1940. Books and records maintained by advisers are subject to periodic inspections by the Commissioner. Investment advisers are also subject to annual report requirements that include submission of a statement of financial condition with specific supporting schedules (Rule 260.241.2). Financial statements must be audited if the adviser has held or accepted custody of client funds or securities, or has owed money or securities to any client during the covered period and has acted under a general power-of-attorney or trading authorization.

Investment advisers are generally bound to conduct their activities in accordance with fair, equitable and ethical principles (Rule 260.238). Numerous acts and practices are identified as contrary to that standard, or as violations of the general antifraud provision applicable to advisers. Specific prohibitions include a bar against compensation based on capital gains, except in certain circumstances. There is a suitability requirement specifically applicable to advisers.

In California, investment advisers and investment adviser representatives are subject to specific financial and disciplinary information disclosure requirements (Rule 260.235.4), such that use Part II of Form ADV or its equivalent must be provided to advisory clients and prospective clients. Also, advertising materials by investment advisers that contain particular types of information are prohibited (Rule 260.235), and advertising material generally is subject to the same provisions for filing, and to the same standards, that are applicable to broker-dealers.

Investment Adviser and Representative Filing Fees: The fee for initial or annual renewal registration of an investment adviser is \$125, and \$25 for each investment adviser representative. For federal covered advisers making

notice filings the fee is also \$125, and \$25.00 for each investment adviser representative.

FOOTNOTES:

(n1)Footnote 1. Eligibility for broker-dealer licensing is also subject to general limitations on licenses and certificates to aliens, *see* Rule 250.60, implementing provisions of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996, 8 U.S.C. § 1621 *et seq.* Non-qualifying aliens are not eligible to be licensed in California.

(n2)Footnote 2. An *issuer* that employs agents in connection with any non-exempt security or transaction may be required to post a surety bond in the amount of \$10,000, or an appropriate deposit of cash in lieu of the bond, to be maintained so long as the issuer is engaged in the sale of the securities (Rule 260.216.15).

(n3)Footnote 3. "Financial planning" includes activities such as the preparation of a financial plan, including estate or tax planning recommendations, annual or periodic reviews of financial plans, management and/or monitoring of a client's investments under a financial plan, provision of information and/or advice to a client regarding the purchase or sale of securities, real estate, insurance contracts, annuity contracts or any type of real or personal property under a financial plan. *See* Rule 260.235.2(b).

(n4)Footnote 4. Effective April 5, 2007, all investment adviser and investment adviser representative applications, amendments, reports, notices, related filings, and fees required to be filed with the Commissioner pursuant to the rules promulgated under the Code may be filed electronically with the IARD. *See* Cal. Code Regs. § 260.230(b).



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III STATE FORMS (A-F)

California

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§ VI. Administration and Enforcement

A. Legislative and Rulemaking Developments.

1. In September 2008, California enacted section 25243.5 to the Corporations Code, to adopt the NASAA Model Rule on the use of senior-specific certifications and designations. The law prohibits a broker-dealer or investment adviser, or an agent or representative thereof, except as specified, from using a senior-specific certification, credential, or professional designation indicating or implying that he or she has a special certification or training in advising or servicing senior citizens or retirees in such a way as to mislead any person. The provision becomes effective on July 1, 2009.

2. Compensatory Benefit Plan Rules: Rule(s): 260.140.8, 260.140.41, 260.140.42, 260.140.45, and 260.140.46 governing the qualification and exemption of securities issued in connection with compensatory benefit plans have been amended. Among other things, SEC Rule 701 plans or agreements that intend to utilize the exemption in Corporations Code section 25102(o) will no longer be subject to restrictions on repurchase rights. Other changes allow companies greater flexibility in setting the total number of securities that may be issued under plans, and add flexibility in determining the appropriate exercise price of securities covered by options. Changes became effective on July 9, 2007.

B. Selected Policy Statements/Interpretive Opinions:

Transition to the Investment Adviser Registration Depository for SEC-registered investment advisers and investment adviser representatives. Comm Rel. No. 114-C (Nov. 3, 2000).

The Capital Access Company Law. Comm. Rel. No. 1-CACL (Aug. 9, 1999).

Offices for filing within the Department of Corporations. Comm. Rel. No. 13-G, as amended (Jan. 11, 2001).

"Fairness" hearings under the Corporate Securities Law after enactment of NSMIA. Comm. Rel. No. 102-C (Dec. 1, 1998).

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Participation in NASAA's Coordinated Equity Review. Comm. Rel. No. 111-C (Apr. 16, 1998).

Use of the Internet by broker-dealers and investment advisers for the dissemination of information on products and services. Comm. Rel. No. 107-C (Aug. 19, 1997).

Regulatory Ombudsman Program. Comm. Rel. 16-G (July 10, 1997).

The California Commodity Law of 1990. Rel. No. 1-CCL (Mar. 18, 1997).

Notice of filing and fee payment requirements for investment companies. Comm. Rel. No. 104-C (Dec. 18, 1996).

Notice filing and fee payment requirements for securities offerings under SEC Rule 506. Comm. Rel. No. 103-C (Dec. 12, 1996).

Offers of securities made on the Internet. Comm. Rel. No. 100-C (Nov. 5, 1996).

Expedited review for certain reorganizations. Comm. Statement of Policy, No. 98- C (Nov. 16, 1995).

Expedited review for stock options and stock purchase plans. Comm. Statement of Policy, No. 97-C (Nov. 16, 1995).

Exemption from qualification requirements for securities listed on Tier I of the Philadelphia Stock Exchange. Order, No. 96-C (Sept. 12, 1995).

Exemption from qualification requirements for securities listed on Tier I of the Pacific Stock Exchange. Comm. Rel. No. 95-C (Dec. 27, 1994).

"Qualified Purchaser" limited public offering exemption under *Cal. Corp. Code § 25102(n)*. Comm. Rel. No. 94-C (Sept. 27, 1994).

When does an agreement constitute a "franchise"? Comm. Rel. No. 3-F (June 22, 1994).

The small corporate offering registration (SCOR) application process and offerings of securities under SEC Regulation A. Comm. Rel. No. 93-C (Oct. 13, 1993).

Agents operating under a "local area" name or as an "independent contractor." Comm. Rel. No. 91-C, as amended (Jan. 7, 1994).

Limited Offering Exemption-Corporations Code Section 25102(f). Cmm. Rel. No. 67-C (Oct. 20, 1981).

Guidelines for determining when securities are being "offered to the public." Comm. Rel. No. 5-C (Jan. 31, 1969).

C. Precedent Decisions.

The Department of Corporations has designated the following matters as "precedent" decisions in connection with application and enforcement of the Corporate Securities Law:

(1) *In re American Equity Investment Life Ins. Co., et al.*, Agency Case No. 38300, OAH No. N2004080527 (Dec. 14, 2004). Desist and refrain order against unregistered investment advisers from

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advising people to sell securities in order to buy annuities. Individual Respondents were agents of American Equity, and as agents, they encouraged and facilitated the sale of securities to fund annuities. They gave "advice" to sell securities, and engaged in advising seniors regarding investing.

(2) *Commissioner v. FairShare, Karl M. Sjogren and John G. Wilson*, OAH No. N 19981 10288 (Dept. Corp. Jan. 26, 1999). "Membership" interests in an Internet based operation established to assist start-up and emerging companies raise venture capital through a large number of small investors are securities. Individuals participated in FairShare at different membership levels and, though financial incentives, were encouraged to solicit new members. A key element of FairShare services was the screening and selection of investment opportunities, and members were induced to become members as a means of realizing high returns on venture capital investments. The Administrative Law Judge concluded that membership interests in FairShare were securities under both investment contract and risk capital tests. FairShare created an expectation of profit from investments into start-up companies, an opportunity made available exclusively to members. Membership fees were a necessary part of, and coupled to, the ability of an individual to participate in the larger scheme of making capital investments in new business ventures. Members were dependent on FairShare services, including promotion, screening, due diligence of start-up companies, negotiation of pricing and share allotments, and marketing of new securities to members on exclusive and favorable terms.

(3) *In re Internet & Web Services Corp., et al.*, OAH No. L1998 060195 (Dept. Corp. Sept. 28, 1998). Desist and Refrain Order issued against respondents who created a web site mall and engaged in the offer and sale of securities in the form of investment contracts. Respondents developed "1 World Center" as an Internet shopping location where numerous stores were available. Prospective store "purchasers" were solicited through promotional materials that emphasized the opportunity to establish a successful retailing business with minimal effort and in reliance on the ability of the respondents to set up a "store" and to manage it for the purchaser. The Administrative Law Judge concluded that the web site stores promoted and sold by the respondents were securities under investment contract analysis. The efforts of the promoters in setting up and operating the sites were undeniably significant and essential in the failure or success of the enterprise. The stores were promoted as investments requiring minimal equipment, knowledge and effort. The web site store scheme, on its face and as promoted, constitutes they type of transaction the securities law intends to oversee in order to protect the public. Purchasers were attracted solely by the prospect and promise of significant financial return on their substantial investment.

D. Administrative Fines or Assessment Authority.

Administrative Penalties. Under the Corporate Securities Law, the Commissioner may impose civil money penalties not exceeding \$2,500 for each violation, or in the case of a continuing violation, \$2,500 for each day for which the violation continues. *Cal. Corp. Code § 28900*. Additionally, the Commissioner is authorized to seek the imposition of a money penalty not exceeding \$25,000 for each violation through a civil action brought in any court of competent jurisdiction. *Cal. Corp. Code § 25535*.

E. Ancillary Remedies.

The Law expressly empowers the Commissioner to seek the appointment of conservators, receivers or other fiduciaries as part of a civil injunctive action brought in the Superior Court.



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III STATE FORMS (A-F)

California

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§ VII. Civil Liability/Private Remedies

(Cal. Codes §§ 25500-25510)

Subject to time limits, the Corporate Securities Law establishes several private rights of action as follows:

- A purchaser or seller of a security at a price that was affected by any act or transaction in violation of market-directed antifraud provisions may sue any person who willfully participates in such acts or transactions to recover damages representing the difference between the price paid or received for the security and the market value which the security would have had at the time of the purchase or sale in the absence of the violation, plus interest.
- A purchaser or seller of a security in a transaction involving any false or misleading written or oral communication may sue any violator for rescission or damages as a rescission equivalent. A reasonable care defense is available to a defendant, and there is a tender requirement for rescission.
- A purchaser of a security in a transaction that violates the qualification provisions of the Law may sue for rescission or damages as a rescission equivalent, plus interest. Subject to limitation, liability under this provision extends to underwriters.
- A person who purchases or sells any security while in possession of material non-public information about the issuer is, under circumstances in which the person knows the information is non-public and material, liable to the person to whom the security is sold or from whom it is purchased. The violator is liable for damages representing the difference between the price at which the security was purchased or sold and the market value which it would have had if the information had been known at the time of the transaction, plus interest, but subject to certain defenses.
- A person who trades on the basis of material, non-public information is liable to the *issuer* of the security in an amount up to three times the difference between the price at which the security was purchased or sold and the market value which the security would have had at the time of the transaction if the information had been publicly disclosed. This action may be brought derivatively in the right of the

issuer, and the award may include costs and attorneys' fees. There are certain conditions and limitations on the availability of the action.

The private civil remedies of the California Corporate Securities Law also impose joint and several liability on controlling persons and other persons who materially aid in the commission of violations. A separate, specific, provision addresses the liability of professional persons named by consent in an offering circular or prospectus as having prepared or certified any part of the document or material distributed with it. Due diligence defenses are provided.



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CHAPTER NASAA STATEMENTS OF POLICY NASAA STATEMENTS OF POLICY

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CHAPTER NASAA STATEMENTS OF POLICY NASAA STATEMENTS OF POLICY

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§ NASAA

Adopted October 25, 1995, Amended May 7, 2007

I. INTRODUCTION

A. Application

1. This Statement of Policy applies to the registration of ASSET-BACKED SECURITIES, as defined in Section I.B.7; below, and will be applied by analogy to similar securities issued by ISSUERS that are not required to register as an Investment Company under the Investment Company Act of 1940.

2. The contents of this Statement of Policy shall be referred to herein as "Guidelines". While applications not conforming to the standards contained in these Guidelines shall be looked upon with disfavor, where good cause is shown, certain Guidelines may be modified or waived by the ADMINISTRATOR.

B. Definitions

1. ACQUISITION COST: the cost of an ELIGIBLE ASSET as reflected on the ISSUER'S balance sheet, net of applicable ACQUISITION EXPENSES AND ORIGINATION FEES.

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2. ACQUISITION CRITERIA: the specified characteristics an ELIGIBLE ASSET is required to possess in order for it to be sufficiently similar to other ELIGIBLE ASSETS to make possible a reliable prediction of the CASH. FLOWS associated with the ELIGIBLE ASSETS when pooled in large numbers.

3. ACQUISITION EXPENSES: all direct and indirect expenses incurred by the ISSUER in connection with the selection and acquisition of ELIGIBLE ASSETS, whether or not acquired, other than ORIGINATION FEES.

4. ADMINISTRATOR: the official or agency administering the securities laws of a state, province or commonwealth.

5. AFFILIATE: with respect to another PERSON, any of the following:

(a) Any PERSON directly or indirectly owning, controlling, or holding, with power to vote, ten percent or more of the outstanding voting securities of such other PERSON.

(b) Any PERSON ten percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held, with power to vote, by such other PERSON.

(c) Any PERSON directly or indirectly controlling, controlled by, under common control with such; other PERSON.

(d) Any executive officer, director, trustee, or partner of such other PERSON.

(e) Any legal entity for which such PERSON acts as an executive officer, director, trustee, or partner.

6. ALLOWED EXPENSES TRUSTEE FEES: ongoing fees paid to RATING AGENCIES, SERVICING FEES, ORIGINATION FEES, ACQUISITION EXPENSES, LIQUIDATION EXPENSES, bank service charges, taxes, attorneys' fees, audit fees, and other direct charges incurred by the ISSUER in the ordinary course of the ISSUER'S business, exclusive of ORGANIZATIONAL AND OFFERING EXPENSES, CONVERSION EXPENSES and extraordinary expenses.

7. ASSET-BACKED SECURITIES: securities that provide a STATED RATE OF RETURN to HOLDERS and that

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are primarily serviced as to both return of investment and return on investment by the CASH FLOW from designated ELIGIBLE ASSETS, excluding:

(a) the securities of an investment company, subject to the Investment Company Act of 1940, and

(b) equity interests in limited partnerships or other direct investment vehicles subject to other applicable registration.

8. CASH FLOW: the amount of cash generated from operations, calculated in compliance with Financial Accounting Standards 95, plus receipts from the disposition or liquidation of ELIGIBLE ASSETS.

9. COLLECTION ACCOUNTS: the bank account created to receive CASH FLOW generated by the ELIGIBLE ASSETS and to maintain the segregation of such cash from other assets of the SERVICER.

10. CONVERSION EXPENSES: the expenses associated with changing from one SERVICER to another SERVICER or one TRUSTEE to another TRUSTEE.

11. CREDIT ENHANCEMENT: insurance, letters of credit, lines of credit, over collateralization, seller recourse, reserve accounts, senior claim, guarantees, and other arrangements intended to decrease the likelihood of default on the ASSET-BACKED SECURITIES.

12. ELIGIBLE ASSETS: financial or commercial assets, either fixed or revolving, which are:

(a) generally homogenous in nature,

(b) subject to reasonably objective valuation,

(c) for other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, self-liquidating or easily liquidated, and

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(d) for other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, capable of generating a predictable CASH FLOW.

13. INVESTMENT GRADE: a rating that is in one of the four highest rating categories as determined by a RATING AGENCY.

14. ISSUER: the entity formed to issue the ASSET-BACKED SECURITIES and to hold ownership of, or a security interest in, the ELIGIBLE ASSETS.

15. LIQUIDATION EXPENSES: the expenditures necessary to convert residual or non-performing ELIGIBLE ASSETS, or any underlying collateral into cash, including expenditures necessary to collect on insurance or other CREDIT ENHANCEMENTS.

16. NET WORTH: the excess of total assets over total liabilities as determined by generally accepted accounting principles.

17. OBLIGOR: a PERSON obligated to make the payments on or under an ELIGIBLE ASSET.

18. OPERATING ACCOUNT: the bank account created to receive offering proceeds and revenues from the COLLECTIONS ACCOUNT which are not required to be transferred to the TRUST ACCOUNT, and from which payments are made for additional ELIGIBLE ASSETS and ALLOWED EXPENSES.

19. ORIGINATION FEES: all fees, commissions, or other consideration, other than the purchase price of the ELIGIBLE ASSETS, paid by any party to any party in connection with the origination and sale of ELIGIBLE ASSETS to the ISSUER. ORIGINATION FEES does not include professional fees paid to attorneys, accountants, appraisers, initial fees paid to RATING AGENCIES, and similar professionals for providing routine professional services, which fees shall be deemed ACQUISITION EXPENSES.

20. ORIGINATOR: an entity, which may or may not be the SPONSOR, that creates or originates, directly or indirectly, ELIGIBLE ASSETS to be sold or pledged, to the ISSUER.

21. ORGANIZATIONAL AND OFFERING EXPENSES: All expenses incurred in connection with and in preparing the ASSET-BACKED SECURITIES for registration and subsequently offering and distributing the ASSET-BACKED SECURITIES to the public. ORGANIZATIONAL AND OFFERING EXPENSES include, but are

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not limited to total underwriting and brokerage discounts and commissions (including fees of the underwriters' attorneys), initial fees paid to RATING AGENCIES, expenses for printing, engraving, mailing, salaries of employees while engaged in sales activity, charges of transfer agents, registrars, trustees, escrows holders, depositaries, experts, expenses of qualification of the sale of the securities under Federal and State laws, including taxes and fees, and accountants' and attorneys' fees.

22. PERSON: any natural person, partnership, corporation, association, trust, or other legal entity.

23. PAYING AGENT: the TRUSTEE or other entity responsible for disbursing funds from the TRUST ACCOUNT to the SECURITY HOLDERS in satisfaction of the ISSUER'S obligation for payments on the ASSET-BACKED SECURITIES.

24. PROSPECTUS: the primary disclosure document(s), by whatever name known, utilized for the purpose of offering and selling ASSET-BACKED SECURITIES to the public.

25. RATING AGENCY: Standard and Poor's Ratings Group, a division of McGraw Hill Company; Moody's Investors Service, Inc.; Fitch Investors Service, Inc. or Duff & Phelps Credit Rating Co. or a successor to any of the foregoing.

26. SECURITY HOLDERS: the PERSONS in whose names the ISSUER'S ASSET-BACKED SECURITIES are held and to whom payments pursuant to the terms of the TRUST AGREEMENT are entitled to be made.

27. SERVICER: the entity responsible for the management of the ISSUER'S assets and the conversion of such assets into the CASH FLOW necessary to make stated payments on the ASSET-BACKED SECURITIES.

28. SERVICING AGREEMENT: the contract that establishes the responsibilities and compensation of the SERVICER.

29. SERVICING FEES: compensation paid to the SERVICER pursuant to the terms of the SERVICING AGREEMENT.

30. SPECIAL PURPOSE ENTITY: a trust, corporation, partnership, limited liability company, or other legal entity formed for the purpose of making one or more offerings of ASSET-BACKED SECURITIES, holding an ownership interest or a security interest in the ELIGIBLE ASSETS, and forwarding the CASH FLOWS from the ELIGIBLE

ASSETS to the SECURITY HOLDERS.

31. SPONSOR: any PERSON directly or indirectly instrumental in organizing, wholly or in part, an ISSUER or any PERSON, other than the TRUSTEE, who will control, manage, or participate in the management of an ISSUER or its assets. Not included is any PERSON whose only relationship with the ISSUER is that of an independent SERVICER of the ISSUER'S ELIGIBLE ASSETS, and whose only compensation is as such. "SPONSOR" does not include wholly independent third parties such as attorneys, accountants, RATING AGENCIES, and underwriters whose only compensation is for professional services rendered in connection with the offering of ASSET-BACKED SECURITIES.

32. STATED RATE OF RETURN: a return where the SECURITY HOLDER is entitled to receive either:

(a) a stated principal amount;

(b) interest on the principal amount (which may be a notional principal amount) calculated by reference to:

(i) a fixed rate, or

(ii) a standard or formula which does not reference any change in the market value or fair value of ELIGIBLE ASSETS;

(c) interest on a principal amount (which may be a notional principal amount) calculated by reference to:

(i) auctions among SECURITY HOLDERS and prospective SECURITY HOLDERS, or

(ii) a periodic remarking of the ASSET-BACKED SECURITY;

(d) an amount representing specified fixed or variable portions of the interest generated by the underlying ELIGIBLE ASSETS; or

(e) any combination of the above.

33. TRUST ACCOUNT: the bank account created to receive funds from the COLLECTIONS ACCOUNT and the OPERATING ACCOUNT and from which payments are made on the ASSET-BACKED SECURITIES of the ISSUER.

34. TRUST AGREEMENT: the governing document(s), by whatever name, which defines the pooling arrangements and which establishes the rights, privileges, duties, and responsibilities of the TRUSTEE, the ISSUER, the SECURITY HOLDERS, and, in some cases; the SERVICER in connection with the issuance of the ASSET-BACKED SECURITIES. The Trust established by the TRUST AGREEMENT may or may not be a taxable entity and it may or may not serve as the ISSUER of the ASSET-BACKED SECURITIES. The TRUST AGREEMENT may include the SERVICING AGREEMENT.

35. TRUSTEE: the financial institution meeting the requirements under Section V which is party to the TRUST AGREEMENT and which has the primary responsibility of representing the interests of the SECURITY HOLDERS by assuring the terms of the TRUST AGREEMENT are enforced.

36. TRUSTEE FEES: the fees and other consideration paid to the TRUSTEE for performing services under the TRUST AGREEMENT.

II. REQUIREMENTS OF SPONSOR

A. Experience

For other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, the SPONSOR or its management shall be able to demonstrate the knowledge and expertise necessary to supervise the origination, pooling, and servicing of the type of ELIGIBLE ASSETS being securitized.

B. Financial Condition

1. The SPONSOR shall generally be required to demonstrate that it is solvent and will, with reasonable certainty, be able to meet any financial obligations to the ISSUER.

2. If the ADMINISTRATOR deems it relevant, the SPONSOR shall provide, supplementally, complete audited financial statements for its most recent fiscal year and, if necessary, unaudited financial statements prepared within 135 days of the date that the application for registration of the ASSET BACKED SECURITIES is made effective by the ADMINISTRATOR.

C. CREDIT ENHANCEMENTS

1. The SPONSOR will be required to make or cause to be made an equity contribution to the ISSUER or provide or cause to be provided other substantial CREDIT ENHANCEMENTS to help establish a reasonable likelihood that the STATED RATE OF RETURN will be realized, unless:

(a) the ASSET-BACKED SECURITIES have an INVESTMENT GRADE rating, or

(b) the ADMINISTRATOR waives this requirement.

2. The SPONSOR shall describe the CREDIT ENHANCEMENT in the PROSPECTUS. If the CREDIT ENHANCEMENT is provided by third parties, the description of the CREDIT ENHANCEMENT shall include summary information about the entity providing the CREDIT ENHANCEMENT.

D. Portfolio Characteristics

1. For other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, the SPONSOR must be able to demonstrate, based on designated ACQUISITION CRITERIA or specifically identified ELIGIBLE ASSETS, that the ELIGIBLE ASSETS being pooled will generate sufficient CASH FLOW to make all scheduled payments on the ASSET-BACKED SECURITIES after taking ALLOWED EXPENSES into consideration.

2. For other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, if a significant portion of the CASH FLOW is anticipated to come from the liquidation of tangible assets underlying the ELIGIBLE ASSETS, additional evidence should be provided establishing the ISSUER'S or SERVICER'S ability to reliably predict the value of such tangible assets.

3. For other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, if the CASH FLOW is primarily based upon the credit quality of the OBLIGORS, evidence should be provided demonstrating that adequate measures are taken to quality OBLIGORS.

4. The SPONSOR shall disclose, in the PROSPECTUS, certain information regarding the identified ELIGIBLE ASSETS, including:

(a) the outstanding principal balance of the ELIGIBLE ASSETS,

(b) the outstanding principal balance of the ELIGIBLE ASSETS as a percentage of the total amount of ASSET-BACKED SECURITIES being offered,

(c) the CASH FLOW currently being generated by the ELIGIBLE ASSETS as a percentage of the total amount of ASSET-BACKED SECURITIES being offered,

(d) a description of what constitutes a default,

(e) the amount of ELIGIBLE ASSETS in default,

(f) the amount of ELIGIBLE ASSETS in default as a percentage of the total amount of ASSET-BACKED SECURITIES being offered, and

(g) the amount of ELIGIBLE ASSETS in default as a percentage of the CREDIT ENHANCEMENT.

E. STATED RATE OF RETURN

ASSET-BACKED SECURITIES must have a STATED RATE OF RETURN.

F. Asset Selection

1. ACQUISITION CRITERIA for the ELIGIBLE ASSETS or the relevant characteristics of any specified pool of ELIGIBLE ASSETS must be set forth in the PROSPECTUS and the TRUST AGREEMENT.

2. If ELIGIBLE ASSETS are selected from a larger pool of ELIGIBLE ASSETS owned or controlled by the SPONSOR, the selection process must be random, unless a reasonable basis exists for selecting ELIGIBLE ASSETS on a non-random basis. Any selection method used must be fair and must be fully disclosed in the PROSPECTUS.

G. Asset Repurchases and Substitutions

1. The SPONSOR may repurchase an ELIGIBLE ASSET or may substitute one or more ELIGIBLE ASSETS which are part of the collateral underlying the ASSET-BACKED SECURITIES with new ELIGIBLE ASSETS if:

(a) the ELIGIBLE ASSETS which are to be repurchased or replaced are found not to meet the ACQUISITION CRITERIA or are otherwise found not to comply with the requirements set forth in the TRUST AGREEMENT, and

(b) the repurchase or substitution is not made for the purpose of recognizing gains or decreasing losses resulting from market value changes in the ISSUER'S portfolio of ELIGIBLE ASSETS.

2. The SPONSOR or another PERSON may repurchase the ELIGIBLE ASSETS when the pool of ELIGIBLE ASSETS has been reduced to 15% or less of the original ELIGIBLE ASSETS.

3. A repurchase must be made at a price determined by a fair and reasonable formula set forth in the original PROSPECTUS.

4. If a substitution takes place, the new ELIGIBLE ASSET must have equal or greater scheduled CASH FLOW, approximately the same term and, if appropriate, equal or greater liquidation value than the ELIGIBLE ASSET to be replaced. Compliance with this requirement must be verified by a certified public accountant, or if the ELIGIBLE ASSET is readily marketable, the documentation of the current market value of the ELIGIBLE ASSET.

5. If any repurchases or substitutions take place and the ASSET-BACKED SECURITIES are rated at the time of the initial offering, then the initial rating must be maintained.

6. The SPONSOR shall provide a report representing compliance with these requirements to the TRUSTEE simultaneously with consummating the repurchase or substitution.

7. The SPONSOR shall disclose, in the PROSPECTUS, any obligation it has to repurchase ELIGIBLE ASSETS.

H. Reinvestment of Excess CASH FLOW

CASH FLOW not needed for stated payments on the ASSET-BACKED SECURITIES, reserve deposits, or other designated purposes, may be reinvested in additional ELIGIBLE ASSETS which meet ACQUISITION CRITERIA.

I. Distributions to SPONSOR and Residual Owners

1. Distributions of excess CASH FLOW or ELIGIBLE ASSETS to the SPONSOR, or other residual owners of the ISSUER, while the ASSET-BACKED SECURITIES are outstanding will be allowed, provided that:

(a) the specific circumstances permitting such distributions are fully disclosed in the PROSPECTUS, and

(b) the ability of the ISSUER to make all subsequent stated payments on the ASSET-BACKED SECURITIES, as determined on the date of such distributions, is not materially diminished as a result of such distributions.

2. For other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, the ISSUER must provide reasonable evidence that such distribution rights will not impact the credit quality of the ASSET-BACKED SECURITIES at the time the ASSET-BACKED SECURITIES are registered.

III. REQUIREMENTS OF ISSUER

A. Must be a SPECIAL PURPOSE ENTITY

1. The ISSUER must be a SPECIAL PURPOSE ENTITY and, therefore, will generally not be permitted to:

(a) have employees, other than non-compensated officers, or

(b) incur obligations other than ALLOWED EXPENSES, CONVERSION EXPENSES, ORGANIZATIONAL AND OFFERING EXPENSES and other extraordinary expenses arising from a change of SERVICERS or similar extraordinary event.

2. The ISSUER may make more than one offering, if the ASSET-BACKED SECURITIES have an INVESTMENT

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GRADE rating or if each offering is secured by a distinct pool of assets, with cross-defaults and cross-collateralization prohibited by contract or otherwise.

3. If the ISSUER is not a trust, there must be a supplemental TRUST AGREEMENT administered by a TRUSTEE.

B. Interest in ELIGIBLE ASSETS

1. For other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, the ISSUER'S interest in the ELIGIBLE ASSETS must be an ownership interest or a security interest.

2. The ELIGIBLE ASSETS may be held by a SPECIAL PURPOSE ENTITY other than the ISSUER if the ISSUER'S ownership interest or security in the ELIGIBLE ASSETS is supported by an opinion of counsel as required by Section III.C.2. below.

C. Opinion of Counsel

For offerings where the ISSUER acquires ownership of the ELIGIBLE ASSETS, the ADMINISTRATOR may require the ISSUER to provide an opinion of qualified counsel to the effect that, in the event of a bankruptcy by the SPONSOR or an ORIGINATOR or other seller of ELIGIBLE ASSETS to the ISSUER, the transfer of ELIGIBLE ASSETS would be treated as a true sale.

1. For offerings where the ISSUER acquires a security interest in the ELIGIBLE ASSETS an opinion may be required indicating:

- (a) that the security interest will be perfected based on procedures set forth in the TRUST AGREEMENT, and

- (b) whether financing statements under the Uniform Commercial Code are necessary to perfect security interests in the ELIGIBLE ASSETS.

2. If a SPECIAL PURPOSE ENTITY, other than the ISSUER, is established to hold the ELIGIBLE ASSETS that are pledged to the ISSUER, an opinion may be required indicating that, in the event of a bankruptcy by the SPONSOR or an ORIGINATOR or other seller of ELIGIBLE ASSETS to the SPECIAL PURPOSE ENTITY, the transfer of ELIGIBLE ASSETS would be treated as a true sale.

D. Minimum Offering

For other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, the minimum amount of proceeds required to close the offering shall be sufficient to allow the ISSUER to acquire all specified ELIGIBLE ASSETS or a sufficient to allow of unspecified ELIGIBLE ASSETS to diversify the pool of ELIGIBLE ASSETS to the extent necessary to achieve a high level of confidence with respect to the statistical characteristics of the portfolio.

E. Proceeds Escrow

All funds received prior to achieving the minimum offering size must be deposited in an interest bearing account with an independent escrow agent whose name and address shall be disclosed in the PROSPECTUS. Provision must be made for the return to the investors of 100% of paid subscriptions, plus interest earned, in the event that the established minimum size is not reached.

F. Offering and Investment Period

1. The offering period may not exceed one year from the date of effectiveness unless permitted by the ADMINISTRATOR.

2. The ADMINISTRATOR may require the available proceeds from offerings that do not have an INVESTMENT GRADE rating to be fully invested in ELIGIBLE ASSETS within two months from the date such proceeds are released from escrow.

G. Investments other than in ELIGIBLE ASSETS

For other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, cash held in COLLECTIONS ACCOUNTS, OPERATING ACCOUNTS, TRUST ACCOUNTS or reserve accounts, cash held pending investment in ELIGIBLE ASSETS, cash held pending distribution to SECURITY HOLDERS, and other temporary cash balances may be invested, either directly or through money market funds, in securities that are direct obligations of, or fully guaranteed by, the U.S. Government or a U.S. Government agency or instrumentality, certificates of deposit, demand or time deposits, and bankers acceptances from any state or federally chartered depository institution having an INVESTMENT GRADE rating.

H. Monitoring by Rating Agency

If the ASSET-BACKED SECURITIES are rated at the time of the initial offering the ISSUER must agree to pay to have that rating monitored at least annually.

I. ISSUER Reports

The TRUST AGREEMENT shall provide that the ISSUER or TRUSTEE shall cause to be prepared and distributed to the SECURITY HOLDERS the following reports:

1. concurrently with distributions to SECURITY HOLDERS, a report containing relevant information regarding the performance of the ISSUER'S portfolio of ELIGIBLE ASSETS, including cash flows, delinquency rates, gross and net loss rates substitution, and changes in the outstanding principal balance of ELIGIBLE ASSETS, if applicable;

2. where forecasts have been provided to SECURITY HOLDERS, at least annually, a table comparing the forecasts previously provided with the actual results during the period covered by the report; and

3. an annual audited financial statement of the ISSUER.

IV. REQUIREMENTS OF SERVICER

A. Experience

1. For other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, the SERVICER or its management must have at least three years experience servicing ELIGIBLE ASSETS similar to those to be acquired by the ISSUER.

2. With respect to portfolios of ELIGIBLE ASSETS that require intensive levels of servicing, a greater amount of experience may be required.

3. The SERVICER may be required to provide, supplementally, summary information regarding the performance of prior pools of similar ELIGIBLE ASSETS which it has SERVICED.

B. Financial Condition

1. For other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, the SERVICER must be able to demonstrate that it is solvent and possesses the financial resources necessary to perform under the SERVICING

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AGREEMENT and/or TRUST AGREEMENT.

2. For other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, if the SERVICER is to provide any financial guarantees or advances in connection with the issuance of the ASSET-BACKED SECURITIES it must demonstrate its ability to perform on such guarantees or advances under a default.

3. For other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, if the ADMINISTRATOR deems it relevant, the SERVICER shall provide, supplementary, complete audited financial statements for its most recent fiscal year end and, if necessary, unaudited financial statements prepared within 135 days of the date that the application for registration of the ASSET-BACKED SECURITIES is made effective by the ADMINISTRATOR.

C. Independence

The SERVICER may not be AFFILIATED with the TRUSTEE. For other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, the SERVICER may not be AFFILIATED with any OBLIGOR under any ELIGIBLE ASSET. Provided however, the TRUSTEE may serve as successor SERVICER if it is otherwise qualified to perform the servicing function.

D. SERVICER Reports

The SERVICING AGREEMENT shall require that the SURVIVOR prepare and deliver to the TRUSTEE the following reports, if applicable:

1. On a monthly basis or similar time interval that coincides with the timing of CASH FLOWS from the ELIGIBLE ASSETS:

(a) for other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, a report containing relevant information regarding the performance of the portfolio of ELIGIBLE ASSETS, including cash flows, delinquency rates, gross and net loss rates, substitution, and changes in the outstanding principal balance of ELIGIBLE ASSETS;

(b) information regarding the status of CREDIT ENHANCEMENT, including the extent to which any such CREDIT ENHANCEMENTS have been utilized by the SERVICER to supplement the CASH FLOW associated with the ELIGIBLE ASSETS; and

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(c) for other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, notification of any default in the payment of principal and interest on any other ASSET-BACKED SECURITIES issued by a SPECIAL PURPOSE ENTITY with the same SPONSOR, SERVICER, and business plan.

2. On a quarterly basis:

(a) information regarding the identity of each ORIGINATOR or seller of ELIGIBLE ASSETS to the ISSUER, and if the ORIGINATOR or seller has guaranteed any aspect of performance of any ELIGIBLE ASSETS, complete financial statements of the--ORIGINATOR or seller as of the most recent date available together with specific information regarding the historical performance of the ORIGINATOR'S or seller's portfolio of ELIGIBLE ASSETS;

(b) information regarding the percentage of ELIGIBLE ASSETS acquired from each ORIGINATOR or seller; and

(c) information regarding the diversification of each ORIGINATOR'S or seller's portfolio of ELIGIBLE ASSETS with respect to underlying OBLIGORS, if applicable.

E. Termination and Replacement

1. The SERVICER may not voluntarily withdraw as SERVICER, except as may be required by law, or upon at least 30 days' prior notice to the TRUSTEE, provided that a qualified successor SERVICER has been retained, effective as of the resignation date of its predecessor.

2. In the event that the TRUSTEE, SPONSOR, or SECURITY HOLDERS terminate the SERVICER, the SERVICING AGREEMENT shall designate a qualified successor SERVICER, or the SERVICING AGREEMENT shall specify the criteria for selecting a qualified successor SERVICER. The successor SERVICER must be approved by the TRUSTEE and must be capable of commencing the servicing of the ELIGIBLE ASSETS within a commercially reasonable period of time.

V. REQUIREMENTS OF TRUSTEE

A. General Requirements

1. There shall at all times be one or more TRUSTEES under the TRUST AGREEMENT.

2. At least one TRUSTEE shall at all times be a corporation organized and doing business under the laws of the United States or of any state or territory thereof or of the District of Columbia which:

(a) is authorized under such laws to exercise corporate trust powers;

(b) is subject to supervision or examination by federal, state, territorial, or District of Columbia authority; and

(c) has a rating, or is a subsidiary of an institution having a rating, issued by a nationally recognized bank or financial institution rating organization, in one of the four highest categories.

B. Experience

1. The TRUSTEE or one or more of its corporate trust officers must have at least three years' relevant experience.

2. The TRUSTEE in its commercial capacity must have origination or servicing experience with respect to similar ELIGIBLE ASSETS.

C. Independence

1. The TRUSTEE may not be AFFILIATED with the SERVICER, the SPONSOR, or the ISSUER. Provided however, the TRUSTEE may serve as successor SERVICER if it otherwise qualified to perform the servicing function.

2. The TRUSTEE may not have receive within the last 5 years and may not receive during the terms of the TRUST AGREEMENT more than 5% of its total revenue from all sources, including TRUSTEE'S fees, from the SPONSOR and the SERVICER on a combined basis.

3. The TRUST AGREEMENT shall provide that no more than 5% of the loan portfolio of the TRUSTEE or its AFFILIATES may be loans to either the ISSUER, the SPONSOR, or the SERVICER.

D. Withdrawal or Termination

1. If the TRUSTEE voluntarily withdraws as TRUSTEE, the ISSUER or SPONSOR shall designate a successor TRUSTEE. The withdrawing TRUSTEE may petition a court to appoint a successor TRUSTEE. The withdrawing or resigning TRUSTEE must continue to perform under the TRUST AGREEMENT until the successor TRUSTEE is designated by the ISSUER, the SPONSOR, or the court.

2. If the TRUST AGREEMENT allows the TRUSTEE to be terminated by the SECURITY HOLDERS or by the ISSUER, there must a reasonable procedure set forth in the TRUST AGREEMENT for replacing the TRUSTEE.

E. Duties

At a minimum, the TRUST AGREEMENT shall provide that it shall be the responsibility of the TRUSTEE to perform the following duties:

1. Maintain the custodianship of the documentation delivered to it evidencing title or perfected security interest in the ISSUER'S ELIGIBLE ASSETS.

2. Verify all funds deposited in the TRUST ACCOUNT for the benefit of the SECURITY HOLDERS and use its best efforts to verify all payments called for under the terms the TRUST AGREEMENT.

3. Verify the delivery of all reports and other instruments required pursuant to the terms of the TRUST AGREEMENT and the Securities Exchange Act of 1934.

4. Examine all reports or other instruments furnished to the TRUSTEE pursuant to the terms of the TRUST AGREEMENT and determine, based on the information provided, whether there is a violation of any of the terms and conditions set forth in the TRUST AGREEMENT.

5. In the event that the TRUSTEE determines there has been a default under the terms of the TRUST AGREEMENT, the TRUSTEE shall be responsible for the timely notification of SECURITY HOLDERS and the implementation of appropriate remedial actions, and may not first seek additional indemnification other than that provided in the TRUST AGREEMENT from the SECURITY HOLDERS before taking such actions. The TRUSTEE shall be entitled to reimbursement for all costs relating to a default, but the TRUSTEE shall not be indemnified for its breach of contract, misconduct, or gross negligence.

6. Upon notification of a default under Section IV.D.1.(c), the TRUSTEE may, if it deems it appropriate, replace the SERVICER and take any other steps necessary for the protection of SECURITY HOLDERS.

F. TRUSTEE

Report Annually, the TRUSTEE shall provide a report to the SECURITY HOLDERS which indicates whether the TRUSTEE has fulfilled its obligations under the TRUST AGREEMENT and whether there have been any known uncured defaults under the TRUST AGREEMENT.

VI. SUITABILITY OF SECURITY HOLDERS

A. General Policy

1. The provisions of this Section VI shall not apply to ASSET-BACKED SECURITIES:

(a) which have an INVESTMENT GRADE rating;

(b) which are firmly underwritten; or

(c) for which the SPONSOR is able to demonstrate that there will be a substantial and active secondary market.

2. The SPONSOR shall propose minimum income and net worth standards which are reasonable given the risks associated with the purchase of the ASSET-BACKED SECURITIES. Offerings with greater investor risk shall have minimum standards with a greater income and NET WORTH requirements. The ADMINISTRATOR shall evaluate the standards proposed by the SPONSOR when the ISSUER'S application for registration is reviewed. In evaluating the proposed standards, the ADMINISTRATOR may consider the following:

(a) potential for variances in CASH FLOWS;

(b) intensity of the servicing function;

- (c) potential SECURITY HOLDERS;
- (d) relationships among potential SECURITY HOLDERS and the SPONSOR;
- (e) liquidity of the ASSET-BACKED SECURITIES;
- (f) prior performance of similar pools formed by the SPONSOR;
- (g) financial condition of the SPONSOR;
- (h) CREDIT ENHANCEMENTS;
- (i) transactions between the ISSUER and the SPONSOR; and
- (j) and other relevant factors.

B. Income and Net Worth Standards

1. Unless the ADMINISTRATOR determines that the risks associated with particular ASSET-BACKED SECURITIES would require lower or higher standards, SECURITY HOLDERS shall generally be required to have:

- (a) a minimum annual gross income of \$70,000 and a minimum NET WORTH of \$70,000; or
- (b) a minimum NET WORTH of \$250,000.

2. NET WORTH shall be determined exclusive of home, furnishings, and automobiles.

3. In the case of sales to fiduciary accounts, these minimum standards shall be met by the beneficiary, the fiduciary account, or by the donor or grantor who directly or indirectly supplies the funds to purchase the ASSET-BACKED SECURITIES if the donor or grantor is the fiduciary.

4. The SPONSOR shall set forth in the final PROSPECTUS:

(a) a description of the type of PERSON who might benefit from an investment in the ASSET-BACKED SECURITIES; and

(b) the minimum standards imposed on SECURITY HOLDERS.

C. Determination that Sale to SECURITY HOLDER is Suitable and Appropriate

1. The SPONSOR and each PERSON selling ASSET-BACKED SECURITIES on behalf of the SPONSOR or ISSUER shall make every reasonable effort to determine that the purchase of ASSET-BACKED SECURITIES is a suitable and appropriate investment for each SECURITY HOLDER

2. In making this determination, the SPONSOR and/or each PERSON selling SHARES on behalf of the SPONSOR shall ascertain that the prospective SECURITY HOLDER:

(a) meets the minimum income and net worth standards established for the ISSUER;

(b) can reasonably benefit from the ASSET-BACKED SECURITIES based on the prospective SECURITY HOLDER'S overall investment objectives and portfolio structure;

(c) is able to bear the economic risk of the investment based on the prospective SECURITY HOLDER'S overall financial situation; and

(d) has apparent understanding of:

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- (i) the fundamental risks of the investment;
- (ii) the lack of liquidity of the ASSET-BACKED SECURITIES; and
- (iii) the background and qualifications of the SPONSOR;

3. Each PERSON selling ASSET-BACKED SECURITIES on behalf of the SPONSOR or ISSUER shall make the suitability determination on the basis of information it has obtained from a prospective SECURITY HOLDER. Relevant information for this purpose will include at least the age, investment objectives, investment experience, income, NET WORTH, financial situation, and other investments of the prospective SECURITY HOLDER, as well as any other pertinent factors.

4. Each PERSON selling ASSET-BACKED SECURITIES on behalf of the SPONSOR or ISSUER shall maintain records of the information used to determine that an investment in ASSET-BACKED SECURITIES is suitable and appropriate for a SECURITY HOLDER. These records shall be maintained for at least six years.

5. The ISSUER shall disclose in the final PROSPECTUS the responsibility of each PERSON selling ASSET-BACKED SECURITIES on behalf of the SPONSOR or ISSUER to make every reasonable effort to determine that the purchase of ASSET-BACKED SECURITIES is a suitable and appropriate investment for each SECURITY HOLDER, based on information provided by the SECURITY HOLDER-regarding the SECURITY HOLDER'S financial situation and investment objectives.

D. Subscription Agreements

1. The ADMINISTRATOR may require that SECURITY HOLDERS complete and sign a written subscription agreement.

2. The SPONSOR may require that SECURITY HOLDERS make certain factual representations in the subscription agreement, including the following:

- (a) the SECURITY HOLDER meets the minimum income and net worth standards established for the ISSUER.

(b) The SECURITY HOLDER is purchasing the ASSET-BACKED SECURITIES for his or her own account.

(c) The SECURITY HOLDER has received a copy of the PROSPECTUS.

(d) The SECURITY HOLDER acknowledges that the ASSET-BACKED SECURITIES will not be readily marketable.

3. The SECURITY HOLDERS must separately sign or initial each representation made in the subscription agreement. Except in the case of fiduciary accounts, the SECURITY HOLDERS may not grant any PERSON a power of attorney to make such representations on their behalf.

4. The SPONSOR and/or each PERSON selling ASSET-BACKED SECURITIES on behalf of the SPONSOR or ISSUER shall not require SECURITY HOLDERS to make representations in the subscription agreement which are subjective or unreasonable and which:

(a) might cause the SECURITY HOLDER to believe that he or she has surrendered rights to which he or she is entitled under federal or state law; or

(b) would have the effect of shifting the duties regarding suitability, imposed by law on broker-dealers, to the SECURITY HOLDERS.

5. Prohibited representations include, but are not limited to the following:

(a) The SECURITY HOLDER understands or comprehends the risk factors associated with an investment in the ASSET-BACKED SECURITIES.

(b) The investment is a suitable one for the SECURITY HOLDER.

(c) The SECURITY HOLDER has read the PROSPECTUS.

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(d) In deciding to invest in the ASSET-BACKED SECURITIES, the SECURITY HOLDER has relied solely on the PROSPECTUS, and not on any other information or representations from other PERSONS or sources.

6. The SPONSOR may place the content of the prohibited representations in the subscription agreement in the form of advisory disclosures to SECURITY HOLDERS. The SPONSOR may not place these disclosures in the SECURITY HOLDER representation section of the subscription agreement.

E. Confirmation

The SPONSOR or PERSONS selling the ASSET-BACKED SECURITIES shall send all SECURITY HOLDERS a confirmation of their purchase.

VII. FEES, COMPENSATION AND EXPENSES

A. Disclosure of Consideration

1. For other than ASSET-BACKED SECURITIES with an INVESTMENT may be paid, directly or indirectly, to all parties is fair, competitive, commercially reasonable, and not less favorable to the ISSUER than fees or expenses between unrelated third parties. In general, the SPONSOR is expected to subordinate its interest in the CASH FLOW and liquidation value of ELIGIBLE ASSET'S and the underlying collateral, if any, to that of the SECURITY HOLDERS.

2. The PROSPECTUS must fully disclose and itemize all consideration which may be received in connection with ISSUER'S activities directly or indirectly by the SPONSOR, the SERVICER, and the selling agents, what the consideration is for and how and when it will be paid. This shall be set forth in one location in tabular form.

B. ORGANIZATIONAL AND OFFERING EXPENSES

All items of compensation to underwriters or selling agents, including, but not limited to, selling commissions, expenses, rights of first refusal, consulting fees, finders' fees and all other items of compensation of any kind or description paid by the ISSUER, directly or indirectly, shall be taken into consideration in computing the amount of allowable ORGANIZATIONAL AND OFFERING EXPENSES. Generally, ORGANIZATIONAL AND OFFERING EXPENSES will not be permitted to exceed 15% of gross proceeds.

C. ORIGINATION FEES and ACQUISITION EXPENSES

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For other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, ORIGINATION FEES and ACQUISITION EXPENSES paid or to be paid by the ISSUER, SPONSOR, or their AFFILIATES must be fully justified based on actual services provided and expenses incurred in connection with acquiring the ELIGIBLE ASSETS.

D. Permitted Expenses

1. Other than ALLOWED EXPENSES, ORGANIZATIONAL AND OFFERING EXPENSES, and CONVERSION EXPENSES, the ISSUER may only be charged for the actual cost of goods and services used or incurred for or by the ISSUER and obtained from PERSONS other than the SPONSOR, SERVICER, or their AFFILIATES. No reimbursement shall be permitted for goods or services for which the SPONSOR or SERVICER are entitled to compensation by way of separate fees. Items excluded from permitted expenses include, but are not limited to, the following:

(a) rent or depreciation, utilities, capital equipment, other administrative items of the SPONSOR or SERVICER; and

(b) salaries, fringe benefits, travel expenses, and other administrative items incurred or allocated to any controlling person of the SPONSOR or SERVICER.

2. For other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, the Prospectus shall contain a table showing an itemized listing of the fees and expenses expected to be incurred by the ISSUER annually. The amounts should be expressed in dollars and as a percentage of the gross proceeds of the offering. A fee table similar to the following is recommended:

	ANNUAL PERMITTED EX- PENSES	ESTIMATED PERCENTAGE OF DOLLAR AMOUNT FIRST YEAR AVER- AGE NET ASSETS
ORIGINATION FEES	\$ _____	_____.

		%
ACQUISITION EXPENSES	\$ _____	_____.

		%
SERVICING FEES	\$ _____	_____.

		%
TRUSTEE FEES	\$ _____	_____.

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		_____	%
PROFESSIONAL FEES	\$	_____	_____.
		_____	%
OTHER PERMITTED EXPENSES	\$	_____	_____.
		_____	%
TAXES	\$	_____	_____.
		_____	%
TOTAL ANNUAL EXPENSES	\$	_____	_____.
		_____	%

E. SERVICING FEES

For other than ASSET-BACKED SECURITIES with INVESTMENT GRADE rating, SERVING FEES must be demonstrated to be fair and reasonable based on the actual services performed.

VIII. CONFLICTS OF INTEREST

A. Sales of ELIGIBLE ASSETS to ISSUER

1. For other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, the ISSUER will not be permitted to acquire an interest in ELIGIBLE ASSETS in which the SPONSOR or SERVICER has an interest unless the following conditions are met:

(a) The transaction occurs at the closing of the offering and is fully disclosed in the PROSPECTUS or in the case of revolving and substituted ELIGIBLE ASSETS the terms and conditions of all transfers are fully disclosed in the PROSPECTUS; and

(b) The ELIGIBLE ASSETS are acquired upon terms fair to the ISSUER and at a price not to exceed fair market value, inclusive of ORIGINATION FEES and ACQUISITION EXPENSES.

2. Notwithstanding the requirements of Subsection 1. above, the SPONSOR or SERVICER may purchase or generate ELIGIBLE ASSETS in its own name or the name of a nominee and temporarily hold title thereto, for the purpose of facilitating the acquisition of the ELIGIBLE ASSETS by the ISSUER. If the offering does not have an

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INVESTMENT GRADE rating, the following additional conditions must be met:

(a) The ELIGIBLE ASSETS must be purchased by the ISSUER for a price no greater than the cost of the ELIGIBLE ASSETS to the SPONSOR or SERVICER, adjusted for intervening CASH FLOW and expenses; and

(b) There may be no other benefits arising out of such transaction to the SPONSOR or SERVICER apart from compensation otherwise permitted by these Guidelines and disclosed in the PROSPECTUS.

B. Sales of ELIGIBLE ASSETS to SPONSOR or SERVICER

For other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, a SPONSOR or SERVICER shall not be permitted to acquire ELIGIBLE ASSETS from the ISSUER, except for:

1. repurchases or substitutions permitted under Section II.G. of these Guidelines
2. repurchases where there has been a breach of a representation or warranty pursuant to the TRUST AGREEMENT with respect to ELIGIBLE ASSETS, and
3. circumstances where the proceeds are used to redeem 100% of the outstanding principal amount of ASSET-BACKED SECURITIES, together with interest accrued to the date of redemption, without any penalty to the ISSUER.

C. Commingling

1. Except as provided in Section VIII.C.2 below, the assets of the ISSUER shall not be commingled with the assets of any other PERSON.
2. For other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, all CASH FLOWS generated by the ELIGIBLE ASSETS shall be deposited, daily, into a segregated COLLECTIONS ACCOUNT.
3. For other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, in no event shall the SERVICER hold CASH FLOW in its own account for more than 48 hours, unless such amounts are guaranteed by a

letter of credit, a segregated reserve account, or other arrangement acceptable to the ADMINISTRATOR. Amounts in the COLLECTIONS ACCOUNT may be transferred to an OPERATING ACCOUNT for reinvestment and the payment of ALLOWED EXPENSES or directly to a TRUST ACCOUNT for distribution to SECURITY HOLDERS.

D. Multiple Offerings

For other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, if the ADMINISTRATOR deems it appropriate, the ADMINISTRATOR may delay the registration of ASSET-BACKED SECURITIES of another SPECIAL PURPOSE ENTITY formed by the SPONSOR to purchase similar ELIGIBLE ASSETS until:

1. the offering of the ASSET-BACKED SECURITIES is completed; and
2. 75% of the proceeds of the offering have been invested, or committed to investment, in ELIGIBLE ASSETS.

E. Other AFFILIATED Transactions

For other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, the TRUST AGREEMENT shall provide that all transactions between the ISSUER and the SPONSOR or the SERVICER or their AFFILIATES will be on terms no less favorable to the ISSUER than could be obtained from a NONAFFILIATED entity in an arms length transaction.

IX. DISCLOSURE AND MARKETING

A. Sales Material

Sales Material, including without limitation: books, pamphlets, movies, slides, article reprints, television and radio commercials, materials prepared for broker-dealer use only, sales presentation's (including prepared presentations to prospective SECURITY HOLDERS at group meetings) and all other advertising used in the offer or sale of ASSET-BACKED, SECURITIES shall conform to filing, disclosure and adequacy requirements under all applicable state regulations. Statements made in sales material communicated directly or indirectly to the public may not conflict with, or modify risk factors or other statements made in the PROSPECTUS.

B. PROSPECTUS and its Contents

1. Prohibited Representations

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(a) In connection with the offering and sale of ASSET-BACKED SECURITIES, neither the SPONSOR(S) nor the underwriter(s) may, in writing or otherwise, directly or indirectly, represent or imply that an ADMINISTRATOR had approved the merits of the investment or any aspects thereof.

(b) Any reference to compliance with this Statement of Policy or any provisions herein which connotes or implies compliance shall not be allowed.

(c) The title of the ISSUER may not include the words "mutual fund" or "fund."

2. Forecasts

A forecast of the ISSUER'S economic performance may be included in the PROSPECTUS and in the sales material for the offering if it complies with all of the following requirements:

(i) The forecast is realistic in its predictions and shall clearly identify the assumptions made with respect to all material features of the presentation.

(ii) The forecast is examined by an independent certified public accountant in accordance with the Guide for Prospective Financial Statements and the Statement on Standards for Accountant's Services on Prospective Financial Information as promulgated by the American Institute of Certified Public Accountants. The report of the independent certified public accountant is included in the PROSPECTUS.

(iii) If any part of the forecast appears in the sales material, the entire forecast, including notes, must be presented.

(iv) The forecast is for a period equal to the term of the ASSET-BACKED SECURITIES.

(v) If supplemental projections are included in the PROSPECTUS or the sales material, they must be accompanied by the complete forecast.

3. Prior Portfolio Performance

For other than ASSET-BACKED SECURITIES with an INVESTMENT GRADE rating, for previous offerings, by the SPONSOR, the PROSPECTUS shall disclose relevant facts and performance information for each such offering

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made within ten years of the date the registration application is filed with the ADMINISTRATOR; provided however, information regarding offerings made within six months of the date the registration application is filed with the ADMINISTRATOR may allow the disclosure to be limited to offerings of ASSET-BACKED SECURITIES supported by ELIGIBLE ASSETS similar to those identified for the current offering unless it is determined that information about other offerings is also relevant. The disclosure should generally include the following:

- (a) the ACQUISITION CRITERIA defining the ELIGIBLE ASSETS,
- (b) information indicating whether all stated payments have been made as scheduled,
- (c) the structure and key features of the previous offering, if applicable,
- (d) the size of the portfolio,
- (e) statistical data on losses, delinquencies, recoveries, turnover, and diversification, and
- (f) types and amounts of CREDIT ENHANCEMENTS.

C. Amendments and Supplements

A marked copy of all amendments and supplements to an application shall be filed with the ADMINISTRATOR as soon as the amendment or supplement is available.

Adopted October 2, 2004

I. INTRODUCTION. In order to effectuate the full disclosure of all material facts, the following legends must be included on the cover of the prospectus or offering documents used for the purpose of offering and selling securities. Where good cause is shown or factual accuracy requires, any provisions of these guidelines may be waived by the Administrator or modified, as necessary.

The required language shall be prominently displayed in contrasting color or type.

II. REGULATORY DISCLAIMERS AND LEGENDS.

A. Coordinated Registrations. One of the alternative legends contained in Item 501(b)(7) of Securities and Exchange Commission Regulation S-K must appear on the cover page of any prospectus in an application to register securities

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under state securities law that will be registered with the SEC, as well.

B. Registrations that will not be registered with the SEC. A legend must appear on the cover page of any prospectus in an application to register securities that is filed with the state administrator, and that will not be registered with the SEC, that embodies each of the following items:

1. The securities or offering has not been approved, disapproved, endorsed, or recommended by the state securities administrator.
2. You should make an independent decision whether the offering meets your investment objectives and financial risk tolerance.
3. The administrator has not confirmed the accuracy or truthfulness of the disclosure, or whether it is complete.
4. Any representation to the contrary is illegal.

This guideline requires use of the following example, or other clear, plain language:

You Should Make Your Own Decision Whether This Offering Meets Your Investment Objectives And Risk Tolerance Level. No Federal Or State Securities Commission Has Approved, Disapproved, Endorsed, Or Recommended This Offering. No Independent Person Has Confirmed The Accuracy Or Truthfulness Of This Disclosure, Nor Whether It Is Complete. Any Representation To The Contrary Is Illegal.

C. Other Securities Offerings. A legend must appear on the cover page of any disclosure document used in an offering subject to a notice filing under state securities law, but that will neither be registered with the SEC, nor used in an offering under SEC Rule 506 of Regulation D. The legend must include the following, in addition to items 1 through 4 in part B, above:

5.

The state administrator has not reviewed the disclosure.

6.

The issuer is relying on an exemption from registration or qualification.

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In addition to the legend, the cover page of the disclosure documents must include a statement that the investor may be required to hold the investment for an indefinite period of time, that other important risk factors are explained in detail in this document, and that the nature of the offering's risk requires that investors meet minimum asset/income conditions.

If the state securities administrator has statutory authority, the administrator may, by rule or order, extend the legend and statement requirement in this part C to appear on the cover of disclosure documents used in securities offerings not subject to a notice filing under state securities laws, and exempt from registration with the SEC.

* * * * *

[Note: The NASAA Guidelines for Cover Legends replace the Uniform Disclosure Guideline for Legend, adopted in 1987 and last amended April 29, 1989. Any person considering an offering should consult with the appropriate securities regulators regarding the specific legend requirements of the jurisdictions.]

Adopted October 25, 1995

The North American Securities Administrators Association, Inc. ("NASAA") has recommended that states adopt the following notice provisions in conjunction with the adoption of Section 201--A of the Uniform Securities Act of 1956, as amended:

With respect to any Canadian broker-dealer or agent applying for registration in this state, the Securities Administrator has agreed not to make inquiries of the broker-dealer or agent concerning any possible failure to register in relation to:

(a)

trading activities that may have been conducted in this state with any person from Canada:

(1)

who was temporarily present in this state and with whom the Canadian broker-dealer or agent had a bona fide broker-dealer-client relationship before the person entered the United States; or

(2)

who was present in this state, in relation to a self-directed tax advantaged retirement plan in Canada of which the person is the holder or contributor;

up until a date which is 120 days after the effective date of the limited

Adopted April 17, 1994; Amended April 18, 2004

I.

INTRODUCTION. The North American Securities Administrators Association, Inc. ("NASAA") has determined that the following Statement of Policy ("SOP") for offerings of CHURCH EXTENSION FUND ("CEF") securities is consistent with public INVESTOR protection and is in the public interest. Under this SOP, the term "Church" includes worship facilities or religious organizations identified by other terms such as "Synagogue", "Mosque" or "Parish". Other terms are defined under I.B. and capitalized throughout this SOP.

A.**Application.**

1.

The standards contained in this SOP apply to the offer and sale of NOTES issued by a CEF, the proceeds of which primarily finance or refinance the purchase, construction or improvement of church property and/or buildings or related capital expenditures or the operational needs of various affiliated churches and related religious organizations of a DENOMINATION.

2.

It is intended that this SOP may be applied by an ADMINISTRATOR in any STATE, whether required as a condition for exemption from securities registration or for registration of the NOTES. The ADMINISTRATOR may also allow or require this SOP to be applied by analogy to similar loan funds of NOT-FOR-PROFIT ORGANIZATIONS other than CEFs or religious organizations.

3.

Registration or exemption of NOTES may be denied or disallowed by the ADMINISTRATOR if a proposed offering of NOTES does not sufficiently comply with standards under this SOP. The ADMINISTRATOR may allow waivers or exceptions from certain standards under this SOP, if good cause is shown, or may require different or additional standards based on provisions of statutes or regulations of a STATE.

4.

This SOP is not applicable to single project financing by individual churches or congregations, which is the subject of a separate Statement of Policy Regarding Church Bonds that was adopted by the North American Securities Administrators Association, Inc. on April 14, 2002.

COMMENT:

General obligation financing by a CEF is different in its purposes and operation than the one-time offering of Church Bonds by an individual church or congregation to finance the construction of a single,

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specific church building or other related capital improvements, in which all of the securities are repaid within a set period of time. CEF NOTES are sold for various terms and at varying interest rates and the offerings are normally continuous in nature to provide an ongoing source of financing to the various affiliated churches and related organizations. In order to maintain the CEF as a permanent resource for the affiliated churches and related organizations, repayments of principal on loans made by the CEF are continuously reinvested in new loans to affiliated churches and related organizations.

A CEF should be a single purpose organization or fund with most of its activities related to raising and managing funds for the purpose of making capital loans to its affiliated churches and related organizations, and it should either be incorporated and operated separately from the DENOMINATION and its affiliated churches and related organizations, or its accounting records should be maintained separately. Assets of the CEF should be used primarily for the purpose of financing building projects or property acquisitions for affiliated churches and related organizations. If the CEF is a separately incorporated entity, it normally is not liable for any debts arising from other unrelated activities or programs of the DENOMINATION or its affiliated churches and related organizations.

The primary indebtedness of CEFs is the outstanding NOTES. A significant number of INVESTORS reinvest with the CEF when their NOTES mature. Due to the continuous nature of the offerings and the fact that the funds are not designated for specific capital projects, special repayment provisions, including a sinking fund or trust indenture, for the purpose of making payments on principal or interest due on NOTES, are normally unnecessary and inappropriate.

B.**Definitions.**

1.

ADMINISTRATOR--The official or agency responsible for administering the securities law of a STATE.

2.

ADVERTISING--All information and promotional materials, including, but not limited to, magazine or newsletter advertisements, brochures, video tapes, fliers, church bulletin inserts, mailers and Internet information posted by the ISSUER or DENOMINATION that are used in addition to an OFFERING CIRCULAR to solicit INVESTORS.

3.

AUDITED FINANCIAL STATEMENTS--Financial statements that have been audited and reported upon by an independent Certified Public Accountant in accordance with auditing standards generally accepted in the United States.

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4.

CHANGE IN NET ASSETS--The Change in NET ASSETS as reported in the Statement of Activities of the CEF in conformity with GAAP which reflects the net increase or decrease in NET ASSETS of the CEF.

5.

CHURCH EXTENSION FUND ("CEF")--A NOT-FOR-PROFIT ORGANIZATION affiliated or associated with a DENOMINATION, or a fund that is accounted for separately by a DENOMINATION organized as a NOT-FOR-PROFIT ORGANIZATION, that offers and sells NOTES primarily to provide funding for loans to various affiliated churches and related religious organizations of the DENOMINATION for the acquisition of property, construction or acquisition of buildings and other related capital expenditures or operating needs.

6.

DENOMINATION--A national or regional religious organization or association that consists of or acts on behalf of its individual affiliated churches as well as various affiliated national or regional administrative and religious organizations or units. The organizations, associations, churches or units described in this definition shall be organized as or associated with a NOT-FOR-PROFIT ORGANIZATION.

7.

DENOMINATIONAL ACCOUNTS--Demand and other obligations of a CEF held by national, regional or other affiliated organizations of the DENOMINATION, other than congregations.

8.

GAAP--Generally Accepted Accounting Principles in the United States as established by the Financial Accounting Standards Board (FASB), Accounting Principles Board (APB), Accounting Research Bulletins (ARB) and American Institute of Certified Public Accountants (AICPA). The *AICPA AUDIT AND ACCOUNTING GUIDE FOR NOT-FOR-PROFIT ORGANIZATIONS* provides guidance on specific GAAP for NOT-FOR-PROFIT ORGANIZATIONS.

9.

INVESTOR(s)--PERSON(s) who purchase(s) NOTES.

10.

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ISSUER--The CEF that issues or proposes to issue NOTES.

11.

LOAN DELINQUENCIES--Borrower's loan balances on which payments of principal or interest are delinquent ninety (90) days or more, whether in default or not.

12.

NET ASSETS (as defined by GAAP)--The excess or deficiency of assets over liabilities, classified according to the existence or absence of donor-imposed restrictions.

13.

NOTES--Notes, certificates, similar debt instruments or other evidences of indebtedness which may be certificated or issued in book-entry form by a CEF and represent a general unsecured obligation to repay a specific principal amount at a stated or variable rate of interest when due. The NOTES shall not include DENOMINATIONAL ACCOUNTS (See COMMENT below).

14.

NOT-FOR-PROFIT ORGANIZATION--An entity as described in *section 501(c)(3) of the Internal Revenue Code of 1986*, as amended, that is accounted for as a not-for-profit organization under GAAP. A not-for-profit organization generally possesses the following characteristics (in varying degrees) that distinguish it from a business enterprise: (a) contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return, (b) operating purposes other than to provide goods or services at a profit, and (c) absence of ownership interests like those of business enterprises.

15.

OFFERING CIRCULAR--The disclosure document or "prospectus" that provides material information about the ISSUER and the offering of NOTES.

16.

PERSON--An individual, a corporation, a limited liability company, a partnership, an association, organization, a government or a political subdivision of a government, or other legal entity.

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17.

SEASONED ISSUER--A CEF that, alone or through a predecessor organization, has been in continuous existence for more than ten (10) years, has offered NOTES for more than ten (10) years, and has paid or otherwise satisfied all obligations to pay principal and interest on its NOTES in a timely manner.

18.

SENIOR SECURED INDEBTEDNESS--Any debt or debt securities incurred or issued by a CEF and secured by assets of the CEF in such a manner as to have a priority claim against any of the assets of the CEF over and above the NOTES. Such debt may include, but is not limited to, a mortgage loan incurred for the purchase of an advance church site or CEF headquarters building, and a secured operating line of credit with a commercial financial institution.

19.

STATE--A state, commonwealth, province or similar jurisdiction in the United States, Canada, Puerto Rico or Mexico.

COMMENT:

Although DENOMINATIONAL ACCOUNTS are not included under the definition of NOTES above, a CEF should determine and comply with registration or exemption provisions of securities laws in all STATES where such obligations are held by affiliated organizations of the DENOMINATION.

II.**QUALIFICATION, LICENSING AND MARKETING REQUIREMENTS****A.****Qualification Requirements.**

An ISSUER shall take all steps required under applicable STATE securities laws to insure compliance with the registration or exemption provisions in all STATES in which it intends to offer and sell NOTES. Filing, procedural and review requirements will vary among the STATES. A CEF shall file such forms and pay such fees and comply with the filing, procedural and review requirements to achieve qualification for the offer and sale of its NOTES in each STATE, whether by registration, exemption or otherwise, as determined by that STATE's securities laws, rules and regulations.

COMMENT:

The NOTES should be exempt from federal registration pursuant to Section 3(a) (4) of the Securities Act of 1933, as amended. Many STATES have adopted laws based upon the Uniform Securities Act, which contains an exemption from registration for the NOTES that is similar to the exemption contained in the Securities Act of 1933. There are certain STATES, however, which do not exempt the NOTES from registration. Furthermore, several other STATES provide an exemption from registration but require notice filings or administrative approval before the exemption is available.

B.**No Fees and Commission.**

The NOTES shall be offered and sold without the payment of any direct or indirect underwriting, sales or similar fees or commissions.

C.**Licensing Requirements.**

1.

General Policy.

An ISSUER shall comply with the applicable broker-dealer and agent licensing requirements in each STATE in which it offers or sells NOTES. Therefore, it is necessary to check with the ADMINISTRATOR in each STATE where the NOTES will be offered to determine whether registration or licenser is required.

2.

Waiver.

If a STATE's securities laws or regulations allow, the ADMINISTRATOR may consider waiving:

a.

Testing requirements;

b.

Broker-dealer registration requirements for the ISSUER; and/or

c.

Agent registration requirements for any individual who represents the CEF with respect to its offer or sale of NOTES if that individual is not compensated in connection with the individual's participation by the payment of commissions or other remuneration based, directly or indirectly, on transactions in the NOTES.

COMMENT:

When an ADMINISTRATOR considers waiving certain registration and testing requirements, the following factors may be considered: agents normally are officers, directors, or employees of the CEF; the offer and sale of the NOTES are to a limited class of INVESTORS and not to the general public; the communications with prospective INVESTORS by the Agents normally are accomplished at the offices of the CEF through delivery of the OFFERING CIRCULAR and other written communications by means of the U.S. mails, the Internet or through verbal communications. In connection with any such waiver, an ADMINISTRATOR may collect such fees as are appropriate and required and shall require such affidavits or documents as are deemed appropriate and necessary.

D.**Limited Class of INVESTORS.**

The NOTES shall be sold to a limited class of INVESTORS. The ISSUER shall specify a limited class of INVESTORS that is consistent with its operations and is compatible with the mission, structure, organization and theology of its DENOMINATION. A suggested form of limited class of INVESTORS is:

PERSONs who are, prior to the receipt of the OFFERING CIRCULAR, members of, contributors to (including previous INVESTORS), or participants in the DENOMINATION, the CEF or in any program, activity or organization which constitutes a part of the DENOMINATION or the CEF, or in other religious organizations that have a programmatic relationship with the DENOMINATION or the CEF.

COMMENT:

It is recognized that the concept of "membership" or similar affiliation within the various DENOMINATIONs involves various church structure, organizational and/or theological concepts with which federal and STATE governmental entities cannot and should not interfere. CEFs should direct their offering efforts to PERSONs who have some reasonable association or affiliation with the CEF, its affiliated DENOMINATION or its religious programs.

E.**ADVERTISING.****1.**

General Standards.

An ISSUER may use ADVERTISING that complies with the following standards:

a.

ADVERTISING shall set forth a statement to the following effect: This is not an offer to sell our securities to you and we are not soliciting you to buy our securities. We will offer and sell our securities only in STATES where

authorized. The offering is made solely by our OFFERING CIRCULAR.

b.

ADVERTISING shall not set forth statements, data or information that:

i.

Are materially inconsistent with the statements, data or information set forth in the OFFERING CIRCULAR; or

ii.

When read in connection with the OFFERING CIRCULAR renders either the OFFERING CIRCULAR or ADVERTISING materially misleading; or

iii.

Emphasizes the religious aspect or any other aspect of the offering or ISSUER in a manner that is materially misleading.

2.

Filing.

Subject to the requirements of individual STATES,

a.

Proposed ADVERTISING shall be filed with the ADMINISTRATOR prior to use, except no filing is required for "Tombstone" advertisements with limited information about the ISSUER and proposed offering of NOTES. Such limited information may include: the name and address of the ISSUER; the amount and terms of the NOTES; the purpose of the offering; and the name, address and contact information for PERSONs who may be contacted regarding the offering. The limited "Tombstone" advertisement shall include a statement as required by I.E.1.a., and should also state that interested INVESTORS should request and carefully read the OFFERING CIRCULAR before making their investment decision.

b.

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ADVERTISING, filed pursuant to II.E.2.a. that is subsequently materially changed or modified during the applicable offering period, except as provided in II.E.2.c., below, shall be filed with the ADMINISTRATOR prior to use. The changes and modifications shall be clearly marked, and the ADVERTISING changes and modifications shall comply with II.E.1.

c.

ADVERTISING, that has been filed with the ADMINISTRATOR, and which is subsequently changed or modified in a non-material manner, need not be refiled.

d.

If an advertisement will include interest rates and it is not possible to specify interest rates in advertisements prior to use of the advertisements, the interest rate information shall be filed concurrently with its use.

3.

Use of ADVERTISING.

a.

ADVERTISING shall not be directed at potential INVESTORS in a particular STATE before the proposed offering of NOTES has become registered or authorized for exemption, as applicable, in such STATE.

b.

ADVERTISING shall not be directed to PERSONS who are not or potentially may not be within the limited class of INVESTORS described in II.D.

c.

Subject to the requirements of individual STATES, national, regional or other multi-state publications or information provided by a DENOMINATION or its CEF may include ADVERTISING if the statement required by II.E.1.a. is included in such ADVERTISING.

III.

OPERATIONAL AND STRUCTURAL STANDARDS

A.**Organization and Structure.**

The CEF shall be a NOT-FOR-PROFIT ORGANIZATION, validly organized and existing under the laws of a STATE, that operates exclusively for religious, charitable or educational purposes and qualifies as an organization described in *Section 501(c)(3) of the Internal Revenue Code of 1986*, as amended.

B.**Exempt from Federal Registration.**

The NOTES offered and sold by a CEF should be exempt from registration pursuant to the provisions of Section 3 (a) (4) of the Securities Act of 1933, as amended.

C.**General Obligation Securities.**

1.

The NOTES, which provide general obligation financing for the CEF, shall not be specifically secured by particular loans to specific borrowing entities.

2.

The proceeds from the NOTES may be deposited to a general fund or unrestricted account from which the CEF will make or complete commitments for loans primarily to churches and religious organizations affiliated with the DENOMINATION.

3.

If a material amount of assets, liabilities, revenues or expenses of the CEF are unrelated to CEF operations, appropriate disclosure shall be provided in the OFFERING CIRCULAR. The ADMINISTRATOR may require management of the ISSUER to explain or justify any material balances or transactions that are unrelated to operation of the CEF.

4.

In all cases there shall be a separate accounting for the operations, financial position and cash flows of the CEF.

D.

Limited SENIOR SECURED INDEBTEDNESS.

The amount of any SENIOR SECURED INDEBTEDNESS to which the NOTES are or will be subordinated shall not exceed ten percent (10%) of the tangible assets (total assets less intangible assets as defined by GAAP) of the CEF. To the extent that such subordination of the NOTES exists, appropriate disclosure shall be provided in the OFFERING CIRCULAR.

E.

Limit on Securitization of CEF Loan Portfolio.

A CEF may ordinarily securitize up to ten percent (10%) of its loan portfolio, if all of the following are met:

1.

The loans are securitized and sold on a non-recourse basis predominantly to entities not affiliated with the CEF;

2.

The proceeds from the sale of the securitized loans will be used to make additional loans to churches and other entities within the DENOMINATION; and

3.

The securitization will not hinder the ability of the CEF to repay the principal and interest on the NOTES when due.

The ADMINISTRATOR may allow a greater portion of the CEF's loan portfolio to be securitized if management of the CEF provides sufficient justifications based on the particular circumstances of the CEF.

COMMENT:

Reasonableness of the extent of securitization of a CEF's loan portfolio can vary in relation to several factors, including but not limited to: experience and expertise of CEF management personnel; the extent to which the CEF meets or exceeds the requirements of financial standards under IV.; and the loan policies of the CEF.

F.**Management of the CEF.**

One or more executive officers or other individuals engaged in the day to day management of the CEF shall have at least three years of relevant experience in lending and investment activities involving churches or similar organizations or otherwise must demonstrate sufficient knowledge and experience to manage loans, investments and operations of the CEF.

IV.**FINANCIAL STANDARDS****A.****General.**

1.

An ISSUER shall not offer and sell more NOTES than it can reasonably expect to repay, when due, in the ordinary course of its operations. Although each offering must be viewed in the context of the individual facts and circumstances surrounding each ISSUER and its offering, the following are the financial standards which an ADMINISTRATOR may consider in reviewing a proposed offering.

2.

AUDITED FINANCIAL STATEMENTS of the ISSUER and/or the OFFERING CIRCULAR must disclose sufficient information to evaluate the extent of compliance with the standards in this section of the SOP. To facilitate review by the ADMINISTRATOR and INVESTORS, the OFFERING CIRCULAR should provide the financial information required by this section in a tabular or graphic presentation. An ISSUER may be deemed to have complied with certain standards in this section of the SOP even if it fails to meet one or more of the other standards at the time of any one offering period, if: the ISSUER complies with or exceeds the requirements of the remaining standards and the information and data furnished reflects the ability of the ISSUER to repay its NOTES and other debt obligations when due in the ordinary course of its operations.

B.**Capital Adequacy.**

At the end of its most recent fiscal year as reported in its AUDITED FINANCIAL STATEMENTS, the ISSUER's NET ASSETS shall be positive and equal to five percent (5%) or more of its total assets.

C.**Liquidity Status.**

1.

At the end of its most recent fiscal year as reported in its AUDITED FINANCIAL STATEMENTS, the ISSUER's cash, cash equivalents, readily marketable securities and available lines of credit shall have a value of at least eight percent (8%) of the principal balance of its total outstanding NOTES, except that the value of available lines of credit for meeting this standard shall not exceed two percent (2%) of the principal balance of its total outstanding NOTES.

2.

Management of the CEF shall establish and administer investment policies that provide for reasonable and prudent diversification and preservation of its cash, cash equivalents and readily marketable securities for compliance with IV.C.1.

D.**Cash Flow Performance.**

For each of the ISSUER's three (3) most recent fiscal years as reported in its AUDITED FINANCIAL STATEMENTS, the coverage ratio of available cash as compared to cash redemptions of NOTES, exclusive of DENOMINATIONAL ACCOUNTS, shall be at least one to one (1:1). In determining the ISSUER's available cash, the following may be considered:

1.

Cash provided by its normal CEF operating activities as reported in its Statements of Cash Flows;

2.

Liquid assets (the total of cash, cash equivalents and readily marketable securities) at the beginning of its fiscal year;

3.

Loan principal repayments, less loan disbursements;

4.

Cash generated from the sale of NOTES, exclusive of DENOMINATIONAL ACCOUNTS, except to the extent that year-end redemptions exceed deposits to, or investments in, such DENOMINATIONAL ACCOUNTS during its fiscal year; and

5.

Funds from other sources.

COMMENT:

In determining the amount of the ISSUER's available cash, the ADMINISTRATOR also may consider any other source of immediately available funds, such as a line of credit or other source of credit with a bank or other financial institution.

E.

Loan Quality.

1.

LOAN DELINQUENCIES during the ISSUER's most recent fiscal year as reported in its AUDITED FINANCIAL STATEMENTS and disclosed in the OFFERING CIRCULAR shall not be excessive and shall be at such a level that the overall quality of its loan portfolio will allow the ISSUER:

a.

To maintain sufficient Capital Adequacy in compliance with IV.B.; and

b.

Receive the timely repayments of sufficient loan principal necessary to meet the liquidity and cash flow requirements as set forth in IV.C. and IV.D.

2.

When the LOAN DELINQUENCIES are material, the extent of the LOAN DELINQUENCIES and the quality of the ISSUER's loan portfolio should be explained and emphasized as a risk factor in the OFFERING CIRCULAR.

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If LOAN DELINQUENCIES exceed ten percent (10%) of the CEF's total loan portfolio and no risk factor is disclosed, the ADMINISTRATOR may require management of the ISSUER to provide information to demonstrate that its LOAN DELINQUENCIES do not represent a material risk based on historical trends of the CEF and management's ability to obtain satisfactory repayments of delinquent loans.

COMMENT:

A risk factor disclosure based on part 2 does not necessarily correct a deficiency under part 1 of this standard.

3.

Management of the CEF shall establish and administer lending policies that provide reasonable assurance of sufficient loan quality to prevent excessive LOAN DELINQUENCIES that could result in loan losses by the CEF. The provisions of lending policies, such as, but not limited to, requirements for appraisals of properties to be financed, financial statements of borrowers, and limits or criteria for loan to value ratios, debt-service ratios and geographic concentration of loans shall be disclosed in the OFFERING CIRCULAR.

4.

A CEF's loan program shall be primarily secured. Unless a lower percentage is justified by management of the ISSUER, at least ninety percent (90%) of the CEF's outstanding loans shall be secured by real or personal property or guaranteed by third parties. In evaluating justifications provided by management of the ISSUER, the ADMINISTRATOR may take into account, in addition to the quantity of secured and unsecured loans, the CEF's compliance with the other financial standards in this section, history of repayments of unsecured loans, provision for loan losses and other factors relative to the CEF's loan program and financial strength. The ADMINISTRATOR may require management of the CEF to file information about the property securing loans or the ability of third parties to provide guarantees.

F.

Operating Trends.

The CHANGE IN NET ASSETS of the ISSUER, less any non-recurring or extraordinary items, for three (3) of the last five (5) fiscal years as reported in the AUDITED FINANCIAL STATEMENTS of the ISSUER shall be positive. The ADMINISTRATOR may limit or require justification of material non-monetary contributions to be included in the CHANGE IN NET ASSETS of the ISSUER.

G.

SEASONED ISSUER Compliance.

The ADMINISTRATOR may consider the ISSUER's status as a SEASONED ISSUER for evaluating compliance with the above financial standards in any given fiscal year, if the ISSUER can show that:

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1.

It has fulfilled the requirements of the financial standards for at least three (3) out of its five (5) most recent fiscal years; or

2.

The average of the relevant financial information for its five (5) most recent fiscal years reflects compliance with the financial standards; and

3.

Management of the ISSUER has taken appropriate action to correct or mitigate the circumstances that caused noncompliance and can demonstrate satisfactory plans or ability to meet the financial standards and repay NOTES in future years.

H.

Transition.

1.

A CEF which has offered and sold NOTES prior to adoption of this SOP may continue to comply with the Capital Adequacy and Liquidity Status provisions in IV.B. and IV.C. of the NASAA Statement of Policy Regarding Guidelines for "General Obligation Financing by Religious Denominations", adopted April 17, 1994, based on information in its AUDITED FINANCIAL STATEMENTS for fiscal years ending before January 1, 2007. A CEF must comply with IV.B. and IV.C. of this SOP based on information in its AUDITED FINANCIAL STATEMENTS for fiscal years ending after January 1, 2007. The ADMINISTRATOR may allow a longer transition period if management of the ISSUER provides information to the ADMINISTRATOR which justifies a longer transition period.

2.

A new CEF that begins operations after the date this SOP is adopted by NASAA shall comply with the capital adequacy and liquidity standards under IV.B. and IV.C. of this SOP, but the CEF will not be expected to completely comply with IV.D. and IV.F. that require several years of operations. The new CEF shall demonstrate compliance with subsections other than IV.B. and IV.C. based on its actual period of operations since inception as reported in its AUDITED FINANCIAL STATEMENTS.

V.**ISSUANCE OF NOTES**

An ISSUER that meets the standards of this SOP shall be entitled to offer and sell its NOTES under the following provisions.

A.

No Trust Indentures or Sinking Fund Required. Trust indentures or sinking funds shall not be required in connection with the NOTES.

B.**Extension or Roll-Over After Notice.**

1.

NOTES, upon maturity, may be extended or rolled over under the expressed terms and conditions stated in the OFFERING CIRCULAR, if:

a.

Each INVESTOR is provided with written notification of the maturity and the proposed extension or rollover of the NOTES at least thirty (30) days prior to the NOTES' maturity dates and the ISSUER retains appropriate documentation as may be required by the ADMINISTRATOR to demonstrate mailing or delivery of the written notification; and

b.

Each INVESTOR is or has been provided with the ISSUER's most current OFFERING CIRCULAR.

2.

If the INVESTOR notifies the Issuer in writing on or prior to the maturity date that the INVESTOR elects not to extend or roll-over the NOTE, then at maturity, the ISSUER shall promptly repay the principal and interest accrued thereon.

C.

Compound Interest.

Interest payable on NOTES may be compounded for payment at maturity of the NOTES if accrued interest is included with redemption amounts for determining compliance with IV.D.

VI.**OFFERING CIRCULAR**

INVESTORS shall receive adequate material information in order to make informed investment decisions, and the ISSUER must provide INVESTORS with a complete OFFERING CIRCULAR prior to their purchase of NOTES.

The OFFERING CIRCULAR must be written in clearly understandable language and disclose all relevant and material information that affects or would affect a prospective INVESTOR's decision to purchase the NOTES. **THE INFORMATION OUTLINED BELOW IS PROVIDED AS A GUIDE, BUT IS NOT INTENDED TO BE ALL-INCLUSIVE AND THE ISSUER MUST INCLUDE OTHER INFORMATION NOT SPECIFICALLY LISTED THAT WOULD BE IMPORTANT FOR AN INVESTOR'S UNDERSTANDING OF THE ISSUER AND THE NOTES.**

Any material adverse changes in the financial condition of the ISSUER or material changes in other information in the OFFERING CIRCULAR during the offering period shall be promptly disclosed in an appropriate supplement, or an amendment to the OFFERING CIRCULAR, and shall be promptly filed with each ADMINISTRATOR.

The following information must be included in the OFFERING CIRCULAR unless the ISSUER can demonstrate to the ADMINISTRATOR that a particular type of information is not applicable or material to an understanding of the ISSUER or the NOTES. Disclosure of additional types of information not listed below may be requested by the ADMINISTRATOR.

A.**Cover Page.**

1.

Name of the ISSUER.

2.

Principal address and telephone number of the ISSUER.

3.

A brief description of the NOTES offered including interest rates and maturity terms available.

4.

The total amount of the offering, the estimated offering expenses and the net proceeds of the offering.

5.

A statement that the offering is subject to certain risks and the page number(s) in the OFFERING CIRCULAR where the risk factors are disclosed.

6.

The limited class of INVESTORS to whom the NOTES will be sold.

7.

The date of the OFFERING CIRCULAR and the proposed offering period.

8.

Any legends that are required by applicable STATE laws, rules or regulations, or are deemed to be appropriate by the ADMINISTRATOR. The following are uniform model legends:

THESE SECURITIES MAY EITHER BE REGISTERED OR EXEMPT FROM REGISTRATION IN THE VARIOUS STATES OR JURISDICTIONS IN WHICH THEY ARE OFFERED OR SOLD BY THE ISSUER. THIS OFFERING CIRCULAR HAS BEEN FILED WITH THE SECURITIES ADMINISTRATORS IN SUCH STATES OR JURISDICTIONS THAT REQUIRE IT FOR REGISTRATION OR EXEMPTION.

THESE SECURITIES ARE ISSUED PURSUANT TO A CLAIM OF EXEMPTION FROM REGISTRATION UNDER SECTION 3(a)(4) OF THE FEDERAL SECURITIES ACT OF 1933. A REGISTRATION STATEMENT RELATING TO THESE SECURITIES HAS NOT BEEN FILED WITH THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION.

THESE SECURITIES HAVE NOT BEEN RECOMMENDED BY ANY FEDERAL OR STATE SECURITIES COMMISSION OR REGULATORY AUTHORITY. FURTHERMORE, THE FOREGOING AUTHORITIES HAVE NOT DETERMINED THE ACCURACY, ADEQUACY, TRUTHFULNESS, OR COMPLETENESS OF THIS DOCUMENT AND HAVE NOT PASSED UPON THE MERIT OR VALUE OF THESE SECURITIES, OR APPROVED, DISAPPROVED OR ENDORSED THE OFFERING. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

IN MAKING AN INVESTMENT DECISION, INVESTORS MUST RELY ON THEIR OWN EXAMINATION OF THE ISSUER AND THE TERMS OF THE OFFERING, INCLUDING THE DISCLOSURE, MERITS, AND RISKS INVOLVED.

THE NOTES ARE NOT SAVINGS OR DEPOSIT ACCOUNTS OR OTHER OBLIGATIONS OF A BANK AND ARE NOT INSURED BY THE FEDERAL DEPOSIT INSURANCE CORPORATION, ANY STATE BANK INSURANCE FUND OR ANY OTHER GOVERNMENTAL AGENCY. THE PAYMENT OF PRINCIPAL AND INTEREST TO AN INVESTOR IN THE NOTES IS DEPENDENT UPON THE ISSUER'S FINANCIAL CONDITION. ANY PROSPECTIVE INVESTOR IS ENTITLED TO REVIEW THE ISSUER'S FINANCIAL STATEMENTS, WHICH SHALL BE FURNISHED AT ANY TIME DURING BUSINESS HOURS UPON REQUEST. THE NOTES ARE NOT OBLIGATIONS OF, NOR GUARANTEED BY, [NAME OF DENOMINATION], OR BY ANY CHURCH, CONFERENCE, INSTITUTION OR AGENCY AFFILIATED WITH [NAME OF DENOMINATION].

NO PERSON HAS BEEN AUTHORIZED TO GIVE ANY INFORMATION OR TO MAKE ANY REPRESENTATION IN CONNECTION WITH THIS OFFERING OTHER THAN THOSE CONTAINED IN THIS OFFERING CIRCULAR, AND IF GIVEN OR MADE, SUCH INFORMATION OR REPRESENTATION MUST NOT BE RELIED ON AS HAVING BEEN MADE BY [NAME OF ISSUER].

9.

Disclose any other state-specific limitations or conditions of sales to INVESTORS.

10.

An advisory disclosure such as the following should be included for consideration by INVESTORS:

INVESTORS ARE ENCOURAGED TO CONSIDER THE CONCEPT OF INVESTMENT DIVERSIFICATION WHEN DETERMINING THE AMOUNT OF NOTES THAT WOULD BE APPROPRIATE FOR THEM IN RELATION TO THEIR OVERALL INVESTMENT PORTFOLIO AND PERSONAL FINANCIAL NEEDS.

COMMENT:

An ISSUER may use a national OFFERING CIRCULAR in all STATES in which it offers and sells its securities. Disclosure of specific legends or other information may be required by various STATE laws, rules or ADMINISTRATORS. If there is insufficient space on the front side of the cover page of the OFFERING CIRCULAR for the information described in VI.A., or when otherwise appropriate, such information may be disclosed on the reverse side of the cover page or on additional pages immediately following the cover page of the OFFERING CIRCULAR.

B.

SUMMARY

A summary of narrative and financial information that highlights the key aspects and risks of the NOTES and the financial and operational characteristics of the ISSUER should be presented concisely in the OFFERING CIRCULAR following the cover page or risk factor section. The Summary section should include the disclosure of the ISSUER's proposed use of proceeds and a summary in tabular form of the financial data specified by VI.I.1. for the ISSUER's most recent fiscal year.

C.

RISK FACTORS

1.

Format and Use of Risk Factors.

a.

Risk factors should immediately follow the Cover or the Summary. Consistent with investor protection, a comprehensive listing of the material risks to the potential INVESTOR in the offering should be located at the forefront of the OFFERING CIRCULAR. Potential INVESTORS often focus on the forepart of the document. When comparing potential investment opportunities, consistency in format of complex disclosure documents further assists the INVESTOR.

b.

The Risk factor section is a list identifying the material risks associated with the offering. The risk factor section should **not** be a comprehensive discussion of the risks and counterbalancing considerations. Like the summary section, the risk factor section is a summary of the material disclosures that are discussed and analyzed in more detail in the appropriate, related sections of the body of the OFFERING CIRCULAR. Consistent with this purpose, most risk factors will not be comprehensive discussions of the issues. The risk factor section itself should be limited in length. In order to emphasize the nature of the disclosures as risks, no ameliorative statements should appear in the risk factors.

c.

The risk factors that identify risks the potential INVESTOR is likely to find most significant should appear at or close to the beginning of the list.

d.

A caption shall precede each risk factor and shall appear in off-set or emphasized type. As a listing of the material risks of the NOTES, captions should stand out to the eye of the reader. *Italicized*, **bold-face**, or underlined type assists the reader to quickly comprehend the scope and nature of the particular risk factors, and permits the reader to focus further on the risk factors of most interest to that reader. For the same reason, ISSUERS should avoid lengthy captions.

2.

Risk Factor Content.

a.

Each caption should succinctly identify the risky element of the factor. The caption should avoid the use of general, boiler-plate language. As a topic sentence to the factor, the caption can further streamline and shorten the factor.

b.

Specific cross-references point the reader to complete discussions of the issue. Risk factors should not merely repeat *verbatim* disclosure appearing elsewhere in the disclosure document. Where appropriate, the risk factor should be a two or three sentence summary with a cross reference to the discussion appearing elsewhere in the OFFERING CIRCULAR. In some cases, there may be no need to repeat the risk factor in the body of the OFFERING CIRCULAR. Potential INVESTORS often focus interest on disclosure that is of most interest to them, and cross-references assist the potential INVESTOR in locating this disclosure.

c.

Eliminate general, boiler-plate risk factors that could apply to any type of securities offering. Include only risks that are material to the particular offering, the particular ISSUER, or specific to NOTES.

3.

Specific Risk Factors for CEF NOTES.

The ISSUER must describe to the INVESTORS the risks of investing in the NOTES. Particular care must be taken with respect to risks associated with the financial condition of the ISSUER. Statements to the effect that little or no risk is involved in buying NOTES are prohibited, and such statements by most ISSUERS will be regarded as material misrepresentations. It is important that the ISSUER concisely describe all of the relevant and material risks. These risks could include, but are not limited to, explanations of any of the following risks, **if applicable** to the particular offering. The captions of those risk factors may be, but are not required to be, similar to the following:

a.

NOTES are unsecured general obligations of the ISSUER, and INVESTORS will be dependent solely upon the financial condition and operations of the ISSUER for repayment of principal and interest.

b.

No sinking fund or trust indenture has been or will be established to ensure or secure the repayment of NOTES.

c.

The NOTES are subordinate in ranking and priority in relation to the ISSUER's existing and anticipated future SENIOR SECURED INDEBTEDNESS (See III.D.).

d.

No public market exists for the NOTES and none will develop, and therefore, the transferability of the NOTES is limited and restricted.

e.

The recent negative changes or trends in the financial condition of the ISSUER and its operations may adversely affect the ISSUER's ability to make payments of principal and interest on the NOTES when due.

f.

The ISSUER's liquid assets invested in readily marketable securities are subject to various market risks which may result in losses if market values of investments decline.

g.

There are no income tax benefits with respect to investment in the NOTES and interest paid or payable on NOTES is taxed as ordinary income regardless of whether interest is received by the INVESTOR or retained and compounded by the ISSUER.

h.

The ISSUER's loans are made primarily to affiliated churches and related religious organizations, including local churches, whose ability to repay the loans depend primarily upon contributions that they receive from their members.

i.

The loan policies of the ISSUER for loans to its affiliated churches and its related religious organizations are less stringent than loan policies of commercial lenders.

j.

Future changes in federal or STATE laws may adversely affect the ISSUER's ability to continue to sell its NOTES.

k.

The ISSUER is involved in activities other than its CEF Operations.

l.

There are risks involved in specific transactions or arrangements, such as loan securitizations, undertaken or entered into by the CEF.

m.

There are risks related to geographic concentration of loans to affiliated churches or other related organizations within a limited region, such that changes in economic conditions of that region could affect the ability of the churches or organizations, as a group, to repay the loans.

n.

Risks of investment in the NOTES may be greater than implied by relatively low interest rates on the NOTES and the NOTES are not insured by any governmental agency or private insurance company.

D.

HISTORY AND OPERATIONS

1.

Describe the ISSUER, including the name, address of principal business office, STATE and date of incorporation, type and nature of the corporation (not-for-profit, tax exempt, etc.).

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2.

Describe the history of the ISSUER and its denominational affiliation or association.

3.

Describe the religious purposes of the ISSUER and the general nature and purposes of its operations.

4.

Describe the nature and extent of the offering of the NOTES and the extent of the ISSUER's offerings on a nationwide basis.

5.

Describe the current operation and principal business activities of the ISSUER.

6.

Disclose or cross-reference information required by III.C.1.

E.**USE OF PROCEEDS**

Describe in detail how the proceeds from the sale of the NOTES are expected to be used by the CEF and other material information related thereto. If a material amount of proceeds are to be used for purposes other than operating a CEF program, the OFFERING CIRCULAR shall include thorough explanations and justifications for such uses. The ADMINISTRATOR may disallow the offering of NOTES if such unrelated uses are not sufficiently explained or justified.

F.**FINANCING AND OPERATIONAL ACTIVITIES**

Describe the financing operations and activities of the ISSUER, including;

1.

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A description and summary, in tabular form, of the ISSUER's outstanding NOTES and debt obligations, categorized to the extent necessary to inform an INVESTOR of the nature and type of NOTES and debt obligations that it has sold and incurred. To the extent that the information is not disclosed in the AUDITED FINANCIAL STATEMENTS of the ISSUER or the footnotes attached thereto, the OFFERING CIRCULAR should include the principal amounts due at maturity.

2.

A description of the receipts that the ISSUER received from the sale of its NOTES and the amount of any redemptions that it made on its NOTES in its prior fiscal year.

3.

A description and summary, in tabular form, of the amount and nature of the ISSUER's outstanding loans receivable at the end of its last fiscal year. To the extent that the information is not disclosed in the AUDITED FINANCIAL STATEMENTS of the ISSUER or the footnotes attached thereto, the OFFERING CIRCULAR should include a summary of the maturities of the outstanding loans receivable and a listing of individually material loans receivable. The disclosure of loans receivable shall also demonstrate that loans are primarily secured as required under IV.E.4. Information concerning loans guaranteed by third parties, including a summary of the financial condition of guarantors, shall be disclosed if material.

4.

Descriptions of the ISSUER's direct and indirect revenues and expenses that are unrelated to its CEF operations, if material.

5.

A description of any other related material financial information of the ISSUER's financial activities and operations that relate to its ability to repay the principal and interest on its outstanding NOTES and other debt securities when due.

G.

LENDING ACTIVITIES

Describe the lending activities of the ISSUER such as:

1.

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The nature and types of its loans receivable;

2.

Its loan policies;

3.

Material loans made to a single borrower;

4.

The nature and extent of any material LOAN DELINQUENCIES for its last three (3) fiscal years; and

5.

The nature and extent of any material loan losses that the ISSUER has incurred within its last three (3) fiscal years.

H.**INVESTING ACTIVITIES**

Describe the investing activities of the ISSUER, including:

1.

A description and summary of the nature and amount of any invested funds which the ISSUER maintains pending utilization for its loan activities or for purposes of maintaining a reasonable liquidity as required by IV.C.1.

2.

A description of the policies of the ISSUER as required by IV.C.2. with respect to making and maintaining such investments, including the types of investments the ISSUER is permitted to make under its investment policy and any limitations on such investments. Any investment(s) currently held by the ISSUER that does not comport with this policy must be disclosed and a reason provided as to why the ISSUER holds that investment(s).

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3.

The name(s) of the PERSON(s) responsible for setting or altering the ISSUER's investment policy and the PERSON(s) responsible for making and maintaining the ISSUER's investments. If the ISSUER has engaged a third party to make or maintain its investments, the identity of that third party must be disclosed.

4.

A description in tabular form of the ISSUER's outstanding investments categorized according to the types of investments held (equity securities, government securities, corporate bonds, etc.) which discloses the amount invested in each category, both in monetary terms and as a percentage of the ISSUER's total investments. The monetary value of investments disclosed in the table should be presented in conformity with GAAP for NOT-FOR-PROFIT ORGANIZATIONS.

5.

The ISSUER's aggregate realized and unrealized gains and losses from investments for each of its last three fiscal years.

6.

Any other material information regarding the ISSUER's investments.

I.**SELECTED FINANCIAL DATA**

1.

Disclose the following selected financial data in tabular form for each of the ISSUER's last five fiscal years as reported in or derived from its AUDITED FINANCIAL STATEMENTS:

a.

cash, cash equivalents and readily marketable securities (combined);

b.

total loans receivable;

c.

amount and percent of unsecured loans receivable;

d.

LOAN DELINQUENCIES as a percent of loans receivable;

e.

total assets;

f.

total NOTES payable;

g.

amount of NOTES redeemed during the fiscal year;

h.

other long-term debt;

i.

NET ASSETS; and

j.

CHANGE IN NET ASSETS.

2.

Include, to the extent relevant and material, any discussion and analysis by management of the ISSUER that

will assist INVESTORS in understanding the nature of the operations of the ISSUER and the selected financial data.

J.

DESCRIPTION OF NOTES

1.

Describe the type and nature of the NOTES and the manner in which the interest thereon will be computed and/or accrued.

2.

Describe the terms of the NOTES, including any right to early redemption and any penalties that will applied thereto.

3.

Describe the nature of cash or cash equivalent that will be acceptable for purchase of the NOTES.

4.

Describe the restrictions and limitations on transferability of the NOTES.

5.

Describe the ranking and priority of the NOTES in relation to other indebtedness of the ISSUER.

K.

PLAN OF DISTRIBUTION

1.

Describe the method and manner in which the NOTES will be offered and sold to INVESTORS, including the methods of solicitation and subscription.

2.

State that no underwriting or selling agreements exist, and that no direct or indirect commissions or other remuneration will be paid to any individuals or organizations in connection with the offer and sale of the NOTES.

COMMENT:

The NOTES will be offered and sold through officers and/or employees of the ISSUER or other representatives of the DENOMINATION, subject to the requirements of II.C. which should be disclosed if relevant to the offering.

L.

TAX ASPECTS

Describe the federal tax aspects of ownership of the NOTES and state that the interest paid or accrued on the NOTES will be taxable as ordinary income to INVESTORS.

M.

LITIGATION AND OTHER MATERIAL TRANSACTIONS

1.

Describe all present, pending or threatened material legal proceedings, including those that are known to be contemplated by governmental authorities, administrative bodies, or other administrative PERSONs to which the ISSUER or its property is or may become a party.

2.

Include the name of the court or agency in which the proceedings are pending, the date that the proceedings were instituted, the principal parties involved, a description of the factual basis underlying the proceedings and the relief sought.

3.

Disclose any transactions that may materially affect the offering or an INVESTOR'S investment decision and which are not otherwise mentioned in the OFFERING CIRCULAR.

N.

MANAGEMENT

1.

Describe the organizational structure of the ISSUER, including how the members of its Board of Directors or other legal governing body are chosen or replaced.

2.

Identify all directors and executive officers or PERSONs having similar authority of the ISSUER, and describe their experience and credentials, the functions they perform for the ISSUER and the dates that their terms of office expire.

3.

Disclose if any director or officer of the ISSUER has, during the past ten years, been convicted of any criminal proceeding (other than for traffic violations or other minor misdemeanors), is the subject of any pending criminal proceedings, or was the subject of any order, judgment or decree of any court enjoining such individual from any activities associated with the offer or sale of securities.

4.

Disclose in tabular form all direct and indirect remuneration, which includes, but is not limited to, salaries, health and other insurance, pensions or retirement plans and the use of the ISSUER's assets for personal purposes, that are paid by the ISSUER to the following:

a.

its executive officers, directors or PERSONs having similar authority for the ISSUER's last fiscal year in the aggregate, and

b.

its executive officers, directors or PERSONs having similar authority, individually, if the remuneration equals or exceeds \$150,000 during the ISSUER's last fiscal year.

5.

Describe all material employment contracts, perquisites of employment and conflicts of interests of the

ISSUER's officers, directors, or PERSONs having similar authority.

O.

FINANCIAL STATEMENTS

1.

AUDITED FINANCIAL STATEMENTS of the ISSUER are required in the OFFERING CIRCULAR for the proposed offering of NOTES and shall include all financial statements and notes required by GAAP as follows:

a.

Statements of Financial Position (Balance Sheets) for the ISSUER's two most recent fiscal years;

b.

Statements of Activities (Revenues, Expenses and the CHANGE IN NET ASSETS) for the ISSUER's three most recent fiscal years;

c.

Statements of Cash Flows for the ISSUER's three most recent fiscal years with gross rather than net reporting of financing and investing activities; and

d.

Notes to the Financial Statements to explain accounting policies and provide other disclosures required by GAAP for NOT-FOR-PROFIT ORGANIZATIONS or as required by this SOP.

If the ISSUER has not existed or been in operation for the time periods specified above, the ISSUER shall provide AUDITED FINANCIAL STATEMENTS for the actual number of fiscal years or period of operation since its inception.

2.

The audit report of independent Certified Public Accountants shall include an unqualified opinion that indicates the financial statements are presented fairly, in all material respects, in conformity with GAAP, and the audit report shall not include an explanatory paragraph regarding substantial doubt about the ISSUER's ability to continue as

a "going concern".

P.

INVESTOR REPORTS

The OFFERING CIRCULAR shall state that the ISSUER's current AUDITED FINANCIAL STATEMENTS will be made available to INVESTORS upon written request, and will be mailed to INVESTORS within 120 days of its last fiscal year end.

CROSS REFERENCE SHEET

The ISSUER shall file a cross reference sheet or supplemental outline with the ADMINISTRATOR to provide references to documents or tabular information to demonstrate compliance with the standards under Sections III. through VI. of this SOP. Cross references to the OFFERING CIRCULAR or other documents filed with the ADMINISTRATOR should indicate the page numbers where compliance is demonstrated by disclosures or contents of documents.

Provisions of the offering of NOTES or documents filed with the ADMINISTRATOR which vary from requirements of this SOP must be explained by footnote. Footnotes should be numbered sequentially and presented on an attachment to the cross reference sheet or outline. Requests for waivers or exceptions from standards should be thoroughly explained and justified in a letter to the ADMINISTRATOR and filed with the application for registration or exemption of the NOTES.

Adopted April 25, 1993

I. INTRODUCTION. The North American Securities Administrators Association, Inc. ("NASAA") has determined that the following guideline relating to debt securities is consistent with public investor protection and is in the public interest. Nothing shall prevent the Securities Administrator ("Administrator") from applying different standards than those contained in this Statement of Policy.

II. DEFINITIONS. The following definitions shall apply to this Statement of Policy.

A.

ADJUSTED CASH FLOW is the Issuer's CASH FLOW adjusted on a pro forma basis to reflect:

1.

The elimination of interest and fees on debt or debt securities and of cash dividends on preferred stock that are to be retired with the proceeds derived from the offering;

2.

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The effect of any acquisitions or capital expenditures that were made by the Issuer after its last fiscal year, or which are proposed or required for the current fiscal year, which materially affect the Issuer's CASH FLOW;

3.

The effect of interest and fees on debt w debt securities or cash dividends paid after the Issuer's last fiscal year:

4.

The effect of any interest and fees on debt or debt securities and of cash dividends on preferred stock or common stock that were issued during the Issuer's last fiscal year, but which were outstanding for only a portion of such fiscal year, as if such debt, debt securities, preferred stock or common stock had been outstanding for the entire fiscal year;

5.

The effect of imputed or deferred charges of zero coupon debt or debt securities for the Issuer's last fiscal year and any additional charges on such debt or debt securities issued after the Issuer's last fiscal year;

6.

The effect of accrued dividends on preferred stock for the Issuer's last fiscal year and any additional dividends on such preferred stock issued after the Issuer's last fiscal year; and

7.

The effect of any other material changes to the Issuer's future CASH FLOW.

B.

An AFFILIATE is a PERSON who, directly or indirectly, CONTROLS, is CONTROLled by, or is under common CONTROL with the PERSON specified herein.

C.

An ASSOCIATE, when used to indicate a relationship with a PERSON, includes:

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1.

Corporations or legal entities, other than the Issuer or majority-owned subsidiaries of the Issuer, of which a PERSON is an officer, director, partner, or a direct or indirect, legal or beneficial owner of five percent (5%) or more of any class of EQUITY SECURITIES;

2.

Trusts or other estates in which a PERSON has a substantial beneficial interest or for which a PERSON serves as a trustee or in a similar capacity; and

3.

A PERSON'S spouse and relatives, by blood or by marriage, if the PERSON is a PROMOTER of the Issuer, its subsidiaries, its AFFILIATES, or its parent.

D.

CASH FLOW is the Issuer's after-tax earnings that are derived from its normal operations, exclusive of extraordinary and nonrecurring items, less interest and dividends, plus certain noncash charges against earnings such as depreciation, depletion and amortization, determined according to generally accepted accounting principles, consistently applied.

E.

CONTROL is the power to direct or influence the direction of the management or policies of a PERSON, directly or indirectly, through the ownership of voting securities, by contract or otherwise.

F.

EQUITY SECURITIES include shares of common stock or similar securities and convertible securities, warrants, options or rights that may be converted into or exercised to purchase, shares of common stock or similar securities.

G.

A PERSON is an individual, a corporation, a limited liability company, a partnership, an association, a joint-stock company, a trust, an unincorporated organization, a government or a political subdivision of a government, or any other legal entity.

H.

A PROMOTER may include:

1.

A PERSON who, alone or in conjunction with one or more PERSONS, directly or indirectly, took the initiative in founding or organizing the Issuer or CONTROLS the Issuer:

2.

A PERSON who, directly or indirectly, receives, as consideration for services and/or property rendered, five percent (5%) or more of any class of the Issuer's EQUITY SECURITIES or five percent (5%) or more of the proceeds from the sale of any class of the Issuer's EQUITY SECURITIES. A PERSON, who receives securities or proceeds solely as underwriting compensation, is excluded from the definition of PROMOTER if that PERSON falls outside of the definitions of II.H.1., above, or II.H.3., 4., or 5., below.

3.

A PERSON who is an officer or director of the Issuer;

4.

A PERSON who legally or beneficially, directly or indirectly, owns five percent (5%) or more of any class of the Issuer's EQUITY SECURITIES ("5% shareholder") if that PERSON was in CONTROL of the Issuer at the time of acquiring five percent (5%) or more of any class of the Issuer's EQUITY SECURITIES or if that PERSON is in CONTROL of the Issuer at the time of the public offering of the Issuer's EQUITY SECURITIES; or

5.

A PERSON who is an AFFILIATE or an ASSOCIATE of a PERSON specified in II.H.1., 2., 3., or 4., above.

III.

A public offering of debt securities may be disallowed by the Administrator if the Issuer's ADJUSTED CASH FLOW for the last fiscal year or its average ADJUSTED CASH FLOW for the last three (3) fiscal years prior to the public offering was insufficient to cover its fixed charges, meet its debt obligations as they became due, and service the debt securities being offered.

IV.

Notwithstanding II.A.6., above, accrued dividends of cumulative preferred stock having a stated interest rate may be excluded from ADJUSTED CASH FLOW at the discretion of the Administrator.

V.

The Administrator, in his or her discretion, may choose to not apply III., above, to public offerings of convertible debt securities that are superior in right of payment of interest and liquidation proceeds to any convertible debt that is or may be legally or beneficially, directly or indirectly, owned by PROMOTERS. The risks of failure to meet debt service obligations and the equity characteristics of such securities must be disclosed in the prospectus. An offering of such securities may be reviewed using guidelines for equity offerings.

VI.

Unless the Administrator permits otherwise, public offerings of debt securities shall be offered and sold pursuant to a Trust Indenture ("Indenture") which adequately protects the rights of the purchasers. Some of these protections are:

A.

The Indenture shall comply with the provisions of the Trust Indenture Act of 1939. This shall be disclosed in the offering document.

B.

The events of default of the Indenture shall be disclosed in the offering document.

C.

The trustee shall be provided with adequate reports, including any compliance reports from independent auditors, to allow the trustee to ensure compliance with the Indenture.

D.

Neither the trustee nor its PROMOTERS may be major creditors of the Issuer or its AFFILIATES.

E.

The Indenture shall provide that upon any consolidation, merger, recapitalization, reorganization, pledge

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foreclosure, equity or share exchange, conveyance or transfer of the properties and assets of the Issuer substantially as an entirety, or any other transaction having a substantially equivalent effect, the successor PERSON shall expressly assume the payment obligations on the debt securities and the performance of the covenants of the Indenture.

F.

The Indenture shall provide that interest will accrue and be paid to the date(s) of redemption or conversion of the debt securities.

VII.

If the Issuer's CASH FLOW is subject to cyclical fluctuations or if the Administrator deems it necessary for investor protection, the Administrator may require that the Issuer establish a sinking fund or redemption requirements.

NASAA Broker-Dealer Sales Practice Committee
Adopted 4/27/97

Any broker dealer or agent who engages in one or more of the following practices shall be deemed to have engaged in "dishonest or unethical practices in the securities business" as used in Section 204 of the Uniform Securities Act and such conduct may constitute grounds for denial, suspension or revocation of registration or such other action authorized by statute.

A. Sales Load Communications:

1.

In connection with the solicitation of investment company shares, failing to adequately disclose to a customer all sales charges, including asset based and contingent deferred sales charges, which may be imposed with respect to the purchase, retention or redemption of such shares.

2.

In connection with the solicitation of investment company shares, stating or implying to a customer that the shares are sold without a commission, are "no load" or have "no sales charge" if there is associated with the purchase of the shares: (i) a front-end load; (ii) a contingent deferred sales load; (iii) a SEC Rule 12b-1 fee or a service fee if such fees in total exceeds .25% of average net fund assets per year; or (iv) in the case of closed-end investment company shares, underwriting fees, commissions or other offering expenses.

3.

In connection with the solicitation of investment company shares, failing to disclose to any customer any relevant: (i) sales charge discount on the purchase of shares in dollar amounts at or above a breakpoint; or (ii) letter of

intent feature, if available, which will reduce the sales charges.

4.

In connection with the solicitation of investment company shares, recommending to a customer the purchase of a specific class of investment company shares in connection with a multi-class sales charge or fee arrangement without reasonable grounds to believe that the sales charge or fee arrangement associated with such class of shares is suitable and appropriate based on the customer's investment objectives, financial situation and other securities holdings, and the associated transaction or other fees.

B. Recommendations:

1.

In connection with the solicitation of investment company shares, recommending to a customer the purchase of investment company shares which results in the customer simultaneously holding shares in different investment company portfolios having similar investment objectives and policies without reasonable grounds to believe that such recommendation is suitable and appropriate based on the customer's investment objectives, financial situation and other securities holdings, and any associated trans-action charges or other fees.

2.

In connection with the solicitation of investment company shares, recommending to a customer the liquidation or redemption of investment company shares for the purpose of purchasing shares in a different investment company portfolio having similar investment objectives and policies without reasonable grounds to believe that such recommendation is suitable and appropriate based on the customer's investment objectives, financial situation and other securities holdings and any associated transaction charges or other fees.

C. Disclosure:

1.

In connection with the solicitation of investment company shares, stating or implying to a customer the fund's current yield or income without disclosing the fund's most recent average annual return, calculated in a manner prescribed in SEC Form N-1A, for one, five and ten year periods and fully explaining the difference between current yield and total return; provided, however, that if the fund's registration statement under the Securities Act of 1933 has been in effect for less than one, five, or ten years, the time during which the registration statement was in effect shall be substituted for the periods otherwise prescribed.

2.

In connection with the solicitation of investment company shares, stating or implying to a customer that the

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investment performance of an investment company portfolio is comparable to that of a savings account, certificate of deposit or other bank deposit account without disclosing to the customer that the shares are not insured or otherwise guaranteed by the FDIC or any other government agency and the relevant differences regarding risk, guarantees, fluctuation of principal and/or return, and any other factors which are necessary to ensure that such comparisons are fair, complete and not misleading.

3.

In connection with the solicitation of investment company shares, stating or implying to a customer the existence of insurance, credit quality, guarantees or similar features regarding securities held, or proposed to be held, in the investment company's portfolio without disclosing to the customer other kinds of relevant investment risks, including but not limited to, interest rate, market, political, liquidity, or currency exchange risks, which may adversely affect investment performance and result in loss and/or fluctuation of principal notwithstanding the creditworthiness of such portfolio securities.

4.

In connection with the solicitation of investment company shares, stating or implying to a customer: (i) that the purchase of such shares shortly before an ex-dividend date is advantageous to such customer unless there are specific, clearly described tax or other advantages to the customer; or (ii) that a distribution of long-term capital gains by an investment company is part of the income yield from an investment in such shares.

5.

In connection with the solicitation of investment company shares, making: (i) projections of future performance; (ii) statements not warranted under existing circumstances; or (iii) statements based upon non-public information.

D. Prospectus: In connection with the solicitation of investment company shares, the delivery of a prospectus, in and of itself, shall not be dispositive that the broker dealer or agent provided the customer full and fair disclosure.

E. Definitions: For the purpose of this rule the following terms shall mean:

1.

"Recommend": any affirmative act or statement that endorses, solicits, requests, or commends a securities transaction to a customer or any affirmative act or statement that solicits, requests, commands, importunes or intentionally aids such person to engage in such conduct.

2.

"Solicitation": any oral, written or other communication used to offer or sell investment company shares excluding any proxy statement, report to shareholders, or other disclosure document relating to a security covered under

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Section 18(b)(2) of the Securities Act of 1933 that is required to be and is filed with the Commission or any national securities organization registered under Section 15A of the Securities Exchange Act of 1934.

(Note: This Statement of Policy is intended to supplement, not supplant, the NASAA Statement of Policy Regarding the Dishonest or Unethical Business Practices.)

Adopted April 27, 1997

I.

INTRODUCTION. The North American Securities Administrators Association, Inc. ("NASAA") has determined that the following guidelines relating to PROMOTERS' EQUITY INVESTMENT in PROMOTIONAL OR DEVELOPMENT STAGE COMPANIES is consistent with public investor protection and is in the public interest. Nothing shall prevent the Securities Administrator ("Administrator") from applying different standards than those contained in this Statement of Policy.

II.

DEFINITIONS. The terms used in this Statement of Policy are defined pursuant to the NASAA Statement of Policy Regarding Corporate Securities Definitions.

III.

A public securities offering by a PROMOTIONAL OR DEVELOPMENT STAGE COMPANY may be disallowed by the Administrator if the PROMOTERS' EQUITY INVESTMENT is less than:

A.

Ten percent (10%) of the first \$1,000,000 of the aggregate public offering; and

B.

Seven percent (7%) of the next \$500,000 of the aggregate public offering; and

C.

Five percent (5%) of the next \$500,000 of the aggregate public offering; and

D.

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Two and one-half percent (2 1/2 %) of the balance over \$2,000,000,

which may include items submitted by the PROMOTER to meet this requirement whose value has been accepted by the Administrator.

Adopted by the NASAA Membership on April 17, 1994

I. INTRODUCTION.

A.

Application.

1.

The standards contained in this Guideline apply to the offer and sale of debt securities in the form of general obligation financing, such as notes, certificates, or similar debt instruments (herein referred to as NOTES) issued by a religious DENOMINATION, or a national or regional unit thereof or other entity affiliated or associated therewith (herein collectively referred to as a "CHURCH EXTENSION FUND" or "CEF"), the proceeds of which primarily finance or refinance the purchase, construction or improvement of church property and/or buildings or related capital expenditures or the operational needs of various affiliated churches and related religious organizations "related organizations" of the DENOMINATION.

2.

While offers and sales not conforming to the standards contained herein shall be looked upon with disfavor, if good cause is shown certain standards of the Guideline may be modified or waived by the ADMINISTRATOR.

3.

This Guideline is not applicable to single project financing by individual churches or congregations, which is the subject of a separate Statement of Policy entitled "Church Bonds" that was adopted by the North American Securities Administrators Association, Inc. on April 29, 1981.

COMMENT:

General obligation financing by a CEF is different in its purposes and operation than the one-time offering of Church Bonds by an individual church or congregation to finance the construction of a single, specific church building or other related capital improvements, in which all of the securities are repaid within a set period of time. CEF NOTES are sold for various terms and at varying interest rates and the offerings are normally continuous in nature to provide an ongoing source of financing to the various affiliated churches and related organizations. In order to maintain the CEF as a permanent resource for the affiliated churches and related organizations, repayments of principal on loans made by the CEF are continuously reinvested in new loans to affiliated churches and related organizations. A CEF normally is a single purpose organization and has no significant operating activities other than raising funds and

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making capital loans to its affiliated churches and related organizations. Since the CEF is generally incorporated and operated separately from the DENOMINATION and its affiliated churches and related organizations, assets of the CEF are used primarily for the purpose of financing building projects for affiliated churches and related organizations. To the extent the CEF is a separately incorporated entity, it normally is not liable for any debts arising from other unrelated activities or programs of the DENOMINATION or its affiliated churches and related organizations. The history of most CEFs reflects an absence of delinquency or default in payments on amounts owed under their NOTES. The primary indebtedness of most CEFs consists of the outstanding NOTES. A significant number of INVESTORS reinvest with the CEF when their NOTES mature. Therefore, the establishment of any special repayment provisions, including a sinking fund or trust indenture, for the purpose of making payments on principal or interest due on NOTES, is normally unnecessary and inappropriate in view of the continuous nature of the offerings and the fact that the funds are not designated for specific capital projects.

B.

Definitions.

1.

ADMINISTRATOR--The official or agency administering the securities law of a state.

2.

ADVERTISING--Advertising and promotional materials, including, but not limited to, magazine or newsletter advertisements, brochures, video tapes, fliers church bulletin inserts and mailers, that are used, in addition to OFFERING CIRCULAR, to solicit INVESTORS.

3.

AUDITED FINANCIAL STATEMENTS--Financial statements prepared in accordance with generally accepted accounting principles applied on a consistent basis, and examined and reported upon by an independent certified public accountant.

4.

CHURCH EXTENSION FUND ("CEF")--A unit or division of a DENOMINATION or other entity affiliated or associated with a DENOMINATION that offers and sells NOTES primarily to provide funding for loans for construction and other related capital improvements or operating needs to various affiliated church and related religious organizations of the DENOMINATION.

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5.

DENOMINATION--A national or regional religious organization or association that consists of or acts on behalf of its individual affiliated churches as well as the various national or regional administrative and other religious organizations or units affiliated with the DENOMINATION.

6.

DENOMINATIONAL ACCOUNTS--Demand and short-term obligations and accounts issued by the CEF and held by national, regional or other affiliated units, institutions or organizations of the DENOMINATION, exclusive of demand and short-term NOTES which are generally offered and sold through OFFERING CIRCULARs pursuant to the registration, exemption or qualification process.

7.

INVESTOR(S)--PERSON(S) who purchase(s) NOTES.

8.

ISSUER--The CEF that offers and sells NOTES.

9.

LOAN DELINQUENCIES--Borrower's loan balances on which payments of principal or interest are delinquent ninety (90) days or more whether in default or not.

10.

NET INCOME--All items of CEF income and revenue, including operating income, gift revenues and gains or losses from investments, less all items of expense, as reflected in the CEF's AUDITED FINANCIAL STATEMENTS.

11.

NET WORTH--The unrestricted equity or fund balance that represents the difference between assets and liabilities, as reflected in the CEF's AUDITED FINANCIAL STATEMENTS. (Internally restructured funds may be considered unrestricted for this purpose).

12.

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NOTES--Notes, certificates, or similar debt instruments issued by a CEF which represent a general unsecured obligation to repay a specific principal amount, at a stated or variable rate of interest, when due.

13.

OFFERING CIRCULAR--The disclosure document prepared by the ISSUER.

14.

PERSON--An individual, a corporation, a limited liability company, a partnership, an association, a joint-stock company, a trust, an unincorporated organization, a government or a political subdivision of a government, or other legal entity.

15.

SEASONED ISSUER--A CEF that, alone or through a predecessor organization, has been in continuous existence for more than ten (10) years, has offered NOTES for more than ten (10) years, and has paid or otherwise satisfied all uncontested obligations to pay principal and interest on its NOTES in a timely manner.

16.

SENIOR SECURED INDEBTEDNESS--Any debt or debt securities incurred or issued by a CEF and secured by assets of the CEF in such a manner as to have a priority claim against any of the assets of the CEF over and above the NOTES.

II. QUALIFICATION, LICENSING AND MARKETING REQUIREMENTS.

A.

Qualification Requirements. An ISSUER shall take all steps required under applicable state securities law to insure compliance with the registration or exemption provisions in all states in which it intends to offer and sell NOTES. Filing, procedural and review requirements will vary among the states. A CEF shall file such forms and pay such fees and comply with the filing, procedural and review requirements to achieve qualification for the offer and sale of its NOTES in each state, whether by registration, exemption or otherwise, as determined by that state's securities laws, rules and regulations.

COMMENT:

It is anticipated that the NOTES will be exempt from federal registration pursuant to Section 3(a)(4) of the Securities Act of 1933, as amended. Individual states have adopted their own securities laws to govern the offer and sale of securities within their respective jurisdictions. NOTES are securities under state securities laws. Many states, however, have adopted laws based upon the Uniform Securities Act, which contains an exemption from registration for the NOTES that is similar to the exemption contained

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in the Securities Act of 1933. There are certain states, however, which do not exempt the NOTES from registration. Furthermore, certain other states provide an exemption from registration but require notice filings or administrative approval before the exemption is available.

B.

No Fees and Commission. The NOTES shall be offered and sold without the payment of any direct or indirect underwriting, sales or similar fees or commissions.

C.

Licensing Requirements.

1.

General Policy. An ISSUER shall comply with the applicable broker-dealer and agent licensing requirements in each state in which it offers or sells NOTES.

2.

Waiver. If a state's securities laws or regulations allow, the ADMINISTRATOR may consider waiving:

a.

Testing requirements;

b.

Broker-dealer registration requirements; and/or

c.

Agent registration requirements with respect to officers, directors or other employees of the CEF ("Agents"), who represent the CEF in effecting or attempting to effect offers and sales of the NOTES, provided, however, the Agents:

1)

Receive no commission or similar remuneration in connection with the offer and sale of the NOTES;

2)

Perform significant functions for the CEF other than the sale of NOTES; and

3)

Represent only the CEF in effecting or attempting to effect offers and sales of securities.

COMMENT:

When an ADMINISTRATOR considers waiving certain registration and testing requirements, the following factors may be considered. Agents normally are officers, directors, or employees of the CEF. The offer and sale of the NOTES are to a limited class of INVESTORS and not to the general public. The communications with prospective INVESTORS by the Agents normally are accomplished at the offices of the CEF through delivery of the OFFERING CIRCULAR and other written communications by means of the U.S. mails or through verbal communications. In connection with any such waiver, an ADMINISTRATOR may collect such fees as are appropriate and required and shall require such affidavits or documents as are deemed appropriate and necessary.

D.

Limited Class of INVESTORS. The NOTES shall be sold to a limited class of INVESTORS. Each ISSUER should define a limited class of INVESTORS that is consistent with its operations and is compatible with the structure, organization and theology of its DENOMINATION. A suggested form of limited class of INVESTORS is:

PERSONS who were, prior to the receipt of the OFFERING CIRCULAR, members of, contributors to (including INVESTORS), or participants in the DENOMINATION, the CEF or in any program, activity or organization which constitutes a part of the DENOMINATION or the CEF, or in other church organizations that have a programmatic relationship with the DENOMINATION or the CEF.

COMMENT:

It is recognized that the concept of "membership" or similar nomenclature within the various DENOMINATIONS involves various church structure, organizational and/or theological concepts with which federal and state governmental entities cannot and should not interfere. Most CEFs presently direct their offering efforts to PERSONS who have some reasonable association or affiliation with the CEF, its affiliated DENOMINATION or its religious programs.

E.

Advertising.

1.

General Standards. An ISSUER may use ADVERTISING that complies with the following standards:

a.

ADVERTISING shall set forth a statement to the following effect:

This shall not constitute an offer to sell or the solicitation of an offer to buy, nor shall there be any sale of these securities in any state in which such offer, solicitation or sale is not authorized. The offering is made solely by the OFFERING CIRCULAR.

b.

ADVERTISING shall be directed to PERSONS who fall within, or potentially will fall within, the limited class of INVESTORS described in II. D. above.

c.

ADVERTISING shall not set forth statements, data or information that:

(1)

Is inconsistent with the statements, data or information set forth in the OFFERING CIRCULAR; or

(2)

When read in connection with the OFFERING CIRCULAR renders either the OFFERING CIRCULAR or ADVERTISING misleading or confusing.

2.

Filing.

a.

If required by state law or by the ADMINISTRATOR, ADVERTISING shall be filed with the ADMINISTRATOR prior to use.

b.

ADVERTISING, filed pursuant to II.E.2.a., above, that is subsequently materially changed or modified during the applicable offering period, except as provided in II.E.2.c., below, shall be filed with the ADMINISTRATOR as a notice filing concurrently with its use, provided that the changes and modifications are clearly marked, and the ADVERTISING changes and modifications comply with II.E.1. above.

c.

ADVERTISING, that has been filed with the ADMINISTRATOR, and which is subsequently changed or modified in a non-material manner, need not be refiled unless it is required by the ADMINISTRATOR.

III. OPERATIONAL AND STRUCTURAL STANDARDS.

A.

Organization and Structure. A CEF shall be an organization that is organized and operates exclusively for religious, charitable or educational purposes and as an organization described in *Section 501(c)(3) of the Internal Revenue Code of 1986*, as amended.

B.

Exempt from Federal Registration. The NOTES offered and sold by a CEF shall be exempt from registration pursuant to the provisions of Section 3(a)(4) of the Securities Act of 1933, as amended.

C.

General Obligation Securities. The NOTES offered by a CEF shall be offered under one or more programs of general obligation financing.

1.

The NOTES are not specifically secured by particular loans to specific borrowing entities.

2.

The proceeds from the NOTES are deposited to a general fund from which the CEF makes and completes commitments for loans primarily to churches and religious organizations affiliated with the DENOMINATION.

3.

To the extent that a material amount of operating revenues or expenses of the CEF arise out of activities other than general obligation financing programs, appropriate disclosure of such activities shall be made.

4.

In all cases there shall be a separate accounting for the operations of the CEF.

D.

Limited Senior Secured Indebtedness. Except as provided in the COMMENT below,

NOTES that are offered by a CEF normally shall be of the same rank and priority as its other debt securities and debt obligations.

1.

The amount of any SENIOR SECURED INDEBTEDNESS to which the NOTES are or will be subordinated shall not exceed ten percent (10%) of the tangible assets of the CEF.

2.

To the extent that such subordination of the NOTES exists, appropriate disclosure shall be required.

COMMENT:

Within the operations of a CEF, SENIOR SECURED INDEBTEDNESS is often in the form of: (1) a mortgage loan incurred for the purchase of an advance church site or headquarters building and/or (2) a secured operating line of credit with a commercial financial institution.

IV. FINANCIAL STANDARDS.

A.

General. An ISSUER should offer and sell no more NOTES than it can reasonably expect to repay, when due, in the ordinary course of its business. Although each offering must be viewed in the context of the individual facts and circumstances surrounding each ISSUER and its offering, the following are the financial standards which an ADMINISTRATOR may consider in reviewing a proposed offering.

COMMENTS:

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To the extent that the AUDITED FINANCIAL STATEMENTS or the other information in the OFFERING CIRCULAR do not disclose sufficient information to evaluate the extent of compliance with the standards in this Guideline, the ISSUER shall furnish supplemental data and information to the ADMINISTRATOR. Further, an ISSUER may be deemed to have complied with the standards in this Guideline even if it fails to meet one or more of the standards at the time of any one offering period, if: the ISSUER complies with or exceeds the requirements of the remaining standards; and the information and data furnished reflects the ability of the ISSUER to repay its NOTES and other debt obligations when due in the ordinary course of business.

B.

Capital Adequacy. At the end of its most recent fiscal year, the ISSUER's NET WORTH shall be positive and at least equal to three percent (3%) of its total assets.

COMMENT:

This standard should be evaluated in the light of the financial operating history of the CEF.

C.

Liquidity Status. At the end of its most recent fiscal year, the ISSUER's cash, cash equivalent and readily marketable assets shall have market value of at least five percent (5%) of the principal balance of its total outstanding NOTES.

COMMENT:

In evaluating compliance with this standard, the ADMINISTRATOR also may consider the ISSUER's other sources of immediately available funds, such as a line of credit or other source of credit with a bank or other financial institution.

D.

Cash Flow Performance. For each of the ISSUER's three (3) most recent fiscal years and, as estimated, for each of the ISSUER's next two (2) fiscal years, the coverage ratio of available cash as compared to cash redemptions, exclusive of DENOMINATIONAL ACCOUNTS, shall be at least one to one (1:1). In determining the ISSUER's available cash, the ADMINISTRATOR may consider:

1.

Cash provided by its normal operating activities;

2.

Liquid assets (market value) at the beginning of its fiscal year;

3.

Loan principal repayments;

4.

Cash generated from the sale of NOTES, exclusive of DENOMINATIONAL ACCOUNTS, except to the extent that year-end redemptions exceed deposits to, or investments in, such DENOMINATIONAL ACCOUNTS during its fiscal year;

5.

Funds from other sources; and

6.

Loan disbursements.

COMMENT:

For the ISSUER's next two (2) fiscal years, projected cash redemptions may be based on the ISSUER's five (5) year historical experience by applying the average percent of actual redemptions compared to maturing obligations each year. For the ISSUER's next two (2) years, projected cash generated from the sale of NOTES may be based on the ISSUER's five (5) year historical experience, by calculating the average amount of cash generated from its sale of NOTES, exclusive of DENOMINATIONAL ACCOUNTS, for its five (5) year historical period. Further, in determining the amount of the ISSUER's available cash, the ADMINISTRATOR also may consider any other source of immediately available funds, such as a line of credit or other source of credit with a bank or other financial institution.

E.

Loan Quality.

1.

LOAN DELINQUENCIES during the ISSUER's most recent fiscal year, reviewed in light of its historical operating experience, shall not be excessive and shall be at such a level that the overall quality of its loan portfolio will allow the ISSUER:

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a.

To maintain a positive NET WORTH; and

b.

Receive the timely repayments of sufficient loan principal necessary to meet the liquidity and cash flow requirements as set forth in IV. C. and D. above.

2.

When the LOAN DELINQUENCIES become material, the extent of the LOAN DELINQUENCIES and the quality of the ISSUER's loan portfolio should be disclosed as risk factors in the OFFERING CIRCULAR.

F.

Profitability. The ISSUER's NET INCOME, less any non-recurring or extraordinary items, for three (3) of its last five (5) fiscal years shall be positive.

G.

SEASONED ISSUER Compliance. A SEASONED ISSUER shall be deemed to comply with the above financial standards in any given fiscal year, if it can show that:

1.

It has fulfilled the requirements of the financial standards for at least three (3) out of its five (5) most recent fiscal years;

2.

The average of its five (5) most recent fiscal years reflects compliance with the financial standards; or

3.

The information and data furnished indicates the ability of the SEASONED ISSUER to repay its NOTES and other debt obligations when due in the ordinary course of its business.

V. ISSUANCE OF NOTES. An ISSUER that meets the standards of this Guideline shall be entitled to offer and sell

its NOTES under the following provisions.

A.

No Trust Indentures or Sinking Fund Required. Trust indentures or sinking funds shall not be required in connection with the NOTES.

B.

Extension or Roll-Over After Notice. NOTES, upon maturity, may be extended or rolled over under the expressed terms and conditions stated in the OFFERING CIRCULAR, if:

1.

Each INVESTOR is provided with written notification of the maturity and the proposed extension of rollover of the NOTES at least thirty (30) days prior to the NOTES' maturity dates;

2.

Each INVESTOR is or has been provided with the ISSUER's most current OFFERING CIRCULAR; and

3.

The INVESTOR notifies the ISSUER in writing on or prior to the maturity date that the INVESTOR elects not to extend or roll-over the NOTE, the ISSUER promptly shall repay the principal and interest accrued thereon.

C.

Compound Interest. NOTES may contain provisions pursuant to which interest payable thereon may be retained and compounded.

VI. DISCLOSURE To insure that INVESTORS receive adequate information to make informed investment decisions, the ISSUER must provide INVESTORS with OFFERING CIRCULARS prior to their investments.

VII. OFFERING CIRCULAR. The OFFERING CIRCULAR should include a narrative or descriptive form of all of the relevant and material information relating to the ISSUER and the NOTES, and any other material information that affects or would affect an offeree's decision to purchase the NOTES. The following materials and relevant information must be included in the OFFERING CIRCULAR.

A.

Cover Page.

1.

The name of the ISSUER.

2.

The ISSUER's principal business address and telephone number.

3.

A brief description of the NOTES offered including interest rates and maturity terms available.

4.

The total amount of the offering, the estimated offering expenses and the net proceeds of the offering.

5.

A statement that the offering is subject to certain risks and the page(s) of the OFFERING CIRCULAR that disclose(s) the risk factors.

6.

The limited class of INVESTORS to whom the NOTES will be sold.

7.

Any legends that are required by applicable state laws, rules or regulations, or are deemed to be appropriate by the ADMINISTRATOR.

8.

The date of the OFFERING CIRCULAR.

COMMENT:

An ISSUER may use a national OFFERING CIRCULAR in all states or jurisdictions in which it offers and sells its securities. Disclosure of specific legends or other information may be required by various state laws, rules or ADMINISTRATORS. If there is insufficient space on the front side of the cover page of the OFFERING CIRCULAR for the information and materials described in VII.A.6. and A.7., above, or when otherwise appropriate, such information and materials may be disclosed on the reverse side of the cover page or on additional pages immediately following the cover page of the OFFERING CIRCULAR.

B.

Specific State Information.

1.

Set forth any required state legends and other information unique to the state required by law or through the state review process.

2.

Set forth any limitations on the sale of the NOTES to investors in any state.

C.

History and Operations.

1.

Describe the ISSUER, including the name, address of principal business office, state and date of incorporation, type and nature of the corporation (not-for-profit, tax exempt, etc.).

2.

Describe the history of the ISSUER and its denominational affiliation or association.

3.

Describe the religious purposes of the ISSUER and the general nature and purposes of its operations.

4.

Describe the nature and extent of the offering of the NOTES and the extent of the ISSUER's offerings on a nationwide basis.

5.

Describe the current operation and principal business activities of the ISSUER.

D.

Risk Factors.

1.

The OFFERING CIRCULAR must describe to the INVESTORS the risks of investing in the NOTES.

2.

Statements to the effect that little or no risk is involved in purchasing NOTES are prohibited, and such statements by an ISSUER will be regarded as material misrepresentations.

3.

An ISSUER must fully describe all of the relevant risks including, if applicable:

a.

That the NOTES are unsecured general obligations of the ISSUER, and that the INVESTORS will be dependent solely upon the financial condition of the ISSUER for repayment of principal and interest;

b.

That no sinking fund or trust indenture has been or will be established;

c.

The ranking and priority of the NOTES in relation to the ISSUER's existing and anticipated future NOTES and indebtedness. (See III.D, above.)

d.

That no public market exists for the NOTES and that none will develop, and therefore the transferability of the NOTES is limited and restricted.

e.

The financial condition of the ISSUER, including any relevant information concerning its income or losses from operations and any other information relevant to the ISSUER's ability to make payments of principal and interest on the NOTES when due.

f.

The ISSUER's policy on the maintenance of liquid funds (reserves). g. The INVESTOR's tax consequences with respect to investments in the NOTES.

h.

That the ISSUER's loans are made primarily to affiliated churches and related religious organizations, including local churches, whose ability to repay the loans depends primarily upon contributions that they receive from their members.

i.

The loan policies with respect to the ISSUER's relationship with its affiliated churches and its related religious organizations which distinguish it from commercial lenders.

j.

The risks involved in future changes in federal or state laws that may affect the ISSUER's ability to continue to sell its NOTES.

k.

The risks involved in the ISSUER's activities other than its CEF Operations.

E.

Use of Proceeds. Describe how the proceeds from the sale of the NOTES are to be used and other material information related thereto.

F.

Financing and Operational Activities. Describe the financing operations and activities of the ISSUER including:

1.

A description and summary, in tabular form, of the ISSUER's outstanding NOTES and debt obligations, categorized to the extent necessary to inform an INVESTOR of the nature and type of NOTES and debt obligations that it has sold and incurred. To the extent that the information is not disclosed in the AUDITED FINANCIAL STATEMENTS of the ISSUER or the footnotes attached thereto, the OFFERING CIRCULAR should include the principal amounts due at maturity.

2.

A description of the receipts that the ISSUER received from the sale of its NOTES and the amount of any redemptions that it made on its NOTES in its prior fiscal year.

3.

A description and summary, in tabular form, of the amount and nature of the ISSUER's outstanding loans receivable at the end of its last fiscal year. To the extent that the information is not disclosed in the AUDITED FINANCIAL STATEMENTS of the ISSUER or the footnotes attached thereto, the OFFERING CIRCULAR should include a summary of the maturities of the various outstanding loans receivable of the ISSUER.

4.

A description and summary of the nature and amount of any invested funds which the ISSUER maintains, pending utilization for its loan activities or maintaining a reasonable liquidity, and a description of the policies of the ISSUER with respect to the maintenance of such invested funds.

5.

A description of the ISSUER's direct and indirect non-related CEF revenues and expenses, if a significant percentage of the ISSUER's operating revenues or expenses arise out of its non-related CEF operations.

6.

A description of any other related material financial information of the ISSUER's financial activities and operations that relate to its ability to repay the principal and interest on its outstanding NOTES and other debt securities when due.

G.

Lending Activities. Describe the lending activities of the ISSUER such as:

1.

The nature and types of its loans receivable;

2.

Its loan policies;

3.

Material loans made to a single borrower;

4.

The nature and extent of any material LOAN DELINQUENCIES for its last three (3) fiscal years; and

5.

The nature and extent of any material loan losses that the ISSUER has incurred within its last three (3) fiscal years.

H.

Selected Financial Data.

1.

Set forth in tabular form certain selected financial data of the ISSUER's last five fiscal years, including: cash and liquid reserve balances, outstanding NOTES and debt obligations, outstanding loans receivable, fund balance, and NET INCOME (loss).

2.

Include, to the extent relevant and material, any discussion and analysis by management of the ISSUER that will assist INVESTORS in understanding the nature of the operations of the ISSUER and the occurrence of any item of income or loss arising out of its operations.

I.

Description of NOTES.

1.

Describe the type and nature of the NOTES and the manner in which the interest thereon will be computed and/or accrued.

2.

Describe the terms of the NOTES, including any right to early redemption and any penalties that will be applied thereto.

3.

Describe the nature of cash or cash equivalent that will be acceptable for purchase of the NOTES.

4.

Describe the restrictions and limitations on transferability of the NOTES.

5.

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Describe the ranking and priority of the NOTES in relation to other indebtedness of the ISSUER.

J.

Plan of Distribution.

1.

Describe the method and manner in which the NOTES will be offered and sold to INVESTORS, including the methods of solicitation and subscription.

2.

State that no underwriting or selling agreements exist, and that no direct or indirect commissions or other remuneration will be paid to any individuals or organizations in connection with the offer and sale of the NOTES.

COMMENT:

The NOTES will be offered and sold through officers and/or employees of the ISSUER or other representatives of the DENOMINATION.

K.

Tax Aspects. Describe the federal tax aspects of ownership of the NOTES and state that the interest paid or accrued on the NOTES will be taxable as ordinary income to INVESTORS.

L.

Litigation and Other Material Transactions.

1.

Describe all present, pending or threatened material legal proceedings, including those that are known to be contemplated by governmental authorities, administrative bodies, or other PERSONs to which the ISSUER or its property is or may become a party.

2.

Include the name of the court or agency in which the proceedings are pending, the date that the proceedings were instituted, the principal parties involved, a description of the factual basis underlying the proceedings and the relief

sought.

3.

Disclose any transactions that may materially affect the offering or an INVESTOR's investment decision and which are not otherwise mentioned in the OFFERING CIRCULAR.

M.

Management.

1.

Describe the organizational structure of the ISSUER, including how the members of its Board of Directors or other legal governing body are chosen or replaced.

2.

Identify all directors and executive officers or persons having similar authority of the ISSUER, and describe the functions they perform for the ISSUER and the dates that their terms of office expire.

3.

Disclose if any director or officer of the ISSUER has, during the past ten years, been convicted of any criminal proceeding (other than for traffic violations or other minor misdemeanors), is the subject of any pending criminal proceedings, or was the subject of any order, judgment or decree of any court enjoining such person from any activities associated with the offer or sale of securities.

4.

Disclose all direct and indirect remuneration paid by the ISSUER to its executive officers or directors or persons having similar authority for the ISSUER's last fiscal year in the aggregate and individually, if the remuneration, which includes, but is not limited to, salaries, pensions, retirement plans and the use of the ISSUER's assets for personal purposes, equals or exceeds the amount requiring disclosure as set forth in the rules and regulations of the Securities and Exchange Commission.

5.

Describe all material employment contracts, perquisites of employment and conflicts of interests of the

ISSUER's officers, directors, or persons having authority.

N.

Financial Statements.

1.

The ISSUER's AUDITED FINANCIAL STATEMENTS shall consist of:

a.

Statements of assets and liabilities (balance sheet) for its two most recent fiscal years;

b.

Statements of revenues and expenses (income statement or aggregation of fund balances) for its three most recent fiscal years;

c.

Statements of cash flows for its three most recent fiscal years;

d.

A description of any recent changes in its current accounting policies; and

e.

A copy of the report of the independent certified public accountant shall precede the financial statements.

2.

Any material adverse changes in the financial condition of the ISSUER during the offering period shall be promptly disclosed in an appropriate supplement, or an amendment to the OFFERING CIRCULAR, and shall be promptly filed with each ADMINISTRATOR.

O.

Investor Reports. The OFFERING CIRCULAR shall state that the ISSUER's current AUDITED FINANCIAL STATEMENTS will be made available to INVESTORS upon written request, and will be mailed to INVESTORS within 120 days of its last fiscal year end.

COMMENTS:

This outline is not all inclusive, and individual circumstances surrounding each ISSUER should be taken into account in determining what is material and relevant and what should be disclosed in the OFFERING CIRCULAR. All unique or unusual aspects or features that are material or relevant to the ISSUER, which are not covered by this outline, should be disclosed in the OFFERING CIRCULAR. Any disclosure suggested in the outline that is not material or relevant to the ISSUER's offering or its operations need not be included in the OFFERING CIRCULAR.

Statement of the North American Securities Administrators Association

Adopted, March 26, 1995.

II.

The members of the North American Securities Administrators Association ("N.A.S.A.A.") are aware that certain broker-dealers have established local offices by purportedly franchising the operations of these offices to individuals who then engage in the conduct of securities business. These broker-dealers may regard their registered agents, who operate within these "franchised" offices, as independent contractors. Such agents may conduct business with the public in the name of the broker-dealer who sponsored the agents or under a name that gives the appearance that the office is a different entity. N.A.S.A.A. is concerned that broker-dealers who attempt to establish independent contractors or franchised local offices may believe that supervisory duties and liabilities do not apply to these agents and local offices. Under the Uniform Securities Act, any person who sells or purchases securities for another person is, by definition, either a "broker-dealer" or an "agent" unless that person falls within an exception to the appropriate definition. Section 401(c) of the Uniform Securities Act defines a "broker-dealer" as any person engaged in the business of effecting transactions in securities for the account of others or for his own account. Although the definition provides certain exceptions, none of the exceptions is based upon one's status as an independent contractor or franchise. Section 401 (b) of the Uniform Securities 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. Nowhere in the definition of an "agent" is an independent contractor or franchisee excluded from the definition. Therefore, neither the classification of an office as a "franchisee" nor the classification of an agent as an "independent contractor" alters the supervisory responsibilities of a broker-dealer imposed under the Uniform Securities Act. Section 204(j) of the Uniform Securities Act provides that an administrator may deny, suspend, or revoke the registration of a broker-dealer if the broker-dealer has failed to supervise reasonably its agents. The broker-dealer is legally bound by this supervision requirement regardless of any belief that its agents are independent contractors or that a branch office is an independent franchisee. By causing its agent to become registered as an agent, or by sponsoring an agent's registration application, a broker-dealer legally consents to this statutory supervision requirement for all its offices and agents and is legally responsible for any acts of an agent in connection with the broker-dealer's securities business, including acts which the broker-dealer may consider to be outside the scope of the agent's representation of the broker-dealer. In conclusion, it is the position of N.A.S.A.A. that purported "independent contractor" and "franchisee" status does not alter the relationship between a broker-dealer and its agents under the Uniform Securities Act. Any agent sponsored by a

broker-dealer and registered by a jurisdiction through such sponsorship is a representative of the broker-dealer in the conduct of securities business for all regulatory purposes, regardless of any agreement between the broker-dealer and the agent relating to "independent contractor" or "franchisee" status. Unless an agent is registered separately as a broker-dealer, the agent is considered to be a representative of the sponsoring broker-dealer, acting on its behalf. Similarly, unless an office is registered separately as a broker-dealer, that office is considered to be a local office of the sponsoring broker-dealer, acting on its behalf through its agents, and not an independent franchisee.

Statement of the North American Securities Administrators Association STATEMENTS OF POLICY_and_@_NASAA SOP)_and_footnotes(n1);.vk n1

Adopted, April 29, 1989.

I. Introduction

The number and dollar amount of securities transactions among the world's securities markets soared during the 1980s. This phenomenon was precipitated by the convergence of several factors. Most dramatic, perhaps were technological advances witnessed in global telecommunications and fund transfer systems operated by international banking systems.

During this period, significant shifts were observed in official government policy of many countries towards injecting competition into the private sector by dismantling domestic monopolies and withdrawing support from nationalized industries. This policy was manifested by several large flotations on the stock markets of shares of nationalized companies being privatized, most notably those in Great Britain. Also, public policy in countries outside North America now encourage individual share owning.

Governments realized, however, that individual investors needed protection from unscrupulous promoters and sharp business practices of brokers. Therefore, most embarked on either implementing a new comprehensive scheme of securities regulation or substantially strengthened existing regulation. Governments understood that the public would participate only in markets which were perceived as fair and honest due to investor protections afforded by a regime of effective securities regulation.

Another, but sinister, participant in the internationalization of the securities markets has been the criminal element. Launderers of drug monies, insider trading rings, and securities defrauders operating from protected havens have expanded their activities into the emerging international securities markets. Domestic markets which traditionally have been concerned with protecting investors from unscrupulous persons operating within their own jurisdiction now are confronted with threats to the integrity of their markets emanating from countries far from their borders.

The foregoing developments pose numerous challenges to the mission of securities regulators of maintaining the integrity of their capital markets through enforcement of investor protection standards while simultaneously according investor and market access to legitimate capital-raising activities spanning national borders.

II. Investor Protection

The development and growth of international securities require that minimum standards of investor protection be established and made applicable to issuers, broker-dealers, investment advisers and other securities professionals dealing with investors in international securities transactions.

A. Securities Registration and Disclosure

Investors participating in international securities transactions should be protected by registration and prospectus requirements. Although such requirements may vary according to the type of transaction or sophistication of the

investor, certain minimum standards should be established. Such standards would address disclosure, financial information prepared under commonly accepted accounting principles, auditing standards, auditor independence and other principles consistent with the protection of public investors. STATEMENTS OF POLICY_and_@_NASAA SOP)_and_footnotes(n2);.vk n2

In addition, regulators should support the requirement of continuous disclosure to the securities markets by issuers whose securities are freely traded. Monitoring and compliance with public disclosure requirements should be vested in a government regulator.

Regulatory review of private placements, or according a right of access by the regulator to disclosure documents being used in a private placement should be maintained. A recent survey of one rather large NASAA state indicated that of all filings made by foreign issuers with that jurisdiction during the last 6 months, over 50% of such filings were private placements and therefore exempt from review by the U.S. Securities and Exchange Commission (SEC). As evidenced by the number of such enforcement cases brought annually by NASAA jurisdictions, regulators also have experienced a significant amount of enforcement problems in this area.

B. Broker-Dealer and Investment Adviser Regulation

All firms engaged in the business of effecting transactions in, or advising on the purchase or sale of, securities should be required to obtain a license for the conduct of such business from a securities regulator. The regulator should have authority to deny a license if the applicant does not possess sufficient capital to enter the business or its principals lack minimum knowledge and experience in the securities business.

Similarly, a record of past serious securities law violations of any jurisdiction, rules of a self-regulatory organization or significant evidence of customer abuse or dishonest or unethical practices in the securities business should constitute grounds for denial of a license. Disclosure to prospective customers of prior securities law violations should be mandatory.

As broker-dealers and investment adviser activities expand across national borders and subsidiaries are established in other national jurisdictions, securities regulators must work together to develop consistent capital adequacy standards for such firms to ensure stability and liquidity. Special attention must be paid to those jurisdictions which permit banks or bank subsidiaries to engage in the securities business.

For those firms with foreign subsidiaries, the relevant regulators should establish open lines of communication among counterparts in the parent company's domicile and other jurisdictions where foreign subsidiaries have been established to become better informed about the global activities of such firms. Thus, regulators would be in a better position to respond to events which might have an adverse effect on the financial and operational activities of such firms in their domestic markets.

C. Cooperative Enforcement Efforts

Criminal elements also are taking advantage of the internationalization of the securities markets. It is now not uncommon that illegal activities occurring in the domestic market of one country, or multiple countries, are being controlled by persons resident in another country, often in a jurisdiction which affords protection to such persons through blocking statutes and bank secrecy laws. Those countries should seek to narrow the application of such laws only to bona fide and legitimate purposes and permit exceptions where regulators are able to indicate that those laws are being used to shield unscrupulous activity. Further, countries which require that an activity must be illegal in its jurisdiction before rendering enforcement assistance should reconsider such a policy which acts as a deterrent to cooperative law enforcement efforts.

Securities regulators should recognize that their enforcement programs must include an international dimension. Responses to inquiries from foreign regulators should be made with dispatch. Establishment of agreements governing on-going exchanges of investigatory and regulatory information should be encouraged.

NASAA, the SEC, and other securities regulators have endorsed the Cooperative Enforcement Resolution passed by the International Organization of Securities Commissions (IOSCO) in 1987.

In addition, NASAA members, as well as the SEC, have entered into several Memoranda of Understanding with foreign securities regulators to facilitate an ongoing exchange of regulatory and enforcement information. This activity should continue.

In 1968, NASAA began exploring, through a written survey among global securities regulators and law enforcement agencies, the feasibility of establishing an International Securities Law Violators Data Base. This would serve as a clearinghouse of *public* actions taken against securities law violators submitted by program participants. It is further evidence of the multinational cooperation required to be effective regulators in the 1990s.

III. Facilitating Legitimate Transnational Capital Formation

Securities regulators should encourage legitimate capital raising activities which span national borders. Artificial barriers to entry into domestic markets by foreign competitors should be eliminated to produce a level playing field for all participants. The level playing field, however, should be governed by minimum rules to ensure investor protection. Regulation S proposed by the SEC and the participation of NASAA with the SEC and Canada in development of the multijurisdictional securities registration project evidence such activity.

Regulators should look to methods to ease administrative burdens which may accompany compliance with such rules. STATEMENTS OF POLICY_and_@_NASAA SOP)_and_footnotes(n3);vk n3

Among other things, consideration should be given to establishment of centralized depositories for receipt of licensing and securities registration documents which would be re-distributed to appropriate regulatory authorities for review, comment and approval.

Given continued technological advances, it is conceivable that the foregoing would be facilitated through a computerized system with access afforded the applicants/registrants in their own offices by means of a desktop computer terminal.

Both NASAA and the SEC have been long involved in such efforts. NASAA spearheaded the development of the Central Registration Depository which centrally receives and then re-distributes documentation for broker-dealer and agent licensure in the United States. NASAA also has worked alongside the SEC in the development of the EDGAR program which aims to centralize filing of securities registration and disclosure documents.

IV. Coordination, Mutual Assistance and Consultation

A. Coordination

Coordination and acceptance of a common standard by securities regulators in the following several areas are crucial if a truly international securities market is to develop: accounting principles for the presentation of financial information; auditing standards; auditor independence principles; capital adequacy ratios for brokerage firms (including definitive treatment of bank and non-bank firms) routing, execution, clearance and settlement systems; and securities registration systems.

Regulators should participate in international organizations such as IOSCO and the International Accounting Standards Committee to develop commonly acceptable rules.

B. Mutual Assistance

Securities regulators should provide assistance to other government agencies, international organizations, self-regulatory organizations and other bodies whose goal is providing investor protection in the international securities markets. Those organizations which possess a long history of experience in regulating the securities markets have a unique opportunity to assist other jurisdictions which recently have enacted a scheme of securities regulation or are attempting to foster legitimate capital markets in their own countries as a means of increasing their economic vitality. Those regulators should view positively such opportunities recognizing, however, that the culture and economic realities of another jurisdiction may not be suitable for transplanting intact the regulatory regime of one country to another. Relating experiences, rather than form, is more important.

C. Consultation

Securities regulation and regulatory structures have evolved based upon national history, political realities and accepted business practices in each particular culture. In many jurisdictions, regulatory authority is shared, either with private corporations with public responsibilities (e.g., stock exchanges and self-regulatory organizations) or other governmental authorities. Each regulator has a valuable history of regulatory experience, but more importantly, a legal duty to acquit certain public responsibilities. STATEMENTS OF POLICY_and_@_NASAA SOP)_and_footnotes(n4);.vk n4

In the consultative process, which must occur if an integrated, functional international securities market is to be achieved, great care should be taken not to overlook the views and potential contributions of all regulatory bodies. The tasks are so enormous that no one regulator or privileged group of regulators could possibly address all the nuances of each issue requiring examination.

Although some organizations undoubtedly will emerge in a leadership role, the fruits of the process depend directly upon the concrete contributions made. As securities regulators with over 70 years experience, the government agencies comprising the NASAA membership have made, and will continue to make, important contributions toward the internationalization process consistent with their statutory mandate of providing investor protection.

NASAA has been alert to the issues implicit in the internationalization of the securities markets and has addressed many of them. It intends to be a partner with all other securities regulators in the consultative process which no doubt will continue well into the next decade.

The views expressed by NASAA in this Statement on Internationalization of the Securities Markets are designed to stimulate discussion concerning regulation of the international securities markets. It does not necessarily reflect the position of any individual NASAA jurisdiction.

Comments may be addressed to Mr. John C. Baldwin, NASAA President and mailed to the NASAA Corporate Office at 555 New Jersey Ave., N.W., Suite 750, Washington, D.C. 20001, with a copy to Mr. Wayne Klein, Chair, NASAA Internationalization Committee, Idaho Securities Bureau, 700 W. State St., Boise, ID 83720.

Anyone issuing securities in the United States must comply with state securities laws with respect to offering or selling securities, effecting transactions in securities or advising on the purchase or sale of securities. As the representative of the state securities administrators, NASAA is able to provide guidance as to whom to contact in each state jurisdiction with respect to the applicability of state securities law to any securities-related issue, transaction or activity. To receive such information, contact the NASAA Corporate Office at the aforementioned address or telephone (202) 737-0900 or FAX (202) 783-3571.

3-NASAA STATEMENTS OF POLICY Blue Sky Regulation § NASAA

Adopted April 27, 1997

WHEREAS the [Administrator] (the "Administrator") is charged with the administration of [name of state securities act], the (Jurisdiction's) Uniform Securities Act (the "Act") and Sections 000, *et seq.* of the Regulations of the Jurisdiction promulgated under the Act;

WHEREAS, at Section 412(a) of the Act, it is provided, in part, that "[t]he [Administrator] may from time to time make, amend and rescind such ... orders as necessary to carry out the provisions of this act ...;"

WHEREAS, at Section 201(a) of the Act, it is provided "[i]t is unlawful for any person to transact business in this state as a broker-dealer or agent unless he is registered under this act...;"

WHEREAS, at Section 201(c) of the Act, it is further provided "[i]t is unlawful for any person to transact business in this state as an investment adviser unless ... he is so registered under this act...;" [Note: may also insert similar provision governing investment adviser agents/representatives]

WHEREAS the [Administrator] acknowledges that the Internet, the World Wide Web, and similar proprietary or common carrier electronic systems (collectively, the "Internet") have facilitated greatly the ability of broker-dealers, investment advisers, broker-dealer agents and investment adviser agents/representatives to advertise and otherwise disseminate information on products and services to prospective customers and clients;

WHEREAS the [Administrator] also acknowledges that certain communications made on the Internet are directed generally to anyone having access to the Internet and may be transmitted through postings on Bulletin Boards, displays on "Home Pages" or similar methods (hereinafter, "Internet Communications");

WHEREAS the [Administrator] further acknowledges that in certain instances, by distributing information on available products and services through Internet Communications available to persons in this state, broker-dealers, investment advisers, their broker-dealer agents and their investment adviser agents/representatives could be construed as "transacting business" for purposes of Sections 201(a) and 201(c) of the Act so as to require registration in this state, since the Internet Communications would be received in this state regardless of the intent of the person originating such communication; and

WHEREAS the [Administrator] finds that the issuance of this Order is necessary and appropriate in the public interest and for the protection of investors and consistent with the purposes fairly intended by the policy and provisions of the Act;

NOW THEREFORE, IT IS HEREBY ORDERED as follows:

1.

Broker-dealers, investment advisers, broker-dealer agents (hereinafter "BD agents") and investment adviser agents/representatives (hereinafter "IA reps") who use the the Internet, the World Wide Web, and similar proprietary or common carrier electronic systems (collectively, hereinafter the "Internet") to distribute information on available products and services through certain communications made on the Internet directed generally to anyone having access to the Internet, and transmitted through postings on Bulletin Boards, displays on "Home Pages" or similar methods (hereinafter, "Internet Communications") shall not be deemed to be "transacting business" in this state for purposes of Sections 201(a) and 201(c) of the Act based solely on that fact if the following conditions are observed:

A.

The Internet Communication contains a legend in which it is clearly stated that

(1)

the broker-dealer, investment adviser, BD agent or IA rep in question may only transact business in this state if first registered, excluded or exempted from state broker-dealer, investment adviser, BD agent or IA rep registration requirements, as may be; and

(2)

follow-up, individualized responses to persons in this state by such broker-dealer, investment adviser, BD agent or IA rep that involve either the effecting or attempting to effect transactions in securities, or the rendering of personalized investment advice for compensation, as may be, will not be made absent compliance with state broker-dealer, investment adviser, BD agent or IA rep registration requirements, or an applicable exemption or exclusion;

B.

The Internet Communication contains a mechanism, including and without limitation, technical "firewalls" or other implemented policies and procedures, designed reasonably to ensure that prior to any subsequent, direct communication with prospective customers or clients in this state, said broker-dealer, investment adviser, BD agent or IA rep is first registered in this state or qualifies for an exemption or exclusion from such requirement. Nothing in this paragraph shall be construed to relieve a state registered broker-dealer, investment adviser, BD agent or IA rep from any applicable securities registration requirement in this state;

C.

The Internet Communication does not involve either effecting or attempting to effect transactions in securities, or the rendering of personalized investment advice for compensation, as may be, in this state over the Internet, but is limited to the dissemination of general information on products and services; and

D.

In the case of a BD agent or IA rep:

(1)

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the affiliation with the broker-dealer or investment adviser of the BD agent or IA rep is prominently disclosed within the Internet Communication;

(2)

the broker-dealer or investment adviser with whom the BD agent or IA rep is associated retains responsibility for reviewing and approving the content of any Internet Communication by a BD agent or IA rep;

(3)

the broker-dealer or investment adviser with whom the BD agent or IA rep is associated first authorizes the distribution of information on the particular products and services through the Internet Communication; and

(4)

in disseminating information through the Internet Communication, the BD agent or IA rep acts within the scope of the authority granted by the broker-dealer or investment adviser;

2.

The position expressed in this Interpretive Order extends to state broker-dealer, investment adviser, BD agent and IA rep registration requirements only, and does not excuse compliance with applicable securities registration, antifraud or related provisions;

3.

Nothing in this Order shall be construed to affect the activities of any broker-dealer, investment adviser, BD agent and IA rep engaged in business in this state that is not subject to the jurisdiction of the Administrator as a result of the National Securities Markets Improvements Act of 1996, as amended; and

4.

This Order shall remain in effect unless and until subsequently amended or rescinded.

So ordered at (city, state) this _____ day of _____, 1997

(name)

(title)

*Statement of Policy Regarding Loans and Material Affiliated Transactions**Amended November 18,1997*

I.

INTRODUCTION. The North American Securities Administrators Association, Inc. ("NASAA") has determined that the following guideline relating to loans and other material affiliated transactions is consistent with public investor protection and is in the public interest. Nothing shall prevent the Securities Administrator ("Administrator") from applying different standards than those contained in this Statement of Policy.

II.

DEFINITIONS. The terms used in this Statement of Policy are defined pursuant to the NASAA Statement of Policy Regarding Corporate Securities Definitions.

III.

Where there have been or will be loans and other material affiliated transactions as described in this Statement of Policy, the offer or sale of securities may be disallowed by the Administrator unless the Issuer has, and represents in the prospectus or offering document that it will maintain, at least 2 INDEPENDENT DIRECTORS on its board of directors.

IV.

The offer or sale of securities may be disallowed by the Administrator if the Issuer or its AFFILIATES will have loans outstanding after the offering, or intends to make loans to or loan guarantees on behalf of its PROMOTERS, other than:

A.

Advances to officers, directors, and employees for travel, business expense, and similar ordinary operating expenditures;

B.

Loans or loan guarantees made for the purchase of an Issuer's securities by its officers, directors, and employees, and loans for relocation of officers, directors, and employees, provided the loans or loan guarantees that are ongoing were approved by a majority of the INDEPENDENT DIRECTORS of the Issuer's board of directors who did

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not have an interest in the transactions and who had access,at the issuer's expense,to issuer's or independent legal counsel;or

C.

Loans made by an Issuer or its AFFILIATES whose primary business is that of making loans,provided that:

1.

The loans will be evidenced by promissory notes naming the lender as payee;

2.

The loans will bear interest at rates which are comparable to those normally charged by other commercial lenders for similar loans made in the lender's locale; Statement of Policy Regarding Loans and Material Affiliated Transactions;

3.

The loans will be repaid pursuant to appropriate amortization schedules and contain default provisions comparable to those normally used by other commercial lenders for similar loans made in the lender's locale;

4.

The loans will be made only if credit reports and financial statements show the loans to be collectible and the borrowers are satisfactory credit risks,in light of the nature and terms of the loans and other circumstances;

5.

The loans meet the loan policies normally used by other commercial lenders for similar loans made in the lender's locale;

6.

The purposes of the loans and the disbursements of proceeds will be reviewed and monitored in a manner comparable to that normally used by other commercial lenders for similar loans made in the lender's locale;and

7.

The loans will not violate the requirements of any banking or other financial institutions regulatory authority.

V.

Except for loans described in IV.,above,all loans existing at the time of the application for registration shall be repaid in full prior to the offering.The Administrator may waive this requirement if:

A.

Repayment of the loans will be made pursuant to appropriate amortization schedules;or

B.

Any portion of the offering is made on behalf of a PROMOTER and the PROMOTER undertakes to immediately repay the loans from the proceeds of the offering.

VI.

The offer or sale of securities may be disallowed by the Administrator if the Issuer or its AFFILIATES have engaged in other material transactions with PROMOTERS, unless the prospectus discloses the terms of transactions and indicates whether such terms were as favorable to the issuer or its AFFILIATES as those generally available from unaffiliated third parties;and

A.

The transaction is ratified by a majority of the Issuer's INDEPENDENT DIRECTORS who did not have an interest in the transactions and who had access,at the issuer's expense,to issuer's or independent legal counsel;or

B.

For transactions which were entered into when there were less than two such disinterested INDEPENDENT DIRECTORS,the prospectus.*Statement of Policy Regarding Loans and Material Affiliated Transactions* discloses that the Issuer lacked sufficient disinterested INDEPENDENT DIRECTORS to ratify the transactions at the time the transactions were initiated.

VII.

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The Issuer shall disclose in the prospectus or offering document whether or not it or its AFFILIATES have made or will make loans to, have made or will make loan guarantees on behalf of, or have engaged or will engage in material transactions with PROMOTERS and the terms and details relating thereto. If material affiliated transactions or loans have been made, or may be made, the Administrator may require the following representations to appear in the prospectus or offering document:

A.

All future material affiliated transactions and loans will be made or entered into on terms that are no less favorable to the Issuer than those that can be obtained from unaffiliated third parties; and

B.

All future material affiliated transactions and loans, and any forgiveness of loans, must be approved by a majority of the Issuer's INDEPENDENT DIRECTORS who do not have an interest in the transactions and who had access, at the issuer's expense, to issuer's or independent legal counsel.

NOTE:

The Issuer and its officers and directors should consider their due diligence and their obligations to affirmatively demonstrate a reasonable basis for the representations in VI. and VII., above. In particular, they should consider whether the representations in VII.B., above, should be embodied in the Issuer's charter or bylaws.

NOTE:

In order to satisfy the ratification provisions of Sections IV.B., VI.A., and VII. of this Statement of Policy the issuer must have at least two INDEPENDENT DIRECTORS on its board of directors. In the event the issuer has only two INDEPENDENT DIRECTORS on its board or directors, both INDEPENDENT DIRECTORS must be disinterested in and approve loans and other material transactions covered by Sections IV.B., VI.A., and VII.B.

Adopted 4/27/97

Any offer or sale of a security by an issuer in a transaction that meets the requirements of this rule is exempted from [Sections requiring registration and filing of advertising materials].

(A)

Sales of securities shall be made only to persons who are or the issuer reasonably believes are accredited investors. "Accredited investor" is defined in 17 CFR 230.501(a) [amendment or successor rule] [some states may elect to include the entire text of SEC Rule 501(a) in lieu of an incorporation by reference].

(B)

The exemption is not available to an issuer that is in the development stage that either has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies, or other entity or person.

(C)

The issuer reasonably believes that all purchasers are purchasing for investment and not with the view to or for sale in connection with a distribution of the security. Any resale of a security sold in reliance on this exemption within 12 months of sale shall be presumed to be with a view to distribution and not for investment, except a resale pursuant to a registration statement effective under sections [insert registration sections] or to an accredited investor pursuant to an exemption available under [state securities act].

(D)

(1) The exemption is not available to an issuer if the issuer, any of the issuer's predecessors, any affiliated issuer, any of the issuer's directors, officers, general partners, beneficial owners of 10% or more of any class of its equity securities, any of the issuer's promoters presently connected with the issuer in any capacity, any underwriter of the securities to be offered, or any partner, director or officer of such underwriter:

(a)

within the last five years, has filed a registration statement which is the subject of a currently effective registration stop order entered by any state securities administrator or the United States Securities and Exchange Commission;

(b)

within the last five years, has been convicted of any criminal offense in connection with the offer, purchase or sale of any security, or involving fraud or deceit;

(c)

is currently subject to any state or federal administrative enforcement order or judgment, entered within the last five years, finding fraud or deceit in connection with the purchase or sale of any security; or

(d)

is currently subject to any order, judgment or decree of any court of competent jurisdiction, entered within the last five years, temporarily, preliminarily or permanently restraining or enjoining such party from engaging in or continuing to engage in any conduct or practice involving fraud or deceit in connection with the purchase or sale of any

security.

(2)

Subparagraph (D)(1) shall not apply if:

(a)

the party subject to the disqualification is licensed or registered to conduct securities related business in the state in which the order, judgment or decree creating the disqualification was entered against such party;

(b)

before the first offer under this exemption, the state securities administrator, or the court or regulatory authority that entered the order, judgment, or decree, waives the disqualification; or

(c)

the issuer establishes that it did not know and in the exercise of reasonable care, based on a factual inquiry, could not have known that a disqualification existed under this paragraph.

(E)

(1) A general announcement of the proposed offering may be made by any means.

(2)

The general announcement shall include only the following information, unless additional information is specifically permitted by the [Administrator]:

(a)

The name, address and telephone number of the issuer of the securities;

(b)

The name, a brief description and price (if known) of any security to be issued;

(c)

A brief description of the business of the issuer in 25 words or less;

(d)

The type, number and aggregate amount of securities being offered;

(e)

The name, address and telephone number of the person to contact for additional information; and

(f)

A statement that:

(i)

sales will only be made to accredited investors;

(ii)

no money or other consideration is being solicited or will be accepted by way of this general announcement;
and

(iii)

the securities have not been registered with or approved by any state securities agency or the U.S. Securities and Exchange Commission and are being offered and sold pursuant to an exemption from registration.

(F) The issuer, in connection with an offer, may provide information in addition to the general announcement under paragraph (E), if such information:

(1) is delivered through an electronic database that is restricted to persons who have been pre-qualified as accredited investors; or

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(2) is delivered after the issuer reasonably believes that the prospective purchaser is an accredited investor.

(G) No telephone solicitation shall be permitted unless prior to placing the call, the issuer reasonably believes that the prospective purchaser to be solicited is an accredited investor.

(H) Dissemination of the general announcement of the proposed offering to persons who are not accredited investors shall not disqualify the issuer from claiming the exemption under this rule.

(I) The issuer shall file with the [Commission/Division] a notice of transaction, a consent to service of process, a copy of the general announcement, and a [\$ fee/fee language[within 15 days after the first sale in this state.]

(Adopted September 10, 1996, Amended May 7, 2007)

I. Introduction

A. *Application.*

1. The rules contained in these guidelines apply to qualifications and registrations of direct participation mortgage programs in the form of limited partnerships, trusts, limited liability companies, and limited liability partnerships (herein sometimes called "PROGRAMS" or "partnerships") and will be applied by analogy to mortgage PROGRAMS in other forms. These guidelines are a counterpart to the NASAA Real Estate Programs policy statement. While applications not conforming to the standards contained herein shall be looked upon with disfavor, where good cause is shown certain guidelines may be modified or waived by the ADMINISTRATOR.

2. Where the individual characteristics of specific PROGRAMS warrant modification from these standards, they will be accommodated, insofar as possible while still being consistent with the spirit of these guidelines. A CROSS REFERENCE SHEET in the form set forth in Section IX.G. shall be furnished with the application.

3. Where these guidelines conflict with requirements of the Securities and Exchange Commission, the guidelines will not apply.

B. *Definitions.* [The following words and terms, when used in these guidelines, shall have the following meanings,

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unless the context clearly indicates otherwise.]

1. ACQUISITION AND ORIGINATION EXPENSES--Expenses including but not limited to legal fees and expenses, travel and communications expenses; costs of appraisals, accounting fees and expenses, title insurance funded by the PROGRAM, and miscellaneous expenses related to the origination, selection and acquisition of mortgages, whether or not acquired.

2. ACQUISITION AND ORIGINATION FEES--The total of all fees and commissions paid by any party in connection with making or investing in PROGRAM mortgage loans. Included in the computation of such fees or commissions shall be any selection fee, mortgage placement fee, nonrecurring management fee, and any origination fee, loan fee, or points paid; by borrowers to the SPONSOR, or any fee of a similar nature, however designated.

3. ADMINISTRATOR--the agency or official administering the securities law of the state.

4. AFFILIATE--means:

a. any PERSON directly or indirectly controlling, controlled by, or under common control with another PERSON;

b. any PERSON owning or controlling 10% or more of the outstanding voting securities of such other PERSON;

c. any officer, director, or partner of such PERSON; and

d. if such other PERSON is an officer, director, or partner, any company for which such PERSON acts in any such capacity.

5. ASSESSMENTS--Additional amounts of capital which may be mandatorily required of or paid at the option of a PARTICIPANT beyond his subscription commitment.

6. ASSET BASED FEE--Compensation to a SPONSOR computed according to Section IV.I.2. of these guidelines.

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7. AUDITED FINANCIAL STATEMENTS--Financial statements (Balance Sheet, Statement of Income, Statement of PARTICIPANTS' Equity and Statement of Cash Flows) prepared in accordance with generally accepted accounting principles and accompanied by an independent auditor's report containing:

(A) an unqualified opinion;

(B) an opinion containing no material qualification; or

(C) no explanatory paragraph disclosing information relating to material uncertainties (except as to litigation) or going concern issues.

8. BASE AMOUNT--That portion of the CAPITAL CONTRIBUTIONS originally committed to INVESTMENT IN MORTGAGES without regard to and not including leverage and including working capital reserves allowable under subsection IV.I.1.(c) (relating to Fees--Compensation--Expenses). The BASE AMOUNT shall be recomputed annually after the second full year of PROGRAM operations by subtracting from the then fair market value of the PROGRAM's mortgages as determined by independent appraisals plus the working capital reserves allowable under subsection IV.I.1.c., an amount equal to the PROGRAM'S outstanding debt.

9. CAPITAL CONTRIBUTION--The gross amount of investment in a PROGRAM by a PARTICIPANT, or all PARTICIPANTS, as the case maybe.

10. CAPITAL TRANSACTION--The repayment of principal or prepayment of a mortgage to the extent classified as a return of capital for federal income tax purposes, and the foreclosure, sale, exchange, condemnation, eminent domain taking or other disposition of a mortgage or of a property subject to a mortgage, or the payment of insurance or a guarantee with respect to a mortgage.

11. CARRIED INTEREST--An equity interest in a PROGRAM which participates in all allocations and distributions, other than the PROMOTIONAL INTEREST provided for in Section IV.D. (relating to Fees--Compensation--Expenses), for which full consideration is not paid or to be paid.

12. CASH AVAILABLE FOR DISTRIBUTION--CASH FLOW less amount set aside for creation or restoration of reserves.

13. CASH FLOW--PROGRAM cash funds provided from operations (other than repayments of mortgage loan principal) including without limitation, interest, points, revenue participations, participations in property appreciation, and interest or dividends from interim investments, after deducting cash funds used to pay general PROGRAM expenses and debt payments.

COMMENT:

Only funds which constitute interest payments shall be included in cash flow. Funds which may be deemed to constitute interest payments are (i) contractual current interest payments, (ii) interest accrued or deferred, when received, and (iii) contingent interest based upon the PROGRAM'S share of gross or net income from properties on which the PROGRAM has made a loan. All other funds shall be considered to be net proceeds of sale or refinancing (CAPITAL TRANSACTION).

14. COMPETITIVE REAL ESTATE COMMISSION--That real estate or brokerage commission paid for the purchase or sale of property which is reasonable, customary, and competitive in light of the size, type, and location of the property.

15. CROSS-REFERENCE-SHEET--A compilation of the guideline sections, referenced to the page of the PROSPECTUS, partnership agreement, or other exhibits, along with a justification of any deviation from the guidelines.

16. FINANCING--All indebtedness INCURRED BY THE PROGRAM, the principal amount of which is scheduled to be paid over a period of not less than 48 months, where not more than 50% of the principal amount of which is scheduled to be paid during the first 24 months. Nothing in this definition shall be construed as prohibiting a bona fide pre-payment provision in the financing agreement.

17. FRONT-END FEES--Fees and expenses paid by any party for any services rendered to organize the PROGRAM and to acquire assets for the PROGRAM, including ORGANIZATION AND OFFERING EXPENSES, ACQUISITION AND ORIGINATION EXPENSES, ACQUISITION AND ORIGINATION FEES, interest on deferred fees and expenses, and any other similar fees, however designated by the SPONSOR.

18. INDEPENDENT EXPERT--A PERSON with no material current or prior business or Personal relationship with the SPONSOR who is engaged to a substantial extent in the business of rendering opinions regarding the value of assets of the type held by the PROGRAM, and who is qualified to perform such work.

19. INVESTMENT IN MORTGAGES--The amount of CAPITAL CONTRIBUTIONS used to make or invest in mortgage loans or the amount actually paid or allocated to the purchase of mortgages, working capital reserves allocable thereto (except that working capital reserves in excess of 3.0% shall not be included), and other cash payments such as interest and taxes but excluding FRONT-END FEES.

20. NET WORTH--The excess of total assets over total liabilities as determined by generally accepted accounting principles, except that if any of such assets have been depreciated, then the amount of depreciation relative to any particular asset may be added to the depreciated cost of such asset to compute total assets, provided that the amount of depreciation may be added only to the extent that the amount resulting after adding such depreciation does not exceed the fair market value of such asset.

21. NON-SPECIFIED MORTGAGE PROGRAMS--PROGRAMS other than SPECIFIED MORTGAGE PROGRAMS.

22. ORGANIZATION AND OFFERING EXPENSES--Those expenses incurred in connection with and in preparing a PROGRAM for registration and subsequently offering and distributing it to the public, including sales commissions paid to broker-dealers in connection with the distribution of the PROGRAM and all advertising expenses.

23. PARTICIPANT--The holder of a PROGRAM INTEREST.

24. PERSON--Any natural PERSON, partnership, corporation, association, or other entity.

25. PROGRAM--A limited or general partnership, limited liability company, limited liability partnership, trust, joint venture, unincorporated association or similar organization other than a corporation formed and operated for the primary purpose of investment in mortgage loans.

26. PROGRAM INTEREST--The limited partnership unit or other indicium of ownership in a PROGRAM.

27. PROGRAM MANAGEMENT FEE--A fee paid to the SPONSOR or other PERSONS for management and administration of the PROGRAM.

28. PROPERTY MANAGEMENT FEE--The fee paid for day-to-day professional property management services.

29. PROSPECTUS--Shall have the meaning given to that term by the Securities Act of 1933, Section 2(10), including a preliminary PROSPECTUS, provided, however, that such term as used herein shall also include an offering circular as described in the Securities Act of 1933, Rule 256, or, in the case of an intrastate offering, any document by whatever name known, utilized for the purpose of offering and selling securities to the public.

30. PURCHASE PRICE--The price paid upon or in connection with the purchase of a particular mortgage, but excluding points and prepaid interest, ACQUISITION AND ORIGINATION FEES and ACQUISITION AND ORIGINATION EXPENSES.

31. ROLL-UP--A transaction involving the acquisition, merger, conversion, or consolidation, either directly or indirectly of the PROGRAM and the issuance of securities of a ROLL-UP ENTITY. Such term does not include:

(a) a transaction involving securities of the PROGRAM that have been listed for at least 12 months on a national securities exchange or traded through the National Association of Securities Dealers Automated Quotation National Market System; or

(b) a transaction involving the conversion to corporate, trust, limited liability company, or association form of only the PROGRAM if, as a consequence of the transaction, there will be no significant adverse change in any of the following:

(i) PARTICIPANTS' voting rights;

(ii) the term of existence of the PROGRAM;

(iii) SPONSOR compensation; or

(iv) the PROGRAM'S investment objectives.

32. ROLL-UP ENTITY--A partnership, real estate investment trust, corporation, trust, limited liability company or other entity that would be created or would survive after the successful completion of a proposed ROLL-Up transaction.

33. SPECIFIED MORTGAGE PROGRAM--A PROGRAM where, at the time a securities registration is ordered effective, more than 75% of the net proceeds from the sale of PROGRAM INTERESTS is allocable to the origination or purpose of specific mortgage loans. Reserves shall be included in the nonspecified portion.

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34. SPONSOR--Any PERSON directly or indirectly instrumental in organizing, wholly or in part, a PROGRAM or any PERSON who will manage or participate in the management of a PROGRAM, and any AFFILIATE of any such PERSON, but does not include a PERSON whose only relation with the PROGRAM is as that of an independent property manager, whose only compensation is as such. SPONSOR does not include wholly independent third parties such as attorneys, accountants, and underwriters whose only compensation is for professional services rendered in connection with the offering of PROGRAM INTERESTS. A PERSON may also be a SPONSOR of the PROGRAM by:

(a) Taking the initiative, directly or indirectly, in founding or organizing the business or enterprise of the PROGRAM, either alone or in conjunction with one or more other PERSONS;

(b) Receiving a material participation in the PROGRAM in connection with the founding or organizing of the business of the PROGRAM, in consideration of services or property, or both services and property;

(c) Having a substantial number of relationships and contacts with the PROGRAM;

(d) Possessing significant rights to control PROGRAM properties;

(e) Receiving fees for providing services to the PROGRAM which are paid on a basis that is not customary in the industry; or

(f) Providing goods or services to the PROGRAM on a basis which was not negotiated at arms-length with the PROGRAM.

II. REQUIREMENTS OF SPONSORS.

A. *Experience.* The SPONSOR, the general partner, or their chief operating officers shall have at least two years relevant real estate lending or other experience demonstrating the knowledge and experience to acquire and manage the type of assets being acquired or originated, and any of the foregoing or any AFFILIATE providing services to the PROGRAM shall have had not less than four years relevant experience in the kind of service being rendered or otherwise must demonstrate sufficient knowledge and experience to perform the services proposed.

B. *NET WORTH Requirement of SPONSOR.* The financial condition of the SPONSOR liable for the debts of the PROGRAM must be commensurate with any financial obligations assumed in the offering and in the operation of the

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PROGRAM. As a minimum, such SPONSOR shall have an aggregate financial NET WORTH, exclusive of home, automobile, and home furnishings, of the greater of either \$50,000 or an amount at least equal to 5.0% of the gross amount of all offerings sold within the prior 12 months, plus 5.0% of the gross amount of the current offering to an aggregate maximum NET WORTH of such SPONSOR of \$1 million. In determining NET WORTH for this purpose, evaluation will be made of contingent liabilities and the use of promissory notes, to determine the appropriateness of their inclusion in computation of NET WORTH.

C. *Reports to ADMINISTRATOR.* Each application for registration shall contain a commitment, executed by the SPONSOR, to submit to the ADMINISTRATION upon request any report or statement required to be distributed to PARTICIPANTS pursuant to VII.C. (relating to Rights and Obligations of PARTICIPANTS).

D. *Liability and Indemnification.*

1. The PROGRAM shall not provide for indemnification of the SPONSOR for any liability or loss suffered by the SPONSOR, nor shall it provide that the SPONSOR be held harmless for any loss or liability suffered by the PROGRAM, unless all of the following conditions are met:

a. the SPONSOR has determined, in good faith, that the course of conduct which caused the loss or liability was in the best interests of the PROGRAM;

b. the SPONSOR was acting on behalf of or performing services for the PROGRAM;

c. such liability or loss was not the result of negligence or misconduct by the SPONSOR; and

d. such indemnification or agreement to hold harmless is recoverable only out of the assets of the PROGRAM and not from the PARTICIPANTS.

2. Notwithstanding anything to the contrary contained in Section II.D.1., the SPONSOR (which shall include AFFILIATES only if such AFFILIATES are performing services on behalf of the PROGRAM) and any PERSON acting as a broker-dealer shall not be indemnified for any losses, liabilities or expenses arising from an alleged violation of federal or state securities laws unless the following conditions are met:

a. there has been a successful adjudication on the merits of each count involving alleged securities law violations as to the particular indemnitee, or

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b. such claims have been dismissed with prejudice on the merits by a court of competent jurisdiction as to the particular indemnitee, or

c. a court of competent jurisdiction approves a settlement of the claims against a particular indemnitee and finds that indemnification of the settlement and related costs should be made, and

d. in the case of subparagraph c. of this paragraph, the court of law considering the request for indemnification has been advised of the position of the Securities and Exchange Commission and the position of any state securities regulatory authority in which securities of the PROGRAM were offered or sold as to indemnification for violations of securities laws; provided that the court need only be advised of and consider the positions of the securities regulatory authorities of those states:

(1) which are specifically set forth in the PROGRAM agreement; and

(2) in which plaintiffs claim they were offered or sold PROGRAM interests.

(3) The PROGRAM may not incur the cost of that portion of liability insurance which insures the SPONSOR for any liability as to which the SPONSOR is prohibited from being indemnified under this subsection.

(4) The provision of advancement from PROGRAM funds to a SPONSOR or its AFFILIATES for legal expenses and other costs incurred as a result of any legal action is permissible if the following conditions are satisfied:

a. The legal action relates to acts or omissions with respect to the performance of duties or services on behalf of the PROGRAM.

b. The legal action is initiated by a third party who is not a PARTICIPANT, or the legal action is initiated by a PARTICIPANT and a court of competent jurisdiction specifically approves such advancement; and

c. The SPONSOR or its AFFILIATES undertake to repay the advanced funds to the PROGRAM in cases in which such PERSON is not entitled to indemnification under subsection II.D.(1) of this section.

E. *Fiduciary Duty.*

The PROGRAM agreement shall provide that the SPONSOR shall have fiduciary responsibility for the safekeeping and use of all funds and assets of the PROGRAM, whether or not in the SPONSOR's possession or control, and that the SPONSOR shall not employ, or permit another to employ such funds or assets in any manner except for the exclusive benefit of the PROGRAM. In addition, the PROGRAM shall not permit the PARTICIPANT to contract away the fiduciary duty owed to the PARTICIPANT by the SPONSOR under the common law.

F. *Terminated SPONSOR.*

1. Upon the occurrence of a terminating event, the PROGRAM may be required to pay to the terminated SPONSOR all amounts then accrued and owing to the terminated SPONSOR. Additionally, the PROGRAM may terminate the SPONSOR's interest in PROGRAM income, losses, distributions, and capital by payment of an amount equal to the then--present fair market value of the terminated SPONSOR'S interest determined by agreement of the terminated SPONSOR and the PROGRAM, or, if they cannot agree, by arbitration in accordance with the then--current rules of the American Arbitration Association. The expense of arbitration shall be borne equally by the terminated SPONSOR and the PROGRAM.

2. The method of payment to the terminated SPONSOR must be fair; and must protect the solvency and liquidity of the PROGRAM. Where the termination is voluntary, the method of payment will be deemed presumptively fair where it provides for a non-interest bearing unsecured promissory note with principal payable, if at all, from distributions which the terminated SPONSOR otherwise would have received under the partnership agreement had the SPONSOR not terminated. Where the termination is involuntary, the method of payment will be deemed presumptively fair where it provides for an interest bearing promissory note coming due in no less than 5 years with equal installments each year.

III. SUITABILITY OF PARTICIPANTS.

A. *General Policy.*

1. The SPONSOR shall establish minimum income and NET WORTH standards for PERSONS who purchase PROGRAM INTERESTS.

2. The SPONSOR shall propose minimum NET WORTH standards which are reasonable given the type of PROGRAM and the risks associated with PROGRAM INTERESTS. PROGRAMS with greater investor risk shall have minimum standards with a substantial NET WORTH requirement. The ADMINISTRATOR shall evaluate the standards

proposed by the SPONSOR when the PROGRAM'S application for registration is reviewed. In evaluating the proposed standards, the ADMINISTRATOR may consider the following:

- a. tax implications;
- b. credit equity of borrowers;
- c. potential variances in cash distributions;
- d. potential PARTICIPANTS;
- e. relationship between potential PARTICIPANTS and the SPONSOR;
- f. liquidity of PROGRAM interests;
- g. performance of the SPONSOR'S prior PROGRAMS;
- h. financial condition of the SPONSOR;
- i. conflicts of interest, including potential transactions between the PROGRAM and the SPONSOR;
- j. loan-to-value ratios;
- k. characteristics of properties subject to mortgages
- l. limited PROGRAM diversification; and

m. any other relevant factors.

B. Income and NET WORTH Standards

1. Unless the Administrator determines that the risk associated with the PROGRAM would require lower or higher standards, or except as provided in Section V.I.5, each PARTICIPANT shall have:

a. a minimum annual gross income of \$70,000, and a minimum NET WORTH of \$70,000; or

b. a minimum NET WORTH of \$250,000.

2. NET WORTH shall be determined exclusive of home, home furnishings, and automobiles.

3. In the case of sales to fiduciary accounts, these minimum standards shall be met by the beneficiary, the fiduciary account, or by a donor or grantor who directly or indirectly supplies the funds to purchase the PROGRAM INTERESTS if the donor or grantor is the fiduciary.

4. The SPONSOR shall set forth in the final PROSPECTUS:

a. the investment objectives of the PROGRAM;

b. a description of the type of PERSON who might benefit from an investment in the PROGRAM; and

c. the minimum standards imposed on each PARTICIPANT in the PROGRAM.

C. Determination that Sale to a PARTICIPANT is Suitable and Appropriate.

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1. The SPONSOR and each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM shall make every reasonable effort to determine that the purchase of PROGRAM INTERESTS is a suitable and appropriate investment for each PARTICIPANT.

2. In making this determination, the SPONSOR or each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or the PROGRAM shall ascertain that the prospective PARTICIPANT:

- a. meets the minimum income and NET WORTH standard established for the PROGRAM;
- b. can reasonable benefit from an investment in the PROGRAM based on the prospective PARTICIPANT'S overall investment objectives and portfolio structure;
- c. is able to bear the economic risk of the investment based on the prospective PARTICIPANT'S overall financial situation;
- d. has apparent understanding of:
 - (i) the fundamental risks of the investment;
 - (ii) the risk that the PARTICIPANT may lose the entire investment;
 - (iii) the lack of liquidity of PROGRAM INTERESTS;
 - (iv) the restrictions on transferability of PROGRAM INTERESTS;
 - (v) background and qualifications of the SPONSOR or PERSONS responsible for directing and managing the PROGRAM; and
 - (vi) the tax consequences of the investment.

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3. The SPONSOR and each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or the PROGRAM will make this determination on the basis of the information it has obtained from the prospective PARTICIPANT. Relevant information for this purpose will include at least the age, investment objectives, investment experience, income, NET WORTH, financial situation, and other investment of the prospective PARTICIPANT, as well as any other pertinent factors.

4. The SPONSOR and each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or the PROGRAM shall maintain records of the information used to determine that an investment in PROGRAM INTERESTS is suitable and appropriate for each PARTICIPANT. The SPONSOR or each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM shall maintain these records for at least six years.

5. The SPONSOR shall disclose in the final PROSPECTUS the responsibility of the SPONSOR and each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM shall make every reasonable effort to determine that the purchase of PROGRAM INTERESTS is a suitable and appropriate investment for each PARTICIPANT, based on information provided by the PARTICIPANT regarding the PARTICIPANT'S financial situation and investment objectives.

D. Subscription Agreements.

1. The ADMINISTRATOR may require that each PARTICIPANT complete and sign a written subscription agreement.

2. The SPONSOR may require that each PARTICIPANT acknowledge that the investment is not liquid.

3. If the representation in Section III.D.2. above is included in the Subscription Agreement, the PARTICIPANT must separately sign or initial that representation. Except in the case of fiduciary accounts, the PARTICIPANT may not grant any PERSON a power of attorney to make such representation on his or her behalf.

4. The SPONSOR and each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM shall not require a PARTICIPANT to make representations in the subscription agreement which are subjective or unreasonable and which:

a. might cause the PARTICIPANT to believe that he or she has surrendered any rights to which he or she is

entitled under federal or state law; or

b. would have the effect of shifting duties regarding suitability, imposed by law on broker-dealers, to the PARTICIPANT.

5. Prohibited representations include, but are not limited to the following:

a. The PARTICIPANT understands or comprehends the risks associated with an investment in the PROGRAM.

b. The investment is a suitable one for the PARTICIPANT.

c. The PARTICIPANT has read the PROSPECTUS.

d. In deciding to invest in the PROGRAM, the PARTICIPANT has relied solely on the PROSPECTUS, and not on any other information or representations from other PERSONS or sources.

6. The SPONSOR may place the content of the prohibited representations in the subscription agreement in the form of disclosures to the PARTICIPANT. The SPONSOR may not place these disclosures in the PARTICIPANT representation part of the subscription agreement.

E. Completion of Sale.

1. The SPONSOR or any PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM may not complete a sale of PROGRAM INTERESTS to a PARTICIPANT until at least five business day after the date the PARTICIPANT receives a final PROSPECTUS.

2. The SPONSOR or the PERSON designated by the SPONSOR shall send each PARTICIPANT a confirmation of his or her purchase.

F. Minimum Investment. The ADMINISTRATOR may require a minimum initial and subsequent cash investment

amount.

IV. FEES--COMPENSATION--EXPENSES.

A. Fees, Compensation, and Expenses to be Reasonable.

1. The total amount of consideration of all kinds which may be paid directly or indirectly to all parties shall be reasonable.

2. The PROSPECTUS must fully disclose and itemize all consideration which may be received from the PROGRAM directly or indirectly by the SPONSOR, its AFFILIATES and underwriters, what the consideration is for and how and when it will be paid. This shall be set forth in one location in tabular form.

B. Organization and Offering Expenses. All ORGANIZATION AND OFFERING EXPENSES incurred in order to sell PROGRAM INTERESTS shall be reasonable and shall comply with all statutes, rules, and regulations imposed in connection with the offering of other securities in the state.

C. Investment in Mortgages.

1. FRONT-END FEES paid to the SPONSOR shall be in accordance with this subsection.

a. The SPONSOR shall be required to commit a substantial portion of the PROGRAM'S CAPITAL CONTRIBUTIONS toward INVESTMENT IN MORTGAGES. The remaining CAPITAL CONTRIBUTIONS may be used to pay FRONT-END FEES. The total amount of FRONT-END FEES, whenever paid and from whatever source, shall be limited to an amount equal to the initial amount of CAPITAL CONTRIBUTIONS not applied to INVESTMENT IN MORTGAGES.

2. At a minimum, the SPONSOR shall commit a percentage of the CAPITAL CONTRIBUTIONS to INVESTMENT IN MORTGAGES which is equal to 82%. [Refer to Section IV.I.1.c. of these Guidelines for the minimum required INVESTMENT IN MORTGAGES for a PROGRAM electing an ASSET-BASED FEE.]

3. If the SPONSOR enters into an INVESTMENT IN MORTGAGES commitment in excess of that specified in

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paragraph 2. of this subsection, the SPONSOR may take a fully participating CARRIED INTEREST equal to 1.0% for the first 2.5% of additional INVESTMENT IN MORTGAGES, 1.0% for the next 2.0% of additional INVESTMENT IN MORTGAGES, and 1.0% for each 1.0% of additional INVESTMENT IN MORTGAGES thereafter.

4. For PROGRAMS whose total CAPITAL CONTRIBUTIONS do not exceed \$2 million, the ADMINISTRATOR may reduce the required amount of INVESTMENT IN MORTGAGES to 71%.

5. Notwithstanding the language in paragraph 4. of this subsection, the \$2 million limitation is intended to be a benchmark figure and may be adjusted upward or downward by the ADMINISTRATOR based on the marketplace in the ADMINISTRATOR'S jurisdiction.

D. Promotional Interest.

An interest in the PROGRAM will be allowed as a PROMOTIONAL INTEREST and PROGRAM MANAGEMENT FEE, provided the amount or percentage of such interest is reasonable. Such an interest will be considered presumptively reasonable if it is within the limitations expressed in paragraphs 1-3 of this subsection.

1. an interest equal to:

a. 10% of distributions from CASH AVAILABLE FOR DISTRIBUTION; and

b. 15% of CASH AVAILABLE FOR DISTRIBUTION and cash to be distributed from the net proceeds remaining from CAPITAL TRANSACTIONS in the PROGRAM'S mortgages after payment to investors from such proceeds, an amount equal to 100% of CAPITAL CONTRIBUTIONS, plus an amount equal to 6.0% of CAPITAL CONTRIBUTIONS per annum cumulative. The 6.0% cumulative return may be reduced, but not below zero, by the aggregate amount of prior distributions to investors from CASH AVAILABLE FOR DISTRIBUTION. The SPONSOR'S interest in CASH AVAILABLE FOR DISTRIBUTION and proceeds of CAPITAL TRANSACTIONS provided for in this Section IV.D.1.b. may be increased 1% for each percentage point below 10% that the SPONSOR accepts in its interest in CASH AVAILABLE FOR DISTRIBUTION, allowed under Section IV.D.1.a.

3. Dissolution and liquidation of the PROGRAM. The distribution of assets upon dissolution and liquidation of the PROGRAM shall conform to the applicable subordination provisions of paragraph 1. of this subsection, and appropriate language shall be included in the PROGRAM agreement.

4. The maximum dollar amount of the SPONSOR'S distributive share permitted under paragraph 1. or 2. of this subsection may not be increased by any allocation to the SPONSOR made for the purpose of satisfying the requirements

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of the Internal Revenue Code, applicable regulations, or any Revenue Ruling or Revenue Procedure. In the absence of adequate justification provided under subsection IV.C.(3) of this section for any unsubordinated participation in cash to be distributed from the net proceeds remaining from the CAPITAL TRANSACTIONS in the PROGRAM'S mortgages, the Administrator may require an express limitation in the PROGRAM agreement that the dollar amount of the SPONSOR'S distributive share will not exceed the maximum amount that would be allowable under paragraphs (1) or (2) of this subsection.

E. Real Estate Brokerage Commissions on Resale of Property.

The total compensation paid to all PERSONS for the sale of a property held by the PROGRAM as the result of foreclosure shall be limited to a competitive real estate commission, not to exceed 6.0% of the contract price for the sale of the property. If the SPONSOR provides a substantial amount of the services in the sales effort, he may receive up to 1/2 of the competitive real estate commission, not to exceed 3.0%, and subordinated as in subsection D. of this section. If the SPONSOR participates with an independent broker on resale, the subordination requirement shall apply only to the commission earned by the SPONSOR.

F. Property Management Fee.

Should the SPONSOR or its AFFILIATES perform property management services with respect to a foreclosed property as permitted under subsection IV.A.1. of this section, the fees paid to the SPONSOR or its AFFILIATES shall be the lesser of the maximum fees set forth in paragraphs 1.-3. of this subsection, or the fees which are competitive for similar services in the same geographic area. Included in such fees shall be bookkeeping services and fees paid to nonrelated PERSONS for property management services.

1. In the case of a residential property, the maximum PROPERTY MANAGEMENT FEE (included all rent-up, leasing, and re-leasing fees and bonuses, and leasing related services, paid to any PERSON) shall be 5.0% of the gross revenues from such property.

2. In the case of industrial and commercial property, except as set forth in paragraph 3. of this subsection, the maximum PROPERTY MANAGEMENT FEE from such leases shall be 6.0% of the gross revenues where the SPONSOR or its AFFILIATES includes leasing, re-leasing, and leasing related services. Conversely the maximum PROPERTY MANAGEMENT FEE from such leases shall be 3.0% of the gross revenues where the SPONSOR or its AFFILIATES do not perform the leasing, re-leasing, and leasing related services with respect to the property.

3. In the case of industrial and commercial properties which are leased on a long term (10 or more years) net (or similar) bases, the maximum PROPERTY MANAGEMENT FEE from such leases shall be 1.0% of the gross revenues, except for a one time initial leasing fee of 3.0% of the gross revenues on each lease payable over the first five full years of the original term of the lease.

G. Insurance Services.

The SPONSOR or his AFFILIATE may provide insurance brokerage services in connection with obtaining insurance on a PROGRAM property held as the result of foreclosure so long as the cost of providing such service, including cost of the insurance, is no greater than the lowest quote obtained from two unaffiliated insurance agencies and the coverage and terms are likewise comparable. In no event may such services be provided by the SPONSOR or his AFFILIATES unless they are independently engaged in the business of providing such services to other than AFFILIATES and at least 75% of their insurance brokerage service gross revenue is derived from other than AFFILIATES.

H. Mortgage Servicing Fee.

The SPONSOR or its AFFILIATES may provide mortgage servicing, for which it may be paid a fee, which, when added to all other fees paid in connection with the servicing of a particular mortgage, does not exceed the lesser of the customary, competitive fee for the provision of such mortgage services on that type of mortgage or 1/4 of 1.0% of the principal outstanding in such loan.

I. Asset Based Fee.

1. Eligibility. A PROGRAM may elect to compensate the SPONSOR according to the provisions of this section only if the PROGRAM meets all of the following:

a. The PROSPECTUS states that a primary investment objective of the PROGRAM is to generate and to distribute CASH FLOW from PROGRAM operations.

b. The anticipated life of the PROGRAM does not exceed 20 years from the date the offering is declared effective by the Securities and Exchange Commission ("SEC"). However, the partnership agreement may provide that the PROGRAM will be extended by the affirmative vote of a majority of the PARTICIPANTS.

c. The PROGRAM will invest not less than 84% of the CAPITAL CONTRIBUTIONS as the INVESTMENT IN MORTGAGES. The remaining CAPITAL CONTRIBUTIONS may be used to pay FRONT-END FEES. The total amount of FRONT-END FEES, whenever paid, shall be limited to the initial amount of CAPITAL CONTRIBUTIONS not applied to INVESTMENT IN MORTGAGES. Of this INVESTMENT IN MORTGAGES, not more than 3.0% of the CAPITAL CONTRIBUTIONS may be included as a working capital reserve.

2. Computation. The annual asset-based fee shall be 0.75% of the BASE AMOUNT. On CAPITAL CONTRIBUTIONS temporarily held while awaiting INVESTMENT IN MORTGAGES, the ASSET BASED FEE shall be 0.5% of those CAPITAL CONTRIBUTIONS. The SPONSOR may also be allowed the following additional

fees and compensation:

- a. a PROPERTY MANAGEMENT FEE as provided in subsection F. of this section;
- b. real estate commissions as provided in subsection E. of this section;
- c. a back-end promotional interest as provided in subsection D.1.b. of this section;
- d. fees for insurance services as allowed by subsection G. of this section;
- e. FRONT-END FEES limited as provided in subsection I.1.c. of this section;
- f. reimbursement for PROGRAM expenses as provided in Section V.D. of these guidelines (relating to Conflicts of Interest and Investment Restrictions);
- g. fees, interest, and other charges as allowed in Section V.I.3. of these guidelines (relating to Conflicts of Interest and Investment Restrictions);
- h. additional CARRIED INTEREST as provided in subsection C.3. of this section; and
- i. except as provided in a. through h. of this paragraph, the SPONSOR shall receive no fees or other compensation from the PROGRAM.

3. Limitations. An election to compensate the SPONSOR with an ASSET BASED FEE as provided in this subsection shall be subject to the following limitations:

- a. The PROGRAM may reinvest the proceeds from CAPITAL TRANSACTIONS in its mortgages during the 7 years following the date of its effectiveness with the SEC. No deduction for FRONT-END FEES shall be allowed on such reinvestments. Such reinvested proceeds shall not count toward satisfaction of PARTICIPANTS' return of capital or preferred return under Sections IV.D.1. and 2. Beginning on a date 7 years after the date of effectiveness with the

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SEC, no reinvestment of the proceeds from CAPITAL TRANSACTIONS shall be allowed.

b. The ASSET BASED FEE may be accrued without interest when PROGRAM funds are not available for its payment. Any accrued ASSET BASED FEE may be paid from the next available cash flow or net proceeds from CAPITAL TRANSACTIONS in mortgages. No ASSET BASED FEE may be paid from PROGRAM reserves.

c. A SPONSOR that is terminated and entitled to compensation from the PROGRAM as provided in the partnership documents and governed by Section II.F. of these guidelines (relating to Requirements of SPONSORS) shall be paid the ASSET BASED FEE through the date of such termination.

d. Except as modified by this paragraph, all other portions of this statement of policy shall apply where appropriate to PROGRAMS electing an ASSET BASED FEE.

V. CONFLICTS OF INTEREST AND INVESTMENT RESTRICTIONS.

A. Sales, Leases, and Related PROGRAM Transactions.

1. Sales of mortgages to PROGRAM. A PROGRAM shall not acquire a mortgage in which a SPONSOR has an interest unless:

a. However, the SPONSOR may acquire a mortgage in its own name and temporarily hold title thereto for the purpose of facilitating the acquisition of such mortgage, provided that such mortgage is purchased by the PROGRAM for a price no greater than the cost of such mortgage to the SPONSOR, except compensation in accordance with Section IV. of these guidelines (relating to Fees--Compensation--Expenses), and provided there is no other benefit arising out of such transaction to the SPONSOR apart from compensation otherwise permitted by these sections. Accordingly, all income generated and expenses associated with mortgage so acquired shall be treated as belonging to the PROGRAM. The SPONSOR shall not sell a mortgage to the PROGRAM pursuant to this subparagraph if the cost of the mortgage exceeds the funds reasonably anticipated to be available to the PROGRAM to purchase the mortgage. The PROSPECTUS and the PROGRAM agreement shall set forth in a manner satisfactory to the ADMINISTRATOR the methodology to be utilized for determining which mortgages will ultimately be transferred to the PROGRAM when the cost of the mortgage acquired by the SPONSOR on behalf of the PROGRAM exceeds PROGRAM funds available to purchase the mortgage.

OR

b. The purchase is made from a PROGRAM formed by the SPONSOR pursuant to the rights of first refusal

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required by subsection V.G. of this section. In such a case the purchase price should be no more than fair market value as determined by an independent appraisal.

2. Sales to the SPONSOR. A PROGRAM shall not sell a mortgage to the SPONSOR unless all of the following criteria are met:

(i) the PROGRAM does not have sufficient offering proceeds available to retain the mortgage (or contract rights related thereto);

(ii) the PROSPECTUS discloses that the SPONSOR will purchase all mortgages (or contract rights) that the PROGRAM does not have sufficient proceeds to retain;

(iii) the SPONSOR pays the PROGRAM an amount in cash equal to the cost of the mortgage (or contract rights) to the PROGRAM (including all cash payments and carrying costs related thereto);

(iv) the SPONSOR assumes all of the PROGRAM'S obligations and liabilities incurred in connection with the holding of the mortgage (or contract rights) by the PROGRAM;

(v) the sale of the SPONSOR occurs not later than 90 days following the termination date of the offering;

(vi) the methodology to be used by the SPONSOR in determining which mortgages it will purchase in the event that the PROGRAM's offering proceeds are insufficient to retain all mortgages must be fully disclosed in the PROSPECTUS.

3. Dealing with related PROGRAMS. A PROGRAM shall not acquire a mortgage from, or sell a mortgage to a PROGRAM in which the SPONSOR has an interest.

4. Sales of Foreclosed Properties. A PROGRAM shall not sell a foreclosed property to the SPONSOR or to a PROGRAM in which the SPONSOR has an interest.

B. *Exclusive Agreement.* A PROGRAM shall not give a SPONSOR an exclusive right or employment to sell or otherwise dispose of PROGRAM mortgages or other PROGRAM assets.

C. *Commissions on Reinvestment or Distribution.* A PROGRAM shall not pay, directly or indirectly, a commission or fee (except as permitted under Section IV. of these guidelines (relating to Fees--Compensation--Expenses)) to a SPONSOR in connection with the reinvestment or distribution of the proceeds of a CAPITAL TRANSACTION.

D. *Services Rendered to the PROGRAM by the SPONSOR.*

1. Expenses of the PROGRAM.

a. All expenses of the PROGRAM shall be billed directly to and paid by the PROGRAM. The SPONSOR may be reimbursed for the actual cost of goods and materials used for or by the PROGRAM and obtained from entities unaffiliated with the SPONSOR. The SPONSOR may be reimbursed for the administrative services necessary to the prudent operation of the PROGRAM provided that the reimbursement shall be at the lower of the SPONSOR's actual cost or the amount the PROGRAM would be required to pay to independent parties for comparable administrative services in the same geographical location. No reimbursement shall be permitted for services for which the SPONSOR is entitled to compensate by way of a separate fee. Excluded from the allowable reimbursement (except as permitted under Section IV.C.1. of these guidelines (relating to Fees--Compensation--Expenses)) shall be:

(i) rent or depreciation, utilities, capital equipment, other administrative items; and

(ii) salaries, fringe benefits, travel expenses, and other administrative items incurred or allocated to any controlling PERSONS of the SPONSOR or AFFILIATES.

b. Controlling PERSON, for purpose of this section, includes but is not limited to, any PERSON, whatever their title, who performs functions for the SPONSOR similar to those of:

(i) chairman or member of the board of directors;

(ii) executive management, such as the president, vice-president or senior vice-president, corporate secretary, or treasurer;

(iii) senior management, such as the vice-president of an operating division who reports directly to executive management; or

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(iv) those holding 5.0% or more equity interest in the SPONSOR or a PERSON having the power to direct or cause the direction of the SPONSOR, whether through the ownership of voting securities, by contract, or otherwise.

c. The annual PROGRAM report must contain a breakdown of the costs reimbursed to the SPONSOR. Within the scope of the annual audit of the SPONSOR's financial statement, the independent certified public accountants must verify the allocation of such costs to the PROGRAM. The method of verification shall at a minimum provide:

(i) a review of the time records of individual employees, the costs of whose services were reimbursed; and

(ii) a review of the specific nature of the work performed by each such employee.

d. The methods of verification shall be in accordance with generally accepted auditing standards and shall accordingly include such tests of the accounting records and such other auditing procedures which the SPONSOR's independent certified public accountants consider appropriate in the circumstance. The additional costs of such verification will be itemized by said accountants on a PROGRAM by PROGRAM basis and may be reimbursed to the SPONSOR by the PROGRAM in accordance with this subsection only to the extent that such reimbursement when added to the cost for administrative services rendered does not exceed the competitive rate for such services as determined in this paragraph. The PROSPECTIJS must disclose in tabular form an estimate of such proposed expenses for the next fiscal year together with a breakdown by year of such expenses reimbursed in each of the last five public PROGRAMS formed by the SPONSOR.

2. Other goods and services. Except as provided in Section IV. of these guidelines (relating to Fees--Compensation--Expenses) and paragraph V.D.1. of this subsection, other goods and services may be provided by the SPONSOR for the PROGRAM only if all of the following criteria are met.

a. The goods or services must be necessary to the prudent operation of the PROGRAM.

b. The compensation, price, or fee must be equal to either:

(i) the lesser of 90% of the compensation, price, or fee of any nonaffiliated PERSON who is rendering comparable services or selling or leasing comparable goods on competitive terms in the same geographic location or 90% of the compensation, price, or fee charged by the SPONSOR for rendering comparable services or selling or leasing comparable goods on competitive terms; or

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(ii) if at least 95% of gross revenues attributable to the business of rendering such services or selling or leasing such goods are derived from PERSONS other than AFFILIATES, the compensation, price, or fee charged by a nonaffiliated PERSON who is rendering comparable services or selling or leasing comparable goods on competitive terms in the same geographic location.

c. The goods or services shall be provided pursuant to a written contract which precisely describes such goods or services and all compensation to be paid. The contract may be modified in any material respect only by the vote of a majority in interest of the PARTICIPANTS and shall be terminable without penalty on 60 days' notice.

d. The goods and services provided and the written contract referred to in subparagraph c. of this paragraph must be fully disclosed in the PROSPECTUS.

e. The SPONSOR must have been previously engaged in the business of rendering services or selling or leasing such goods as an ordinary and ongoing business for a period of at least three years.

f. The SPONSOR must receive at least 33% of gross revenues for such goods or services from PERSONS other than AFFILIATES.

g. Except as provided in Section IV. of these guidelines (relating to Fees--Compensation--Expenses), paragraph V.D.1. of this subsection, and other than as provided in subparagraphs b., d., e., and f. of this paragraph, the SPONSOR may provide additional goods and services to the PROGRAM if all of the following criteria are met:

(i) the goods or services may only be provided by the SPONSOR in extraordinary circumstances;

(ii) the compensation, price, or fee must be competitive with the compensation, price, or fee, of any non-AFFILIATED PERSON who is rendering comparable services or selling or leasing comparable goods on competitive terms which could reasonably be made available to the PROGRAM;

(iii) the fees and other terms of the contract shall be fully disclosed;

(iv) the SPONSOR must be previously engaged in the business of rendering such services or selling or leasing such goods, independently of the PROGRAM and as an ordinary and ongoing business;

(v) there must be compliance with subparagraphs a. and c. of this Section V.D.2.

E. Rebates, Kickbacks, and Reciprocal Arrangements.

1. No rebates or give-ups may be received by the SPONSOR nor may the SPONSOR participate in any reciprocal business arrangement which would circumvent these rules. Furthermore, the PROSPECTUS and PROGRAM charter documents shall contain language prohibiting the rebates or give-ups as well as language prohibiting reciprocal business arrangements which would circumvent the restrictions against dealing with AFFILIATES or promoters.

2. No SPONSOR shall directly or indirectly pay or award any commissions or other compensation to any PERSON engaged by a potential investor for investment advice as an inducement to such adviser to advise the purchaser of interests in a particular PROGRAM; provided, however, that this clause shall not prohibit the normal sales commissions payable to a registered broker-dealer or of other properly licensed PERSON for selling PROGRAM interests.

F. Commingling of Funds. The funds of a PROGRAM shall not be commingled with the funds of any other PERSON. Nothing contained in this subsection however, shall prohibit a SPONSOR from establishing a master fiduciary account pursuant to which separate subtrust accounts are established for the benefit of AFFILIATED PROGRAMS, provided, that PROGRAM funds are protected from claims of such other PROGRAMS and/or creditors. The prohibition of this subsection shall not apply to investments meeting the requirements of subsection G. of this section.

G. Investments In or With Other PROGRAMS.

1. The PROGRAM shall be permitted to invest in general partnerships or joint ventures (including entities in limited liability company and limited liability partnership form) with non-AFFILIATES that own and operate one or more particular mortgages if the PROGRAM, alone or together with any publicly registered AFFILIATE of the PROGRAM meeting the requirements of paragraph 2. of this subsection acquires a controlling interest in such a general partnership or joint venture, but in no event shall duplicate fees be permitted. For purposes of this paragraph, "controlling interest" means an equity interest possessing the power to direct or cause the direction of the management and policies of the general partnership or joint venture, including the authority to:

a. review all contracts entered into by the general partnership or joint venture that will have a material effect on its business or assets;

b. cause a sale of the mortgage or its interest therein subject in certain cases where required by the partnership or joint venture agreement, to limits as to time, minimum amounts, and/or a right of first refusal by the joint venture partner or consent of the joint venture partner;

c. approve budgets and major capital expenditures subject to a stated minimum amount;

d. veto any sale of the mortgage, or, alternatively, to receive a specified preference on sale or proceeds; and

e. exercise a right of first refusal on any desired sale by the joint venture partner of its interest in the mortgage except for transfer to an AFFILIATE of the joint venture partner.

2. The PROGRAM shall be permitted to invest in general partnerships or joint ventures with other publicly registered AFFILIATES of the PROGRAM if all the following conditions are met:

a. the PROGRAMS have substantially identical investment objectives.

b. there are no duplicate fees.

c. the compensation to SPONSORS is substantially identical in each PROGRAM.

d. each PROGRAM must have a right of first refusal to buy if the other PROGRAMS wish to sell assets held in the joint venture.

e. The investment of each PROGRAM is substantially the same terms and conditions.

f. the PROSPECTUS discloses the potential risk of impasse on joint venture decisions since no PROGRAM may have the right to buy the asset from the partnership or joint venture, it may not have the resources to do so.

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3. The PROGRAM shall be permitted to invest in general partnerships or joint ventures with AFFILIATES other than publicly registered AFFILIATES of the PROGRAM only under the following conditions:

a. the investment is necessary to relieve the SPONSOR from any commitment to purchase a mortgage entered into in compliance with subsection V.A.1.a. of this section prior to the closing of the offering period of the PROGRAM;

b. there are no duplicate fees;

c. the investment of each entity is on substantially the terms and conditions;

d. the PROGRAM provides for a right of first refusal to buy if the SPONSOR wishes to sell a mortgage held in the joint venture; and

e. the PROSPECTUS discloses the potential risk of impasse on joint venture decisions.

4. Other than as specifically permitted in paragraphs 2. and 3. of this subsection, the PROGRAM shall not be permitted to invest in general partnerships or joint ventures with AFFILIATES.

5. A PROGRAM shall be permitted to invest in general partnership interests of limited partnerships only if the PROGRAM alone or together with any publicly registered AFFILIATE of the PROGRAM meeting the requirements of paragraph 2. of this subsection acquires a "controlling interest" as defined in paragraph V.H.1. of this subsection, no duplicate fees are permitted, no additional compensation beyond that permitted by Section IV. of these guidelines (relating to Fees--Compensation-- Expenses), shall be paid to the SPONSOR, and the PROGRAM agreement shall comply with this section.

6. A PROGRAM that is an "upper-tier PROGRAM" shall be permitted to invest in interests of other PROGRAMS (the "lower-tier PROGRAMS") only if all of the following conditions are met.

a. If the SPONSOR of the lower-tier PROGRAM is a SPONSOR of the upper-tier PROGRAM, the PROGRAM agreement of the upper-tier PROGRAM shall:

(i) prohibit the PROGRAM from investing in such lower-tier PROGRAM unless the PROGRAM agreement

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of the lower-tier PROGRAM contains provisions complying with Section IX.F. of these Guidelines (relating to Miscellaneous Provisions) and provisions acknowledging privity between the lower-tier SPONSOR and the PARTICIPANTS, and

(ii) provide that compensation payable in the aggregate from both tiers shall not exceed the amounts permitted under Section IV. of these guidelines (relating to Fees--Compensation-- Expenses).

b. If the SPONSOR of the lower-tier PROGRAM is not a SPONSOR of the upper-tier PROGRAM, the PROGRAM agreement of the upper-tier PROGRAM shall prohibit that PROGRAM from investing in the lower-tier PROGRAM unless the PROGRAM agreement of the lower-tier contains provisions complying with Sections II.E. and F. of these Guidelines (relating to Requirements of SPONSORS); VII. A.-D., H. and J (relating to Rights and Obligations of PARTICIPANTS); and IX.C. of these Guidelines (relating to Miscellaneous Provisions); and shall provide that the compensation payable at both tiers shall not exceed the amounts permitted in Section IV. of these Guidelines (relating to Fees--Compensation-- Expenses).

c. Each lower-tier PROGRAM shall have as its PARTICIPANTS only publicly registered upper-tier PROGRAMS, provided, however, that special limited partners (or PARTICIPANTS holding comparable interests) not AFFILIATED with the SPONSOR shall be permitted if the interests taken result in no diminution in the control exercisable by the other PARTICIPANTS.

d. No PROGRAM may be structured with more than two tiers.

e. The PROGRAM agreement of the upper-tier PROGRAM must contain a prohibition against duplicate fees.

f. The PROGRAM agreement of the upper-tier PROGRAM must provide that the PARTICIPANTS in the upper-tier PROGRAM can, upon the vote of a majority in interest and without the concurrence of the SPONSOR, direct the SPONSOR Of the upper-tier PROGRAM (acting on behalf of the upper-tier PROGRAM) to the any action permitted to a PARTICIPANT (e.g. the upper-tier PROGRAM) in the lower-tier PROGRAM.

g. The PROSPECTUS must fully and prominently disclose the two-tiered arrangement and any risks related thereto.

7. Notwithstanding subsections V.G.6.b. through g. of this section, if the SPONSOR of the lower-tier PROGRAM is not a SPONSOR of the upper-tier PROGRAM, an upper-tier PROGRAM may invest in a lower-tier PROGRAM that holds a particular mortgage to be qualified pursuant to the Internal Revenue Code of 1986, Section 42(g) as amended, if

PARTICIPANTS in both tiers are provided all of the rights and obligations requires by Section VII. of these Guidelines (relating to Rights and Obligations of PARTICIPANTS) and the PROGRAM agreement of the upper-tier PROGRAM agreement contains a prohibition against payment of duplicate fees.

H. *Lending practices.*

1. No loans may be made by the PROGRAM to the SPONSOR or an AFFILIATE, except as provided in subsection V.H.2. of this section and II.D.4. of these guidelines (relating to Requirements of SPONSORS).

2. The PROGRAM may provide mortgage loans to PROGRAMS formed by or AFFILIATED with the SPONSOR in those circumstances in which such activities have been fully justified the ADMINISTRATOR. These AFFILIATED transactions must at the minimum meet the following conditions:

a. the circumstances under which the loans will be made and the actual terms of the loan must be fully disclosed in the PROSPECTUS; or

b. an independent and qualified adviser must issue a letter of opinion to the effect that any proposed loan to an AFFILIATE of the PROGRAM is fair and at least as favorable to the PROGRAM as a loan to an unaffiliated borrower in similar circumstances. In addition, the SPONSORS will be required to obtain a letter of opinion from the independent adviser in connection with any disposition, renegotiation, or other subsequent transaction involving loans made to a SPONSOR or an AFFILIATE of the SPONSOR. The independent adviser must be identified in the initial PROGRAM PROSPECTUS. The independent adviser's compensation must be paid by the SPONSOR and not be reimbursable by the PROGRAM;

c. loans made to third parties, the proceeds of which are used to purchase or refinance a property or other asset in which the SPONSOR or an AFFILIATE has an equity or security interest, must meet the requirements of subparagraph a. or b. of this paragraph.

3. On loans made available to the PROGRAM by the SPONSOR, the SPONSOR may not receive interest or similar charges or fees in excess of the amount which would be charged by unrelated lending institutions on comparable loans for the same purpose, in the same locality of the property if the loan is made in connection with a particular property. No prepayment charge or penalty shall be required by the SPONSOR on a loan to the PROGRAM secured by either a first or junior or all-inclusive trust deed, mortgage, or encumbrance on the property, except to the extent that such prepayment charge or penalty is attributable to the underlying encumbrance.

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4. The SPONSOR shall be prohibited from providing FINANCING except as permitted by paragraph 3. of this subsection, in which case there will be independent advisers for each publicly registered party to the transaction.

COMMENT A:

Full disclosure of the terms of the loans and the circumstances under which they will be made includes, but is not limited to identification of the borrower(s) and the property(ies) securing the loan(s), a description of the parameters of the loan(s) or model loan documents, disclosure of the SPONSOR'S or the AFFILIATES' interest in such property, and a description of the terms and circumstances surrounding such interest.

COMMENT B:

In order for the adviser to be considered qualified and independent, the following conditions must be met:

(i) The adviser must be a long-established, nationally recognized investment banking firm, accounting firm, mortgage banking firm, real estate financial consulting firm or advisory firm;

(ii) The adviser must have a staff of real estate professionals;

(iii) The compensation of the adviser must be determined and embodied in a written contract before the opinion is rendered;

(iv) If an adviser has been engaged to render a fairness opinion who is not the adviser previously engaged by the PROGRAM to render this or the preceding fairness opinion, the SPONSOR shall inform the investors (by no later than the next annual report) of the date when such adviser was engaged, and whether there were any disagreements with the former adviser on any matters of valuation, assumptions, methodology, accounting principles and practice, or disclosure, which disagreements, if not resolved to the satisfaction of the former adviser would have caused him to make reference, in connection with the fairness opinion, to the subject matter of the disagreement or decline to give an opinion;

(v) The adviser, directly or indirectly, has no interest in, nor any material business or professional relationship with, the PROGRAM, the SPONSOR, the borrower, or any AFFILIATES thereof. Independence will be considered to be impaired if, for example, during the period of the adviser's engagement, or at any time of expressing his opinion, he or his firm: (i) has, or was committed to acquire any direct or indirect ownership interest in the PROGRAM, SPONSOR, borrower, or AFFILIATES thereof, or (ii) had any joint closely held business investment with the PROGRAM, SPONSOR, borrower, or any AFFILIATE thereof, which was material in relation to the adviser's net worth; or (iii) had any loan to or from the PROGRAM, SPONSOR, borrower, or AFFILIATES thereof.

The foregoing examples are not intended to be all-inclusive. However, for purposes of determining whether or not a business or professional relationship or joint investment is material, the gross revenue derived by the adviser from the PROGRAM, SPONSOR, borrower, and their AFFILIATES shall be deemed material if it exceeds 5% of the annual gross revenue derived by the adviser from all sources, or exceeds 5% of the individual's or advisory firm's net worth (on an estimated fair market value basis).

I. *Requirement for Real Property Appraisal.* Every mortgage loan originated, purchased or otherwise acquired by the PROGRAM must be supported by a current appraisal prepared by a competent, independent appraiser. The appraisal shall be maintained in the SPONSOR'S records for at least five years, and shall be made available for inspection and duplication by any PARTICIPANT. The PROSPECTUS shall contain notice of this right. Also a mortgagee's or owner's

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title insurance policy or commitment as to the priority of a mortgage or the condition of title shall be obtained. Further, the SPONSOR of the PROGRAM shall observe the following policies in connection with investing in or making mortgage loans.

1. The PROGRAM may not invest in or make mortgage loans on any one property which would exceed, in the aggregate, an amount equal to 20% of the CAPITAL CONTRIBUTIONS to be raised by the PROGRAM.

2. The PROGRAM may not invest in or make mortgage loans to or from any one borrower which would exceed, in the aggregate, an amount greater than 20% of the CAPITAL CONTRIBUTIONS to be raised by the PROGRAM.

3. The PROGRAM may not invest in or make mortgage loans on unimproved real property in an amount in excess of 25% of the CAPITAL CONTRIBUTIONS to be raised by the PROGRAM.

4. The PROGRAM shall not invest in real estate contracts of sale otherwise known as land sale contracts unless such contracts of sale are in recordable form and are appropriately recorded in chain of title.

5.

a. The PROGRAM normally shall not make or invest in mortgage loans on any one property if at the time of the acquisition of the mortgage the aggregate amount of all mortgage loans outstanding on the property, including the loans of the PROGRAM, would exceed an amount equal to 85% of the appraised value of the property as determined by an independent appraisal, unless substantial justification exists because of the presence of other underwriting criteria.

b. If the total amount of all mortgage loans outstanding on any one property, including the loans of the PROGRAM, exceeds 80% of the value of the property, and such loans are not supported by the presence of other underwriting criteria, the minimum financial suitability standards for PARTICIPANTS shall be increased to a minimum annual gross income of \$85,000, and a minimum net worth of \$330,000. For purposes of this paragraph V.I.5, the "aggregate amount of all mortgage loans outstanding on the property, including the loans of the PROGRAM," shall include all interest (excluding contingent participations in income and/or appreciation in value of the mortgaged property), the current payment of which may be deferred pursuant to the terms of such loans. This restriction applies to all loans, including construction loans.

6. The PROGRAM is permitted to borrow money when it has taken over the operation of a property in order to prevent defaults under existing loans, or there otherwise is a need for additional capital with respect to such a property.

COMMENT:

This Section provides certain minimum standards in connection with the investment in or making of

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mortgage loans by a PROGRAM. The standards may be exceeded for a particular registration if the mortgage loans are supported by sound underwriting criteria, such as the net worth of the borrower; the credit rating of the borrower based on historical financial performance; or collateral adequate to justify waiver of application of this Section. The standards may also be exceeded where program mortgage loans are or will be insured or guaranteed by a government or a government agency; where the loan is secured by a pledge or assignment of other real estate or another real estate mortgage; where rents are assigned under a lease where a tenant or tenants have demonstrated through historical net worth and cash flow the ability to satisfy the terms of the lease; or where similar criteria are presented that are satisfactory to the Administrator.

J. PROGRAM indebtedness.

1. The PROGRAM shall not incur indebtedness at its commencement.
2. The total amount of indebtedness incurred by the PROGRAM shall at no time exceed the sum of 70% of the aggregate fair market value of all PROGRAM mortgages.

K. Appraisal and Compensation.

1. In connection with a proposed ROLL-UP, an appraisal of all PROGRAM assets shall be obtained from a competent, independent expert. If the appraisal will be included in a PROSPECTUS used to offer the securities of a ROLL-UP ENTITY, the appraisal shall be filed with the Securities and Exchange Commission and the states as an Exhibit to the Registration Statement for the offering. Accordingly, an issuer using the appraisal shall be subject to liability for violation of the Securities Act of 1933, Section 11, and comparable provisions under state laws for any material misrepresentations or material omissions in the appraisal. PROGRAM assets shall be appraised on a consistent basis. The appraisal shall be based on an evaluation of all relevant information, and shall indicate the value of the PROGRAM's assets as of a date immediately prior to the announcement of the proposed ROLL-UP. The appraisal shall assume an orderly liquidation of the PROGRAM's assets over a 12 month period. The terms of the engagement of the independent expert shall clearly state that the engagement is for the benefit of the PROGRAM and its PARTICIPANTS. A summary of the independent appraisal, indicating all material assumptions underlying the appraisal, shall be included in a report to the PARTICIPANTS in connection with a proposed ROLL-UP.

2. In connection with a proposed ROLL-UP the PERSON sponsoring the ROLL-UP shall offer to PARTICIPANTS who vote "no" on the proposal the choice of:

- A. accepting the securities of the ROLL-UP ENTITY offered in the proposed ROLL-UP; or

B. one of the following:

(i) remaining as PARTICIPANTS in the PROGRAM and preserving their interests therein on the same terms and conditions as existed previously; or

(ii) receiving cash in an amount equal to the PARTICIPANTS' pro-rata share of the appraised value of the net assets of the PROGRAM.

3. The PROGRAM shall not participate in any proposed ROLL-UP which would result in PARTICIPANTS having democracy rights in the ROLL-UP ENTITY which are less than those provided for under Section VII.A. and B. of these guidelines (relating to Rights and Obligations of PARTICIPANTS). If the ROLL-UP ENTITY is a corporation, the voting rights of PARTICIPANTS shall correspond to the voting rights provided for in these guidelines to the greatest extent possible.

4. The PROGRAM shall not participate in any proposed ROLL-UP which includes provision which would operate to materially impede or frustrate the accumulation of shares by any purchaser of the securities of the ROLL-UP ENTITY (except to the minimum extent necessary to preserve the tax status of the ROLL-UP ENTITY). The PROGRAM shall not participate in any proposed ROLL-UP which would limit the ability of a PARTICIPANT to exercise the voting rights of its securities of the ROLL-UP ENTITY on the basis of the number of PROGRAM interests held by that PARTICIPANT.

5. The PROGRAM shall not participate in any proposed ROLL-UP in which the PARTICIPANTS' rights of access to the records of the ROLL-UP ENTITY will be less than those provided for under Section VII.D. of these guidelines relating to Rights and Obligations of PARTICIPANTS).

6. The PROGRAM shall not participate in any proposed ROLL-UP in which any of the costs of the transaction would be borne by the PROGRAM if the ROLL-UP is not approved by the PARTICIPANTS.

VI. NON-SPECIFIED MORTGAGE PROGRAMS.

A. *Minimum Capitalization.* A non-specified mortgage PROGRAM shall provide for minimum cash gross proceeds from the offering of not less than \$1 million to be available for INVESTMENT IN MORTGAGES.

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B. *Experience of SPONSOR.* For non-specified mortgage PROGRAMS, the SPONSOR or at least one of its principals must establish that he has the equivalent of not less than five years' experience in real estate business in an executive capacity and two years' experience in the management and acquisition of the type of mortgage loans to be acquired or otherwise must demonstrate to the satisfaction of the ADMINISTRATOR that he has sufficient knowledge and experience to acquire and manage the type of mortgages proposed to be acquired by the non-specified mortgage PROGRAM.

C. *Statement of Investment Objectives.* A non-specified mortgage PROGRAM shall state types of mortgages in which it proposes to invest or originate. The size and characteristics of such mortgage loans shall be consistent with the objectives of the PROGRAM and the experience of the SPONSORS. As a minimum, the following restrictions on investment objectives shall be observed.

(1) The statement of investment objectives shall indicate whether the PROGRAM will enter into joint venture arrangements and the projected extent thereof.

(2) The statement of investment objectives shall not include a quantitative estimate of the PROGRAM's anticipated economic performance or anticipated return to investors (in the form of distributable funds or tax benefits). The presentation of a proposed level of economic performance or return to investors (in the form of distributable funds or tax benefits) in connection with a non-specified mortgage PROGRAM is prohibited by Section VIII.C. of these guidelines (relating to Disclosure and Marketing Requirements).

D. *Period of Offering and Expenditure of Proceeds.* Subject to compliance with applicable state securities laws and regulations, an offering of securities in a non-specified mortgage PROGRAM may extend for up to two years from the date of original effectiveness provided that the minimum amount of PROGRAM interests necessary to satisfy the greater of the minimum capitalization requirements of subsection A. of this section or the impound requirements set by the PROGRAM is sold within one year of commencement of the offering. While the proceeds of an offering are awaiting investment in mortgage loans, the proceeds may be temporarily invested in short-term highly liquid investments where there is appropriate safety of principal, such as U.S. Treasury Bonds or Bills. Any proceeds of the offering of PROGRAM interests not invested within the later of two years after commencement of the offering or one year after the termination of the offering (except for necessary, operating capital) shall be distributed pro rata to the PARTICIPANTS as a return of capital so long as the adjusted INVESTMENT IN MORTGAGES is in compliance with Section IV.C. of these guidelines (relating to Fees--Compensation--Expenses).

E. *Multiple PROGRAMS.* The method for the allocation of the acquisition of mortgages by two or more PROGRAMS of the same SPONSOR seeking to acquire similar types of properties shall be reasonable. The method also shall, be described in the PROSPECTUS.

VII. RIGHTS AND OBLIGATIONS OF PARTICIPANTS.

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A. *Meetings.* Meetings of the PROGRAM may be called by the SPONSOR or the PARTICIPANTS holding more than 10% of the then outstanding PROGRAM interests, for any matters for which the PARTICIPANTS may vote as set forth in the PROGRAM agreement. Upon receipt of a written request either in PERSON or by certified mail stating the purpose(s) of the meeting, the SPONSOR shall provide all PARTICIPANTS, within 10 days after receipt of said request, written notice (either in PERSON or by certified mail) of a meeting and the purpose of such meeting to be held on a date not less than 15 nor more than 60 days after receipt of said request, at a time and place convenient to PARTICIPANTS.

B. *Voting Rights of Limited Partners.*

1. To the extent permitted by the law of the state of formation, the PROGRAM agreement shall provide that a majority of the outstanding PROGRAM interests may, without necessity for concurrence by the general partner, vote to:

- a. amend the PROGRAM agreement;
- b. remove the SPONSOR(s);
- c. elect a new SPONSOR(s);
- d. approve or disapprove the sale or liquidation of all or substantially all of the assets of the PROGRAM except pursuant to a plan disclosed in the final PROSPECTUS; and
- e. dissolve the PROGRAM.

2. Without concurrence of a majority of the outstanding PROGRAM interests, the SPONSOR(s) may not:

- a. amend the PROGRAM agreement except for amendments which do not adversely affect the rights of PARTICIPANTS;
- b. voluntarily withdraw as a SPONSOR unless such withdrawal would not affect the tax status of the

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PROGRAM and would not materially adversely affect the PARTICIPANT;

c. appoint a new SPONSOR(s);

d. sell all or substantially all of the PROGRAM's assets other than in the ordinary course of the PROGRAM's business;

e. cause the merger or other reorganization of the PROGRAM; or

f. dissolve the PROGRAM. Notwithstanding subparagraph c. of this paragraph, an additional SPONSOR may be appointed without obtaining the consent of the PARTICIPANTS if the addition of such PERSON is necessary to preserve the tax status of the PROGRAM, such PERSON has no authority to manage or control the PROGRAM under the PROGRAM agreement, there is no change in the identity of PERSONS who have authority to manage or control the PROGRAM, and the admission of such PERSON as an additional general partner does not materially adversely affect the PARTICIPANTS.

3. Any amendment to the PROGRAM agreement which modifies the compensation or distributions to which a SPONSOR is entitled or which affects the duties of a SPONSOR may be conditioned upon the consent of the SPONSOR. With respect to any PROGRAM interests owned by the SPONSOR, the SPONSOR may not vote or consent on matters submitted to the PARTICIPANTS regarding the removal of the SPONSOR or regarding any transaction between the PROGRAM and the SPONSOR. In determining the existence of the requisite percentage of PROGRAM interests necessary to approve a matter on which the SPONSOR may not vote or consent, any PROGRAM interests owned by the SPONSOR shall not be included.

4. If the law of the State of formation provides that the PROGRAM will dissolve upon termination of a SPONSOR(s) unless the remaining SPONSOR(s) continues the existence of the PROGRAM, the PROGRAM agreement shall obligate the remaining SPONSOR(s) to continue the PROGRAM's existence; and if there will be no remaining SPONSOR(S), the termination of the last SPONSOR shall not be effective for a period of at least 120 days during which time a majority of the outstanding PROGRAM INTERESTS shall have the right to elect a SPONSOR who shall agree to continue the existence of the PROGRAM.

5. The PROGRAM agreement shall provide for a successor SPONSOR where the only SPONSOR of the PROGRAM is an individual.

C. Reports to Holders of PROGRAM INTERESTS. The PROGRAM agreement shall provide that the SPONSOR

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shall cause to be prepared and distributed to the holders of PROGRAM interests during each year the following reports:

1. In the case of a PROGRAM registered under the Securities Exchange Act of 1934, Section 12(g), within 60 days after the end of each quarter of the PROGRAM, a report containing:

- a. a balance sheet, which may be unaudited;
- b. a statement of income for the quarter then ended, which may be unaudited; and
- c. a statement of cash flows for the quarter then ended, which may be unaudited; and
- d. other pertinent information regarding the PROGRAM and its activities during the quarter covered by the report.

2. In the case of all PROGRAMS, within 75 days after the end of each PROGRAM's fiscal year, all information necessary for the preparation of the PARTICIPANTS' federal income tax returns.

3. In the case of all PROGRAMS, within 120 days after the end of each PROGRAMS' fiscal year, an annual report containing:

- a. audited financial statements accompanied by an auditor's report which, for purposes of this section only, may contain a qualified, adverse, or disclaimer opinion or explanatory paragraph;
- b. a report of the activities of the PROGRAM during the period covered by the report; and
- c. where forecasts have been provided to the holders of PROGRAM INTERESTS, a table comparing the forecasts previously provided with the actual results during the period covered by the report,

4. Such report shall set forth distributions to PARTICIPANTS for the period covered thereby and shall separately identify distributions from:

- a. CASH FLOW from operations during the period;
- b. CASH FLOW from operations during a prior period which had been held as reserves;
- c. proceeds from CAPITAL TRANSACTIONS;
- d. lease payments on net leases with builders and sellers; and
- e. reserves from the gross proceeds of the offering originally obtained from the PARTICIPANTS.

D. *Access to Records.* Every PARTICIPANT shall at all times have access to the records of the PROGRAM and may inspect and copy any of them. The limited partnership agreement, by-laws, or other PROGRAM agreement shall include the following provisions regarding access to the list of PARTICIPANTS:

1. An alphabetical list of names, addresses, and business telephone numbers of the PARTICIPANTS of the PROGRAM along with the number of PROGRAM interests held by each of them (the "PARTICIPANT list") shall be maintained as a part of the books and records of the PROGRAM and shall be available for inspection by any PARTICIPANT or its designated agent at the home office of the PROGRAM upon the request of the PARTICIPANT.
2. The PARTICIPANT list shall be updated at least quarterly to reflect changes in the information contained therein.
3. A copy of the PARTICIPANT list shall be mailed to any PARTICIPANT requesting the PARTICIPANT list within ten days of the request. The copy of the PARTICIPANT list shall be printed in alphabetical order, on white paper, and in a readily readable type size (in no event smaller than 10-point type). A reasonable charge for copy work may be charged by the PROGRAM.
4. The purposes for which a PARTICIPANT may request a copy of the PARTICIPANT list include, without limitation, matters relating to PARTICIPANT' voting rights under the PROGRAM agreement, tender offers, and the exercise of PARTICIPANT'S' rights under federal proxy laws; and

5. If the SPONSOR of the PROGRAM neglects or refuses to exhibit, produce, or mail a copy of the PARTICIPANT list as requested, the SPONSOR shall be liable to any PARTICIPANT requesting the list for the costs, including attorneys' fees, incurred by that PARTICIPANT for compelling the production of the PARTICIPANT list, and for actual damages suffered by any PARTICIPANT by reason of such refusal or neglect. It shall be a defense that the actual purpose and reason for the requests for inspection or for a copy of the PARTICIPANT list is to secure such list of PARTICIPANTS or other information for the purpose of selling such list or copies thereof, or of using the same for a commercial purpose other than in the interest of the applicant as a PARTICIPANT relative to the affairs of the PROGRAM. The SPONSOR may require the PARTICIPANT requesting the PARTICIPANT list to represent that the list is not requested for a commercial purpose unrelated to the PARTICIPANT'S interest in the PROGRAM. The remedies provided, hereunder to PARTICIPANTS requesting copies of the PARTICIPANT list are in addition to, and shall not in any way limit, other remedies available to PARTICIPANTS under federal law, or the laws of any state.

E. *Admission of PARTICIPANTS.* Admission of PARTICIPANTS to the PROGRAM shall be subject to the following:

1. *Admission of Original PARTICIPANTS.* Upon the original sale of PROGRAM INTERESTS by the PROGRAM, the purchasers should be admitted as PARTICIPANTS not later than 15 days after the release from impound of the purchaser's funds to the PROGRAM, and thereafter purchasers should be admitted into the PROGRAM not later than the last day of the calendar month following the date their subscription was accepted by the PROGRAM. Subscriptions shall be accepted or rejected by the PROGRAM within 30 days of their receipt; if rejected, all funds should be returned to the subscriber within 10 business days.

2. *Admission of Substituted PARTICIPANTS and Recognition of Assignees.* The PROGRAM shall amend the certificates of the PROGRAM least once each calendar quarter to effect the substitution of substituted PARTICIPANTS, although the SPONSOR may elect to do so more frequently. In the case of assignments, where the assignee does not become a substituted PARTICIPANT, the PROGRAM shall recognize the assignment not later than the last day of the calendar month following receipt of notice of assignment and required documentation.

3. *Rights of Assignees.*

a. Except where deemed inappropriate by the ADMINISTRATOR, PERSONS holding PROGRAM interests by assignment from entities holding limited partnership interests in a PROGRAM for the purpose of assigning all or a portion of such interests to PERSONS investing in such PROGRAM (hereinafter the "assignor") shall be expressly granted the same rights as if they were limited partners except as prohibited by applicable local law including, but not limited to, the rights enumerated in this section.

b. The assignment agreement and PROSPECTUS shall provide that the assignor's management shall have fiduciary responsibility for the safekeeping and use of all funds and assets of the assignees, whether or not in the

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assignor management's possession or control, and that the management of the assignor shall not employ, or permit another to employ such funds or assets in any manner except for the exclusive benefit of the assignees. In addition, the agreement shall not permit the assignees to contract away the fiduciary duty owed to the assignees by the assignor's management under the common law of agency.

F. *Redemption of PROGRAM INTERESTS.* Ordinarily, the PROGRAM and the SPONSOR may not be mandatorily obligated to redeem or repurchase any of its PROGRAM interests, although the PROGRAM and the SPONSOR may not be precluded from purchasing such outstanding interests if such purchase does not impair the capital or the operation of the PROGRAM. Notwithstanding the foregoing, a mortgage PROGRAM may provide for mandatory redemption rights under the following necessitous circumstances:

1. death or legal capacity of the owner, or
2. a substantial reduction in the owner's NET WORTH or income provided that:
 - a. the PROGRAM has sufficient cash to make the purchase;
 - b. the purchase will not be in violation of applicable legal requirements;
 - c. not more than 15% of the outstanding units are purchased in any year; and
 - d. where the purchase price is not mutually agreed upon, the matter shall be submitted to arbitration.

G. *Transferability of PROGRAM INTERESTS.* Restrictions on assignment of PROGRAM INTERESTS or on the substitution of a PARTICIPANT are generally disfavored and will be allowed only if:

1. they comply with the safe harbor provisions of Internal Revenue Service Notice 88-75 (or other safe harbors adopted by the Internal Revenue Service that protect against treatment as a publicly traded partnership); or
2. they are intended to preserve the tax status of the PROGRAM or the characterization or treatment of income or loss;

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3. in the case of paragraph (2) of this subsection any restriction must be affirmatively supported by an opinion of counsel;

4. The PROGRAM agreement shall require the SPONSOR to eliminate or modify any restriction on substitution or assignment at such time as the restriction is no longer necessary.

H. *Dividend Reinvestment Plans.* A PROGRAM may offer PARTICIPANTS the opportunity to elect to have cash distributions reinvested in the PROGRAM or subsequent PROGRAMS if the following conditions are met:

1. the PROGRAM and subsequent PROGRAMS in which the PARTICIPANTS reinvest are registered or exempted under the state's blue sky laws;

2. counsel for the PROGRAM submits an opinion that the pooling of the funds for reinvestment is not in itself a security;

3. the subsequent PROGRAM has substantially identical investment objectives as the original PROGRAM;

4. the PARTICIPANTS are free to elect to revoke reinvestment within a reasonable time and such right is fully disclosed in the offering documents;

5. prior to each reinvestment the PARTICIPANTS receive a current updated disclosure document which contains at a minimum the following information:

a. the minimum investment amount;

b. the type or source of proceeds (e.g., cash distributions from operations or CAPITAL TRANSACTIONS) which may be reinvested;

c. the tax consequences of the reinvestment to the PARTICIPANTS;

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6. counsel for the PROGRAM submits an opinion that different consideration paid on reinvestment is not in violation of the state law (the difference arises when one PARTICIPANT agrees to payment of commission to the broker-dealer and another PARTICIPANT does not agree to payment of commission);

7. the broker-dealer or the issuer assumes responsibility for blue sky compliance and performance of due diligence responsibilities and has contacted the PARTICIPANTS to ascertain whether the PARTICIPANTS continue to meet the state's suitability standard for participation in each reinvestment;

8. if a broker-dealer is involved, it shall obtain writing an agreement from the client by which the client agrees to the payment of compensation to the broker-dealer in connection with individual reinvestment.

I. *Special Reports.* Within 60 days after the end of each quarter during which there have been mortgage loan originations or acquisitions, a "special report" (which may be part of the quarterly report) shall be sent to all PARTICIPANTS until the proceeds of the offering are committed or returned to the investors. The report shall disclose the amount of the mortgage loan, disclose the terms of the loan, identify the borrower, identify the property securing the mortgage loan, and disclose the appraised value of the property.

J. *Arbitration of Disputes.* Except as permitted in Section II.F. of these guidelines (relating to Requirements of SPONSORS), no provision requiring mandatory arbitration of disputes between the PARTICIPANT and the SPONSOR or the PROGRAM is permitted. Nothing contained herein shall apply to preexisting contracts between broker-dealers and PARTICIPANTS.

VIII. DISCLOSURE AND MARKETING REQUIREMENTS.

A. *Sales Promotional Efforts.*

1. Sales literature. Sales literature, sales presentations (including prepared presentations to prospective investors at group meetings), and advertising used in the offer or sale of PROGRAM INTERESTS shall conform in all applicable respects to requirements of filing, disclosure, and adequacy currently imposed on sales literature, sales presentations, and advertising used in the sale of corporate securities.

K. *Contents of PROSPECTUS.* The PROSPECTUS shall meet the requirements of Guide 5 of the Securities and Exchange Commission. The use of proceeds tabular summary required by Guide 5 shall include a separate line item for

estimated ACQUISITION AND ORIGINATION EXPENSES to be incurred by the PROGRAM. All of the information required to be set forth in the use of proceeds tabular summary by Guide 5 shall also be provided for estimated ACQUISITION AND ORIGINATION EXPENSES, including an estimate of ACQUISITION AND ORIGINATION EXPENSES to be paid to the SPONSOR. The description of the method for the allocation of the acquisition of mortgages by two or more PROGRAMS of the same SPONSOR shall meet the requirements of Section VI.E. of these guidelines (relating to Non-specified Property PROGRAMS). The ADMINISTRATOR may require additional disclosure if, in the ADMINISTRATOR's opinion, specific facts concerning the offering require it.

L. Forecasts.

1. Use of forecasts. The presentation of predicted future results of operations of real estate PROGRAMS shall be permitted but not required for specified mortgage PROGRAMS and shall be prohibited for non-specified mortgage PROGRAMS. The covers of the PROSPECTUS must contain in bold face language one of the following statements.

a. For specified mortgage PROGRAMS: FORECASTS ARE CONTAINED IN THIS PROSPECTUS (OFFERING CIRCULAR). ANY PREDICTIONS AND REPRESENTATIONS, WRITTEN OR ORAL, WHICH DO NOT CONFORM TO THOSE CONTAINED IN THE PROSPECTUS (OFFERING CIRCULAR) SHALL NOT BE PERMITTED.

b. For non-specified mortgage PROGRAMS: THE USE OF FORECASTS IN THIS OFFERING IS PROHIBITED. ANY REPRESENTATIONS TO THE CONTRARY AND ANY PREDICTIONS, WRITTEN OR ORAL, AS TO THE AMOUNT OR CERTAINTY OF ANY PRESENT OR FUTURE CASH BENEFIT OR TAX: CONSEQUENCE WHICH MAY FLOW FROM AN INVESTMENT IN THIS PROGRAM IS NOT PERMITTED.

2. Presentation of forecasts. Forecasts for specified mortgage PROGRAMS shall be included in the PROSPECTUS or sales material of the PROGRAM only if they comply with the following requirements.

a. General. Forecasts shall be realistic in their predictions and shall clearly identify the assumptions made with respect to all material features of the presentation. Forecasts shall be examined by an independent certified public accountant in accordance with the Statement on Standards for Accountant's Services on Prospective Financial Information and the Guide For Prospective Financial Statements, as promulgated by the American Institute of Certified Public Accountants. The accountant's examination report shall be included in the PROSPECTUS. No forecasts shall be permitted in any sales literature which does not appear in the sales literature, all forecasts must be presented.

b. Material information. Forecasts shall include all the following information:

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- (i) Annual predicted revenue by source; including the occupancy rate used in predicting rental revenue.
 - (ii) Annual predicted expenses.
 - (iii) Debt obligation--annual payment for principal and interest, points and financing fees, shown as dollars, not percentages.
 - (iv) The loan-to-value standard to be followed by the PROGRAM.
 - (v) Predicted annual cash flow.
 - (vi) Predicted annual taxable income or loss and a simplified explanation of the tax treatment of such results; assumed tax brackets may not be used.
 - (vii) Accounting policies--e.g., with respect to points, financing costs, and depreciation.
- c. Presentation.
- (i) Caveat. Forecasts shall prominently display a statement to the effect that they represent a mere prediction of future events based on assumptions which may or may not occur and may not be relied upon to indicate the actual results which will be obtained.
 - (ii) Additional guidelines. Explanatory notes describing assumptions made and referring to risk factors should be integrated with tabular and numerical information.
- d. Additional disclosures and limitations.
- (i) Forecasts shall be for a period at least equivalent to the anticipated holding period for the mortgage, or 10 years, whichever is shorter, and project a final disposition of mortgages.

3. No quantitative estimate of anticipated return. The PROSPECTUS and sales material shall not include a quantitative estimate of a PROGRAM'S anticipated economic performance or anticipated return to PARTICIPANTS (in the form of distributable funds or tax benefits), except as permitted under subsection C. of this section.

IX. MISCELLANEOUS PROVISIONS.

A. *Reserves.* Provisions should be made for adequate reserves in the future by retention of a reasonable percentage of proceeds from the offering and regular receipts for normal repairs, replacements, and contingencies. Normally, not less than 1.0% of the offering proceeds will be considered adequate.

B. *Reinvestment of Cash Flow.* Reinvestment of cash flow (excluding proceeds resulting from a CAPITAL TRANSACTION) shall not be allowed. Proceeds of CAPITAL TRANSACTIONS may be reinvested only within 7 years of the original effectiveness of the PROGRAM'S registration. The partnership agreement and the PROSPECTUS shall set forth that reinvestment of proceeds of a CAPITAL TRANSACTION will not take place unless sufficient cash will be distributed to pay any state or federal income tax (assuming investors are in a specified tax bracket) created by the disposition or refinancing of mortgage. Such a prohibition must be contained in the PROSPECTUS.

C. *Financial Information Required on Application.* In any offering of interests by a PROGRAM, the PROGRAM shall provide as an exhibit to the application the following financial information.

1. Financial statements of PROGRAM. The PROSPECTUS shall include audited financial statements of the PROGRAM for each of the last three fiscal years (or for the life of the PROGRAM, if less), provided that the only audited balance sheet that shall be required shall be as of the end of the most recent fiscal year of the PROGRAM. When a PROGRAM has operated less than one fiscal year, audited financial statements are not required unless requested by the ADMINISTRATOR.

2. Balance sheet of corporate SPONSOR. Audited financial statements consisting only of an audited balance sheet for each corporate SPONSOR as of the end of the SPONSOR's most recent fiscal year shall be included in the PROSPECTUS.

3. Other SPONSORS. A balance sheet for each non-corporate SPONSOR (including individual partners or individual joint ventures of a SPONSOR) as of a date not more than 135 days prior to the date of filing the application shall be submitted. Such balance sheet shall be prepared in accordance with generally accepted accounting principles and reviewed and reported upon by an independent certified public accountant under the review standards set forth by the American Institute of Certified Public Accountants, and shall be signed and sworn to by such SPONSOR. A

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representation of the amount of such NET WORTH must be included in the PROSPECTUS, or in the alternative, a representation that such SPONSOR meets the NET WORTH requirements of Section II.B. of these guidelines (relating to Requirements of Sponsors) shall be so included.

4. Interim Financial information. Where an audited balance sheet required by this subsection is as of a date more than 90 days prior to the date of filing, an unaudited balance sheet as of date not more than 90 days prior to the date of filing shall also be provided. Where the application is made in coordination with a Registration Statement submitted to the Securities and Exchange Commission pursuant to the Securities Act of 1933, an interim unaudited balance sheet as of a date not more than 135 days prior to the date of filing shall be provided only if the audited balance sheet is as of a date more than 134 days prior to the date of filing. Interim unaudited statements of income, partners' equity, and cash flows shall also be provided with the unaudited balance sheet in instances where such statements are required by this subsection as part of the audited financial statements for the last fiscal year. The ADMINISTRATOR may require the interim unaudited information to be included in the PROSPECTUS when the audited information required by this section must be included.

5. Filing of other statements. The ADMINISTRATOR may permit the omission of one or more of the statements requires under this subsection and the filing (in substitution thereof) of appropriate statements and verifying financial information having comparable relevance to an investor in determining whether to invest in the PROGRAM. Such substitution will only be allowed where the ADMINISTRATOR finds this would be consistent with the protection of investors.

D. *Opinions of Counsel.* The application for qualification and registration shall contain a favorable ruling from the Internal Revenue Service or an opinion of independent counsel to the effect that the issuer will be taxed as a "partnership" and not as an "association" for federal income tax purposes. An opinion of counsel shall be in form and substance satisfactory to the ADMINISTRATOR, and shall be unqualified except to the extent permitted by the ADMINISTRATOR. However, an opinion of counsel may be based on reasonable assumptions, such as:

1. facts or proposed operations as set forth in the offering circular or PROSPECTUS and organizational documents;

2. the absence of future changes in applicable laws;

3. the securities offered are paid for;

4. compliance with certain procedures such as the execution and delivery of certain documents and the filing of a certificate of limited partnership or and amended certificate; and

5. the continued maintenance of or compliance with certain financial, ownership, or other requirements by the issuer or SPONSOR.

E. Supplemental information. The ADMINISTRATOR may request from counsel as supplemental information such supporting legal memoranda and an analysis as he shall deem appropriate under the circumstances. To the extent the opinion of counsel or Internal Revenue Service ruling is based on the maintenance of or compliance with certain requirements or conditions by the issuer or SPONSOR the offering circular or PROSPECTUS shall contain representations that such requirements or conditions will be met and the partnership agreement shall, to the extent practicable, contain provisions requiring such compliance. There shall be included also an opinion of independent counsel to the effect that the securities being offered are duly authorized or created and validly issued interests in the issuer, and that the liability of the public investors will be limited to their respective total agreed upon investment in the issuer. The ADMINISTRATOR may request an opinion of counsel concerning tax aspects when this appears necessary for the protection of investors.

F. Provisions of Partnership Agreement. The requirements and/or provisions of appropriate portions of the following sections shall be included in the partnerships agreement: I.B. of these guidelines (relating to Definitions); II.A.-F. of these guidelines (relating to Requirements of SPONSORS); IV.C.-I. of these guidelines (relating to Fees--Compensation--Expenses); V. A.-K. of these guidelines (relating to Conflicts of Interest and Investment Restrictions); VI.C. and D. of these guidelines (relating to Non-specified Mortgage PROGRAMS); VII A.-F., H., J. and K. of these guidelines (relating to Rights and Obligations of PARTICIPANTS), and subsections A.-B. of this section.

G. General Instructions--Mortgage Program Guidelines.

1. The Cross Reference Sheet should be completed with the application for registration.

2. Sections which are not applicable should be noted as such.

3. Provisions of the PROGRAM which vary from the guidelines must be explained by footnote; for example, if the PROGRAM uses a defined term which is different from the guidelines definition, the variance must be explained. Footnotes should be numbered sequentially in the column designated footnotes and should be presented on a rider identified as footnotes with each footnote on the rider numerically corresponding to the footnote identified on the Cross Reference Sheet.

4. A section is provided at the bottom of each page of the Cross Reference Sheet for additional or supplemental cross references. Lines are provided in the event additional cross references are needed with respect to subsections of

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the guidelines not specifically identified on the top of the page, or in the event there were insufficient lines to present all relevant cross references with respect to an item appearing on that page.

5. The last page of The Cross Reference Sheet should be executed by preparer.

6. These general instructions should be removed before filing with the ADMINISTRATOR.

H. *Amendments and Supplements.* A redlined copy of all amendments and supplements to an application shall be filed with the ADMINISTRATOR as soon as the amendment or supplement is available.

MORTGAGE GUIDELINES CROSS REFERENCE SHEET

(See IX.G. General Instructions to Mortgage Program Guidelines)

Name of Applicant: _____

<i>Section Number</i>	<i>Page Number</i>	<i>Footnote See Instruc- tion 3</i>	<i>Guideline Section</i>
<i>Partnership Agreement</i>	<i>Prospectus</i>		
_____	_____	_____	I. B. DEFINITIONS
_____	_____	_____	
_____	_____	_____	1. Acquisition and Origination Ex- penses
_____	_____	_____	2. Acquisition and Origination Fees
_____	_____	_____	
_____	_____	_____	4. Affiliate
_____	_____	_____	
_____	_____	_____	5. Assessments
_____	_____	_____	
_____	_____	_____	6. Asset Based Fee
_____	_____	_____	
_____	_____	_____	7. Audited Financial Statements
_____	_____	_____	
_____	_____	_____	8. Base Amount
_____	_____	_____	
_____	_____	_____	9. Capital Contribution
_____	_____	_____	
_____	_____	_____	10. Capital Transaction
_____	_____	_____	
_____	_____	_____	11. Carried Interest
_____	_____	_____	

			12.	Cash Available for Distribution
			13.	Cash Flow
			14.	Competitive Real Estate Com-
				mission
			16.	Financing
			17.	Front-End Fees

Additional or Supplemental Cross References

[illegible]

Additional or Supplemental Cross References

			E.	Fiduciary Responsibility	
			F.	Terminated Sponsor	
			III.	SUITABILITY OF PARTICIPANTS	

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			B.	Income and NET WORTH Standards
			C.	Determination that Sale to a Participant is Suitable and Appropriate
			D.	Subscription Agreements
			E.	Completion of Sale
			F.	Minimum Investment
			IV.	FEES- -COMPENS- ATION--EXPENSES
			A.	Fees, Compensation, and Expenses to be Reasonable
			B.	Organization and Offering Expenses
			C.	Investment in Mortgages
			D.	Promotional Interest
			E.	Real Estate Brokerage Commissions
			F.	Property Management Fee
			G.	Insurance Services
			H.	Mortgage Servicing Fee
			I.	Asset Based Fee
				1. Eligibility

Additional or Supplemental Cross References

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			2. Computation
			3. Limitations
			V. CONFLICTS OF INTEREST AND INVESTMENT RE- STRICTIONS
			A. Sales, Leases and Related PRO- GRAM Transactions
			1. Sales of Mortgages to PRO- GRAM
			2. Sales to the SPONSOR
			3. Dealing with related PRO- GRAMS
			4. Sales of Foreclosed Properties
			B. Exclusive Agreement
			C. Commissions on Reinvestment or Distribution
			D. Services Rendered to the PRO- GRAM By the SPONSOR
			1. Expenses of the PROGRAM
			2. Other goods and services.
			E. Rebates, Kickbacks, and Recip- rocal Arrangements
			F. Commingling of Funds
			G. Investments In or With Other Programs
			H. Lending Practices
			I. Requirement for Real Property Appraisal
			J. PROGRAM Indebtedness

			K.	Appraisal and Compensation
			VI.	NON-SPECIFIED MORTGAGE PROGRAMS
			A.	Minimum Capitalization
			B.	Experience of SPONSOR
			C.	Statement of Investment Objectives
			D.	Period of Offering and Expenditure of Proceeds
			E.	Multiple PROGRAMS
			VII.	RIGHTS AND OBLIGATIONS FOR PARTICIPANTS
			A.	Meetings
			B.	Voting Rights of Limited Partners
			C.	Reports to Holders of PROGRAMS INTERESTS
			D.	Access to Records
			E.	Admission of PARTICIPANTS
			F.	Redemption of PROGRAMS INTERESTS
			G.	Transferability of PROGRAM INTERESTS
			H.	Dividend Reinvestment Plans
			I.	Special Reports

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_____	_____	_____	J. Arbitration of Disputes
_____	_____	_____	
_____	_____	_____	VIII. DISCLOSURE AND MARKET- ING REQUIREMENTS
_____	_____	_____	B. Contents of PROSPECTUS
_____	_____	_____	
_____	_____	_____	

Additional or Supplemental Cross References

_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
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_____	_____	_____	_____	_____
_____	_____	_____	C. Forecasts	
_____	_____	_____		
_____	_____	_____	IX. MISCELLANEOUS PROVI- SIONS	
_____	_____	_____	A. Reserves	
_____	_____	_____		
_____	_____	_____	B. Reinvestment of Cash Flow	
_____	_____	_____		
_____	_____	_____	C. Financial Information Required on Application	
_____	_____	_____		
_____	_____	_____	D. Opinions of Counsel	
_____	_____	_____		
_____	_____	_____	E. Supplemental Information	
_____	_____	_____		
_____	_____	_____	F. Provision of Partnership Agree- ment	
_____	_____	_____		

Additional or Supplemental Cross References

_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____

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Response to this cross reference sheet has been prepared by:

Name: _____

Title: _____

Adopted by the NASAA membership on March 29, 1992, Amended May 7, 2007

I. INTRODUCTION

A. Application.

1. These Omnibus Guidelines (the "Guidelines") apply to the registration and qualification of PROGRAMS for which statements of policy have not been adopted by the North American Securities Administrators Association.

2. While applications not conforming to the standards contained herein shall be looked upon with disfavor, where good cause is shown, certain Guidelines may be modified or waived by the ADMINISTRATOR.

B. Definitions.

1. ACQUISITION EXPENSES--Expenses, including but not limited to legal fees and expenses, travel and communication expenses, costs of appraisals, non-refundable option payments on assets not acquired, accounting fees and expenses, and miscellaneous expenses relating to the purchase or acquisition of assets, whether or not acquired.

2. ACQUISITION FEES--The total of all fees and commissions paid by any party in connection with the initial purchase or acquisition of assets by the PROGRAM. Included in the computation of such fees or commissions shall be any commission, selection fee, supervision fee, financing fee, non-recurring management fee or any fee of a similar nature, however designated.

3. ADMINISTRATOR--The official or agency administering the securities laws of a state, province, or commonwealth.

4. AFFILIATE--An AFFILIATE of another PERSON includes any of the following:

(a) Any PERSON directly or indirectly owning, controlling, or holding with power to vote ten percent or more of the outstanding voting securities of such other PERSON.

(b) Any PERSON ten percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held, with power to vote, by such other PERSON.

(c) Any PERSON directly or indirectly controlling, controlled by, or under common control with such other PERSON.

(d) Any executive officer, director, trustee or partner of such other PERSON.

(e) Any legal entity on which such PERSON acts as an executive officer, director, trustee, or partner.

5. ASSESSMENTS--Additional amounts of capital which may be mandatorily required of, or paid voluntarily by, a PARTICIPANT beyond his or her subscription commitment excluding deferred payments.

6. CAPITAL CONTRIBUTIONS--The total investment, including the original investment and amounts reinvested pursuant to distribution reinvestment plan in a PROGRAM by a PARTICIPANT or by all PARTICIPANTS, as the case may be. Unless otherwise specified, CAPITAL CONTRIBUTIONS shall be deemed to include principal amounts to be received on account of deferred payments.

7. CASH AVAILABLE FOR DISTRIBUTION--CASH FLOW plus cash funds available for distribution from PROGRAM reserves less amounts set aside for restoration or creation of reserves.

8. CASH FLOW--PROGRAM cash funds provided from operations, without deduction for depreciation, but after deducting cash funds used to pay all other expenses, debt payments, capital improvements and replacements. Cash withdrawn from reserves is not CASH FLOW.

9. CONTROLLING PERSON--Includes, but is not limited to, all PERSONS, whatever their titles, who perform

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functions for the SPONSOR similar to those of: (a) chairman or member of the board of directors; (b) executive officers; and (c) those holding ten percent or more equity interest in the SPONSOR or a PERSON having the power to direct or cause the direction of the SPONSOR, whether through the ownership of voting securities, by contract, or otherwise.

10. CROSS REFERENCE SHEET--A compilation of the Guideline sections, referenced to the page of the PROSPECTUS and PROGRAM agreement, or other exhibits, and justification for any deviation from the Guidelines. Such compilation shall comply with the provisions set forth on the CROSS REFERENCE SHEET.

11. FRONT END FEES--Fees and expenses paid by any party for any services rendered to organize the PROGRAM and to acquire assets for the PROGRAM, including ORGANIZATION AND OFFERING EXPENSES, ACQUISITION FEES, ACQUISITION EXPENSES, and any other similar fees, however designated by the SPONSOR.

12. INDEPENDENT EXPERT--A PERSON with no material current or prior business or personal relationship with the SPONSOR who is engaged to a substantial extent in the business of rendering opinions regarding the value of assets of the type held by the PROGRAM, and who is qualified to perform such work.

13. INVESTMENT IN PROGRAM ASSETS--The amount of capital contributions actually paid or allocated to the purchase or development of assets acquired by the PROGRAM (including working capital reserves allocable thereto, except that working capital reserves in excess of three percent shall not be included) and other cash payments such as interest and taxes, but excluding FRONT-END FEES.

14. NET ASSET FEE--An annual fee equal to a percentage of the PROGRAM'S annual ending net assets (assets less liabilities) determined in accordance with generally accepted accounting principles.

15. NET WORTH--The excess of total assets over total liabilities as determined by generally accepted accounting principles.

16. ORGANIZATIONAL AND OFFERING EXPENSES--All expenses incurred by and to be paid from the assets of the PROGRAM in connection with and in preparing a PROGRAM for registration and subsequently offering and distributing it to the public, including, but not limited to, total underwriting and brokerage discounts and commissions (including fees of the underwriter's attorneys), expenses for printing, engraving, mailing, salaries of employees while engaged in sales activity, charges of transfer agents, registrars, trustees, escrow holders, depositories, experts, expenses of qualification of the sale of its securities under Federal and State laws, including taxes and fees, accountants' and attorneys' fees.

17. PARTICIPANT--The holder of a PROGRAM INTEREST.

18. PAYOUT--The point in time when all PARTICIPANTS have received cash distributions from the PROGRAM in an amount equal to their total CAPITAL CONTRIBUTIONS.

19. PERSON--Any natural PERSON, partnership, corporation, association, trust or other legal entity.

20. PROGRAM--A limited or general partnership, joint venture, unincorporated association or similar organization other than a corporation formed and operated for the primary purpose of investment in and the operation of or gain from and interest in the assets to be acquired by such entity.

21. PROGRAM INTEREST--The limited partnership unit or other indicia of ownership in a PROGRAM.

22. PROMOTIONAL INTEREST--A percentage interest of the SPONSOR in all PROGRAM revenues, costs and expenses, other than FRONT END FEES, for which the SPONSOR is not obligated to make a CAPITAL CONTRIBUTION in the form of cash or tangible property.

23. PROSPECTUS--Shall have the meaning given to that term by section 2(10) of the Securities Act of 1933, including a preliminary PROSPECTUS; provided, however, that such term as used herein shall also include an offering circular as described in Rule 256 of the General Rules and Regulations under the Securities Act of 1933 or, in the case of an intrastate offering, any document by whatever name known, utilized for the purpose of offering and selling securities to the public.

24. ROLL-UP--A transaction involving the acquisition, merger, conversion or consolidation, either directly or indirectly, of the PROGRAM and the issuance of securities of a ROLL-UP ENTITY. Such term does not include:

(a) a transaction involving securities of the PROGRAM that have been for at least 12 months listed on a national exchange or that are traded through the National Association of Securities Dealers Automated Quotation--National Market System; or

(b) a transaction involving the reorganization to corporate, trust or association form of only the PROGRAM if, as a consequence of the proposed reorganization, there will be no significant adverse change in any of the following:

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- (i) PARTICIPANT'S voting rights;
- (ii) the term of existence of the PROGRAM;
- (iii) SPONSOR compensation; or
- (iv) the PROGRAM'S investment objectives.

25. ROLL-UP ENTITY--A partnership, trust, corporation or other entity that would be created or survive after the successful completion of a proposed ROLL-UP transaction.

26. SPECIFIED ASSET PROGRAM--A PROGRAM where, at the time a securities registration is ordered effective, at least 75% of the net proceeds from the sale of PROGRAM INTERESTS are allocable to the purchase, construction, renovation, or improvement of individually identified assets or assets that provide a reasonably objective basis in conformity with the Guidelines of the American Institute of Certified Public Accountants to allow the issuance of prospective financial statements. Reserves shall not be included in the 75%.

27. SPONSOR--Any PERSON directly or indirectly instrumental in organizing, wholly or in part, a PROGRAM or any PERSON who will control, manage or participate in the management of a PROGRAM, and any AFFILIATE of such PERSON. Not included is any PERSON whose only relation with the PROGRAM is that of an independent manager of a portion of PROGRAM assets, and whose only compensation is as such. "SPONSOR" does not include wholly independent third parties such as attorneys, accountants, and underwriters whose only compensation is for professional services rendered in connection with the offering of PROGRAM INTERESTS. A PERSON may also be deemed a SPONSOR of the PROGRAM by:

(a) taking the initiative, directly or indirectly, in founding or organizing the business or enterprise of the PROGRAM, either alone or in conjunction with one or more other PERSONS;

(b) receiving a material participation in the PROGRAM in connection with the founding or organizing of the business of the PROGRAM, in consideration of services or property, or both services and property;

(c) having a substantial number of relationships and contacts with the PROGRAM;

(d) possessing significant rights to control PROGRAM properties;

(e) receiving fees for providing services to the PROGRAM which are paid on a basis that is not customary in the industry; or

(f) providing goods or services to the PROGRAM on a basis which was not negotiated at arm's length with the PROGRAM.

II. REQUIREMENTS OF SPONSOR

A. *Experience.* The SPONSOR, the general partner, or their chief operating officers shall have at least three years relevant experience demonstrating the knowledge and experience to acquire and manage the type of assets being acquired, and any of the foregoing, or any AFFILIATE providing services to the PROGRAM, shall have had not less than four years relevant experience in the kind of service being rendered or otherwise must demonstrate sufficient knowledge and experience to perform the services proposed.

COMMENT:

"Relevant experience" should be interpreted to include actual direct experience by the chief executive officer, or other PERSONS at the management level, either as a principal or agent in performing the services to be provided to the PROGRAM. This would include acquiring and managing assets for one's own account or acting as an agent in acquiring and managing assets comparable to that which the PROGRAM will acquire.

B. *Financial Condition.* The financial condition of the SPONSOR liable for the debts of the PROGRAM must be commensurate with any financial obligations assumed in connection with the offering and the operation of the PROGRAM. As a minimum, such SPONSOR shall have an aggregate financial NET WORTH, exclusive of home, automobiles, and home furnishings, of the greater of either \$100,000, or 5.0% of the first \$20 million of both the gross amount of securities currently being offered and the gross amount of any originally issued direct participation PROGRAM securities sold by the SPONSOR within the prior 12 months, plus 1.0% of all amounts in excess of the first \$20 million. In determining NET WORTH for this purpose, evaluation will be made of contingent liabilities and the use of promissory notes, to determine the appropriateness of their inclusion in the computation of NET WORTH. Promissory notes may be included in NET WORTH if the maker can demonstrate the ability to pay upon demand and the terms of the notes are satisfactory to the ADMINISTRATOR. The gross amount of an offering includes the principal amounts to be received on account of deferred payments.

C. *Reports.* Each application for registration shall contain a commitment, executed by the SPONSOR, to submit to the ADMINISTRATOR, upon request, reports and statements required to be distributed to PARTICIPANTS pursuant to

section VI. C.

COMMENT:

The SPONSOR need not file with the ADMINISTRATOR all reports that will be distributed to PARTICIPANTS, but should retain copies of such reports of information and make them available to the ADMINISTRATOR as required.

D. *Fiduciary Duty of SPONSOR.* The PROGRAM agreement shall provide that the SPONSOR shall have a fiduciary responsibility for the safekeeping and use of all funds and assets of the PROGRAM, whether or not in the SPONSOR's immediate possession or control, and that the SPONSOR shall not employ, or permit another to employ, such funds or assets in any manner except for the exclusive benefit of the PROGRAM. In addition, the PROGRAM shall not permit the PARTICIPANT to contract away the fiduciary obligation owed to the PARTICIPANT by the SPONSOR under common law.

E. *Termination of SPONSOR.*

1. The SPONSOR may not voluntarily withdraw from the PROGRAM without 120 days prior written notice to the PARTICIPANTS. If the PARTICIPANTS or any remaining SPONSOR elect to continue the PROGRAM, the withdrawing SPONSOR shall pay all expenses incurred as a result of its withdrawal.

2. Upon termination of the SPONSOR, the PROGRAM may be required to pay to the terminated SPONSOR all amounts then accrued and owing to the terminated SPONSOR. Additionally, the PROGRAM may terminate the SPONSOR's interest in PROGRAM revenues, expenses, income, losses, distributions, and capital by payment of an amount equal to the then present fair market value of the terminated SPONSOR's interest, determined by agreement of the terminated SPONSOR and the PROGRAM, or, if they cannot agree, by arbitration in accordance with the then current rules of the American Arbitration Association. The expense of arbitration shall be borne equally by the terminated SPONSOR and the PROGRAM.

3. The method of payment to the terminated SPONSOR must be fair and must protect the solvency and liquidity of the PROGRAM. When the termination is voluntary, the method of payment will be presumed to be fair if it provides for a non-interest bearing unsecured promissory note with principal payable, if at all, from distributions which the terminated SPONSOR otherwise would have received under the program agreement had the SPONSOR not been terminated. When the termination is involuntary, the method of payment will be presumed to be fair if it provides for an interest bearing promissory note maturing in not less than five years with equal installments each year.

4. The agreement should also provide for a successor SPONSOR where the only SPONSOR of the PROGRAM is an individual.

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F. *Tax Ruling or Opinion.* The SPONSOR shall, if the ADMINISTRATOR deems it appropriate, have a tax ruling from the U.S. Internal Revenue Service or an opinion of qualified independent tax counsel concerning the flow-through of tax benefits and other tax consequences to the PARTICIPANT. An opinion of counsel shall be in a form and substance satisfactory to the ADMINISTRATOR and shall be unqualified except to the extent permitted by the ADMINISTRATOR. Also included shall be, an opinion of independent counsel to the effect that the securities being offered are duly authorized and validly issued INTERESTS in the issuer, and that the liability of the public investors will be limited to their respective total agreed upon investment in the issuer.

COMMENT:

An opinion meeting the requirements of ABA Formal Opinion 346 (Revised) of the American Bar Association Standing Committee on Ethics and Professional Responsibility and any applicable law shall be deemed satisfactory.

G. *Liability and Indemnification.*

1. The PROGRAM shall not provide for indemnification of the SPONSOR for any liability or loss suffered by the SPONSOR, nor shall it provide that the SPONSOR be held harmless for any loss or liability suffered by the PROGRAM, unless all of the following conditions are met:

(a) The SPONSOR has determined, in good faith, that the course of conduct which caused the loss or liability was in the best interests of the PROGRAM.

(b) The SPONSOR was acting on behalf of or performing services for the PROGRAM.

(c) Such liability or loss was not the result of negligence or misconduct by the SPONSOR.

(d) Such indemnification or agreement to hold harmless is recoverable only out of PROGRAM net assets and not from PARTICIPANTS.

2. Notwithstanding anything to the contrary contained in Section II.G.1., the SPONSOR and any person acting as broker-dealer shall not be indemnified for any losses, liabilities or expenses arising from or out of an alleged violation of federal or state securities laws unless one or more of the following conditions are met:

(a) There has been a successful adjudication on the merits of each count involving alleged securities law violations as to the particular indemnitee.

(b) Such claims have been dismissed with prejudice on the merits by a court of competent jurisdiction as to the particular indemnitee.

(c) A court of competent jurisdiction approves a settlement of the claims against a particular indemnitee and finds that indemnification of the settlement and related costs should be made, and the court of law considering the request for indemnification has been advised of the position of the Securities and Exchange Commission and the published position of any state securities regulatory authority in which securities of the PROGRAM were offered or sold as to indemnification for violations of securities laws.

3. The PROGRAM may not incur the cost of that portion of liability insurance which insures the SPONSOR for any liability as to which the SPONSOR is prohibited from being indemnified under this section.

4. The advancement of PROGRAM funds to a SPONSOR or its AFFILIATES for legal expenses and other costs incurred as a result of any legal action for which indemnification is being sought is permissible only if all of the following conditions are satisfied:

(a) The legal action relates to acts or omissions with respect to the performance of duties or services on behalf of the PROGRAM.

(b) The legal action is initiated by a third party who is not a PARTICIPANT, or the legal action is initiated by a PARTICIPANT and a court of competent jurisdiction specifically approves such advancement.

(c) The SPONSOR or its AFFILIATES undertake to repay the advanced funds to the PROGRAM, together with the applicable legal rate of interest thereon, in cases in which such PERSON is found not to be entitled to indemnification.

H. *Arbitration Provisions.* The PROGRAM agreement may contain provisions relating to the use of arbitration as a means of dispute resolution; provided however, it may not require arbitration for allegations involving breach of contract, negligence, violations of state or federal securities laws, breach of fiduciary duty or other misconduct by the SPONSOR, nor shall it provide for mandatory venue. PROGRAM agreements which contain arbitration provisions shall prominently disclose such fact on the cover page of the PROGRAM agreement. Allocation of the cost of arbitration may be made a matter for determination in the proceedings. This Section II.H is not intended to prohibit arbitration agreements entered into as a condition for opening or maintaining an account with a broker-dealer, who may also be a SPONSOR. In addition, this section II.H should not be interpreted to prohibit separate arbitration agreements between SPONSORS and PARTICIPANTS if the agreements are not a condition of making an investment in the

PROGRAM.

III. SUITABILITY OF PARTICIPANTS

A. General Policy.

1. The SPONSOR shall establish minimum income and net worth standards for PERSONS who purchase PROGRAM INTERESTS.

2. The SPONSOR shall propose minimum income and net worth standards which are reasonable given the type of PROGRAM and the risks associated with the purchase of PROGRAM INTERESTS. PROGRAMS with greater investor risk shall have minimum standards with a substantial NET WORTH requirement. The ADMINISTRATOR shall evaluate the standards proposed by the SPONSOR when the PROGRAM'S application for registration is reviewed. In evaluating the proposed standards, the ADMINISTRATOR may consider the following:

(a) the PROGRAM'S use of leverage;

(b) tax implications;

(c) mandatory deferred payments;

(d) assessments;

(e) balloon payment financing;

(f) potential variances in cash distributions;

(g) potential PARTICIPANTS;

- (h) relationship between potential PARTICIPANTS and the SPONSOR;
- (i) liquidity of PROGRAM INTERESTS;
- (j) performance of SPONSOR'S prior programs;
- (k) financial condition of the SPONSOR;
- (l) potential transactions between the PROGRAM and the SPONSOR; and
- (m) any other relevant factors.

B. Income and Net Worth Standards.

1. Unless the ADMINISTRATOR determines that the risks associated with the PROGRAM would require lower or higher standards, each PARTICIPANT shall have:

- (a) a minimum annual gross income of \$70,000 and a minimum NET WORTH of \$70,000; or
- (b) a minimum NET WORTH of \$250,000.

2. NET WORTH shall be determined exclusive of home, home furnishings, and automobiles.

3. In the case of sales to fiduciary accounts, these minimum standards shall be met by the beneficiary, the fiduciary account, or by the donor or grantor who directly or indirectly supplies the funds to purchase the PROGRAM INTERESTS if the donor or grantor is the fiduciary.

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4. The SPONSOR shall set forth in the final PROSPECTUS:

- (a) the investment objectives of the PROGRAM;
- (b) a description of the type of PERSON who might benefit from an investment in the PROGRAM; and
- (c) the minimum standards imposed on each PARTICIPANT in the PROGRAM.

C. Determination that Sale to PARTICIPANT is Suitable and Appropriate.

1. The SPONSOR and each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM shall make every reasonable effort to determine that the purchase of PROGRAM INTERESTS is a suitable and appropriate investment for each PARTICIPANT.

2. In making this determination, the SPONSOR or each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM shall ascertain that the prospective PARTICIPANT:

- (a) meets the minimum income and net worth standards established for the PROGRAM;
- (b) can reasonably benefit from the PROGRAM based on the prospective PARTICIPANT'S overall investment objectives and portfolio structure;
- (c) is able to bear the economic risk of the investment based on the prospective PARTICIPANT'S overall financial situation; and
- (d) has apparent understanding of:
 - (i) the fundamental risks of the investment;

- (ii) the risk that the PARTICIPANT may lose the entire investment;
- (iii) the lack of liquidity of PROGRAM INTERESTS;
- (iv) the restrictions on transferability of PROGRAM INTERESTS;
- (v) the background and qualifications of the SPONSOR or the PERSONS responsible for directing and managing the PROGRAM; and
- (vi) the tax consequences of the investment.

3. The SPONSOR or each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM will make this determination on the basis of information it has obtained from a prospective PARTICIPANT. Relevant information for this purpose will include at least the age, investment objectives, investment experience, income, NET WORTH, financial situation, and other investments of the prospective PARTICIPANT, as well as any other pertinent factors.

4. The SPONSOR or each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM shall maintain records of the information used to determine that an investment in PROGRAM INTERESTS is suitable and appropriate for each PARTICIPANT. The SPONSOR or each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM shall maintain these records for at least six years.

5. The SPONSOR shall disclose in the final PROSPECTUS the responsibility of the SPONSOR and each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM to make every reasonable effort to determine that the purchase of PROGRAM INTERESTS is a suitable and appropriate investment for each PARTICIPANT, based on information provided by the PARTICIPANT regarding the PARTICIPANT'S financial situation and investment objectives.

D. Subscription Agreements.

1. The ADMINISTRATOR may require that each PARTICIPANT complete and sign a written subscription agreement.

2. The SPONSOR may require that each PARTICIPANT make certain factual representations in the subscription agreement, including the following:

- (a) The PARTICIPANT meets the minimum income and net worth standards established for the PROGRAM.
- (b) The PARTICIPANT is purchasing the PROGRAM INTERESTS for his or her own account.
- (c) The PARTICIPANT has received a copy of the PROSPECTUS.
- (d) The PARTICIPANT acknowledges that the investment is not liquid.

3. The PARTICIPANT must separately sign or initial each representation made in the subscription agreement. Except in the case of fiduciary accounts, the PARTICIPANT may not grant any PERSON a power of attorney to make such representations on his or her behalf.

4. The SPONSOR and each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM shall not require a PARTICIPANT to make representations in the subscription agreement which are subjective or unreasonable and which:

- (a) might cause the PARTICIPANT to believe that he or she has surrendered rights to which he or she is entitled under federal or state law; or
- (b) would have the effect of shifting the duties regarding suitability, imposed by law on broker-dealers, to the PARTICIPANT.

5. Prohibited representations include, but are not limited to the following:

- (a) The PARTICIPANT understands or comprehends the risks associated with an investment in the PROGRAM.

(b) The investment is a suitable one for the PARTICIPANT.

(c) The PARTICIPANT has read the PROSPECTUS.

(d) In deciding to invest in the PROGRAM, the PARTICIPANT has relied solely on the PROSPECTUS, and not on any other information or representations from other PERSONS or sources.

6. The SPONSOR may place the content of the prohibited representations in the subscription agreement in the form of disclosures to the PARTICIPANT. The SPONSOR may not place these disclosures in the PARTICIPANT representation section of the subscription agreement.

E. Completion of Sale.

1. The SPONSOR or any person selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM may not complete a sale of PROGRAM INTERESTS to a PARTICIPANT until at least five business days after the date the PARTICIPANT receives a final prospectus.

2. The SPONSOR or the PERSON designated by the SPONSOR shall send each PARTICIPANT a confirmation of his or her purchase.

F. Minimum Investment.

The ADMINISTRATOR may require a minimum initial and subsequent cash investment amount.

IV. FEES, COMPENSATION, AND EXPENSES

A. Introduction.

1. The total amount of consideration of all kinds which may be paid directly or indirectly to all parties shall be reasonable.

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2. The PROSPECTUS must fully disclose and itemize all consideration which may be received in connection with the PROGRAM directly or indirectly by the SPONSOR and underwriters, what the consideration is for and how and when it will be paid. This shall be set forth in one location in tabular form.

3. This Section of these Guidelines will ordinarily not be applied to PROGRAMS being registered by a SPONSOR which has qualified repetitive PROGRAMS with a permitted structure of fees, compensation and expenses prior to the effective date of these Guidelines. This Section of these Guidelines should be applied in a flexible manner to all other PROGRAMS to take into consideration competition against PROGRAMS with ongoing variance from the provisions of this Section and characteristics of the particular plan of business of each PROGRAM including whether it requires intensive continuing management activities by the SPONSOR.

B. FRONT END FEES.

1. All FRONT END FEES shall be reasonable and generally will not be allowed to exceed 18% of the gross proceeds of the offering, regardless of the source of payment. Any reimbursement to the SPONSOR for deferred ORGANIZATIONAL AND OFFERING EXPENSES, including any interest thereon, if any, will be included within the 18% limitation.

2. All items of compensation to underwriters or dealers, including, but not limited to, selling commissions, expenses, rights of first refusal, consulting fees, finders' fees and all other items of compensation of any kind or description paid by the PROGRAM, directly or indirectly, shall be taken into consideration in computing the amount of allowable selling commissions.

C. INVESTMENT IN PROGRAM ASSETS.

1. The SPONSOR shall commit a substantial percentage of the CAPITAL CONTRIBUTIONS toward INVESTMENT IN PROGRAM ASSETS. The remaining CAPITAL CONTRIBUTIONS may be used to pay FRONT END FEES.

2. The percentage of CAPITAL CONTRIBUTIONS committed to INVESTMENT IN PROGRAM ASSETS will generally be required to be at least 82 percent.

D. COMPENSATION FOR PROGRAM MANAGEMENT.

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1. Any management compensation taken by the SPONSOR shall be reasonable, taking into account all relevant factors.

2. Management compensation will be considered presumptively reasonable if it complies with the following limitations:

(a) For Business Development Companies, it is limited to the participation in net gains allowed by the Investment Company Act of 1940.

(b) For other PROGRAMS, it is limited to either:

(i) a 5.0% PROMOTIONAL INTEREST prior to PAYOUT and a 15.0% PROMOTIONAL INTEREST after PAYOUT; or

(ii) A NET ASSET FEE of not more than 0.75%.

3. SPONSORS that elect to receive a NET ASSET FEE will not be entitled to any payment upon termination for NET ASSET FEES attributable to future periods.

4. SPONSORS that elect to receive a NET ASSET FEE may be allocated up to 1% of the PROGRAM'S profits and losses if such allocation is necessary to preserve the PROGRAM'S status for tax purposes.

E. *Other Goods or Services.* The SPONSOR may provide other goods or services to the PROGRAM in connection with the operation of PROGRAM assets as long as the SPONSOR, as a fiduciary, determines such self-dealing arrangement is in the best interest of the PROGRAM. The terms pursuant to which all goods or services are provided to the PROGRAM by the SPONSOR shall be embodied in a written contract, the material terms of which must be fully disclosed to the PARTICIPANTS. The contract may only be modified by vote of a majority of the then outstanding PROGRAM INTERESTS. The contract shall contain a clause allowing termination without penalty on 60 days notice.

1. At a minimum, arrangements must meet all of the following criteria:

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(a) The SPONSOR must be independently engaged in the business of providing such goods or services to PERSONS other than AFFILIATES and at least 33% of the SPONSOR'S associated gross revenues must come from PERSONS other than AFFILIATES.

(b) The compensation, price or fee charged for providing such goods or services must be comparable and competitive with the compensation, price or fee charged by PERSONS other than AFFILIATES in the same geographic location who provide comparable goods or services which could reasonably be made available to the PROGRAM.

(c) Except in extraordinary circumstances, the compensation and other material terms of the arrangement must be fully disclosed in the PROSPECTUS. Extraordinary circumstances are limited to instances when immediate action is required and the goods or services are not immediately available from PERSONS other than AFFILIATES.

2. If the SPONSOR is not engaged in the business to the extent required by Section IV.E.1.(a). above, the SPONSOR may provide other goods and services if all of the following additional conditions are met:

(a) It can demonstrate the capacity and capability to provide such goods or services on a competitive basis.

(b) The goods or services are provided at the lesser of cost or the competitive rate charged by PERSONS other than AFFILIATES in the same geographic location who are in the business of providing comparable goods or services.

(c) The cost is limited to the reasonable necessary and actual expenses incurred by the SPONSOR on behalf of the PROGRAM in providing such goods or services, exclusive of expenses of the type which may not be reimbursed under Section IV.F.1.

(d) Expenses are allocated in accordance with generally accepted accounting principles and are made subject to the special audit required by Section IV.F.2.

F. Expenses of the PROGRAM.

1. All expenses of the PROGRAM shall be billed to and paid by the PROGRAM. The SPONSOR may be reimbursed for the actual cost of goods and services used for or by the PROGRAM and obtained from PERSONS other than AFFILIATES. The SPONSOR may be reimbursed for the administrative services necessary to the prudent operation of the PROGRAM; provided, the reimbursement shall be the lower of the SPONSOR'S actual cost or the

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amount the PROGRAM would be required to pay PERSONS other than AFFILIATES for comparable administrative services in the same geographic location; and provided, further, that such costs are reasonably allocated to the PROGRAM on the basis of assets, revenues, time records or other method conforming with generally accepted accounting principles. No reimbursement shall be permitted for services for which the SPONSOR is entitled to compensation by way of a separate fee. Excluded from the allowable reimbursement shall be:

(a) rent or depreciation, utilities, capital equipment, other administrative items of the SPONSOR; and

(b) salaries, fringe benefits, travel expenses and other administrative items incurred or allocated to any CONTROLLING PERSON of the SPONSOR.

2. The annual PROGRAM report must contain a breakdown of the costs reimbursed to the SPONSOR. Within the scope of the annual audit of the SPONSOR'S financial statements, the independent certified public accountants must issue a special report on the allocation of such costs to the PROGRAM in accordance with the PROGRAM agreement. The special report shall be in accordance with the American Institute of Certified Public Accountants United States Auditing Standards relating to special reports. The additional costs of such special report will be itemized by said accountants on a PROGRAM by PROGRAM basis and may be reimbursed to the SPONSOR by the PROGRAM in accordance with this subparagraph only to the extent that such reimbursement, when added to the cost for administrative services rendered, does not exceed the competitive rate for such services as determined above. The special report shall at minimum provide:

(a) a review of the time records of individual employees, the costs of whose services were reimbursed; and

(b) a review of the specific nature of the work performed by each such employee.

COMMENT:

The following is an illustration of a report prepared by ABC Accountants expressing an opinion on reimbursed costs of XYZ PROGRAM.

We have audited the accompanying schedule of cost reimbursed as defined in the PROGRAM agreement dated _____ of XYZ PROGRAM as of December 31, 19XX. This schedule is the responsibility of the PROGRAMS management. Our responsibility is to express an opinion of this schedule based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of cost reimbursed is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts of and disclosures in the schedule of cost reimbursed. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the schedule of cost reimbursed referred to above presents fairly, in all material respects, the cost reimbursed of XYZ PROGRAM as of December 31, 19XX as defined in the PROGRAM agreement referred to in

the first paragraph.

3. The PROSPECTUS shall disclose in tabular form an itemized estimate of such proposed expenses for the next fiscal year together with a breakdown by year of such expenses reimbursed in each of the last five public PROGRAMS formed by the SPONSOR.

V. CONFLICTS OF INTEREST AND INVESTMENT RESTRICTIONS

A. Sales and Leases to PROGRAM.

1. A PROGRAM shall not purchase or lease assets in which a SPONSOR has an interest unless all of the following conditions are met:

(a) The transaction occurs at the formation of the PROGRAM and is fully disclosed in its PROSPECTUS.

(b) The assets are sold upon terms fair to the PROGRAM and at a price not to exceed the lesser of cost or fair market value as determined by an INDEPENDENT EXPERT.

2. Notwithstanding provisions of Subsection 1 above, the SPONSOR may purchase assets in its own name (and assume loans in connection therewith) and temporarily hold title thereto, for the purposes of facilitating the acquisition of the assets, the borrowing of money, obtaining financing for the PROGRAM, or completion of construction of the assets, provided that all of the following conditions are met:

(a) The assets are purchased by the PROGRAM for a price no greater than the cost of the assets to the SPONSOR.

(b) All income generated by, and expenses associated with, the assets so acquired shall be treated as belonging to the PROGRAM.

(c) There are no other benefits arising out of such transaction to the SPONSOR apart from compensation otherwise permitted by these Guidelines.

B. Sales and Leases to SPONSOR.

1. A SPONSOR shall not acquire assets from the PROGRAM unless approved by the PARTICIPANTS in accordance with subsection VI.B.1(d).

2. A PROGRAM may lease assets to the SPONSOR only if both of the following are met:

(a) The transaction occurs at the formation of the PROGRAM, and is fully disclosed in the PROSPECTUS.

(b) The terms of the lease are fair to the PROGRAM.

C. Loans. No loans may be made by the PROGRAM to the SPONSOR.

D. Exchange of PROGRAM INTERESTS. The PROGRAM may not acquire assets in exchange for PROGRAM INTERESTS.

E. Exclusive agreement. The PROGRAM shall not give the SPONSOR an exclusive right to sell or exclusive employment to sell assets for the PROGRAM.

F. Commissions on financing, refinancing or reinvestment. A PROGRAM shall not pay, directly or indirectly, a commission or fee to a SPONSOR (except as permitted under Section IV.B.1) in connection with the reinvestment of CASH AVAILABLE FOR DISTRIBUTION or of the proceeds of the resale, exchange, or refinancing of PROGRAM assets.

G. Rebates, Kickbacks, and Reciprocal Arrangements.

1. No rebates or give-ups may be received by the SPONSOR nor may the SPONSOR participate in any reciprocal business arrangements which would circumvent these Guidelines. Furthermore, the PROSPECTUS and PROGRAM agreement shall contain language prohibiting the above, as well as language prohibiting reciprocal business arrangements which would circumvent the restrictions against dealing with AFFILIATES or promoters.

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2. No SPONSOR shall directly or indirectly pay or award any commissions or other compensation to any PERSON engaged to sell PROGRAM INTERESTS or give investment advice to a potential PARTICIPANT; provided, however, that this clause shall not prohibit the payment to a registered broker-dealer or other properly licensed PERSON of normal sales commissions for selling PROGRAM INTERESTS.

H. *Commingling.* The funds of a PROGRAM shall not be commingled with the funds of any other PERSON. Nothing contained in this section shall prohibit the SPONSOR from establishing a master fiduciary account pursuant to which separate sub-trust accounts are established for the benefit of AFFILIATED PROGRAMS, provided that PROGRAM funds are protected from the claims of such other PROGRAMS and creditors of the PROGRAMS. The prohibition of this Section shall not apply to investments meeting the requirements of Section V.I.

I. *Investment in Other PROGRAMS.*

1. The PROGRAM shall be permitted to invest in general partnerships or joint ventures with non-AFFILIATES that own and operate specific assets, if the PROGRAM, alone or together with any publicly registered AFFILIATE of the PROGRAM meeting the requirements of Subsection (b) below, acquires a controlling interest in such a general partnership or joint venture, but in no event shall duplicate fees be permitted. For purposes of this section, "controlling interest" means an equity interest possessing the power to direct or cause the direction of the management and policies of the general partnership or joint venture, including the authority to:

(a) review all contracts entered into by the general partnership or joint venture that will have a material effect on its business or assets;

(b) cause a sale or refinancing of the assets or its interest therein subject, in certain cases where required by the partnership or joint venture agreement, to limits as to time, minimum amounts and/or a right of first refusal by the joint venture partner or consent of the joint venture partner;

(c) approve budgets and major capital expenditures, subject to a stated minimum amount;

(d) veto any sale or refinancing of the assets, or alternatively, to receive a specified preference on sale or refinancing proceeds; and

(e) exercise a right of first refusal on any desired sale or refinancing by the joint venture partner of its interest in

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the assets, except for transfer to an AFFILIATE of the joint venture partner.

2. The PROGRAM shall be permitted to invest in general partnerships or joint ventures with other publicly registered AFFILIATES of the PROGRAM if all of the following conditions are met:

- (a) The PROGRAMS have substantially identical investment objectives.
- (b) There are no duplicate fees.
- (c) The compensation payable by the general partnership or joint venture to the SPONSORS in each PROGRAM that invests in such partnership or joint venture is substantially identical.
- (d) Each PROGRAM has a right of first refusal to buy if the other PROGRAM wishes to sell assets held in the joint venture.
- (e) The investment of each PROGRAM is on substantially the same terms and conditions.
- (f) The PROSPECTUS discloses the potential risk of impasse on joint venture decisions since no PROGRAM controls, and the potential risk that while a PROGRAM may have the right to buy the assets from the partnership or joint venture, it may not have the resources to do so.

3. The PROGRAM shall be permitted to invest in general partnerships or joint ventures with AFFILIATES other than publicly registered AFFILIATES of the PROGRAM only if all of the following conditions are met:

- (a) The investment is necessary to relieve the SPONSOR from any commitment to purchase the assets entered into in compliance with Section V.A.2. prior to the closing of the offering period of the PROGRAM.
- (b) There are no duplicate fees.
- (c) The investment of each entity is on substantially the same terms and conditions.

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(d) The PROGRAM has a right of first refusal to buy if the SPONSOR wishes to sell assets held in the joint venture.

(e) The PROSPECTUS discloses the potential risk of impasse on joint venture decisions.

4. PROGRAMS structured to conduct operations through separate single-purpose entities managed by the SPONSOR (multi-tier arrangements) shall be permitted provided that the terms of any such arrangements do not result in the circumvention of any of the requirements or prohibitions contained in these Guidelines. In particular, all such PROGRAM agreements shall accompany the PROSPECTUS, if available, and shall contain provisions which assure that all of the following restrictions will be present:

(a) There will be no duplication or increase in ORGANIZATION AND OFFERING EXPENSES, SPONSOR's compensation, program expenses or other fees and costs.

(b) There will be no substantive alteration in the fiduciary and contractual relationship between the SPONSOR and the PARTICIPANTS.

(c) There will be no diminishment in the voting rights of PARTICIPANTS.

5. Other than as specifically permitted in Subsections (2), (3) and (4) above, the PROGRAM shall not be permitted to invest in general partnerships or joint ventures with AFFILIATES.

6. A PROGRAM shall be permitted to invest in general partnership interests of limited partnerships only if the PROGRAM, alone or together with any publicly registered AFFILIATE of the PROGRAM meeting the requirements of Subsection (2) above, acquires a "controlling interest" as defined in Subsection (1), no duplicate fees are permitted, no additional compensation beyond that permitted by the ADMINISTRATOR is paid to the SPONSOR, and the PROGRAM agreement complies with Section V.

COMMENT:

Nothing contained in Section V.I. may be used to circumvent or abrogate the restrictions and requirements of these Guidelines, including, but not limited to, Section V.A.

J. *Lending Practices.* On financing made available to the PROGRAM by the SPONSOR, the SPONSOR may not receive interest in excess of the lesser of the SPONSOR's cost of funds or the amounts which would be charged by

unrelated lending institutions on comparable loans for the same purpose. The SPONSOR shall not impose a prepayment charge or penalty in connection with such financing and the SPONSOR shall not receive points or other financing charges. The SPONSOR shall be prohibited from providing permanent financing for the PROGRAM. For purposes of this Section, "permanent financing" shall mean any financing with a term in excess of 12 months.

K. *Minimum Capitalization.* The minimum amount of funds to activate a PROGRAM shall be sufficient to accomplish the objectives of the PROGRAM, including "spreading the risk". Where it appears unlikely that the stated objectives of the PROGRAM can be achieved with the minimum subscriptions, the ADMINISTRATOR may require a greater amount or a lesser amount based on the stated objectives of the PROGRAM. All funds received prior to activation of the PROGRAM must be deposited in an interest bearing account with an independent custodian, trustee, or escrow agent whose name and address shall be disclosed in the PROSPECTUS. Provision must be made for the return to public investors of 100% of paid subscriptions, including interest earned, in the event that the established minimum to activate the PROGRAM is not reached.

L. *Statement of Objectives.* The PROSPECTUS must state specific investment objectives of the PROGRAM. It should indicate whether the primary objective is to obtain current income, tax benefits, or capital appreciation for its PARTICIPANTS.

M. *Multiple PROGRAMS.* The method for the allocation of the acquisition of properties by two or more PROGRAMS of the same SPONSOR seeking to acquire similar types of assets shall be reasonable. The method also shall be described in the PROSPECTUS.

N. *Period of Offering and Expenditure of Proceeds.* The offering period of PROGRAM INTERESTS in a PROGRAM may not exceed one year from the date of effectiveness unless permitted by the ADMINISTRATOR. While the proceeds of an offering are awaiting INVESTMENT IN PROGRAM ASSETS, the proceeds may be temporarily placed into short-term, highly liquid investments which afford appropriate safety of principal, such as U.S. Treasury Bonds or Bills. Any proceeds of the offering of PROGRAM INTERESTS not committed for investment within the later of two years from the date of effectiveness or one year from termination of the offering, unless a longer period is permitted by the ADMINISTRATOR, shall be distributed pro rata to the PARTICIPANTS as a return of capital without deduction of FRONT END FEES.

O. *ASSESSMENTS.* Mandatory ASSESSMENTS of any kind shall be prohibited.

P. *Appraisal and Compensation.*

1. In connection with a proposed ROLL-UP, an appraisal of all PROGRAM assets shall be obtained from a competent INDEPENDENT EXPERT. If the appraisal will be included in a PROSPECTUS used to offer the securities

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of a ROLL-UP ENTITY, the appraisal shall be filed with the Securities and Exchange Commission and the ADMINISTRATOR as an Exhibit to the Registration Statement for the offering. Accordingly, an issuer using the appraisal shall be subject to liability for violation of Section 11 of the Securities Act of 1933 and comparable provisions under State law for any material misrepresentations or material omissions in the appraisal. PROGRAM assets shall be appraised on a consistent basis. The appraisal shall be based on all relevant information and shall indicate the value of the PROGRAM's assets as of a date immediately prior to the announcement of the proposed ROLL-UP. The appraisal shall assume an orderly liquidation over a 12 month period. The terms of the engagement of the INDEPENDENT EXPERT shall clearly state that the engagement is the benefit of the PROGRAM and its PARTICIPANTS. A summary of the independent appraisal, indicating all material assumptions underlying the appraisal, shall be included in a report to the PARTICIPANTS in connection with a proposed ROLL-UP.

2. In connection with a proposed ROLL-UP, the PERSON sponsoring the ROLL-UP shall offer to PARTICIPANTS who vote "no" on the proposal the choice of:

(a) accepting the securities of the ROLL-UP ENTITY offered in the proposed ROLL-UP; or

(b) one of the following:

(i) remaining as PARTICIPANTS in the PROGRAM and preserving their INTERESTS therein on the same terms and conditions as existed previously; or

(ii) receiving cash in an amount equal to the PARTICIPANTS' pro rata share of the appraised value of the net assets of the PROGRAM.

COMMENT:

With respect to the options specified in Subsection V.P.2.(b), the PERSON sponsoring the ROLL-UP needs only offer one of these alternatives to dissenting investors who do not wish to accept the security of the ROLL-UP ENTITY.

3. The PROGRAM shall not participate in any proposed ROLL-UP which, if approved, would result in PARTICIPANTS having democracy rights in the ROLL-UP ENTITY which are less than those provided for under Sections VI. A. and VI. B. of these Guidelines. If the ROLL-UP ENTITY is a corporation, the democracy rights of PARTICIPANTS shall correspond to the democracy rights provided for in these Guidelines to greatest extent possible.

4. The PROGRAM shall not participate in any proposed ROLL-UP which includes provisions which would operate to materially impede or frustrate the accumulation of shares by any purchaser of the securities of the ROLL-UP ENTITY (except to the minimum extent necessary to preserve the tax status of the ROLL-UP ENTITY). The

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PROGRAM shall not participate in any proposed ROLL-UP which would limit the ability of a PARTICIPANT to exercise the voting rights of its securities of the ROLL-UP ENTITY on the basis of the number of PROGRAM INTERESTS held by that PARTICIPANT.

5. The PROGRAM shall not participate in any proposed ROLL-UP in which PARTICIPANTS' rights of access to the records of the ROLL-UP ENTITY will be less than those provided for under Section VI. D. of these Guidelines.

6. The PROGRAM shall not participate in any proposed ROLL-UP in which any of the costs of the transaction would be borne by the PROGRAM if the ROLL-UP is not approved by the PARTICIPANTS.

VI. Rights and Obligations of PARTICIPANTS

A. *Meetings.* Meetings of the PROGRAM may be called by the SPONSOR or the PARTICIPANTS holding ten percent or more of the then outstanding PROGRAM INTERESTS, for any matters for which the PARTICIPANTS may vote as set forth in the PROGRAM agreement. Upon receipt of a written request, either in PERSON or by certified mail, stating the purpose(s) of the meeting, the SPONSOR shall provide all PARTICIPANTS within ten days after receipt of said request, written notice, either in PERSON or by mail, of a meeting and the purpose of such meeting to be held on a date not less than fifteen nor more than sixty days after distribution of such notice, at a time and place specified in the request, or if none is specified, at a time and place convenient to PARTICIPANTS.

B. Voting Rights of PARTICIPANTS

1. The PROGRAM agreement must provide that a majority of the then outstanding PROGRAM INTERESTS may, without the necessity for concurrence by the SPONSOR, vote to:

(a) amend the PROGRAM agreement;

(b) dissolve the PROGRAM;

(c) remove the SPONSOR and elect a new SPONSOR; and

(d) approve or disapprove the sale of all or substantially all of the assets of the PROGRAM, when such sale is to

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be made other than in the ordinary course of the PROGRAM's business.

2. Without concurrence of a majority of the outstanding PROGRAM INTERESTS, the SPONSOR may not:

(a) amend the PROGRAM agreement except for amendments which do not adversely affect the rights of PARTICIPANTS;

(b) voluntarily withdraw as a SPONSOR unless such withdrawal would not affect the tax status of the PROGRAM and would not materially adversely affect the PARTICIPANT;

(c) appoint a new SPONSOR;

(d) sell all or substantially all of the PROGRAM's assets other than in the ordinary course of the PROGRAM's business; or

(e) cause the merger or other reorganization of the PROGRAM.

3. With respect to any PROGRAM INTERESTS owned by the SPONSOR, the SPONSOR may not vote or consent on matters submitted to the PARTICIPANTS regarding the removal of the SPONSOR or regarding any transaction between the PROGRAM and the SPONSOR. In determining the existence of the requisite percentage in interest of PROGRAM INTERESTS necessary to approve a matter on which the SPONSOR may not vote or consent, any PROGRAM INTERESTS owned by the SPONSOR shall not be included.

C. Reports to PARTICIPANTS. The PROGRAM agreement shall provide that the SPONSOR shall cause to be prepared and distributed to PARTICIPANTS during each year the following reports:

1. In the case of PROGRAM registered under Section 12(g) of the Securities Exchange Act of 1934, within sixty days after the end of each quarter of the PROGRAM, a report containing the same financial information contained in the PROGRAM's Quarterly Report on Form 10-Q filed by the PROGRAM under the Securities Exchange Act of 1934.

2. In the case of all other PROGRAMS, within sixty days of the end of the first six months of each fiscal year, a report, prepared on the same accounting basis to be utilized in the annual reports, containing:

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- (a) a balance sheet, which may be unaudited;
- (b) a statement of income for the period then ended, which may be unaudited;
- (c) a statement of PARTICIPANTS' equity for the period then ended, which may be unaudited;
- (d) a statement of CASH FLOW for the period then ended, which may be unaudited; and
- (e) other pertinent material regarding the PROGRAM and its activities during the period covered by the report.

3. In the case of all PROGRAMS, within 120 days after the end of each PROGRAM'S fiscal year, an annual report containing:

(a) a balance sheet as of the end of each fiscal year and statements of income, PARTICIPANTS' equity, and CASH FLOW, for the year then ended, all of which shall be prepared in accordance with generally accepted accounting principles and accompanied by an auditor's report containing an opinion of an independent certified public accountant;

(b) a report of the activities of the PROGRAM during the period covered by the report; and

(c) where forecasts have been provided to the PARTICIPANTS, a table comparing the forecasts previously provided with the actual results during the period covered by the report; and

(d) a report setting forth distributions to PARTICIPANTS for the period covered thereby and separately identifying distributions from:

(i) CASH FLOW from operations during the period,

(ii) CASH FLOW from operations during a prior period which have been held as reserves,

(iii) proceeds from disposition of PROGRAM assets; and

(iv) reserves from the gross proceeds of the offering originally obtained from the PARTICIPANTS.

4. In the case of all PROGRAMS, within 75 days after the end of each PROGRAM'S fiscal year, all information necessary for the preparation of the PARTICIPANTS' federal income tax returns.

5. Where PROGRAM INTERESTS have been purchased on a deferred payment basis, on which there remains an unpaid balance during any period covered by any report required by Subsections 1, 2, and 3, hereof; then such report shall contain a detailed statement of the status of all deferred payments, actions taken by the PROGRAM in response to any defaults, and a discussion and analysis of the impact on capital requirements of the PROGRAM.

D. Access to *PROGRAM Records*.

Every PARTICIPANT shall at all times have access to the records of the PROGRAM and may inspect and copy any of them. However, the ADMINISTRATOR may consider the appropriateness of including a clause in the PROGRAM agreement to restrict access to trade secrets relating to PROGRAM investments. The limited partnership agreement, by-laws or other PROGRAM agreement shall include the following provisions regarding access to the list of PARTICIPANTS:

1. An alphabetical list of the names, addresses and business telephone numbers of the PARTICIPANTS of the PROGRAM along with the number of PROGRAM INTERESTS held by each of them (the "PARTICIPANT list") shall be maintained as a part of the books and records of the PROGRAM and shall be available for inspection by any PARTICIPANT or its designated agent at the home office of the PROGRAM upon the request of the PARTICIPANT.

2. The PARTICIPANT list shall be updated at least quarterly to reflect changes in the information contained therein.

3. A copy of the PARTICIPANT list shall be mailed to any PARTICIPANT requesting the PARTICIPANT list within ten days of the request. The copy of the PARTICIPANT list shall be printed in alphabetical order, on white paper, and in a readily readable type size (in no event smaller than 10-point type). A reasonable charge for copy work may be charged by the PROGRAM.

4. The purposes for which a PARTICIPANT may request a copy of the PARTICIPANT list include, without

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limitation, matters relating to PARTICIPANTS' voting rights under the PROGRAM agreement and the exercise of PARTICIPANTS' rights under federal proxy laws.

5. If the SPONSOR of the PROGRAM neglects or refuses to exhibit, produce, or mail a copy of the PARTICIPANT list as requested, the SPONSOR shall be liable to any PARTICIPANT requesting the list for the costs, including attorneys' fees, incurred by that PARTICIPANT for compelling the production of the PARTICIPANT list, and for actual damages suffered by any PARTICIPANT by reason of such refusal or neglect. It shall be a defense that the actual purpose and reason for the requests for inspection or for a copy of the PARTICIPANT list is to secure such list of PARTICIPANTS or other information for the purpose of selling such list or copies thereof, or of using the same for a commercial purpose other than in the interest of the applicant as a PARTICIPANT relative to the affairs of the PROGRAM. The SPONSOR may require the PARTICIPANT requesting the PARTICIPANT list to represent that the list is not requested for a commercial purpose unrelated to the PARTICIPANT'S interest in the PROGRAM. The remedies provided hereunder to PARTICIPANTS requesting copies of the PARTICIPANT list are in addition to, and shall not in any way limit, other remedies available to PARTICIPANTS under federal law, or the laws of any state.

E. *Admission of PARTICIPANTS.* Admission of PARTICIPANTS to the PROGRAM shall be subject to the following:

1. Admission of Original PARTICIPANTS. Upon the original sale of PROGRAM INTERESTS, the purchasers should be admitted as PARTICIPANTS not later than the last day of the calendar month following the date their subscription was accepted by the PROGRAM. Subsequent subscriptions shall be accepted or rejected by the program within 30 days of their receipt; if rejected, all subscription monies should be returned to the subscriber within 10 business days.

2. Admission of Substituted PARTICIPANTS and Recognition of Assignees. The PROGRAM shall amend its records at least once each calendar quarter to effect the substitution of substituted PARTICIPANTS, although the SPONSOR may elect to do so more frequently. In the case of assignments, where the assignee does not become a substituted PARTICIPANT, the PROGRAM shall recognize the assignment not later than the last day of the calendar month following receipt of notice assignment and required documentation.

3. Except where deemed inappropriate by the ADMINISTRATOR, PERSONS holding PROGRAM INTERESTS for the purpose of assigning all or a portion of such interests (hereinafter "Assignor") shall be expressly granted the same rights as if they were PARTICIPANTS except as prohibited by applicable law, including but not limited to, the rights enumerated under Article VI of these Guidelines. The assignment agreement and PROSPECTUS shall provide that the Assignor's management shall have fiduciary responsibility for the safekeeping and use of all funds and assets of the Assignees, whether or not in the Assignor management's possession or control, and that the management of the Assignor shall not employ, or permit another to employ, such funds or assets in any manner except for the exclusive benefit of the Assignees. In addition, the agreement shall not permit the Assignees to contract away the fiduciary duty owed to the Assignees by the Assignor's management under the common law of agency.

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F. *Redemption of PROGRAM INTERESTS.* Ordinarily, the PROGRAM and the SPONSOR are not obligated to redeem or repurchase any of the PROGRAM INTERESTS. However, the PROGRAM and the SPONSOR are not precluded from voluntarily repurchasing or redeeming the PROGRAM INTERESTS if such repurchase or redemption does not impair the capital or operations of the PROGRAM. A PROGRAM may provide for mandatory redemption rights under the following circumstances:

1. death or legal incapacity of the PARTICIPANT, or
2. a substantial reduction in the PARTICIPANT'S NET WORTH or income provided that all of the following are met:
 - (a) the PROGRAM has sufficient cash to make the purchase.
 - (b) the purchase will not be in violation of applicable legal requirements.
 - (c) not more than 15% of the outstanding units are purchased in any year.

A penalty may be assessed on the redemption of the PROGRAM INTEREST if the penalty accrues to the benefit of the PROGRAM. The SPONSOR is prohibited from receiving a fee on the redemption of PROGRAM INTERESTS by the PROGRAM. Where the purchase price is not mutually agreed upon, the matter may be submitted to arbitration.

G. *Transferability of PROGRAM INTEREST.* Restrictions on assignment of PROGRAM INTERESTS or a substitution of limited partners are generally disfavored and such restrictions will be allowed only to the extent necessary to preserve the tax status of the partnership or the characterization or treatment of income or loss. Any restriction must be affirmatively supported by an opinion of counsel. A charge may be imposed by the PROGRAM to cover its actual, necessary and reasonable administrative and filing expenses incurred in connection with a transfer. Such a charge shall be disclosed in the PROSPECTUS.

H. *Distribution Reinvestment Plans.* A PROGRAM may offer PARTICIPANTS the opportunity to elect to have cash distributions reinvested in the PROGRAM or subsequent PROGRAMS if all of the following conditions are met:

1. The PROGRAM and subsequent PROGRAMS in which the PARTICIPANTS reinvest are registered or exempted under applicable state securities laws.

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2. No sales commissions or fees shall be deducted directly or indirectly from the reinvested funds by the SPONSOR.

3. The subsequent PROGRAM has substantially identical investment objectives as the original PROGRAM.

4. The PARTICIPANTS are free to elect or revoke reinvestment within a reasonable time and such right is fully disclosed in the offering documents.

5. The PARTICIPANTS shall have received a PROSPECTUS for the PROGRAM in which the PARTICIPANTS are reinvesting, which is current as of the date of each such reinvestment.

6. The broker-dealer or the issuer assumes responsibility for blue sky compliance and performance of due diligence responsibilities and has contacted the PARTICIPANTS to ascertain whether the PARTICIPANTS continue to meet the applicable states' suitability standard for participation in each reinvestment.

I. *Reinvestment of CASH AVAILABLE FOR DISTRIBUTION.* Reinvestment of CASH AVAILABLE FOR DISTRIBUTION will be allowed if the PROGRAM'S structure requires that CASH AVAILABLE FOR DISTRIBUTION be reinvested for all PARTICIPANTS upon the same terms and does not create differing classes of PROGRAM INTERESTS resulting from inequitable allocations of tax or economic benefits. CASH AVAILABLE FOR DISTRIBUTION reinvested pursuant to this subsection are not considered to be "investments" in the PROGRAM for purposes of calculating CAPITAL CONTRIBUTIONS.

J. *Reinvestment of Proceeds.* Reinvestment of proceeds resulting from the sale or refinancing of PROGRAM assets may take place if sufficient cash will be distributed to pay state and federal income tax, if any, (assuming investors are in a specified tax bracket) created by the sale or refinancing of such assets. Proceeds reinvested pursuant to this subsection are not considered to be "investments" in the PROGRAM for purposes of calculating CAPITAL CONTRIBUTIONS.

K. *Quarterly Distribution.* From time to time and not less than quarterly, the SPONSOR must review the PROGRAM'S accounts to determine whether cash distributions are appropriate. The PROGRAM shall distribute pro rata to the PARTICIPANTS funds received by the PROGRAM and allocated to their accounts which the SPONSOR deems unnecessary to retain in the PROGRAM. In no event, however, shall funds be advanced or borrowed for purpose of distributions, if the amount of such distributions would exceed the partnership's accrued and received revenues for the previous four quarters, less paid and accrued operating costs with respect to such revenues and costs shall be made in accordance with generally accepted accounting principles, consistently applied. Cash distributions from the

PROGRAM to the SPONSOR shall only be made in conjunction with distributions to PARTICIPANTS and only out of funds properly allocated to the SPONSOR'S account.

L. *Distributions in Kind.* Distributions in kind shall not be permitted, except for:

1. distributions of readily marketable securities;

2. distributions of cash from a liquidating trust established for the dissolution of the PROGRAM and the liquidation of its assets in accordance with the terms of the PROGRAM agreement; or

3. distributions of in-kind property which meet all of the following conditions:

(a) The SPONSOR advises each PARTICIPANT of the risks associated with direct ownership of the property;

(b) The SPONSOR offers each PARTICIPANT the election of receiving in-kind property distributions; and

(c) The SPONSOR distributes in-kind property only to those PARTICIPANTS who accept the SPONSOR'S offer.

VII. DISCLOSURE AND MARKETING

A. *Sales Material.* Sales material, including without limitations, books, pamphlets, movies, slides, article reprints, television and radio commercials, materials prepared for broker/dealer use only, sales presentations (including prepared presentations to prospective PARTICIPANTS at group meetings) and all other advertising used in the offer or sale of units shall conform in all applicable respects to filing, disclosure, and adequacy requirements under any applicable state regulations. Statements made in sales material communicated directly or indirectly to the public may not conflict with, or modify, risk factors or other statements made in the PROSPECTUS.

B. *PROSPECTUS and Its Contents.*

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1. *PROSPECTUS*. A PROSPECTUS which is not part of a Registration Statement declared effective by the Securities and Exchange Commission pursuant to the Securities Act of 1933 shall generally conform to the disclosure requirements which would apply if the offering were so registered. The format and information requirements of applicable Guide(s) promulgated by the Securities and Exchange Commission shall be followed, with appropriate adjustments made for the different business of the PROGRAM.

2. *Prohibited Representations*.

(a) In connection with the offering and sale of INTERESTS in a PROGRAM, neither the SPONSOR(S) nor the underwriter(s) may, in writing or otherwise, directly or indirectly, represent or imply that an administrator has approved the merits of the investment or any aspects thereof.

(b) Any reference to the PROGRAM'S compliance with these Guidelines or any provisions herein which connotes or implies compliance shall not be allowed.

3. *Forecasts and Projections*.

(a) Neither the PROSPECTUS nor any sales material communicated directly or indirectly to the public shall contain a quantitative estimate of a PROGRAM'S anticipated economic performance or anticipated return to PARTICIPANTS, in the form of investment objectives, cash distributions, tax benefits or otherwise, except as permitted by this Section of these Guidelines.

(b) The presentation of predicted future results of operations of PROGRAMS shall be permitted but not required for SPECIFIED ASSET PROGRAMS and shall be prohibited for all other PROGRAMS. The cover of the PROSPECTUS must contain in bold face language one of the following statements:

(i) for SPECIFIED ASSET PROGRAMS with forecasts: **"Forecasts are contained in this prospectus. Any representations to the contrary and any predictions, written or oral, which do not conform to that contained in the prospectus shall not be permitted";** or

(ii) for all other PROGRAMS: **"The use of forecasts in this offering is prohibited. Any representations to the contrary and any predictions, written or oral, as to the amount or certainty of any present or future cash benefit or tax consequence which may flow from an investment in this program is not permitted".**

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(b) Content of Forecasts. Forecasts for SPECIFIED ASSET PROGRAMS may be included in the PROSPECTUS, and sales material of the PROGRAM only if they comply with the following requirements:

(i) Generally, forecasts shall be realistic in their predictions and shall clearly identify the assumptions made with respect to all material features of the presentation. Forecasts should be examined by an independent certified public accountant in accordance with the Guide for Prospective Financial Statements and the Statement on Standards for Accountant's Services on Prospective Financial Information as promulgated by the American Institute of Certified Public Accountants. The report of the independent certified public accountant must be included in the PROSPECTUS.

(ii) If any part of the forecast appears in the sales material, the entire forecast must be presented.

(iii) Forecasts shall generally be for a period equivalent to the anticipated holding period for PROGRAM assets. Forecasts which do not extend through the expected term of the PROGRAM'S life must show the effects of a hypothetical liquidation of PROGRAM assets under good and bad conditions. Yield information may not be presented for Forecasts which do not extend through the expected term of the PROGRAM'S life.

(iv) Forecasts shall disclose possible undesirable tax consequences of an early sale of program assets, such as depreciation recapture, the loss of prior year tax credits or the possible failure to generate sufficient cash from the disposition to pay the associated tax liabilities.

(v) In computing any rate of return or yield to investors, only realized gains in value may be included.

VIII. MISCELLANEOUS

A. *Deferred Payments.* Arrangements for deferred payments on account of the purchase price of PROGRAM INTERESTS may be allowed when warranted by the investment objectives of the PROGRAM. Such arrangements shall be subject to all of the following conditions:

1. The period of deferred payments coincides with the anticipated cash needs of the PROGRAM.

2. Deferred payments shall be evidenced by a promissory note of the investor. Such notes shall be with recourse and shall not be negotiable and shall be assignable only subject to defenses of the maker. Such notes shall not contain a provision authorizing a confession of judgment;

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3. Selling commissions and FRONT END FEES paid upon deferred payments are collectible when payment is made on the note;

4. The PROGRAM shall not sell or assign the deferred obligation notes at a discount to meet financing needs of the PROGRAM;

5. In the event of a default in the payment of deferred payments by PARTICIPANTS, their interests may be subjected to a reasonable penalty.

B. *Reserves.* Provisions should be made for adequate reserves in the future by retention of a reasonable percentage of proceeds from the offering and revenues for normal repairs, replacements and contingencies but not for payment of the sponsor fees. Normally, not less than 1 % of the offering proceeds will be considered adequate.

C. *Financial Information of SPONSOR and PROGRAM.* The SPONSOR or the PROGRAM shall provide as an exhibit to the application, or where indicated below, shall provide as part of the prospectus all of the following financial information and financial statements:

1. Balance Sheet of the PROGRAM. A Balance sheet of the PROGRAM as of the end of its most recent fiscal year, prepared in accordance with generally accepted accounting principles and accompanied by an independent auditor's report containing no material qualification or explanatory paragraph relating to material uncertainties or going concern issues, and an unaudited balance sheet as of a date not more than 135 days prior to the date of filing. Such balance sheets shall be included in the PROSPECTUS.

2. Balance sheet of the SPONSOR.

(a) Corporate and/or Partnership SPONSOR. A balance sheet of any corporate and/or partnership SPONSOR as of the end of its most recent fiscal year, prepared in accordance with generally accepted accounting principles and accompanied by an independent auditor's report containing no material qualification or explanatory paragraph relating to material uncertainties or going concern issues, and an unaudited balance sheet as of a date not more than 135 days prior to the date of filing. Such balance sheets shall be included in the PROSPECTUS.

(b) Individual SPONSOR. A statement of financial condition as of a time not more than 135 days prior to the date of filing an application. Such statement of financial condition shall be prepared in accordance with generally

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accepted accounting principles and reviewed and reported upon by an independent certified public accountant or independent public accountant under the review standards as set forth by the American Institute of Certified Public Accountants. A representation of the amount of such NET WORTH must be included in the PROSPECTUS.

3. Filing of Other Statements. The ADMINISTRATOR may, where consistent with the protection of investors, request additional financial statements of the SPONSOR, ADVISOR, PROGRAM BROKER or any AFFILIATE thereof, or permit the omission of one or more of the statements required under this Section and the filing, and substitution thereof, of appropriate statements verifying financial information having comparable relevance to an investor in determining whether he or she should invest in the PROGRAM.

D. Provisions of the PROGRAM Agreement. The requirements and/or provisions of appropriate portions of the following sections shall be included in the PROGRAM agreement: I.B.; II.B.; II.D.; II.E.; II.G.; III.B.; III.C.; III.F.; IV.B.; IV.C.; IV.D.; IV.E.; IV.F.; V.A.; V.B.; V.C.; V.D.; V.E.; V.F.; V.G.; V.H.; V.I.; V.J.; V.N.; V.O.; V.P.; VI.A.; VI.B.; VI.C.; VI.D.; VI.E.; VI.F.; VI.G.; VI.H.; VI.I.; VI.J.; VI.K.; VI.L; VIII.A; VIII.B.;

E. *Amendments and Supplements*. A marked copy of all amendments and supplements to an application shall be filed with the ADMINISTRATOR as soon as the amendment or supplement is available.

F. CROSS REFERENCE SHEET Requirement. The attached CROSS REFERENCE SHEET shall be included with the application for registration.

OMNIBUS GUIDELINES CROSS REFERENCE SHEET

General Instructions

1. This CROSS REFERENCE SHEET should be completed and submitted with the Application for Registration.

2. Sections which are not applicable should be noted as such.

3. Provisions of the PROGRAM which vary from the Guidelines must be explained by endnote; for example, if the PROGRAM uses a defined term which is different from the Guidelines' definition, the variance must be explained. Endnotes should be numbered sequentially in the column designated "Endnotes" and should be presented on a rider identified as "Endnotes" with each endnote on the rider numerically corresponding to the endnote identified on the CROSS REFERENCE SHEET.

OMNIBUS GUIDELINES CROSS REFERENCE SHEET

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Name of Applicant: _____

Section Number Program Agreement	Page Number Prospectus	Endnote: See Instruction 3	Guideline Section
			I. B. Definitions
_____	_____	_____	1. Acquisition expenses
_____	_____	_____	
_____	_____	_____	2. Acquisition fee
_____	_____	_____	
_____	_____	_____	4. Affiliate
_____	_____	_____	
_____	_____	_____	5. Assessments
_____	_____	_____	
_____	_____	_____	6. Capital contribution
_____	_____	_____	
_____	_____	_____	7. Cash available for distribu- tion
_____	_____	_____	
_____	_____	_____	8. Cash flow
_____	_____	_____	
_____	_____	_____	9. Controlling person
_____	_____	_____	
_____	_____	_____	11. Front-end fees
_____	_____	_____	
_____	_____	_____	12. Independent expert
_____	_____	_____	
_____	_____	_____	13. Investment program assets
_____	_____	_____	
_____	_____	_____	15. Organization and offering expenses
_____	_____	_____	
_____	_____	_____	19. Program interest
_____	_____	_____	
_____	_____	_____	21. Roll-up
_____	_____	_____	
_____	_____	_____	22. Roll-up entity
_____	_____	_____	
_____	_____	_____	23. Specified assist program
_____	_____	_____	
_____	_____	_____	24. Sponsor
_____	_____	_____	
			II. Requirements of Sponsors
_____	_____	_____	A. Experience
_____	_____	_____	

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			B. Financial condition
			C. Reports
			D. Fiduciary duty
			E. Termination of sponsor
			F. Tax ruling or opinion
			G. Liability and indemnification
			H. Arbitration
			III. Suitability of the Participant
			B. Standards
			C. Subscription agreements and prospectus delivery
			D. Minimum investment
			IV. Fees-Compensation-Expenses
			B. Front-end fees
			C. Investment in program assets
			D. Compensation for program management
			E. Other goods or services
			F. Expenses
			V. Conflicts of Interest and Investment Restrictions
			A. Sales and leases to program
			B. Sales and leases to sponsor
			C. Loans
			D. Exchange of interests program
			E. Exclusive agreement

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			F. Commissions on financing, refinancing, reinvestment or distribution
			G. Rebates, kickbacks and reciprocal arrangements
			H. Commingling
			I. Investments in other programs
			J. Lending practices
			K. Minimum capitalization
			L. Statement of objectives
			M. Multiple programs
			N. Offering period and expenditure of proceeds
			O. Assessments
			P. Appraisal and compensation
			VI. Rights and Obligations of Participants
			A. Meetings
			B. Voting rights
			C. Reports
			1. 12(g) programs, quarterly reports
			2. Semi-annual report
			3. Annual report
			4. Participants tax information
			5. Mandatory deferred payment reports
			D. Access to records

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			E. Admission of participants
			1. Original participants
			2. Substitute participants
			3. Assignor
			F. Redemption of program interests
			G. Transferability of program interests
			H. Distribution reinvestment plan
			I. Reinvestment of cash available for distribution
			J. Reinvestment of sale or refinancing proceeds
			K. Quarterly distribution
			L. Distribution in kind
			VII. Disclosure
			B. Prospectus and its contents
			3. Forecasts
			VIII. Miscellaneous Provisions
			A. Deferred payments
			B. Reserves
			C. Financial information
			1. Balance sheet of program
			2. Balance sheet of sponsor

ADDITIONAL OR SUPPLEMENTAL CROSS REFERENCES

As released for public comment by the NASAA Board of Directors on December 12, 1991, and adopted by the NASAA membership on March 29, 1992.

A. Application.

1. These guidelines apply to the registration and qualification of Periodic Payment Plans (sometimes referred to as "contractual plans").

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2. Applications not conforming to the standards contained in these Guidelines shall be looked upon with disfavor. However, where good cause is shown, certain guidelines may be modified or waived by the Administrator.

B. *Definitions.* As used in these guidelines, the following terms mean:

1. *Administrator.* The official or agency administering the securities laws of a jurisdiction.

2. *Current Account.* Any account in a Periodic Payment Plan:

(a) which has not been liquidated and

(i) which is no more than six (6) payments in arrears, or

(ii) in which a payment has been made in the past six (6) months; or

(b) in which the total amount deducted from all payments for sales charges or commissions is nine percent (9%) or less of the total amount of payments made.

3. *Periodic Payment Plan.* A plan which issues any certificate, investment contract or other security providing for a series of periodic payments by the holder, and representing an undivided interest in certain specific securities or in a unit or fund of securities purchased wholly or partly with the proceeds of such payment.

4. *Persistency Rate.* The percentage of the total number of accounts in a Periodic Payment Plan which are Current Accounts. For purposes hereof, the computation of the Persistency Rate shall not include any account which has been canceled in accordance with the cancellation right contained in Section 27(f) of the Investment Company Act of 1940, as amended.

II. SUITABILITY STANDARDS. No Periodic Payment Plan may be sold unless a principal of the selling broker/dealer has determined that the Plan is suitable for the purchasing investor. Such determination shall include, but not be limited to, consideration of the following factors:

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A.

the investor's age, marital status, and number of dependents;

B.

the investor's major investment goals and the time frame for achieving those goals;

C.

the investor's current and anticipated future financial status including income, and reasonably anticipated short and long term liabilities or other obligations;

D.

the reasonable likelihood of the investor's continued income;

E.

the investor's ability to address potentially burdensome financial situations, (e.g., the death of a family member) through the use of insurance, savings, or other assets; and

F.

the investor's understanding of the risks inherent in investing in securities and the proper use of savings instruments or accounts for shorter term needs;

The selling broker/dealer shall retain for at least five (5) year's the documents disclosing the basis upon which the determination of suitability was reached as to each purchasing investor.

III. LIMITATION ON COMMISSIONS.

A.

In addition to the refund rights available to an investor in a Periodic Payment Plan pursuant to Sections 27(d) and 27(f) of the Investment Company Act of 1940, as amended, in the event that an investor in a Periodic Payment Plan shall withdraw from the Plan within twenty-eight (28) months of the investor's initial payment, the investor shall receive the sum of (i) the value of his or her account, and (ii) the amount by which all sales charges, commissions or other selling or redemption fees deducted from the investor's account exceed fifteen percent (15%) of the gross payments made by the investor.

B.

For purposes of paragraph III. A. above, each investor shall be provided a notice setting forth his or her cancellation rights. This notice, in the form set forth below, shall be sent not less than thirty (30) days and not more than sixty (60) days prior to the expiration of the investor's cancellation rights. Neither the Sponsor nor its agent(s) shall advise the investor against exercising his or her right to cancel the plan without first determining that such advice is suitable for the particular investor. Such determination shall include, but not be limited to, consideration of the factors set forth in paragraph II of these Guidelines, as well as of other factors indicating the likelihood that the investor will complete the Plan.

IV. DISCLOSURE. Each investor in a Periodic Payment Plan shall be provided with disclosure in the form set forth below. This disclosure shall be executed by the investor and by the selling broker/dealer. The investor shall be provided with an executed copy. The broker/dealer shall retain an executed copy for a period of at least five (5) years.

IMPORTANT MESSAGE REGARDING YOUR (NAME OF PLAN)

Dear Investor:

You have the right within twenty-eight (28) months of the commencement of your Plan to cancel your Plan and receive a refund of all sales charges paid which are in excess of fifteen percent (15%) of the total payments made. In determining whether or not to exercise your cancellation right, you should consider, among other things, the projected cost of your investment and your ability to make the scheduled payments over the life of your Plan as they become due.

If you wish to exercise your cancellation rights, you must send notice to that effect to

_____ by (date of expiration of cancellation rights).

Very truly yours,

[MESSAGE TO BE PUT ON ONE PAGE]

IMPORTANT MESSAGE TO PURCHASER OF A PERIODIC PAYMENT PLAN

Regarding your application for (_____ name of Plan _____) at (monthly) investment amount/total number of years of program). Date (of application) _____

You are applying for an investment account which features a brokerage commission structure which concentrates the sales charge in the first twelve installments. In establishing such an account, you should most carefully consider your financial ability and personal intention to complete all of the scheduled [120 (10 years) or 180 (15 years)] payments. If you do not complete the full schedule of (120 or 180) payments, you will incur very high effective sales charges. These sales charges could cost you up to 50% of the amount invested. You should be aware that there are many mutual funds which are available with brokerage commission structures that do not concentrate the sales charge in the early installments.

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There are two points at which you may withdraw from the plan and receive a full or partial refund of the sales charges: (1) within forty-five (45) days after receiving notice of your cancellation rights, you may cancel the Plan and receive a full refund of all sales charges paid; or (2) within twenty-eight (28) months of the commencement of the Plan, you may cancel the Plan and receive a refund of all sales charges paid which are in excess of fifteen percent (15%) of the total payments made.

In evaluating your ability to invest regularly for a number of years, you should consider your income pattern, contingencies which may arise, and your willingness to invest in securities which fluctuate in value. If you have reason to doubt your ability and likelihood to complete this Plan, you are urged to seek an alternative investment method.

Purchaser's Statement

I have received the above statement.

(Signature of Applicant)

(Printed Name)

(Account Number)

(Date of Signature)

Broker's Statement

I have discussed the above statement with the applicant and believe that he or she understands it.

(Signature of Sales Representative)

(Printed Name)

(Date of Signature)

V. PERSISTENCY RATE and REPORTS.

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A.

For all fiscal years beginning on or after January 1, 1993, the issuer of securities under a Periodic Payment Plan shall file with the Administrator within sixty (60) days of the end of the Plan's fiscal year a report disclosing the Plan's Persistency Rate for all accounts opened in the jurisdiction no less than one year nor more than five years before the last day of the fiscal year.

B.

An issuer who fails to maintain a Persistency Rate of seventy percent (70%) or higher within the jurisdiction shall furnish a report setting forth an explanation for such failure. Failure to furnish such a report or failure to provide an explanation satisfactory to the Administrator shall be grounds for the Administrator to deny, suspend or revoke registration of the Periodic Payment Plan. In making this determination, the Administrator may consider all relevant factors including but not limited to national persistency rates, market conditions, the number of investors in that jurisdiction, the period of time the Plan has been selling in that jurisdiction, legislative and regulatory developments, and any other unusual or unique circumstances.

C.

The Administrator may deny the registration of a Periodic Payment Plan based upon low Persistency Rates in one or more other jurisdictions. This provision shall not apply to the renewal of the registration of any Plan currently registered in the jurisdiction.

VI. INVESTMENT OBJECTIVE. The stated investment objective of a Periodic Payment Plan shall be a fundamental policy of the Plan as defined in Section 8(b) of the Investment Company Act of 1940 and shall be consistent with the goal of providing a long-term investment opportunity suitable for persons of relatively modest means. If a fund's investment objective is not currently a fundamental policy, it shall be made one at the next meeting of shareholders.

Amended April 27, 1997

I.

INTRODUCTION. The North American Securities Administrators Association, Inc. ("NASAA") has determined that the following guideline relating to preferred stock is consistent with public investor protection and is in the public interest. Nothing shall prevent the Securities Administrator ("Administrator") from applying different standards than those contained in this Statement of Policy.

II.

DEFINITIONS. The terms used in this Statement of Policy are defined pursuant to the NASAA Statement of Policy Regarding Corporate Securities Definitions.

III.

A public offering of preferred stock may be disallowed by the Administrator if the Issuer's ADJUSTED NET EARNINGS for the last fiscal year or its average ADJUSTED NET EARNINGS for the last three (3) fiscal years prior to the public offering were insufficient to pay its fixed charges and preferred stock dividends, whether or not accrued, and to meet the redemption requirements, if applicable, of the preferred stock being offered.

IV.

As an alternative to III. above, the Administrator may choose to apply a CASH ANALYSIS. The Administrator may consider the Statement of Cash Flows if the statement demonstrates that the issuer has had positive "Net Cash Provided by Operating Activities" for its last fiscal year. The Administrator may request that the issuer submit a financial statement demonstrating an average positive "Net Cash Provided by Operating Activities" for the last three (3) fiscal years prior to the public offering. In either instance there must be sufficient cash to cover the preferred stock dividend whether or not declared.

V.

Section III. and IV. above shall not apply to public offerings of convertible preferred stock that are superior in right to payment of dividends, interest and liquidation proceeds to any convertible debt and preferred stock that are or may be legally or beneficially, directly or indirectly, owned by PROMOTERS. The risks of failure to declare or pay dividends and the equity characteristics of the convertible preferred stock must be disclosed in the offering prospectus. An offering of such securities may be reviewed using guidelines for equity offerings.

VI.

If the Issuer's NET EARNINGS are subject to cyclical fluctuations or if the Administrator deems it necessary for investor protection, the Administrator may require that the Issuer establish redemption requirements.

VII.

A public offering of EQUITY SECURITIES may be disallowed by the Administrator if the Issuers articles of incorporation authorize its board of directors to issue preferred stock in the future without a vote of the common shareholders unless:

A.

The issuer represents in its prospectus or offering document that it will not offer preferred stock to PROMOTERS except on the same terms as it is offered to all other existing shareholders or to new shareholders; or

B.

The issuance of preferred stock is approved by a majority of the Issuers INDEPENDENT DIRECTORS who do not have an interest in the transaction and who have access, at the issuers expense, to issuers or independent legal counsel.

Last Revised, May 7, 2007

I. INTRODUCTION.

A. Application.

1. The rules contained in these guidelines apply to qualifications and registrations of real estate programs in the form of limited partnerships (herein sometimes called "PROGRAM" or "partnerships") and will be applied by analogy to real estate programs in other forms. While applications not conforming to the standards contained herein shall be looked upon with disfavor, where good cause is shown certain guidelines may be modified or waived by the ADMINISTRATOR.

COMMENT:

The purpose of the guidelines is to establish uniform and consistent standards to be applied by the various state securities ADMINISTRATORS throughout the country. These standards are primarily designed for public real estate syndications and PROGRAMS which make or invest in mortgage loans. With respect to PROGRAMS which make or invest in mortgage loans, all provisions of these guidelines are applicable thereto, unless specifically excluded or modified.

2. Where the individual characteristics of specific PROGRAMS warrant modification from these standards they will be accommodated, insofar as possible while still being consistent with the spirit of these guidelines. The Cross Reference Sheet in the form set forth in Section IX.H. Real Estate Guidelines Cross Reference Sheet shall be furnished with the application.

3. Where these guidelines conflict with requirements of the Securities and Exchange Commission, the guidelines will not apply.

B. Definitions.

1. ACQUISITION EXPENSES--expenses including but not limited to legal fees and expenses, travel and communications expenses, costs of appraisals, non-refundable option payments on property not acquired, accounting

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fees and expenses, title insurance, and miscellaneous expenses related to selection and acquisition of properties, whether or not acquired.

COMMENT:

Definition utilized in section IV.C. making clear that all expenses incurred in acquiring properties for the PROGRAM be included in FRONT-END FEES.

2. ACQUISITION FEE: The total of all fees and commissions paid by any party in connection with making or investing in mortgage loans or the purchase, development or construction of property by a PROGRAM. Included in the computation of such fees or commissions shall be any real estate commission, selection fee, DEVELOPMENT FEE, CONSTRUCTION FEE, nonrecurring management fee, loan fees or points paid by borrowers to the SPONSOR in PROGRAMs which make or invest in mortgage loans, or any fee of a similar nature, however designated. Excluded shall be DEVELOPMENT FEES and CONSTRUCTION FEES paid to PERSONS not affiliated with the SPONSOR in connection with the actual development and construction of a project.

3. ADMINISTRATOR--the official or agency administering the securities law of a state.

4. AFFILIATE--means (i) any PERSON directly or indirectly controlling, controlled by or under common control with another PERSON (ii) any PERSON owning or controlling 10% or more of the outstanding voting securities of such other PERSON (iii) any officer, director, partner of such PERSON and (iv) if such other PERSON is an officer, director or partner, any company for which such PERSON acts in any such capacity.

5. ASSESSMENTS--additional amounts of capital which may be mandatorily required of or paid at the option of a PARTICIPANT beyond his subscription commitment excluding MANDATORY DEFERRED PAYMENTS.

6. ASSET BASED FEE--compensation to a SPONSOR computed according to subsection IV.J.

7. AUDITED FINANCIAL STATEMENTS: Financial statements (balance sheet, statement of income, statement of partners' equity and statement of cash flows) prepared in accordance with generally accepted accounting principles and accompanied by an independent auditor's report containing (i) an unqualified opinion, (ii) an opinion containing no material qualification or (iii) no explanatory paragraph disclosing information relating to material uncertainties (except as to litigation) or going concern issues.

8. BASE AMOUNT--that portion of the CAPITAL CONTRIBUTIONS originally committed to INVESTMENT IN PROPERTIES without regard to leverage and including working capital reserves allowable under subsection IV.J.1.c. The BASE AMOUNT shall be recomputed annually by subtracting from the then fair market value of the PROGRAM's real properties as determined by independent appraisals plus the working capital reserves allowable under subsection

IV.J.1.c., an amount equal to the outstanding debt secured by the PROGRAM's properties.

9. CAPITAL CONTRIBUTION--the gross amount of investment in a PROGRAM by a PARTICIPANT, or all PARTICIPANTS as the case may be. Unless otherwise specified, CAPITAL CONTRIBUTION shall be deemed to include principal amounts to be received on account of mandatory deferred payments.

10. CARRIED INTEREST--an equity interest in a PROGRAM which participates in all allocations and distributions other than the promotional interest provided for in Sections IV.C.3.a., IV.E.1. and IV.E.2., for which full consideration is not paid or to be paid.

11. CASH AVAILABLE FOR DISTRIBUTION--CASH FLOW less amount set aside for restoration or creation of reserves.

12. CASH FLOW--PROGRAM cash funds provided from operations, including lease payments on net leases from builders and sellers, without deduction for depreciation, but after deducting cash funds used to pay all other expenses, debt payments, capital improvements and replacements.

COMMENT:

With respect to PROGRAMS which make or invest in mortgage loans, only funds which constitute interest payments shall be included in CASH FLOW. Funds which may be deemed to constitute interest payments are (i) contractual current interest payments; (ii) interest accrued or deferred, when received, and (iii) contingent interest based upon the PROGRAM'S share of the gross or net income from properties on which the PROGRAM has made a loan. All other funds shall be considered to be net proceeds from a sale or refinancing.

13. COMPETITIVE REAL ESTATE COMMISSION--that real estate or brokerage commission paid for the purchase or sale of property which is reasonable, customary and competitive in light of the size, type and location of the property.

14. CONSTRUCTION FEE: A fee or other remuneration for acting as general contractor and/or construction manager to construct improvements, supervise and coordinate projects or to provide MAJOR REPAIRS OR REHABILITATION on a PROGRAM's property.

15. CROSS REFERENCE SHEET--A compilation of the guideline sections, referenced to the page of the PROSPECTUS, partnership agreement, or other exhibits, and justification of any deviation from the guidelines.

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16. DEVELOPMENT FEE--a fee for the packaging of a PROGRAM's property, including negotiating and approving plans, and undertaking to assist in obtaining zoning and necessary variances and necessary financing for the specific property, either initially or at a later date.

17. FINANCING--shall be defined as: All indebtedness encumbering PROGRAM properties or incurred by the PROGRAM, the principal amount of which is scheduled to be paid over a period of not less than 48 months, and not more than 50 percent of the principal amount of which is scheduled to be paid during the first 24 months. Nothing in this definition shall be construed as prohibiting a bona-fide pre-payment provision in the financing agreement.

18. FRONT-END FEES: Fees and expenses paid by any party for any services rendered to organize the PROGRAM and to acquire assets for the PROGRAM, including ORGANIZATION AND OFFERING EXPENSES, ACQUISITION FEES, ACQUISITION EXPENSES, interest on deferred fees and expenses and any other similar fees, however designated by the SPONSOR.

19. INDEPENDENT EXPERT: A PERSON with no material current or prior business or personal relationship with the SPONSOR who is engaged to a substantial extent in the business of rendering opinions regarding the value of assets of the type held by the PROGRAM, and who is qualified to perform such work.

20. INVESTMENT IN PROPERTIES--The amount of CAPITAL CONTRIBUTIONS used to make or invest in mortgage loans or the amount actually paid or allocated to the purchase, development, construction or improvement of properties acquired by the PROGRAM (including the purchase of properties, working capital reserves allocable thereto (except that working capital reserves in excess of 5% shall not be included), and other cash payments such as interest and taxes but excluding FRONT-END FEES).

21. MANDATORY DEFERRED PAYMENTS--MANDATORY DEFERRED PAYMENTS shall be payments on account of the purchase price of PROGRAM INTERESTS offered in accordance with 17 *CFR* 240.3a12-9.

22. MAJOR REPAIRS AND REHABILITATION: The repair, rehabilitation or reconstruction of a property where the aggregate costs exceed 10% of the fair market value of the property at the time of such services.

23. NET WORTH--the excess of total assets over total liabilities as determined by generally accepted accounting principles, except that if any of such assets have been depreciated, then the amount of depreciation relative to any particular asset may be added to the depreciated cost of such asset to compute total assets, provided that the amount of depreciation may be added only to the extent that the amount resulting after adding such depreciation does not exceed the fair market value of such asset.

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24. NON-SPECIFIED PROPERTY PROGRAMS shall be PROGRAMS other than SPECIFIED PROPERTY PROGRAMS.

25. ORGANIZATION AND OFFERING EXPENSES--those expenses incurred in connection with and in preparing a PROGRAM for registration and subsequently offering and distributing it to the public, including sales commissions paid to broker-dealers in connection with the distribution of the PROGRAM and all advertising expenses.

COMMENT:

All advertising expenses, except those related to PROGRAM property management, charged to a PROGRAM are included within the definition. Fees paid by the PROGRAM, directly or indirectly, to persons for acting as surety, guarantor or in some similar capacity in regard to MANDATORY DEFERRED PAYMENTS shall also be included within this definition.

26. ROLL-UP--A transaction involving the acquisition, merger, conversion, or consolidation, either directly or indirectly of the PROGRAM and the issuance of securities of a ROLL-UP ENTITY. Such term does not include:

(a) a transaction involving securities of the PROGRAM that have been listed for at least 12 months on a national securities exchange or traded through the National Association of Securities Dealers Automated Quotation National Market System; or

(b) a transaction involving the conversion to corporate, trust or association form of only the PROGRAM if, as a consequence of the transaction, there will be no significant adverse change in any of the following:

(i) PARTICIPANTS' voting rights;

(ii) the term of existence of the PROGRAM;

(iii) SPONSOR compensation; or

(iv) the PROGRAM'S investment objectives.

27. ROLL-UP ENTITY--A partnership, real estate investment trust, corporation, trust or other entity that would be created or would survive after the successful completion of a proposed ROLL-UP transaction.

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28. PARTICIPANT--the holder of a PROGRAM INTEREST.

29. PERSON--any natural PERSON, partnership, corporation, association or other legal entity.

30. PROGRAM--a limited or general partnership, joint venture, unincorporated association or similar organization other than a corporation formed and operated for the primary purpose of investment in and the operation of or gain from an interest in real property including such entities formed to make or invest in mortgage loans.

31. PROGRAM INTEREST--the limited partnership unit or other indicia of ownership in a PROGRAM.

32. PROGRAM MANAGEMENT FEE--a fee paid to the SPONSOR or other PERSONS for management and administration of the PROGRAM.

33. PROPERTY MANAGEMENT FEE--the fee paid for day-to-day professional property management services in connection with a PROGRAM's real property projects.

34. PROSPECTUS--shall have the meaning given to that term by Section 2(10) of the Securities Act of 1933, including a preliminary PROSPECTUS; provided, however, that such term as used herein shall also include an offering circular as described in Rule 256 of the General Rules and Regulations under the Securities Act of 1933 or, in the case of an intrastate offering, any document by whatever name known, utilized for the purpose of offering and selling securities to the public.

35. PURCHASE PRICE--the price paid upon the purchase or sale of a particular property, including the amount of ACQUISITION FEES and all liens and mortgages on the property, but excluding points and prepaid interest.

36. SPECIFIED PROPERTY PROGRAM--a PROGRAM where, at the time a securities registration is ordered effective, more than 75% of the net proceeds from the sale of PROGRAM INTERESTS is allocable to the purchase, construction, or improvement of specific properties. Reserves shall be included in the non-specified portion. Net proceeds shall include principal amounts to be received on account of MANDATORY DEFERRED PAYMENTS.

37. SPONSOR--a "SPONSOR" is any PERSON directly or indirectly instrumental in organizing, wholly or in part, a PROGRAM or any PERSON who will manage or participate in the management of a PROGRAM, and any

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AFFILIATE of any such person, but does not include a PERSON whose only relation with the PROGRAM is as that of an independent property manager, whose only compensation is as such. "SPONSOR" does not include wholly independent third parties such as attorneys, accountants, and underwriters whose only compensation is for professional services rendered in connection with the offering of syndicate interests. A PERSON may also be a SPONSOR of the PROGRAM by:

(i) Taking the initiative, directly or indirectly, in founding or organizing the business or enterprise of the PROGRAM, either alone or in conjunction with one or more other PERSONS.

(ii) Receiving a material participation in the PROGRAM in connection with the founding or organizing of the business of the PROGRAM, in consideration of services or property, or both services and property.

(iii) Having a substantial number of relationships and contacts with the PROGRAM.

(iv) Possessing significant rights to control PROGRAM properties.

(v) Receiving fees for providing services to the PROGRAM which are paid on a basis that is not customary in the industry.

(vi) Providing goods or services to the PROGRAM on a basis which was not negotiated at arm's length with the PROGRAM.

II. REQUIREMENTS OF SPONSORS.

A. *Experience.* The SPONSOR, the general partner or their chief operating officers shall have at least two years relevant real estate or other experience demonstrating the knowledge and experience to acquire and manage the type of assets being acquired, and any of the foregoing or any AFFILIATE providing services to the PROGRAM shall have had not less than four years relevant experience in the kind of service being rendered or otherwise must demonstrate sufficient knowledge and experience to perform the services proposed.

COMMENT:

"Relevant real estate or other experience" should be interpreted to include actual direct experience by the chief executive officer, or other PERSONS at the management level, either as a principal or agent in performing the services to be provided to the PROGRAM. This would include acquiring and managing real estate for one's own account or acting as an agent in acquiring and managing real estate comparable to that which the PROGRAM will acquire. If the PROGRAM will be in the business of acquiring shopping centers and office buildings, "relevant real estate experience" would not include experience in

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buying or selling houses. It is apparent that a different level of sophistication and knowledge is required.

B. *NET WORTH Requirement of SPONSOR.* The financial condition of the SPONSOR liable for the debts of the PROGRAM must be commensurate with any financial obligations assumed in the offering and in the operation of the PROGRAM. As a minimum, such SPONSOR shall have an aggregate financial NET WORTH, exclusive of home, automobile and home furnishings, of the greater of either \$50,000 or an amount at least equal to 5% of the gross amount of all offerings sold within the prior 12 months plus 5% of the gross amount of the current offering, to an aggregate maximum NET WORTH of such SPONSOR of one million dollars. In determining NET WORTH for this purpose, evaluation will be made of contingent liabilities and the use of promissory notes, to determine the appropriateness of their inclusion in computation of NET WORTH.

COMMENT:

The inclusion of promissory notes may be insufficient to satisfy the NET WORTH requirements where the maker of the notes is inadequately capitalized. The gross amount of offerings includes the principal amounts to be received on account of mandatory deferred payments.

C. *Reports to ADMINISTRATOR.* Each application for registration shall contain a commitment, executed by the SPONSOR, to submit to the ADMINISTRATOR upon request any report or statement required to be distributed to limited partners pursuant to VII.C.

COMMENT:

The SPONSOR need not file with the ADMINISTRATOR all reports that will be filed with the limited partners, but should retain copies of such reports or information and make them available to the ADMINISTRATOR as required. The length this information must be retained will vary from state to state depending upon its requirements.

D. *Liability and Indemnification.*

1. The PROGRAM shall not provide for indemnification of the SPONSOR for any liability or loss suffered by the SPONSOR, nor shall it provide that the SPONSOR be held harmless for any loss or liability suffered by the PROGRAM, unless all of the following conditions are met:

a. The SPONSOR has determined, in good faith, that the course of conduct which caused the loss or liability was in the best interests of the PROGRAM, and

b. the SPONSOR was acting on behalf of or performing services for the PROGRAM, and

c. such liability or loss was not the result of negligence or misconduct by the SPONSOR, and

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d. such indemnification or agreement to hold harmless is recoverable only out of the assets of the PROGRAM and not from the PARTICIPANTS.

2. Notwithstanding anything to the contrary contained in Section II.D.1., the SPONSOR (which shall include AFFILIATES only if such AFFILIATES are performing services on behalf of the PROGRAM) and any person acting as a broker-dealer shall not be indemnified for any losses, liabilities or expenses arising from or out of an alleged violation of federal or state securities laws unless the following conditions are met:

a. There has been a successful adjudication on the merits of each count involving alleged securities law violations as to the particular indemnitee, or

b. such claims have been dismissed with prejudice on the merits by a court of competent jurisdiction as to the particular indemnitee, or

c. a court of competent jurisdiction approves a settlement of the claims against a particular indemnitee and finds that indemnification of the settlement and related costs should be made, and

d. in the case of subparagraph c., the court of law considering the request for indemnification has been advised of the position of the Securities and Exchange Commission and the position of any state securities regulatory authority in which securities of the PROGRAM were offered or sold as to indemnification for violations of securities laws; provided that the court need only be advised of and consider the positions of the securities regulatory authorities of those states (i) which are specifically set forth in the PROGRAM agreement and (ii) in which plaintiffs claim they were offered or sold PROGRAM INTERESTS.

3. The PROGRAM may not incur the cost of that portion of liability insurance which insures the SPONSOR for any liability as to which the SPONSOR is prohibited from being indemnified under this section.

4. The provision of advancement from PROGRAM funds to a SPONSOR or its AFFILIATES for legal expenses and other costs incurred as a result of any legal action is permissible if the following conditions are satisfied:

a. the legal action relates to acts or omissions with respect to the performance of duties or services on behalf of the PROGRAM;

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b. the legal action is initiated by a third party who is not a PARTICIPANT, or the legal action is initiated by a PARTICIPANT and a court of competent jurisdiction specifically approves such advancement; and

c. the SPONSOR or its AFFILIATES undertake to repay the advanced funds to the PROGRAM in cases in which such PERSON is not entitled to indemnification under Section II.D.1.

E. *Fiduciary Duty*. The program agreement shall provide that the SPONSOR shall have fiduciary responsibility for the safekeeping and use of all funds and assets of the program, whether or not in the SPONSOR'S possession or control, and that the SPONSOR shall not employ, or permit another to employ such funds or assets in any manner except for the exclusive benefit of the PROGRAM.

In addition, the PROGRAM shall not permit the PARTICIPANT to contract away the fiduciary duty owed to the PARTICIPANT by the SPONSOR under the common law.

F. *Terminated SPONSOR*. Upon the occurrence of a terminating event, the partnership may be required to pay to the terminated SPONSOR all amounts then accrued and owing to the terminated SPONSOR. Additionally, the partnership may terminate the SPONSOR'S interest in partnership income, losses, distributions, and capital by payment of an amount equal to the then present fair market value of the terminated SPONSOR'S interest determined by agreement of the terminated SPONSOR and the partnership, or, if they cannot agree, by arbitration in accordance with the then current rules of the American Arbitration Association. The expense of arbitration shall be borne equally by the terminated SPONSOR and the partnership.

The method of payment to the terminated SPONSOR must be fair; and must protect the solvency and liquidity of the partnership. Where the termination is voluntary, the method of payment will be deemed presumptively fair where it provides for a non-interest bearing unsecured promissory note with principal payable, if at all, from distributions which the terminated SPONSOR otherwise would have received under the partnership agreement had the SPONSOR not terminated. Where the termination is involuntary, the method of payment will be deemed presumptively fair where it provides for an interest bearing promissory note coming due in no less than 5 years with equal installments each year.

III. SUITABILITY OF PARTICIPANTS

A. *General Policy*.

1. The SPONSOR shall establish minimum income and net worth standards for PERSONS who purchase PROGRAM INTERESTS.

2. The SPONSOR shall propose minimum income and net worth standards which are reasonable given the type of PROGRAM and the risks associated with the purchase of PROGRAM INTERESTS. PROGRAMS with greater

investor risk shall have minimum standards with a substantial NET WORTH requirement. The ADMINISTRATOR shall evaluate the standards proposed by the SPONSOR when the PROGRAM'S application for registration is reviewed. In evaluating the proposed standards, the ADMINISTRATOR may consider the following:

- a. the PROGRAM'S use of leverage;
- b. tax implications;
- c. MANDATORY DEFERRED PAYMENTS;
- d. assessments;
- e. balloon payment financing;
- f. investments in unimproved land;
- g. potential variances in cash distributions;
- h. potential PARTICIPANTS;
- i. relationship between potential PARTICIPANTS and the SPONSOR;
- j. liquidity of PROGRAM INTERESTS;
- k. performance of SPONSOR'S prior programs;
- l. financial condition of the SPONSOR;

m. potential transactions between the PROGRAM and the SPONSOR; and

n. any other relevant factors.

B. Income and Net Worth Standards.

1. For PROGRAMS other than PROGRAMS with MANDATORY DEFERRED PAYMENTS, unless the ADMINISTRATOR determines that the risks associated with the PROGRAM would require lower or higher standards, each PARTICIPANT shall have:

a. a minimum annual gross income of \$70,000 and a minimum NET WORTH of \$70,000; or

b. a minimum NET WORTH of \$250,000.

2. For PROGRAMS with MANDATORY DEFERRED PAYMENTS, unless the ADMINISTRATOR determines that the risks associated with the PROGRAM would require lower or higher standards, each PARTICIPANT shall have:

a. a minimum annual gross income of \$85,000 and a minimum NET WORTH of \$85,000; or

b. a minimum NET WORTH of \$330,000.

3. NET WORTH shall be determined exclusive of home, home furnishings, and automobiles.

4. In the case of sales to fiduciary accounts, these minimum standards shall be met by the beneficiary, the fiduciary account, or by the donor or grantor who directly or indirectly supplies the funds to purchase the PROGRAM INTERESTS if the donor or grantor is the fiduciary.

5. The SPONSOR shall set forth in the final PROSPECTUS:

- a. the investment objectives of the PROGRAM;
- b. a description of the type of PERSON who might benefit from an investment in the PROGRAM; and
- c. the minimum standards imposed on each PARTICIPANT in the PROGRAM.

C. Determination that Sale to PARTICIPANT is Suitable and Appropriate.

1. The SPONSOR and each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM shall make every reasonable effort to determine that the purchase of PROGRAM INTERESTS is a suitable and appropriate investment for each PARTICIPANT.

2. In making this determination, the SPONSOR or each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM shall ascertain that the prospective PARTICIPANT:

- a. meets the minimum income and net worth standard established for the PROGRAM;
- b. can reasonably benefit from the PROGRAM based on the prospective PARTICIPANT'S overall investment objectives and portfolio structure;
- c. is able to bear the economic risk of the investment based on the prospective PARTICIPANT'S overall financial situation; and
- d. has apparent understanding of:
 - (i) the fundamental risks of the investment;
 - (ii) the risk that the PARTICIPANT may lose the entire investment;

(iii) the lack of liquidity of PROGRAM INTERESTS;

(iv) the restrictions on transferability of PROGRAM INTERESTS;

(v) the background and qualifications of the SPONSOR or the PERSONS responsible for directing and managing the PROGRAM; and

(vi) the tax consequences of the investment.

3. The SPONSOR or each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM will make this determination on the basis of information it has obtained from a prospective PARTICIPANT. Relevant information for this purpose will include at least the age, investment objectives, investment experience, income, NET WORTH, financial situation, and other investments of the prospective PARTICIPANT, as well as any other pertinent factors.

4. The SPONSOR or each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM shall maintain records of the information used to determine that an investment in PROGRAM INTERESTS is suitable and appropriate for each PARTICIPANT. The SPONSOR or each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM shall maintain these records for at least six years.

5. The SPONSOR shall disclose in the final PROSPECTUS the responsibility of the SPONSOR and each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM to make every reasonable effort to determine that the purchase of PROGRAM INTERESTS is a suitable and appropriate investment for each PARTICIPANT, based on information provided by the PARTICIPANT regarding the PARTICIPANT'S financial situation and investment objectives.

D. Subscription Agreements.

1. The ADMINISTRATOR may require that each PARTICIPANT complete and sign a written subscription agreement.

2. The SPONSOR may require that each PARTICIPANT make certain factual representations in the subscription

agreement, including the following:

- a. The PARTICIPANT meets the minimum income and net worth standards established for the PROGRAM.
- b. The PARTICIPANT is purchasing the PROGRAM INTERESTS for his or her own account.
- c. The PARTICIPANT has received a copy of the PROSPECTUS.
- d. The PARTICIPANT acknowledges that the investment is not liquid.

3. The PARTICIPANT must separately sign or initial each representation made in the subscription agreement. Except in the case of fiduciary accounts, the PARTICIPANT may not grant any PERSON a power of attorney to make such representations on his or her behalf.

4. The SPONSOR and each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM shall not require a PARTICIPANT to make representations in the subscription agreement which are subjective or unreasonable and which: a. might cause the PARTICIPANT to believe that he or she has surrendered rights to which he or she is entitled under federal or state law; or b. would have the effect of shifting the duties regarding suitability, imposed by law on broker-dealers, to the PARTICIPANT.

5. Prohibited representations include, but are not limited to the following:

- a. The PARTICIPANT understands or comprehends the risks associated with an investment in the PROGRAM.
- b. The investment is a suitable one for the PARTICIPANT.
- c. The PARTICIPANT has read the PROSPECTUS.

d. In deciding to invest in the PROGRAM, the PARTICIPANT has relied solely on the PROSPECTUS, and not on any other information or representations from other PERSONS or sources.

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6. The SPONSOR may place the content of the prohibited representations in the subscription agreement in the form of disclosures to the PARTICIPANT. The SPONSOR may not place these disclosures in the PARTICIPANT representation section of the subscription agreement.

E. Completion of Sale.

1. The SPONSOR or any person selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM may not complete a sale of PROGRAM INTERESTS to a PARTICIPANT until at least five business days after the date the PARTICIPANT receives a final prospectus.

2. The SPONSOR or the PERSON designated by the SPONSOR shall send each PARTICIPANT a confirmation of his or her purchase.

F. Minimum Investment. The ADMINISTRATOR may require a minimum initial and subsequent cash investment amount.

IV. FEES--COMPENSATION--EXPENSES.

A. Fees, Compensation and Expenses to Be Reasonable.

1. The total amount of consideration of all kinds which may be paid directly or indirectly to all parties shall be reasonable.

2. The PROSPECTUS must fully disclose and itemize all consideration which may be received from the PROGRAM directly or indirectly by the SPONSOR, its AFFILIATES and underwriters, what the consideration is for and how and when it will be paid. This shall be set forth in one location in tabular form.

B. ORGANIZATION AND OFFERING EXPENSES. All ORGANIZATION AND OFFERING EXPENSES incurred in order to sell PROGRAM interests shall be reasonable and shall comply with all statutes, rules and regulations imposed in connection with the offering of other securities in the state.

C. INVESTMENT IN PROPERTIES.

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1.

a. The SPONSOR shall be required to commit a substantial portion of the PROGRAM'S CAPITAL CONTRIBUTIONS toward INVESTMENT IN PROPERTIES. The remaining CAPITAL CONTRIBUTIONS may be used to pay FRONT-END FEES. The total amount of FRONT-END FEES, whenever paid and from whatever source, shall be limited to an amount equal to the initial amount of CAPITAL CONTRIBUTIONS not applied to INVESTMENT IN PROPERTIES. When FRONT-END FEES are paid by the seller of properties, such fees shall not be included in satisfying the required minimum INVESTMENT IN PROPERTIES.

b. If CAPITAL CONTRIBUTIONS are paid on an installment basis, the FRONT-END FEE shall be paid to the SPONSOR pro rata as installments are paid.

c. Notwithstanding Sections IV.C.1.a. and IV.C.2., FRONT-END FEES may be limited as required by Section V.J. If so, the proportion of CAPITAL CONTRIBUTIONS subject to the limitations of Section V.J. shall be the same proportion as the amount of invested assets subject to Section V.J. to the aggregate amount of all investments of the PROGRAM. Borrowed amounts shall not be included in determining the amount of investment.

COMMENT:

This section is to provide an alternative to Section IV.C.1.a. when a SPONSOR is developing a specified property. If the SPONSOR does not elect to follow this alternative, the FRONT-END FEES shall include the DEVELOPMENT FEE and CONSTRUCTION FEE paid to the SPONSOR.

2. At a minimum, the SPONSOR shall commit a percentage of the CAPITAL CONTRIBUTIONS to INVESTMENT IN PROPERTIES which is equal to 82% for PROGRAMS which make or invest in mortgage loans and for all other PROGRAMS is equal to the greater of:

a. 80% of the CAPITAL CONTRIBUTIONS reduced by .1625% for each 1% of financing of PROGRAM properties; or

b. 67% of the CAPITAL CONTRIBUTIONS.

COMMENT:

The expenses incurred and level of effort required in locating and funding mortgages is not as high as that which is required in locating and closing upon real properties. In addition, the fees traditionally payable in the mortgage funding and acquisition area are much lower than those payable in real property acquisitions. For example, real estate commissions which can represent a large portion of the front-end fees in a traditional PROGRAM are not present in a mortgage PROGRAM. Consequently, the FRONT END FEES permissible in a mortgage PROGRAM are less than those permissible in the more traditional real estate equity PROGRAMS.

3. If the SPONSOR enters into an INVESTMENT IN PROPERTIES commitment in excess of that specified in Section 2. above, the following mutually exclusive forms of compensation are viewed as not unreasonable alternatives to FRONT-END FEES:

a. the SPONSOR may take an additional promotional interest in the net proceeds remaining from the sale or refinancing of the properties after payment of such proceeds to PARTICIPANTS in an amount equal to 100% of CAPITAL CONTRIBUTIONS, equal to 1% for each 1% of additional INVESTMENT IN PROPERTIES; or

b. the SPONSOR may take a CARRIED INTEREST which accrues and is payable from the net proceeds remaining from the sale or refinancing of properties only after payment of such proceeds to PARTICIPANTS in an amount equal to 100% of CAPITAL CONTRIBUTIONS, equal to 1% for the first 2% of additional INVESTMENT IN PROPERTIES, plus 1% for the next 1.5% of additional INVESTMENT IN PROPERTIES, plus 1% for each 1% of additional INVESTMENT IN PROPERTIES thereafter; or

c. the SPONSOR may take a fully participating CARRIED INTEREST equal to 1% for the first 2.5% of additional INVESTMENT IN PROPERTIES, 1% for the next 2% of additional INVESTMENT IN PROPERTIES, and 1% for each 1% of additional INVESTMENT IN PROPERTIES thereafter.

COMMENT:

A CARRIED INTEREST may not be taken other than on the basis of the foregoing. In the case of PROGRAMS offering MANDATORY DEFERRED PAYMENTS, the compensation identified in IV.C.3. above as an alternative to FRONT-END FEES paid the SPONSOR shall be credited to the SPONSOR pro rata as installments are paid.

4. For PROGRAMS whose total CAPITAL CONTRIBUTIONS do not exceed \$2 million, the ADMINISTRATOR may reduce the required amount of INVESTMENT IN PROPERTIES to that permitted by 2(b) above notwithstanding the level of indebtedness encumbering the PROGRAM'S properties.

COMMENT:

The purpose of the section is to require the SPONSOR to invest a specified percentage of CAPITAL CONTRIBUTIONS in the acquisition of properties and use the balance for FRONT-END FEES in any manner he wishes, or defer a portion of the FRONT-END FEES to a promotional interest.

This will avoid the necessity of having to attempt to establish the reasonableness of the various FRONT-END FEES on an individual basis. However, the formula continues the tradition of the Guidelines by allowing the SPONSOR's fee to increase as leverage is employed to acquire properties. The PROSPECTUS should include an example demonstrating the mechanics of the formula.

To calculate the percent of financing of PROGRAM properties in Section 2., divide the amount of financing by the PURCHASE PRICE of the property, excluding FRONT-END FEES. The Quotient is multiplied by .1625% to determine the percentage to be deducted from 80%.

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The following are examples of application of the formula using CAPITAL CONTRIBUTIONS of \$1 Million in each case:

a. No financing--80% to be committed to INVESTMENT IN PROPERTIES.

b. 50% financing-- $50 \times .1625\% = 8.125\%$ $80\% - 8.125\% = 71.875\%$ to be committed to INVESTMENT IN PROPERTIES.

c. 80% financing-- $80 \times .1625\% = 13\%$

$80\% - 13\% = 67\%$ to be committed to INVESTMENT IN PROPERTIES.

Notwithstanding the language in paragraph 4 above, the 2 million dollar limitation is intended to be a benchmark figure and may be adjusted upward or downward by an Administrator based on the marketplace in his jurisdiction.

D. PROGRAM MANAGEMENT FEE.

1. A general partner of a PROGRAM owning unimproved land shall be entitled to annual compensation not exceeding 1/4 of 1% of the cost of such unimproved land for operating the PROGRAM until such time as the land is sold or improvement of the land commences by the limited partnership. In no event shall this fee exceed a cumulative total of 2% of the original cost of the land regardless of the number of years held.

2. A general partner of a PROGRAM holding property in government subsidized projects shall be entitled to annual compensation not exceeding 1/2 of 1% of the cost of such property for operating the PROGRAM until such time as the property is sold.

3. PROGRAM MANAGEMENT FEES other than as set forth above shall be prohibited.

E. Promotional Interest. An interest in the PROGRAM will be allowed as a promotional interest and PROGRAM MANAGEMENT FEE, provided the amount or percentage of such interest is reasonable. Such an interest will be considered presumptively reasonable if it is within the limitations expressed below:

1. An interest equal to 25% of cash to be distributed from the net proceeds remaining from the sale or refinancing

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of properties after payment to investors from such proceeds, an amount equal to 100% of CAPITAL CONTRIBUTIONS, plus an amount equal to 6% of CAPITAL CONTRIBUTIONS per annum cumulative (the 6% cumulative return may be reduced, but not below zero, by the aggregate amount of prior distributions to investors from CASH AVAILABLE FOR DISTRIBUTION); or

COMMENT:

The SPONSOR should not participate in sale or refinancing proceeds until the PARTICIPANTS have received a minimum return on their CAPITAL CONTRIBUTIONS.

However, the 6% subordination requirement may be waived in the situation where the PROGRAM invests more than 60% of its CAPITAL CONTRIBUTIONS in newly constructed or totally rehabilitated properties, including housing subsidized under the National Housing Act or similar such programs.

2. An interest equal to:

a. 10% of distributions from CASH AVAILABLE FOR DISTRIBUTION; and

b. 15% of cash to be distributed from the net proceeds remaining from the sale or refinancing of properties after payment to investors from such proceeds, an amount equal to 100% of CAPITAL CONTRIBUTIONS, plus an amount equal to 6% of CAPITAL CONTRIBUTIONS per annum cumulative. The 6% cumulative return may be reduced, but not below zero, by the aggregate amount of prior distributions to investors from CASH AVAILABLE FOR DISTRIBUTION.

COMMENT:

In addition to a 6% per annum cumulative return, investors in traditional equity real estate limited partnerships receive:

(i) Capital gains through product appreciation;

(ii) Federal income taxation deductions during the early years of property operations leading to all or a portion of cash distributions being treated as a return of capital for taxation purposes;

(iii) Equity buildup through a reduction of mortgage loans.

Since PROGRAMS which make or invest in mortgage loans are income oriented and investors in such PROGRAMS may forego a major portion of the benefits set forth in (i) through (iii) above, the per annum cumulative return for such PROGRAMS shall be equal to 300 basis points below the average Federal Home Loan Mortgage Corporation (FHLMC) rate as reported in The Wall Street Journal or similar publication for the 30-day period beginning 35 days prior to the date the PROGRAM is declared effective by the Securities and Exchange Commission. Notwithstanding the foregoing, such minimum cumulative return will not be less than 7% nor required to be more than

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10%.

3. For purposes of this Section, the CAPITAL CONTRIBUTION of the investors shall only be reduced by a cash distribution to investors of the proceeds from the sale or refinancing of properties. In addition, the cumulative return to each investor shall commence no later than the end of the calendar quarter in which his CAPITAL CONTRIBUTION is made.

4. Dissolution and liquidation of the partnership. The distribution of assets upon dissolution and liquidation of the partnership shall conform to the applicable subordination provisions of subsections 1 and 2b. herein, and appropriate language shall be included in the partnership agreement.

5. The maximum dollar amount of the SPONSORS' distributive share permitted under paragraph 1. or 2. above may not be increased by any allocation to the SPONSORS made for the purpose of satisfying the requirements of the Internal Revenue Code, applicable regulations, or any Revenue Ruling or Revenue Procedure. In the absence of adequate justification provided under Section IV.C.3. for any unsubordinated participation in cash to be distributed from the net proceeds remaining from the sale or refinancing of properties, the ADMINISTRATOR may require an express limitation in the PROGRAM agreement that the dollar amount of the SPONSORS' distributive share will not exceed the maximum amount that would be allowable under paragraph 1. or 2. above.

COMMENT:

For PROGRAMS which make or invest in mortgage loans, all funds which constitute repayment of loan principal or which represent an equity interest in sale or refinancing proceeds of a real property underlying a loan shall be subordinated and apportioned in the same manner as provided in Sections IV.E.1. or 2.b. above.

F. REAL ESTATE BROKERAGE COMMISSIONS ON RESALE OF PROPERTY. The total compensation paid to all PERSONS for the sale of a PROGRAM property shall be limited to a COMPETITIVE REAL ESTATE COMMISSION, not to exceed 6% of the contract price for the sale of the property. If the SPONSOR provides a substantial amount of the services in the sales effort, he may receive up to one-half of the COMPETITIVE REAL ESTATE COMMISSION, not to exceed 3%, and subordinated as in E. above. If the SPONSOR participates with an independent broker on resale, the subordination requirement shall apply only to the commission earned by the SPONSOR.

COMMENT:

If the SPONSOR provides a substantial amount of services in connection with the sale, he may then receive up to 1/2 of the brokerage commission, to a maximum of 3%, with the fee subordinated, to a return of 100% of CAPITAL CONTRIBUTIONS plus a 6% annual cumulative return, regardless of the type of property acquired by the PROGRAM.

G. PROPERTY MANAGEMENT FEE. Should the SPONSOR or its AFFILIATES perform property management services permitted under section IV. A.1. of these guidelines, the fees paid to the SPONSOR or its AFFILIATES shall

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be the lesser of the maximum fees set forth in subsections 1. through 3. below or the fees which are competitive for similar services in the same geographic area. Included in such fees shall be bookkeeping services and fees paid to non-related persons for property management services.

1. In the case of a residential property, the maximum PROPERTY MANAGEMENT FEE (including all rent-up, leasing, and re-leasing fees and bonuses, and leasing related services, paid to any person) shall be 5% of the gross revenues from such property.

2. In the case of industrial and commercial property, except as set forth in 3. below, the maximum PROPERTY MANAGEMENT FEE from such leases shall be 6% of the gross revenues where the SPONSOR or its AFFILIATES includes leasing, re-leasing and leasing related services. Conversely the maximum PROPERTY MANAGEMENT FEE from such leases shall be 3% of the gross revenues where the SPONSOR or its AFFILIATES do not perform the leasing, re-leasing and leasing related services with respect to the property.

3. In the case of industrial and commercial properties which are leased on a long term (ten or more years) net (or similar) bases, the maximum PROPERTY MANAGEMENT FEE from such leases shall be 1% of the gross revenues, except for a one time initial leasing fee of 3% of the gross revenues on each lease payable over the first five full years of the original term of the lease.

COMMENT:

This section provides a method to calculate the allowable fees for property management by the SPONSOR. The amount of the fee will be based upon, if competitive, the kinds of property management services performed by the SPONSOR for various types of rental properties and lease arrangements. This section prohibits the SPONSOR from receiving fees for the same service, for which the project has incurred costs to any other PERSON. The salary and fringe benefits of the on-site property personnel may be separately charged, as an operating expense, so long as such manager is not an officer, director, or controlling person of the SPONSOR.

This section is not intended to preclude the charging of a separate competitive fee for the one-time initial rent-up or leasing-up of a newly constructed property if such service is not included in the PURCHASE PRICE of the property paid by the PROGRAM. New construction could include a total rehabilitation.

Under Section 3., the initial leasing fee may be taken during each of the first five years on any lease which may include exercised renewals during that period; however, no initial leasing fee may be collected beyond five years for renewals or extensions with the same tenant or tenant's assignee.

The fee limitation would be considered presumptively reasonable unless the SPONSOR can demonstrate, to the satisfaction of the ADMINISTRATOR, thru empirical data that a higher competitive fee in the geographic area for the services rendered, the type of property to be acquired and the terms of the management contract is justified.

H. *INSURANCE SERVICES.* The SPONSOR or his AFFILIATE may provide insurance brokerage services in connection with obtaining insurance on the PROGRAM'S property so long as the cost of providing such service,

including cost of the insurance, is no greater than the lowest quote obtained from two unaffiliated insurance agencies and the coverage and terms are likewise comparable. In no event may such services be provided by the SPONSOR or his AFFILIATE unless they are independently engaged in the business of providing such services to other than AFFILIATES and at least 75% of their insurance brokerage service gross revenue is derived from other than AFFILIATES.

I. *MORTGAGE SERVICING FEE.* The SPONSOR or his AFFILIATE may provide mortgage services in programs which make or invest in mortgage loans for which he may be paid a fee which when added to all other fees paid in connection with the servicing of a particular mortgage does not exceed the lesser of the customary, competitive fee for the provision of such mortgage services on that type of mortgage or 1/4 of 1% of the principal outstanding in such loan.

J. *ASSET BASED FEE.*

1. *Eligibility.* A PROGRAM may elect to compensate the SPONSOR according to the provisions of this section only if the PROGRAM meets all of the following:

a. The PROSPECTUS states that a primary investment objective of the PROGRAM is to generate and to distribute to the PARTICIPANTS the CASH FLOW from the operation of the properties of the PROGRAM.

b. The anticipated life of the PROGRAM does not exceed 20 years from the date the offering is declared effective by the SEC. However, the partnership agreement may provide that the PROGRAM will be extended by the affirmative vote of a majority of the PARTICIPANTS.

c. The PROGRAM will invest not less than 82% of the CAPITAL CONTRIBUTIONS as the INVESTMENT IN PROPERTIES. The remaining CAPITAL CONTRIBUTIONS may be used to pay FRONT-END FEES. The total amount of FRONT-END FEES, whenever paid, shall be limited to the initial amount of CAPITAL CONTRIBUTIONS not applied to INVESTMENT IN PROPERTIES. Of this INVESTMENT IN PROPERTIES, not more than 3% of the CAPITAL CONTRIBUTIONS may be included as a working capital reserve.

2. *Computation.* The annual ASSET BASED FEE shall be 0.75% of the BASE AMOUNT. On CAPITAL CONTRIBUTIONS temporarily held while awaiting INVESTMENTS IN PROPERTIES, the ASSET BASED FEE shall be 0.5% of those CAPITAL CONTRIBUTIONS. The SPONSOR may also be allowed the following additional fees and compensation:

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- a. A PROPERTY MANAGEMENT FEE as provided in section IV.G.
- b. REAL ESTATE COMMISSIONS as provided in section IV.F.
- c. A promotional interest as provided in subsection IV.E.2.b.
- d. Fees for insurance services as allowed by section IV.H.
- e. FRONT-END FEES as provided in section IV.J.1.c.
- f. Reimbursement for PROGRAM expenses as provided in section V.E.
- g. Fees, interest and other charges as allowed in section V.I.3.
- h. Additional promotional interest in sale or refinancing proceeds as provided in section IV.C.3.a.
- i. Except as provided above, the SPONSOR shall receive no fees or other compensation from the program.

3. *Limitations.* An election to compensate the SPONSOR with an ASSET BASED FEE as provided in this section shall be subject to the following limitations:

a. The PROGRAM may reinvest the proceeds from the sale and refinancing of its PROPERTIES during the 7 years following the date of its effectiveness with the SEC. No deduction for FRONT-END FEES shall be allowed on such reinvestments. Beginning on a date 7 years after the date of effectiveness with the SEC, no reinvestment of the proceeds from the sale and refinancing of the PROPERTIES of the PROGRAM shall be allowed.

b. The ASSET BASED FEE may be accrued without interest when PROGRAM funds are not available for its payment. Any accrued ASSET BASED FEE may be paid from the next available CASH FLOW or net proceeds from sale or refinancing of properties. No ASSET BASED FEE may be paid from PROGRAM reserves.

c. A SPONSOR that is terminated and entitled to compensation from the PROGRAM as provided in the partnership documents and governed by section II.F. shall be paid the ASSET BASED FEE through the date of such termination.

d. Except as modified by this section, all other portions of this Statement of Policy shall apply where appropriate to PROGRAMS electing an ASSET BASED FEE.

V. CONFLICTS OF INTEREST AND INVESTMENT RESTRICTIONS.

A. Sales, Leases and Related Program Transactions.

1. Sales and Leases to PROGRAM. A PROGRAM shall not purchase or lease property in which a SPONSOR has an interest unless:

a. The transaction occurs at the formation of the PROGRAM and is fully disclosed in its PROSPECTUS or offering circular, and

b. The property is sold upon terms fair to the PROGRAM and at a price not in excess of its appraised value, and

c. The cost of the property and any improvements thereon to the SPONSOR is clearly established. If the SPONSOR'S cost was less than the price to be paid by the PROGRAM, the price to be paid by the PROGRAM will not be deemed fair, regardless of the appraised value, unless some material change has occurred to the property which would increase the value since the SPONSOR acquired the property. Material factors may include the passage of a significant amount of time (but in no event less than 2 years prior to the offering of PROGRAM INTERESTS), the assumption by the promoter of the risk of obtaining a rezoning of the property and its subsequent rezoning, or some other extraordinary event which in fact increases the value of the property. If the material factor includes development, construction, or MAJOR REPAIRS OR REHABILITATION of the property by the SPONSOR less than two years prior to the offering of PROGRAM INTERESTS, the costs shall be limited as required by Section V.J.

d. The provisions of this subsection notwithstanding, the SPONSOR may purchase property in its own name (and assume loans in connection therewith) and temporarily hold title thereto for the purpose of facilitating the acquisition of such property, or the borrowing of money or obtaining of financing for the PROGRAM, or completion of construction of the property, or any other purpose related to the business of the PROGRAM, provided that such property is purchased by the PROGRAM for a price no greater than the cost of such property to the SPONSOR, except

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compensation in accordance with Sections IV. and V.J. of these Guidelines, and provided there is no difference in interest rates of the loans secured by the property at the time acquired by the SPONSOR and the time acquired by the PROGRAM, nor any other benefit arising out of such transaction to the SPONSOR apart from compensation otherwise permitted by these Guidelines. Accordingly, all income generated and expenses associated with property so acquired shall be treated as belonging to the PROGRAM.

In no event shall the PROGRAM purchase property from the SPONSOR pursuant to this subparagraph d. if the SPONSOR has held the property for a period in excess of 12 months prior to commencement of the offering. The SPONSOR shall not sell property to the PROGRAM pursuant to this subparagraph d. if the cost of the property exceeds the funds reasonably anticipated to be available to the PROGRAM to purchase the property. The PROSPECTUS and the PROGRAM agreement shall set forth in a manner satisfactory to the ADMINISTRATOR the methodology to be utilized for determining which properties will ultimately be transferred to the PROGRAM when the cost of the property acquired by the SPONSOR on behalf of the PROGRAM exceeds PROGRAM funds available to purchase the property.

e. The purchase is made from a PROGRAM formed by the SPONSOR pursuant to the rights of first refusal required by Section V.H. In such a case the PURCHASE PRICE should be no more than fair market value as determined by an independent appraisal.

2. Sales and Leases to SPONSOR. A PROGRAM shall not sell or lease property to the SPONSOR except as provided herein.

a. The PROGRAM may lease property to the SPONSOR pursuant to a lease-back arrangement made at the outset, the terms of which are fully disclosed in the PROSPECTUS and no less favorable to the PROGRAM than those offered to and accepted by PERSONS who are not AFFILIATES of the SPONSOR.

b. Not more than 10% of aggregate leasable space owned by the PROGRAM may be under lease to the SPONSOR pursuant to terms not less favorable to the PROGRAM than those offered to and accepted by PERSONS who are not AFFILIATES of the SPONSOR; provided that the SPONSOR may not sublet such properties unless all profits derived from such subleases in excess of rentals due on the master lease are paid to the PROGRAM.

c. A SPONSOR may purchase property (or contract rights related thereto) from the PROGRAM only if all of the following criteria are met:

(i) The PROGRAM does not have sufficient offering proceeds available to retain the property (or contract rights related thereto).

(ii) The PROSPECTUS discloses that the SPONSOR will purchase all properties (or contract rights) that the

PROGRAM does not have sufficient proceeds to retain.

(iii) The SPONSOR pays the PROGRAM an amount in cash equal to the cost of the property (or contract rights) to the PROGRAM (including all cash payments and carrying costs related thereto).

(iv) The SPONSOR assumes all of the PROGRAM's obligations and liabilities incurred in connection with the holding of the property (or contract rights) by the PROGRAM.

(v) The sale to the SPONSOR occurs not later than 90 days following the termination date of the offering.

(vi) The methodology to be used by the SPONSOR in determining which properties it will purchase in the event that the PROGRAM's offering proceeds are insufficient to retain all properties must be fully disclosed in the PROSPECTUS.

3. Dealing with Related PROGRAMS. A PROGRAM shall not acquire property from a PROGRAM in which the SPONSOR has an interest.

COMMENT:

This provision prohibits transactions among PROGRAMS where the SPONSOR has an interest whereas section V.A.1. above relates to properties where the SPONSOR has an interest.

B. *Exchange of Limited Partnership Interests.* The PROGRAM may not acquire property in exchange for limited partnership interests, except for property which is described in the PROSPECTUS which will be exchanged immediately upon effectiveness. In addition, such exchange shall meet the following conditions:

1. A provision for such exchange must be set forth in the partnership agreement, and appropriate disclosure as to tax effects of such exchange are set forth in the PROSPECTUS;

2. The property to be acquired must come within the objectives of the PROGRAM;

3. The purchase price assigned to the property shall be no higher than the value supported by an appraisal prepared by an independent qualified appraiser;

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4. Each limited partnership interest must be valued at no less than market value if there is a market or if there is no market, fair market value of the PROGRAM's assets as determined by an independent appraiser within the last 90 days, less its liabilities, divided by the number of interests outstanding;

5. No more than one-half of the interests issued by the PROGRAM shall have been issued in exchange for property;

6. No securities sales or underwriting commissions shall be paid in connection with such exchange.

C. *Exclusive Agreement.* A PROGRAM shall not give a SPONSOR an exclusive right to sell or exclusive employment to sell property for the PROGRAM.

D. *Commissions on Reinvestment or Distribution.* A PROGRAM shall not pay, directly or indirectly, a commission or fee (except as permitted under section IV) to a SPONSOR in connection with the reinvestment or distribution of the proceeds of the resale, exchange, or refinancing of PROGRAM PROPERTY.

COMMENT:

This section clarifies that financing, refinancing, or servicing fees are subject to the limitations of section IV.C.

E. *Services Rendered to the PROGRAM by the SPONSOR.*

1. Expenses of the PROGRAM.

a. All expenses of the PROGRAM shall be billed directly to and paid by the PROGRAM. The SPONSOR may be reimbursed for the actual cost of goods and materials used for or by the PROGRAM and obtained from entities unaffiliated with the SPONSOR. The SPONSOR may be reimbursed for the administrative services necessary to the prudent operation of the PROGRAM provided that the reimbursement shall be at the lower of the SPONSOR'S actual cost or the amount the PROGRAM would be required to pay to independent parties for comparable administrative services in the same geographic location. No reimbursement shall be permitted for services for which the SPONSOR is entitled to compensation by way of a separate fee. Excluded from the allowable reimbursement (except as permitted under IV.C.1.) shall be:

(i) rent or depreciation, utilities, capital equipment, other administrative items; and

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(ii) salaries, fringe benefits, travel expenses, and other administrative items incurred or allocated to any controlling persons of the SPONSOR or AFFILIATES.

Controlling person, for purpose of this section, includes but is not limited to, any person, whatever their title, who performs functions for the SPONSOR similar to those of:

(i) Chairman or member of the Board of Directors;

(ii) Executive Management, such as the

(1) President,

(2) Vice-President or Senior Vice-President,

(3) Corporate Secretary,

(4) Treasurer;

(iii) Senior Management, such as the Vice-President of an operating division who reports directly to Executive Management; or

(iv) Those holding 5% or more equity interest in the SPONSOR or a person having the power to direct or cause the direction of the SPONSOR, whether through the ownership of voting securities, by contract, or otherwise.

b. The annual PROGRAM report must contain a breakdown of the costs reimbursed to the SPONSOR. Within the scope of the annual audit of the SPONSOR'S financial statement, the independent certified public accountants must verify the allocation of such costs to the PROGRAM. The method of verification shall at minimum provide:

(i) A review of the time records of individual employees, the costs of whose services were reimbursed;

(ii) A review of the specific nature of the work performed by each such employee.

The methods of verification shall be in accordance with generally accepted auditing standards and shall accordingly include such tests of the accounting records and such other auditing procedures which the SPONSOR'S independent certified public accountants consider appropriate in the circumstance. The additional costs of such verification will be itemized by said accountants on a PROGRAM by PROGRAM basis and may be reimbursed to the SPONSOR by the PROGRAM in accordance with this subsection only to the extent that such reimbursement when added to the cost for administrative services rendered does not exceed the competitive rate for such services as determined above.

The PROSPECTUS must disclose in tabular form an estimate of such proposed expenses for the next fiscal year together with a breakdown by year of such expenses reimbursed in each of the last five public programs formed by the SPONSOR.

COMMENT:

This section permits the SPONSOR to be reimbursed for a portion of the costs incurred in performing certain administrative functions for the PROGRAM provided the SPONSOR is both qualified to perform such functions and does so at a cost no greater to the PROGRAM than that which an unaffiliated PERSON would charge the PROGRAM. Regardless of the capacity in which controlling persons of the SPONSOR serve the PROGRAM, their salaries may not be allocated to the PROGRAM.

2. Other Goods and Services. Except as provided in Sections IV. V.E.1., and V.J., other goods and services may be provided by the SPONSOR for the PROGRAM only if all of the following criteria are met:

a. The goods or services must be necessary to the prudent operation of the PROGRAM.

b. The compensation, price or fee must be equal to either (i) the lesser of 90% of the compensation, price or fee of any non-affiliated PERSON who is rendering comparable services or selling or leasing comparable goods on competitive terms in the same geographic location or 90% of the compensation, price or fee charged by the SPONSOR for rendering comparable services or selling or leasing comparable goods on competitive terms, or (ii) if at least 95% of gross revenues attributable to the business of rendering such services or selling or leasing such goods are derived from PERSONS other than AFFILIATES, the compensation, price or fee charged by any nonaffiliated PERSON who is rendering comparable services or selling or leasing comparable goods on competitive terms in the same geographic location.

c. The goods or services shall be provided pursuant to a written contract which precisely describes such goods or services and all compensation to be paid. The contract may be modified in any material respect only by the vote of a majority in interest of the limited partners and shall be terminable without penalty on 60 days' notice.

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d. The goods and services to be provided and the written contract referred to in subparagraph c. must be fully disclosed in the PROSPECTUS.

e. The SPONSOR must have been previously engaged in the business of rendering such services or selling or leasing such goods as an ordinary and ongoing business for a period of at least three years.

f. The SPONSOR must receive at least 33% of gross revenues for such goods or services from PERSONS other than AFFILIATES.

g. Except as provided in Sections IV., V.E.1. and V.J., and other than as provided in Section V.E.2.b., d., e., and f. herein, the SPONSOR may provide additional goods and services to the PROGRAM if all of the following criteria are met:

(i) The goods or services may only be provided by the SPONSOR in extraordinary circumstances.

COMMENT: Where the services are available elsewhere from unaffiliated parties, there would be a presumption that there are no extraordinary circumstances. Extraordinary circumstances would only be presumed where there is an emergency situation requiring immediate action by the SPONSOR, and the service is not immediately available from unaffiliated parties. Extraordinary circumstances shall, in no event, include general and administrative expenses, except as otherwise provided herein.

(ii) The compensation, price or fee must be competitive with the compensation, price or fee of any non-affiliated PERSON who is rendering comparable services or selling or leasing comparable goods on competitive terms which could reasonably be made available to the PROGRAM.

(iii) The fees and other terms of the contract shall be fully disclosed.

(iv) The SPONSOR must be previously engaged in the business of rendering such services or selling or leasing such goods, independently of the PROGRAM and as an ordinary and ongoing business.

(v) There must be compliance with subparagraphs a. and c. of this Section V.E.2.

F. *Rebates, Kickbacks and Reciprocal Arrangements.*

1. No rebates or give-ups may be received by the SPONSOR nor may the SPONSOR participate in any reciprocal business arrangements which would circumvent these Rules. Furthermore the PROSPECTUS and PROGRAM charter documents shall contain language prohibiting the above as well as language prohibiting reciprocal business arrangements which would circumvent the restrictions against dealing with AFFILIATES or promoters.

2. No SPONSOR shall directly or indirectly pay or award any commissions or other compensation to any PERSON engaged by a potential investor for investment advice as an inducement to such advisor to advise the purchaser of interests in a particular PROGRAM; provided, however, that this clause shall not prohibit the normal sales commissions payable to a registered broker-dealer or other properly licensed PERSON for selling PROGRAM INTERESTS.

G. *Commingling of Funds.* The funds of a PROGRAM shall not be commingled with the funds of any other PERSON. Nothing contained in this Section however, shall prohibit a SPONSOR from establishing a master fiduciary account pursuant to which separate subtrust accounts are established for the benefit of affiliated limited partnerships, provided, that PROGRAM funds are protected from claims of such other partnerships and/or creditors. The prohibition of this Section shall not apply to investments meeting the requirements of Section V.H.

H. *Investments in or With Other PROGRAMS.*

1. The PROGRAM shall be permitted to invest in general partnerships or joint ventures with non-AFFILIATES that own and operate one or more particular properties if the PROGRAM, alone or together with any publicly registered AFFILIATE of the PROGRAM meeting the requirements of paragraph 2. below, acquires a controlling interest in such a general partnership or joint venture, but in no event shall duplicate fees be permitted. For purposes of this Section, "controlling interest" means an equity interest possessing the power to direct or cause the direction of the management and policies of the general partnership or joint venture, including the authority to:

a. review all contracts entered into by the general partnership or joint venture that will have a material effect on its business or property;

b. cause a sale or refinancing of the property or its interest therein subject in certain cases where required by the partnership or joint venture agreement, to limits as to time, minimum amounts and/or a right of first refusal by the joint venture partner or consent of the joint venture partner;

c. approve budgets and major capital expenditures, subject to a stated minimum amount;

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d. veto any sale or refinancing of the property, or, alternatively, to receive a specified preference on sale or refinancing proceeds; and

e. exercise a right of first refusal on any desired sale or refinancing by the joint venture partner of its interest in the property except for transfer to an AFFILIATE of the joint venture partner.

2. The PROGRAM shall be permitted to invest in general partnerships or joint ventures with other publicly registered AFFILIATES of the PROGRAM if all of the following conditions are met:

a. The PROGRAMS have substantially identical investment objectives.

b. There are no duplicate fees.

c. The compensation to SPONSORS is substantially identical in each PROGRAM.

d. Each PROGRAM must have a right of first refusal to buy if the other PROGRAMS wish to sell property held in the joint venture.

e. The investment of each PROGRAM is on substantially the same terms and conditions.

f. The PROSPECTUS must disclose the potential risk of impasse on joint venture decisions since no PROGRAM controls and the potential risk that while a PROGRAM may have the right to buy the property from the partnership or joint venture, it may not have the resources to do so. COMMENTS: In certain situations, it would be to the advantage of the PROGRAM to be able to invest in a general partnership or joint venture with other PROGRAMS where no PROGRAM has sufficient money to make the entire investment even if the PROGRAM does not acquire a controlling interest. However, there is a need to not only require full disclosure of the general partnership or joint venture arrangements but also to set out substantive standards that must be adhered to in order to provide the protection necessary for this type of investment.

For PROGRAMS which make or invest in mortgage loans, general partnerships or joint venture arrangements are permitted so long as general partnerships or joint ventures with publicly registered AFFILIATES of the PROGRAM satisfy the requirements of Section V.I.2. of these guidelines.

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3. The PROGRAM shall be permitted to invest in general partnerships or joint ventures with AFFILIATES other than publicly registered AFFILIATES of the PROGRAM only under the following conditions: (a) the investment is necessary to relieve the SPONSOR from any commitment to purchase a property entered into in compliance with Section V.A.1.d. prior to the closing of the offering period of the PROGRAM; (b) there are no duplicate fees; (c) the investment of each entity is on substantially the same terms and conditions; (d) the PROGRAM must have a right of first refusal to buy if the SPONSOR wishes to sell property held in the joint venture; and (e) the PROSPECTUS discloses the potential risk of impasse on joint venture decisions.

4. Other than as specifically permitted in paragraphs 2. and 3. above, the PROGRAM shall not be permitted to invest in general partnerships or joint ventures with AFFILIATES.

5. A PROGRAM shall be permitted to invest in general partnership interests of limited partnerships only if the PROGRAM alone or together with any publicly registered AFFILIATE of the PROGRAM meeting the requirements of paragraph 2. above, acquires a "controlling interest" as defined in Section V.H.1., no duplicate fees are permitted, no additional compensation beyond that permitted by Section IV. shall be paid to the SPONSOR, and the PROGRAM agreement shall comply with Section V.

6. A PROGRAM that is a limited partnership (the "Upper-Tier Partnership") shall be permitted to invest in limited partnership interests of other limited partnerships (the "Lower-Tier Partnerships") only if all of the following conditions are met:

a. If the general partner of the Lower-Tier Partnership is a SPONSOR of the Upper-Tier Partnership, the Program agreement of the Upper-Tier Partnership shall:

(1) prohibit the PROGRAM from investing in such Lower-Tier Partnership unless the partnership agreement of the Lower-Tier Partnership contains provisions complying with Section IX.F. of these guidelines and provisions acknowledging privity between the Lower-Tier general partner and the PARTICIPANTS; and

(2) provide that compensation payable in the aggregate from both levels shall not exceed the amounts permitted under Section IV. of these guidelines.

b. If the general partner of the Lower-Tier Partnership is not a SPONSOR of the Upper-Tier Partnership, the PROGRAM agreement of the Upper-Tier Partnership shall prohibit the PROGRAM from investing in the Lower-Tier Partnership unless the partnership agreement of the Lower-Tier Partnership contains provisions complying with Sections II.E. and F.; VII.A.--D., H. and J.; and IX.C. of these guidelines; and shall provide that the compensation payable at both tiers shall not exceed the amounts permitted in Sections IV. of these guidelines.

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c. Each Lower-Tier Partnership shall have as its limited partners only publicly registered Upper-Tier Partnerships; provided, however, that special limited partners not affiliated with the SPONSOR shall be permitted if the interests taken result in no diminution in the control exercisable by the other limited partners.

d. No PROGRAM may be structured with more than two tiers.

e. The PROGRAM agreement of the Upper-Tier Partnership must contain a prohibition against duplicate fees.

f. The PROGRAM agreement of the Upper-Tier Partnership must provide that the limited partners of the Upper-Tier Partnership can, upon the vote of a majority in interest and without the concurrence of the SPONSOR, direct the general partner of the Upper-Tier Partnership (acting on behalf of the Upper-Tier Partnership) to take any action permitted to a limited partner (e.g., the Upper-Tier Partnership) in the Lower-Tier Partnership.

g. The PROSPECTUS must fully and prominently disclose the two-tiered arrangement and any risks related thereto.

7. Notwithstanding Section V.H.6.b. through g., if the general partner of the Lower-Tier Partnership is not a SPONSOR of the Upper-Tier Partnership, an Upper-Tier Partnership may invest in a Lower-Tier Partnership that owns and operates a particular property to be qualified pursuant to *Section 42(g) of the Internal Revenue Code of 1986*, as amended, if limited partners at both tiers are provided all of the rights and obligations required by Section VII. of these guidelines and the PROGRAM agreement of the Upper-Tier Partnership contains a prohibition against payment of duplicate fees.

COMMENT:

Nothing contained in Section V.H. may be used to circumvent or abrogate the restrictions and requirements of these guidelines, including, but not limited to, Section V.A. hereof. However, no provision contained in Section V.H. is intended to restrict or prohibit any payment to a PERSON who is not an AFFILIATE of the SPONSOR otherwise permitted in Section IV. of these guidelines.

I. Lending Practices.

1. No loans may be made by the PROGRAM to the Sponsor or an AFFILIATE except as provided in V.I.2. and II. D.4.

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2. PROGRAMS which make or invest in mortgage loans may provide such loans to PROGRAMS formed by or affiliated with the SPONSOR in those circumstances in which such activities have been fully justified to the ADMINISTRATOR. These affiliated transactions must at the minimum meet the following conditions:

a. the circumstances under which the loans will be made and the actual terms of the loans must be fully disclosed in the prospectus or;

b. an independent and qualified adviser must issue a letter of opinion to the effect that any proposed loan to an AFFILIATE of the PROGRAM is fair and at least as favorable to the PROGRAM as a loan to an unaffiliated borrower in similar circumstances. In addition, the SPONSORS will be required to obtain a letter of opinion from the independent adviser in connection with any disposition, renegotiation or other subsequent transaction involving loans made to a SPONSOR or an AFFILIATE of the SPONSOR. The adviser's compensation must be paid by the SPONSOR and not reimbursable by the PROGRAM.

c. Loans made to third parties, the proceeds of which are used to purchase or refinance property in which the SPONSOR or an AFFILIATE has an equity or security interest, must meet the requirements of V.I.2.a. or b.

COMMENT A:

Full disclosure of the terms of the loans and the circumstances under which they will be made includes, but is not limited to identification of the borrower(s) and the property(ies) securing the loan(s), a description of the parameters of the loan(s) or model loan documents, disclosure of the SPONSORS' or the AFFILIATES' interest in such property, and a description of the terms and circumstances surrounding such interest.

COMMENT B:

In order for the adviser to be considered qualified and independent the following conditions must be met:

(i) The adviser must be a long established, nationally recognized investment banking firm, accounting firm, mortgage banking firm, bank, real estate financial consulting firm or advisory firm;

(ii) The adviser must have a staff of real estate professionals;

(iii) The compensation of the adviser must be determined and embodied in a written contract before an opinion is rendered.

(iv) If an adviser has been engaged to render a fairness opinion who is not the adviser previously engaged to render this or the preceding fairness opinion, the SPONSOR shall inform the investors (by no later than the next annual report) of the date when such adviser was engaged, and whether there were any disagreements with the former adviser

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on any matters of valuation, assumptions, methodology, accounting principles and practice, or disclosure, which disagreements, if not resolved to the satisfaction of the former adviser would have caused him to make reference, in connection with the fairness opinion, to the subject matter of the disagreement or decline to give an opinion.

(v) The compensation of the adviser must be paid by the SPONSOR and the SPONSOR may not claim reimbursement from the PROGRAM for such expenses.

(vi) The adviser, directly or indirectly, has no interest in, nor any material business or professional relationship with, the PROGRAM, the SPONSOR, the borrower, or any AFFILIATES thereof. Independence will be considered to be impaired if, for example, during the period of the adviser's engagement, or at any time of expressing his opinion, he or his firm: (i) had, or was committed to acquire any direct or indirect ownership interest in the PROGRAM, SPONSOR, borrower, or AFFILIATES thereof, or (ii) had any joint closely held business investment with the PROGRAM, SPONSOR, borrower, or any AFFILIATE thereof, which was material in relation to the adviser's net worth; or, (iii) had any loan to or from the PROGRAM, SPONSOR, borrower, or AFFILIATES thereof.

The foregoing examples are not intended to be all-inclusive. However, for purposes of determining whether or not the business or professional relationship or joint investment is material, the gross revenue derived by the adviser from the PROGRAM, the SPONSOR, the borrower, and their AFFILIATES shall be deemed material per se if it exceeds 5% of the annual gross revenue derived by the adviser from all sources or exceeds 5% of the individual's or the advisor's net worth (on an estimated fair market value basis).

3. On loans made available to the PROGRAM by the SPONSOR, the SPONSOR may not receive interest or similar charges or fees in excess of the amount which would be charged by unrelated lending institutions on comparable loans for the same purpose, in the same locality of the property if the loan is made in connection with a particular property. No prepayment charge or penalty shall be required by the SPONSOR on a loan to the PROGRAM secured by either a first or a junior or all-inclusive trust deed, mortgage or encumbrance on the property, except to the extent that such prepayment charge or penalty is attributable to the underlying encumbrance.

4. The SPONSOR shall be prohibited from providing FINANCING except:

a. As permitted by Section V.I.2., in which case there will be independent advisers for each publicly registered party to the transaction; or

b. As permitted by Section V.I.5.

5. An "all-inclusive" or "wrap-around" note and deed of trust (the "all-inclusive note" herein) may be used to finance the purchase of property by the PROGRAM only if the following conditions are complied with:

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a. The SPONSOR under the all-inclusive note shall not receive interest on the amount of the underlying encumbrance included in the all-inclusive note in excess of that payable to the lender on that underlying encumbrance;

b. The PROGRAM shall receive credit on its obligation under the all-inclusive note for payments made directly on the underlying encumbrance, and

c. A paying agent, ordinarily a bank, escrow company, or savings and loan, shall collect payments (other than any initial payment of prepaid interest or loan points not to be applied to the underlying encumbrance) on the all-inclusive note and make disbursements therefrom to the holder of the underlying encumbrance prior to making any disbursement to the holder of the all-inclusive note, subject to the requirements of subparagraph a. above, or, in the alternative, all payments on the all-inclusive and underlying note shall be made directly by the PROGRAM.

J. Development Construction, or MAJOR REPAIRS OR REHABILITATION of Properties.

1. Provision of Services by the SPONSOR. The SPONSOR will be permitted to develop, construct or provide MAJOR REPAIRS AND REHABILITATION for properties, or render any services in connection with such activities only if all of the following conditions are satisfied:

a. The transactions occur upon the formation of the PROGRAM and are for properties specified in the final PROSPECTUS.

b. The specific terms of the contract(s) are ascertainable and fully disclosed in the final PROSPECTUS.

c. The purchase price to be paid by the PROGRAM is based upon a contract price fully disclosed in the final PROSPECTUS which in no event can exceed the lesser of appraised value as completed (assuming a market rate of occupancy) or the sum of the cost of the land and the cost of development, construction or repairs and rehabilitation. For the purposes of this paragraph, the cost of development, construction or repairs and rehabilitation includes the DEVELOPMENT FEE, the CONSTRUCTION FEE, direct costs, the cost of construction site personnel construction administration, legal fees, design costs, engineering costs, and construction site utilities. The costs of construction site personnel and construction administration shall be limited as required by Section V.E.1.a. and shall not include reimbursement of costs of controlling persons as set forth in that section. In no event may any other overhead of the SPONSOR be charged to the PROGRAM or included in the total costs paid. The appraisal shall be prepared in accordance with Section V.L.

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d. The ADMINISTRATOR may require demonstration that the fees and costs payable under paragraph c. above are comparable to and competitive with amounts charged by third parties in the same geographic area. The total of the DEVELOPMENT FEE and the CONSTRUCTION FEE paid in connection with such project shall not exceed 15% of the direct costs of the project. For the purposes of this limitation, direct costs shall not include construction site personnel or construction site utilities.

e. Notwithstanding Section IV.C., the only FRONT-END FEES paid to the SPONSOR in connection with such project shall consist of ORGANIZATION AND OFFERING EXPENSES, a DEVELOPMENT FEE (if applicable), a CONSTRUCTION FEE and a real estate commission in connection with the acquisition of the land from PERSONS who are not AFFILIATES of the general partner. The SPONSOR may not receive any other FRONT-END FEES. The foregoing fees and commissions plus any additional ACQUISITION FEES and ACQUISITION EXPENSES to unaffiliated PERSONS (and any DEVELOPMENT FEE and CONSTRUCTION FEE individually) must be comparable to and competitive with the fees paid to unaffiliated PERSONS rendering comparable services in the same geographic location. The ADMINISTRATOR may require demonstration that such fees, commissions and expenses are comparable and competitive.

f. The SPONSOR must comply with Section V.K.

g. Subcontractors who are affiliates of the general partner must meet the requirements of Section V.E.2.b-f.

h. If the contract price equals the appraised value set forth in subparagraph c. above, the SPONSOR shall be responsible for the direct costs incurred to achieve the appraisal assumptions.

COMMENT:

In lieu of this requirement, the ADMINISTRATOR may impose higher suitability standards for PROGRAM PARTICIPANTS pursuant to Section III.

i. The SPONSOR complies with paragraphs c., d., e. and f. of Section V.E.2.

j. DEVELOPMENT FEES and CONSTRUCTION FEES paid to PERSONS not affiliated with the general partner may be included in INVESTMENT IN PROPERTIES.

K. Completion Bond Requirements.

1. The completion of property acquired which is under construction shall be guaranteed at the price contracted

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by an adequate completion bond or other satisfactory arrangements.

2. For purposes of this Section, satisfactory arrangements include, but are not limited to, the following:

a. A written guarantee of completion by a person, supported by financial statements demonstrating sufficient net worth or adequately collateralized by other real or personal properties or other persons guarantees.

b. A retention of a reasonable portion of the purchase consideration as a potential offset to such purchase consideration in the event the seller does not perform in accordance with the purchase and sale agreement.

3. Other satisfactory arrangements to guarantee completion may be made, provided they are disclosed in the prospectus and the prior written approval of the ADMINISTRATOR has been obtained.

L. Requirement for Real Property Appraisal. All real property acquisitions must be supported by an appraisal prepared by a competent, independent appraiser. The appraisal shall be maintained in the SPONSOR's records for at least five years, and shall be available for inspection and duplication by any PARTICIPANT. The PROSPECTUS shall contain notice of this right.

M. Mortgage Loan PROGRAMS. A PROGRAM will not be permitted to invest in or make mortgage loans unless a real property appraisal is obtained as provided for in Paragraph L of this Section for each mortgage loan and a mortgagee's or owner's title insurance policy or commitment as to the priority of a mortgage or the condition of title is obtained. Further, the sponsor of mortgage loan programs shall observe the following policies in connection with investing in or making mortgage loans:

1. The PROGRAM may not invest in or make mortgage loans on any one property which would exceed, in the aggregate, an amount equal to 20% of the CAPITAL CONTRIBUTIONS to be raised by the program;

2. The PROGRAM may not invest in or make mortgage loans to or from any one borrower which would exceed, in the aggregate, an amount greater than 20% of the CAPITAL CONTRIBUTIONS to be raised by the program;

3. The PROGRAM may not invest in or make mortgage loans on unimproved real property in an amount in excess of 25% of the CAPITAL CONTRIBUTIONS to be raised by the program;

COMMENT:

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Subsections 1. 2. and 3. shall not apply to SPECIFIED PROPERTY PROGRAMS.

4. The PROGRAM shall not invest in real estate contracts of sale otherwise known as land sale contracts unless such contracts of sale are in recordable form and are appropriately recorded in the chain of title;

5. The PROGRAM shall not make or invest in mortgage loans on any one property if the aggregate amount of all mortgage loans outstanding on the property, including the loans of the PROGRAM, would exceed an amount equal to 85% of the appraised value of the property as determined by an independent appraisal unless substantial justification exists because of the presence of other underwriting criteria. For purposes of this subsection 5., the "aggregate amount of all mortgage loans outstanding on the property, including the loans of the PROGRAM," shall include all interest (excluding contingent participations in income and/or appreciation in value of the mortgaged property), the current payment of which may be deferred pursuant to the terms of such loans, to the extent that deferred interest on each loan exceeds 5% per annum of the principal balance of the loan;

COMMENT:

This restriction applies to all loans including construction loans.

6. The PROGRAM is permitted to borrow money to the extent necessary to prevent defaults under existing loans; when the program has taken over the operation of property and there is a need for additional capital; to pay organizational and/or offering expenses.

COMMENT:

This Section provides certain minimum standards in connection with the investment in or making of mortgage loans by a program. The standards may be exceeded for a particular registration if the mortgage loans are supported by sound underwriting criteria, such as the net worth of the borrower; the credit rating of the borrower based on historical financial performance; or collateral adequate to justify waiver from application of this section. The standards may also be exceeded where program mortgage loans are or will be insured or guaranteed by a government or a government agency; where the loan is secured by the pledge or assignment of other real estate or another real estate mortgage; where rents are assigned under a lease where a tenant or tenants have demonstrated through historical net worth and cash flow the ability to satisfy the terms of the lease; or where similar criteria is presented satisfactory to the Administrator.

COMMENT:

MANDATORY DEFERRED PAYMENTS in PROGRAMS which make or invest in mortgage loans may require adherence to more conservative diversification standards as the ADMINISTRATOR deems appropriate.

N. PROGRAM INDEBTEDNESS.

1. Except as contained in paragraph 2, following the termination of the offering the total amount of indebtedness

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incurred by the PROGRAM shall at no time exceed the sum of 85% of the aggregate PURCHASE PRICE of all properties which have not been refinanced, and 85% of the aggregate fair market value of all refinanced properties, as determined by the lender as of the date of refinancing.

2. For PROGRAMS which own properties financed by (i) loans insured or guaranteed by the full faith and credit of the United States government, or of a state or local government, or by an agency or instrumentality of any of them, and/or (ii) loans received from any of the foregoing entities, following the termination of the offering the total amount of indebtedness incurred by the PROGRAM shall at no time exceed the sum of 100% of the aggregate PURCHASE PRICE of all properties which have not been refinanced, and 100% of the aggregate fair market value of all refinanced properties as determined by the lender as of the date of refinancing.

3. For any PROGRAM subject to the limitations of both paragraphs 1 and 2, the maximum percentage of indebtedness for the entire PROGRAM shall be calculated as follows:

(a) divide the total value of properties as determined under paragraph 2 by the total value of properties as determined under paragraphs 1 and 2;

(b) multiply the number 15 by the quotient of subsection (a); and,

(c) add the product from subsection (b) to the number 85.

4. For purposes of this section V.N. only, "indebtedness" shall include the principal of any loan together with any interest that may be deferred pursuant to the terms of the loan agreement which exceeds 5% per annum of the principal balance of such indebtedness (excluding contingent participations in income and/or appreciation in the value of the PROGRAM property); and shall exclude any indebtedness incurred by the PROGRAM for necessary working capital.

O. APPRAISAL AND COMPENSATION.

1. In connection with a proposed ROLL-UP, an appraisal of all PROGRAM assets shall be obtained from a competent, INDEPENDENT EXPERT. If the appraisal will be included in a PROSPECTUS used to offer the securities of a ROLL-UP ENTITY, the appraisal shall be filed with the SEC and the states as an Exhibit to the Registration Statement for the offering. Accordingly, an issuer using the appraisal shall be subject to liability for violation of Section 11 of the Securities Act of 1933 and comparable provisions under state laws for any material misrepresentations or material omissions in the appraisal. PROGRAM assets shall be appraised on a consistent basis. The appraisal shall be

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based on an evaluation of all relevant information, and shall indicate the value of the PROGRAM'S assets as of a date immediately prior to the announcement of the proposed ROLL-UP. The appraisal shall assume an orderly liquidation of the PROGRAM'S assets over a 12 month period. The terms of the engagement of the INDEPENDENT EXPERT shall clearly state that the engagement is for the benefit of the PROGRAM and its PARTICIPANTS. A summary of the independent appraisal, indicating all material assumptions underlying the appraisal, shall be included in a report to the PARTICIPANTS in connection with a proposed ROLL-UP.

2. In connection with a proposed ROLL-UP the PERSON sponsoring the ROLL-UP shall offer to PARTICIPANTS who vote "no" on the proposal the choice of:

(a) accepting the securities of the ROLL-UP ENTITY offered in the proposed ROLL-UP; or

(b) one of the following:

(i) remaining as PARTICIPANTS in the PROGRAM and preserving their interests therein on the same terms and conditions as existed previously; or

(ii) receiving cash in an amount equal to the PARTICIPANTS' pro-rata share of the appraised value of the net assets of the PROGRAM.

COMMENT:

With respect to the options specified in Subsection V.O.2.(b), the PERSON sponsoring the ROLL-UP needs only offer one of these alternatives to dissenting investors who do not wish to accept the security of the ROLL-UP ENTITY.

3. The PROGRAM shall not participate in any proposed ROLL-UP which would result in PARTICIPANTS having democracy rights in the ROLL-UP ENTITY which are less than those provided for under Sections VII.A. and VII.B. of these Guidelines. If the ROLL-UP ENTITY is a corporation, the voting rights of PARTICIPANTS shall correspond to the voting rights provided for in these Guidelines to the greatest extent possible.

4. The PROGRAM shall not participate in any proposed ROLL-UP which includes provisions which would operate to materially impede or frustrate the accumulation of shares by any purchaser of the securities of the ROLL-UP ENTITY (except to the minimum extent necessary to preserve the tax status of the ROLL-UP ENTITY). The PROGRAM shall not participate in any proposed ROLL-UP which would limit the ability of a PARTICIPANT to exercise the voting rights of its securities of the ROLL-UP ENTITY on the basis of the number of PROGRAM INTERESTS held by that PARTICIPANT.

5. The PROGRAM shall not participate in any proposed ROLL-UP in which PARTICIPANTS' rights of access to the records of the ROLL-UP ENTITY will be less than those provided for under Section VII.D. of these Guidelines.

6. The PROGRAM shall not participate in any proposed ROLL-UP in which any of the costs of the transaction would be borne by the PROGRAM if the ROLL-UP is not approved by the PARTICIPANTS.

VI. NON-SPECIFIED PROPERTY PROGRAMS.

The following special provisions shall apply to NON-SPECIFIED PROPERTY PROGRAMS:

A. *Minimum Capitalization.* A NON-SPECIFIED PROPERTY PROGRAM shall provide for minimum cash gross proceeds from the offering of not less than \$1,000,000.00 to be available for INVESTMENT IN PROPERTIES.

B. *Experience of SPONSOR.* For NON-SPECIFIED PROPERTY PROGRAMS, the SPONSOR or at least one of its principals must establish that he has had the equivalent of not less than five years experience in the real estate business in an executive capacity and two years experience in the management and acquisition of the type of properties to be acquired or otherwise must demonstrate to the satisfaction of the ADMINISTRATOR that he has sufficient knowledge and experience to acquire and manage the type of properties proposed to be acquired by the NON-SPECIFIED PROPERTY PROGRAM.

C. *Statement of Investment Objectives.* A NON-SPECIFIED PROPERTY PROGRAM shall state types of properties in which it proposes to invest, such as first-user apartment projects, subsequent-user apartment projects, shopping centers, office buildings, unimproved land, etc., and the size and scope of such projects shall be consistent with the objectives of the PROGRAM and the experience of the SPONSORS. As a minimum the following restrictions on investment objectives shall be observed.

1. Unimproved or non-income producing property shall not be acquired except in amounts and upon terms which can be financed by the PROGRAM's proceeds or from cash available for distribution from operations. Investments in such property shall not exceed 25% of the gross proceeds of the offering. Properties which are expected to produce income within a reasonable period of time shall not be considered non-income producing. For purposes of this subsection two years shall be deemed to be presumptively reasonable.

2. Investments in junior trust deeds and other similar obligations shall be prohibited, except for junior trust deeds which arise from the sale of PROGRAM properties.

COMMENT:

This provision shall not be applicable to: (1) those PROGRAMS formed solely to make or invest in mortgage loans, and (2) in the case of programs whose objectives are to invest in mortgage loans and

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acquire real properties to that portion of net offering proceeds which are utilized to make or invest in mortgage loans. The restrictions on these PROGRAMS are governed, in part, by Section V.M. of these GUIDELINES.

3. The manner in which acquisitions will be financed including the use of an all-inclusive note or wrap-around, and the leveraging to be employed shall all be fully set forth in the statement of investment objectives.

4. The statement of investment objectives shall indicate whether the PROGRAM will enter into joint venture arrangements and the projected extent thereof.

5. The statement of investment objectives shall not include a quantitative estimate of the PROGRAM's anticipated economic performance or anticipated return to investors (in the form of distributable funds or tax benefits). The presentation of a proposed level of economic performance or return to investors (in the form of distributable funds or tax benefits) in connection with a NONSPECIFIED PROPERTY PROGRAM is prohibited by Section VIII.C.

D. Period of Offering and Expenditure of Proceeds. Subject to compliance with applicable state securities laws and regulations, an offering of securities in a NON-SPECIFIED PROPERTY PROGRAM may extend for up to two years from the date of original effectiveness provided that the minimum amount of PROGRAM INTERESTS necessary to satisfy the greater of the minimum capitalization requirements of Section VI.A. or the impound requirements set by the PROGRAM is sold within one year of commencement of the offering. While the proceeds of an offering are awaiting investment in real property, the proceeds may be temporarily invested in short-term highly liquid investments where there is appropriate safety of principal, such as U.S. Treasury Bonds or Bills. Any proceeds of the offering of PROGRAM INTERESTS not invested within the later of two years after commencement of the offering or one year after the termination of the offering, or, if allowed by the ADMINISTRATOR, six months from the last scheduled MANDATORY DEFERRED PAYMENT date (except for necessary operating capital) shall be distributed pro rata to the PARTICIPANTS as a return of capital so long as the adjusted INVESTMENT IN PROPERTIES is in compliance with Section IV.C.

E. Multiple Programs. The method for the allocation of the acquisition of properties by two or more programs of the same SPONSOR seeking to acquire similar types of properties shall be reasonable. The method also shall be described in the prospectus.

VII. RIGHTS AND OBLIGATIONS OF PARTICIPANTS.

A. Meetings. Meetings of the PROGRAM may be called by the SPONSOR or the PARTICIPANTS holding more than 10% of the then outstanding limited partnership interests, for any matters for which the PARTICIPANTS may vote as set forth in the limited partnership agreement. Upon receipt of a written request either in PERSON or by certified mail stating the purpose(s) of the meeting, the SPONSOR shall provide all PARTICIPANTS within ten days after receipt of said request, written notice (either in PERSON or by certified mail) of a meeting and the purpose of such

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meeting to be held on a date not less than fifteen nor more than sixty days after receipt of said request, at a time and place convenient to PARTICIPANTS.

B. Voting Rights of Limited Partners. To the extent permitted by the law of the state of formation, the PROGRAM agreement shall provide that a majority of the outstanding PROGRAM INTERESTS may, without necessity for concurrence by the general partner, vote to: (1) amend the PROGRAM agreement, (2) remove the general partner(s), (3) elect a new general partner(s), (4) approve or disapprove the sale of all or substantially all of the assets of the PROGRAM except pursuant to a plan disclosed in the final PROSPECTUS, and (5) dissolve the PROGRAM. Without concurrence of a majority of the outstanding PROGRAM INTERESTS, the general partner(s) may not (i) amend the PROGRAM agreement except for amendments which do not adversely affect the rights of PARTICIPANTS, (ii) voluntarily withdraw as a general partner unless such withdrawal would not affect the tax status of the PROGRAM and would not materially adversely affect the PARTICIPANT, (iii) appoint a new general partner(s), (iv) sell all or substantially all of the PROGRAM's assets other than in the ordinary course of the PROGRAM's business, (v) cause the merger or other reorganization of the PROGRAM or (vi) dissolve the PROGRAM. Notwithstanding clause (iii) of the preceding sentence, an additional general partner may be appointed without obtaining the consent of the PARTICIPANTS if the addition of such PERSON is necessary to preserve the tax status of the PROGRAM, such PERSON has no authority to manage or control the PROGRAM under the PROGRAM agreement, there is no change in the identity of the PERSONS who have authority to manage or control the PROGRAM, and the admission of such PERSON as an additional general partner does not materially adversely affect the PARTICIPANTS. Any amendment to the PROGRAM agreement which modifies the compensation or distributions to which a general partner is entitled or which affects the duties of a general partner may be conditioned upon the consent of the general partner. With respect to any PROGRAM INTERESTS owned by the SPONSOR, the SPONSOR may not vote or consent on matters submitted to the PARTICIPANTS regarding the removal of the SPONSOR or regarding any transaction between the PROGRAM and the SPONSOR. In determining the existence of the requisite percentage in interest of PROGRAM INTERESTS necessary to approve a matter on which the SPONSOR may not vote or consent, any PROGRAM INTERESTS owned by the SPONSOR shall not be included. If the law of the state of formation provides that the PROGRAM will dissolve upon termination of a general partner(s) unless the remaining general partner(s) continues the existence of the PROGRAM, the PROGRAM agreement shall obligate the remaining general partner(s) to continue the PROGRAM's existence; and if there will be no remaining general partner(s), the termination of the last general partner shall not be effective for a period of at least 120 days during which time a majority of the outstanding PROGRAM INTERESTS shall have the right to elect a general partner who shall agree to continue the existence of the PROGRAM. The PROGRAM agreement shall provide for a successor general partner where the only general partner of the PROGRAM is an individual.

COMMENT:

A sale of all or substantially all of the PROGRAM's assets shall mean the sale of two-thirds or more of the PROGRAM's assets based on the total number of properties and mortgages, or the current fair market value of these assets.

C. Reports to Holders of Limited Partnership Interests. The partnership agreement shall provide that the SPONSOR shall cause to be prepared and distributed to the holder of PROGRAM INTERESTS during each year the following reports:

1. In the case of a PROGRAM registered under Section 12(g) of the Securities Exchange Act of 1934, within sixty days after the end of each quarter of the PROGRAM, a report containing:

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- a. A balance sheet, which may be unaudited,
 - b. A statement of income for the quarter then ended, which may be unaudited, and
 - c. A statement of cash flows for the quarter then ended, which may be unaudited, and
 - d. Other pertinent information regarding the PROGRAM and its activities during the quarter covered by the report;
2. In the case of all PROGRAMS, within 75 days after the end of each PROGRAM'S fiscal year, all information necessary for the preparation of the limited partners' federal income tax returns;
3. In the case of all PROGRAMS, within 120 days after the end of each PROGRAM'S fiscal year, an annual report containing: (i) AUDITED FINANCIAL STATEMENTS accompanied by an auditor's report which, for purposes of this Section only, may contain a qualified, adverse or disclaimer opinion or explanatory paragraph, (ii) a report of the activities of the PROGRAM during the period covered by the report, and (iii) where forecasts have been provided to the holders of limited partnership interests to the holders of limited partnership interests, a table comparing forecasts previously provided with the actual results during the period covered by the report. Such report shall set forth distributions to limited partners for the period covered thereby and shall separately identify distributions from: (a) CASH FLOW from operations during the period, (b) CASH FLOW from operations during a prior period which had been held as reserves, (c) proceeds from disposition of property and investments, (d) lease payments on net leases with builders and sellers, and (e) reserves from the gross proceeds of the offering originally obtained from the limited partners.

COMMENT:

See the additional reporting requirements of section V.E.1.b.

4. Where ASSESSMENTS have been made during any period covered by any report required by paragraphs 1., 2., and 3. hereof, then such report shall contain a detailed statement of such ASSESSMENTS and the application of the proceeds derived from such ASSESSMENTS.
5. Where PROGRAM INTERESTS have been purchased on a mandatory deferred payment basis, on which there remains an unpaid balance during any period covered by any report required by paragraphs 1., 2., and 3., hereof; then such report shall contain a detailed statement of the status of all MANDATORY DEFERRED PAYMENTS, actions taken by the PROGRAM in response to any defaults, and a discussion and analysis of the impact on capital

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requirements of the PROGRAM.

D. *Access to Records.* Every PARTICIPANT shall at all times have access to the records of the PROGRAM and may inspect and copy any of them. The limited partnership agreement, by-laws, or other PROGRAM agreement shall include the following provisions regarding access to the list of PARTICIPANTS:

1. An alphabetical list of the names, addresses, and business telephone numbers of the PARTICIPANTS of the PROGRAM along with the number of PROGRAM INTERESTS held by each of them (the "PARTICIPANT List") shall be maintained as a part of the books and records of the PROGRAM and shall be available for inspection by any PARTICIPANTS or its designated agent at the home office of the PROGRAM upon the request of the PARTICIPANT;

2. The PARTICIPANT List shall be updated at least quarterly to reflect changes in the information contained therein;

3. A copy of the PARTICIPANT List shall be mailed to any PARTICIPANT requesting the PARTICIPANT List within ten days of the request. The copy of the PARTICIPANT List shall be printed in alphabetical order, on white paper, and in a readily readable type size (in no event smaller than 10-point type). A reasonable charge for copy work may be charged by the PROGRAM;

4. The purposes for which a PARTICIPANT may request a copy of the PARTICIPANT List include, without limitation, matters relating to PARTICIPANTS' voting rights under the PROGRAM agreement, and the exercise of PARTICIPANTS' rights under federal proxy laws; and

5. If the SPONSOR of the PROGRAM neglects or refuses to exhibit, produce, or mail a copy of the PARTICIPANT List as requested, the SPONSOR be liable to any PARTICIPANT requesting the list for the costs, including attorneys' fees, incurred by that PARTICIPANT for compelling the production of the PARTICIPANT List, and for actual damages suffered by any PARTICIPANT by reason of such refusal or neglect. It shall be a defense that the actual purpose and reason for the requests for inspection or for a copy of the PARTICIPANT List is to secure such list of PARTICIPANTS or other information for the purpose of selling such list or copies thereof, or of using the same for a commercial purpose other than in the interest of the applicant as a PARTICIPANT relative to the affairs of the PROGRAM. The SPONSOR may require the PARTICIPANT requesting the PARTICIPANT List to represent that the list is not requested for a commercial purpose unrelated to the PARTICIPANT'S interest in the PROGRAM. The remedies provided hereunder to PARTICIPANTS requesting copies of the PARTICIPANT List are in addition to, and shall not in any way limit, other remedies available to PARTICIPANTS under federal law, or the laws of any state.

E. *Admission of PARTICIPANTS.* Admission of PARTICIPANTS to the PROGRAM shall be subject to the following:

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1. Admission of original PARTICIPANTS. Upon the original sale of partnership units by the PROGRAM, the purchasers should be admitted as limited partners not later than 15 days after the release from impound of the purchaser's funds to the PROGRAM, and thereafter purchasers should be admitted into the PROGRAM not later than the last day of the calendar month following the date their subscription was accepted by the PROGRAM. Subscriptions shall be accepted or rejected by the PROGRAM within 30 days of their receipt; if rejected, all funds should be returned to the subscriber within ten (10) business days.

2. Admission of substituted limited partners and recognition of assignees. The PROGRAM shall amend the certificates of limited partnership at least once each calendar quarter to effect the substitution of substituted PARTICIPANTS, although the SPONSOR may elect to do so more frequently.

In the case of assignments, where the assignee does not become a substituted limited partner, the PROGRAM shall recognize the assignment not later than the last day of the calendar month following receipt of notice of assignment and required documentation.

3. Except where deemed inappropriate by the ADMINISTRATOR, PERSONS holding PROGRAM INTERESTS by assignment from entities holding limited partnership interests in a PROGRAM for the purpose of assigning all or a portion of such interests to PERSONS investing in such PROGRAM (hereinafter the "Assignor") shall be expressly granted the same rights as if they were limited partners except as prohibited by applicable local law, including but not limited to, the rights enumerated under Article VII of this Statement of Policy Regarding Real Estate Programs.

The assignment agreement and PROSPECTUS shall provide that the Assignor's management shall have fiduciary responsibility for the safekeeping and use of all funds and assets of the assignees, whether or not in the Assignor management's possession or control, and that the management of the Assignor shall not employ, or permit another to employ such funds or assets in any manner except for the exclusive benefit of the assignees. In addition, the agreement shall not permit the assignees to contract away the fiduciary duty owed to the assignees by the Assignor's management under the common law of agency.

F. *Redemption of PROGRAM INTERESTS.* Ordinarily, the PROGRAM and the SPONSOR may not be mandatorily obligated to redeem or repurchase any of its PROGRAM INTERESTS, although the PROGRAM and the SPONSOR may not be precluded from purchasing such outstanding interests if such purchase does not impair the capital or the operation of the PROGRAM. Notwithstanding the foregoing, a real estate PROGRAM may provide for mandatory redemption rights under the following necessitous circumstances:

1. death or legal incapacity of the owner, or
2. a substantial reduction in the owner's NET WORTH or income provided that: (i) the PROGRAM has sufficient cash to make the purchase, (ii) the purchase will not be in violation of applicable legal requirements, and (iii)

not more than 15% of the outstanding units are purchased in any year. Where the purchase price is not mutually agreed upon, the matter shall be submitted to arbitration.

G. *Transferability of PROGRAM INTERESTS.* Restrictions on assignment of PROGRAM INTERESTS or on the substitution of a limited partner are generally disfavored and such restrictions will be allowed only if (i) they comply with the safe harbor provisions of Internal Revenue Service Notice 88-75 (or other safe harbors adopted by the Internal Revenue Service that protect against treatment as a publicly traded partnership) or (ii) they are intended to preserve the tax status of the partnership or the characterization or treatment of income or loss. In the case of (ii), any restriction must be affirmatively supported by an opinion of counsel. The PROGRAM agreement shall require the SPONSOR to eliminate or modify any restriction on substitution or assignment at such time as the restriction is no longer necessary.

H. *ASSESSMENTS and Defaults.*

1. **ASSESSMENTS.** ASSESSMENTS will not be allowed for NON-SPECIFIED PROGRAMS. In the case of SPECIFIED PROGRAMS, ASSESSMENTS shall be permitted only when specific circumstances demonstrate a need. If the anticipated CASH FLOW from property (after payment of debt service and all operating expenses) is not sufficient to pay taxes and/or special ASSESSMENTS imposed by governmental or quasi-government units, the PROGRAM agreement may include a provision for assessability to meet such deficiencies. Assessability must be limited to the foregoing obligations, and all amounts derived from such ASSESSMENTS must be applied only to satisfaction of said obligations.

2. **Defaults on ASSESSMENTS.** In the event of a default in the payment of ASSESSMENTS by a PARTICIPANT his interests shall not be subject to forfeiture, but may be subject to a reasonable penalty for failure to meet his commitment. Provided that the arrangements are fair, this may take the form of reducing his proportionate interest in the PROGRAM, subordinating his interest to that of nondefaulting partners, a forced sale complying with applicable procedures for notice and sale, the lending of the amount necessary to meet his commitment by the other PARTICIPANTS or a fixing of the value of his interest by independent appraisal or other suitable formula with provision for a delayed payment to him for his interest not beyond a reasonable period, but a debt security issued for such interest should not have a claim prior to that of the other investors in the event of liquidation.

COMMENT:

A limited partner will be reinstated to his full status as a limited partner upon payment of the delinquent ASSESSMENT with interest at the maximum rate allowed by law, within 30 days of the date of default. Default would be the failure to pay the ASSESSMENT within 30 days of the date of notice requesting the ASSESSMENT.

I. *Dividend Reinvestment Plans.* A PROGRAM may offer participants the opportunity to elect to have cash distributions reinvested in the PROGRAM or subsequent programs if the following conditions are met:

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1. The PROGRAM and subsequent programs in which the participants reinvest are registered or exempted under the state's blue sky laws.

2. Counsel for the PROGRAM submits an opinion that the pooling of the funds for reinvestment is not in itself a security.

3. The subsequent program has substantially identical investment objectives as the original PROGRAM.

4. The participants are free to elect or revoke reinvestment within a reasonable time and such right is fully disclosed in the offering documents.

5. Prior to each reinvestment the participants receive a current updated disclosure document which contains at a minimum the following information:

a. The minimum investment amount.

b. The type or source of proceeds (e.g. cash distributions from operations or the sale or disposition of properties) which may be reinvested.

c. The tax consequences of the reinvestment to the participants.

6. Counsel for the PROGRAM submits an opinion that different consideration paid on reinvestment is not in violation of the state law (the difference arises when one participant agrees to payment of commission to the broker-dealer and another participant does not agree to payment of commission).

7. The broker-dealer or the issuer assumes responsibility for blue sky compliance and performance of due diligence responsibilities and has contacted the participants to ascertain whether the participants continue to meet the state's suitability standard for participation in each reinvestment.

8. If a broker-dealer is involved it shall obtain in writing an agreement from the client by which the client agrees to the payment of compensation to the broker-dealer in connection with individual reinvestment.

J. Within 60 days after the end of each quarter during which there have been real property acquisitions, a "Special Report" (which may be part of the quarterly report) shall be sent to all PARTICIPANTS until the proceeds of the offering are committed or returned to the investors. The report shall contain the following information:

1. the location and a description of the general character of all materially important real properties acquired or presently intended to be acquired by or leased to the program, during the quarter.
2. the present or proposed use of such properties and their suitability and adequacy for such use.
3. the terms of any material lease affecting the property.
4. the proposed method of financing, including estimated down payment, leverage ratio, prepaid interest, balloon payment(s), prepayment penalties, due-on-sale or encumbrance clauses and possible adverse effects thereof and similar details of the proposed financing plan, and
5. a statement that title insurance and any required construction, permanent or other financing and performance bonds or other assurances with respect to builders have been or will be obtained on all properties acquired.

COMMENT:

When a PROGRAM is making or investing in mortgage loans then information should be included in these reports not only about the terms and present status of the loan but also such information reasonably available about the underlying property which could influence the value of the loan.

K. *Arbitration of Disputes.* Except as permitted in Section II.F., no provision requiring the mandatory arbitration of disputes between the PARTICIPANT and the SPONSOR or the PROGRAM is permitted. Nothing contained herein shall apply to preexisting contracts between broker-dealers and PARTICIPANTS.

VIII. DISCLOSURE AND MARKETING REQUIREMENTS.

A. *Sales Promotional Efforts.*

1. Sales Literature. Sales literature, sales presentations (including prepared presentations to prospective investors at group meetings) and advertising used in the offer or sale of partnership interests shall conform in all applicable respects to requirements of filing, disclosure and adequacy currently imposed on sales literature, sales presentations and

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advertising used in the sale of corporate securities.

2. Group Meetings. All advertisements of and oral or written invitations to "seminars" or other group meetings at which PROGRAM INTERESTS are to be described, offered or sold shall clearly indicate that the purpose of such meeting is to offer such PROGRAM INTERESTS for sale, the minimum purchase price thereof, and the name of the SPONSOR, underwriter or selling agent. No cash, merchandise or other item of value shall be offered as an inducement to any prospective PARTICIPANTS to attend any such meeting. In connection with the offer or sale of PROGRAM INTERESTS, no general offer shall be made of "free" or "bargain price" trips to visit property in which the PROGRAM or proposed PROGRAM has invested or intends to invest.

All written or prepared audio-visual presentations (including scripts prepared in advance for oral presentations) to be made at such meetings must be submitted in advance to the ADMINISTRATOR not less than three business days prior to the first use thereof. The foregoing paragraphs 1. and 2. shall not apply to meetings consisting only of representatives of securities broker-dealers.

B. *Contents of PROSPECTUS.* The PROSPECTUS shall meet the requirements of Guide 5 of the Securities and Exchange Commission. The use of proceeds tabular summary required by Guide 5 shall include a separate line item for estimated ACQUISITION EXPENSES to be incurred by the PROGRAM. All of the information required to be set forth in the use of proceeds tabular summary by Guide 5 shall also be provided for estimated ACQUISITION EXPENSES, including an estimate of ACQUISITION EXPENSES to be paid to the SPONSOR. The description of the method for the allocation of the acquisition of properties by two or more programs of the same sponsor shall meet the requirements of Section VI.E. The PROSPECTUS shall contain a full description of the terms, consequences, risks to investors and the PROGRAM of any MANDATORY DEFERRED PAYMENTS. The ADMINISTRATOR may require additional disclosure if, in the ADMINISTRATOR'S opinion, specific facts concerning the offering require it.

COMMENT:

Where the ADMINISTRATOR deems it appropriate, offering materials may be required to comment on the ability of investors to rely on tax benefits and cash flow from the PROGRAM to satisfy future obligations on MANDATORY DEFERRED PAYMENTS, the inappropriateness of treating such obligations as options or warrants, possible liability to third-party creditors of the PROGRAM as a result of such unpaid obligations, and/or possible tax consequences of the use of such payment methods.

C. *Forecasts.*

1. Use of Forecasts. The presentation of predicted future results of operations of real estate PROGRAMS shall be permitted but not required for specified property PROGRAMS investing primarily in improved property and shall be prohibited for NON-SPECIFIED PROPERTY PROGRAMS or specified property PROGRAMS investing primarily in unimproved land. The covers of the PROSPECTUS must contain in bold face language one of the following statements:

a. for SPECIFIED PROPERTY PROGRAMS:

FORECASTS ARE CONTAINED IN THIS PROSPECTUS (OFFERING CIRCULAR). ANY PREDICTIONS AND REPRESENTATIONS, WRITTEN OR ORAL, WHICH DO NOT CONFORM TO THOSE CONTAINED IN THE PROSPECTUS (OFFERING CIRCULAR) SHALL NOT BE PERMITTED.

b. for NON-SPECIFIED PROPERTY and unimproved land programs:

THE USE OF FORECASTS IN THIS OFFERING IS PROHIBITED. ANY REPRESENTATIONS TO THE CONTRARY AND ANY PREDICTIONS, WRITTEN OR ORAL, AS TO THE AMOUNT OR CERTAINTY OF ANY PRESENT OR FUTURE CASH BENEFIT OR TAX CONSEQUENCE WHICH MAY FLOW FROM AN INVESTMENT IN THIS PROGRAM IS NOT PERMITTED.

2. Presentation of Forecasts. Forecasts for specified property PROGRAMS shall be included in the PROSPECTUS or sales material of the PROGRAM only if they comply with the following requirements:

a. General. Forecasts shall be realistic in their predictions and shall clearly identify the assumptions made with respect to all material features of the presentation. Forecasts shall be examined by an independent certified public accountant in accordance with the Statement on Standards for Accountants' Services on Prospective Financial Information and the Guide for Prospective Financial Statements as promulgated by the American Institute of Certified Public Accountants. The accountant's examination report shall be included in the PROSPECTUS. No forecasts shall be permitted in any sales literature which does not appear in the PROSPECTUS. If any forecasts are included in the sales literature, all forecasts must be presented.

COMMENT:

If predicted future results of operations are used, they shall be prepared in the form of a forecast by an expert using standard criteria and format.

b. Material Information. Forecasts shall include all the following information:

(i) Annual predicted revenue by source; including the occupancy rate used in predicting rental revenue;

(ii) Annual predicted expenses;

(iii) Mortgage obligation--annual payments for principal and interest, points and financing fees, shown as dollars, not percentages;

(iv) The required occupancy rate in order to meet debt service and all expenses;

(v) Predicted annual CASH FLOW; stating assumed occupancy rate;

(vi) Predicted annual depreciation and amortization with full description of methods to be used;

(vii) Predicted annual taxable income or loss and a simplified explanation of the tax treatment of such results; assumed tax brackets may not be used;

(viii) Predicted construction costs--including disclosure regarding contracts;

(ix) Accounting policies--e.g., with respect to points, financing costs and depreciation.

c. Presentation.

(i) Caveat. Forecasts shall prominently display a statement to the effect that they represent a mere prediction of future events based on assumptions which may or may not occur and may not be relied upon to indicate the actual results which will be obtained.

(ii) Additional Guidelines. Explanatory notes describing assumptions made and referring to risk factors should be integrated with tabular and numerical information.

(iii) Sale-leasebacks. When a sale-leaseback is employed, the statement that the seller is assuming the operating risk and consequently may have charged a higher price for the property must be included.

d. Additional Disclosures and Limitations.

(i) Forecasts shall be for a period at least equivalent to the anticipated holding period for the property, or 10 years, whichever is shorter, and project a resale occurrence, including depreciation recapture, if applicable. The forecasted resale price must be reasonable.

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(ii) Adequate disclosure shall be made of the changing economic effects upon the limited partners resulting principally from federal income tax consequences over the life of the partnership property, e.g., substantial tax losses in early years followed by [an] increasing amount of taxable income in later years.

(iii) Forecasts shall disclose all possible undesirable tax consequences of an early sale of the PROGRAM property (such as, depreciation recapture or the failure to sell the property at a price which would return sufficient cash to meet resulting tax liabilities of the PARTICIPANTS). (iv) In computing the return to investors, no appreciation, so called "equity buildup", or any other benefits from unrealized gains or value shall be shown or included.

3. Unimproved Land.--Forecasts shall not be allowed for unimproved land. Instead, a table of deferred payments specifying the various holding costs, i.e., interest, taxes, and insurance shall be inserted. However, where the PROGRAM intends to develop and sell the land as its primary business, a detailed CASH FLOW statement showing the timing of expenditures and anticipated revenues shall be required. Additionally, the consequences of a delayed selling PROGRAM shall be shown.

4. The PROSPECTUS and sales material shall not include a quantitative estimate of a PROGRAM's anticipated economic performance or anticipated return to PARTICIPANTS (in the form of distributable funds or tax benefits), except as permitted under this Section VIII.C.

COMMENT:

Quantitative estimates of returns are permitted when they are consistent with a financial forecast that has been examined by an independent certified public accountant and the forecast is included in the PROSPECTUS.

IN SPECIFIED PROPERTY PROGRAMS formed to generate tax credits, quantitative statements of tax credit objectives may be included in the PROSPECTUS if they are accompanied by adequate disclosure concerning the risks involved, the limited utility of the tax credits to investors (including appropriate investment suitability), and the analytical basis supporting such statements.

An ADMINISTRATOR may require documentation supporting the reasonableness of any quantitative statements of tax credit objectives.

IX. MISCELLANEOUS PROVISIONS.

A. *Deferred Payments.* Deferred payments or similar arrangements on account of the purchase price of PROGRAM INTERESTS shall not be allowed except as set forth below:

1. MANDATORY DEFERRED PAYMENTS may be allowed in the case of SPECIFIED PROPERTY PROGRAMS to the extent such payments bear a reasonable and demonstrable relationship to the capital needs and objectives of the PROGRAM as described in the presentation of the business development plan in the investor

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disclosure document, but in any event such arrangements shall be subject to the following conditions:

a. A minimum of 50% of the purchase price of the PROGRAM INTERESTS must be paid by the investor at the time of sale, with the remainder to be paid within three years of the earlier of the completion of the offering or one year following the effective date of the offering or such shorter period as the ADMINISTRATOR, under the circumstances, deems appropriate.

b. MANDATORY DEFERRED PAYMENTS shall be evidenced by a promissory note of the investor. Such notes shall be with recourse, shall not be negotiable and shall be assignable only subject to defenses of the maker. Such notes shall not contain a provision authorizing a confession of judgment. In any event, the notes shall provide for venue in the jurisdiction of the investor.

c. The PROGRAM shall not sell or assign the MANDATORY DEFERRED PAYMENT notes at a discount.

d. Selling commissions for PROGRAM INTERESTS sold on a mandatory deferred payment basis are payable pro rata only from cash payments made by the PARTICIPANT.

e. In the event of default in the payment of MANDATORY DEFERRED PAYMENTS by a PARTICIPANT, the PARTICIPANT'S interest may be subject to a reasonable reduction as set forth in the PROSPECTUS and acceptable to the ADMINISTRATOR. Responses to defaults should be designed to protect the capital requirements of the PROGRAM and the best interests of the non-defaulting PARTICIPANTS while being fair to the defaulting PARTICIPANT.

f. The PROGRAM may take a security interest in the PARTICIPANT'S PROGRAM INTERESTS in the amount of the unpaid portion of the note provided that proceedings to enforce the security interest may not be commenced earlier than 30 days after default and notice of intent to foreclose on the security interest. Security interests on PROGRAM INTERESTS that have been fully paid up shall be dissolved promptly.

g. Unless MANDATORY DEFERRED PAYMENTS are guaranteed by the SPONSOR or by a surety bond or other arrangement satisfactory to the ADMINISTRATOR at the start of the offering, the SPONSOR shall not be allowed to purchase PROGRAM INTERESTS recovered as a result of default in MANDATORY DEFERRED PAYMENTS unless, after recovery, such PROGRAM INTERESTS have first been offered to the non-defaulting PARTICIPANTS.

h. Any certificates evidencing PROGRAM INTERESTS purchased on a mandatory deferred payment basis shall

so indicate.

i. Upon receipt of any request to assign or transfer PROGRAM INTERESTS purchased on mandatory deferred payment basis and having an unpaid balance, the SPONSOR, before the assignment or transfer, at its own cost, shall notify the proposed assignee/transferee of the material terms of the mandatory deferred payment obligation, including: the schedule of payments, the status of payments, the status of any encumbrance held by the PROGRAM on the PROGRAM INTEREST; the terms of default, the consequences thereof, and the terms of curing the default. In lieu of such notification the SPONSOR may accept a written statement containing such information and signed by the assignee/transferee.

j. A default would be the failure to make a scheduled payment on the mandatory deferred payment obligation note before 30 days after its due date. A PARTICIPANT shall be allowed to cure a default and avoid any reduction in his interest in the PROGRAM if within a minimum of 30 days from default and notice thereof the PARTICIPANT makes the delinquent payment with interest at the rate set forth in the PROSPECTUS for the curing of defaulted payments.

COMMENT:

Default provisions should have as a priority the integrity of the PROGRAM'S capital. Depending on the circumstances, examples of arrangements which may be appropriate include: 1) a reduction in the PARTICIPANT'S percentage interest in PROGRAM revenues based on the ratio of the cost to the PROGRAM of his unpaid mandatory deferred payment obligation to all CAPITAL CONTRIBUTIONS; 2) a reallocation of the defaulting PARTICIPANT'S right to receive revenues from the PROGRAM and application of such revenues to make up the cost to the PROGRAM of his unpaid mandatory deferred payment obligations; 3) a reallocation of the defaulting PARTICIPANTS right to receive revenues from the PROGRAM to those nondefaulting PARTICIPANTS who have voluntarily paid the defaulting PARTICIPANT'S obligation until such time as such non-defaulting PARTICIPANTS have recovered from this reallocation 200% of the proportionate amount of the defaulted payment which they forwarded; 4) a forced sale of the PROGRAM INTEREST complying with applicable procedures for notice and sale; 5) a delayed buy-out of the defaulting PARTICIPANT'S interest; or 6) a foreclosure on the security interest held by the PROGRAM. "Cost to the PROGRAM" shall be defined in the PROSPECTUS and may include the reasonable costs to the PROGRAM of collecting unpaid installments, reselling the interests, and/or additional financing costs caused by the default.

2. MANDATORY DEFERRED PAYMENTS shall not be allowed in the case of NON-SPECIFIED PROPERTY PROGRAMS except where the SPONSOR is able to satisfy the ADMINISTRATOR that the MANDATORY DEFERRED PAYMENTS bear a reasonable and demonstrable relationship to the capital needs and objectives of the PROGRAM as described in the business development plan in the investor disclosure document. In any event, such arrangements shall be subject to the following conditions:

a. A minimum of 50% of the purchase price of the PROGRAM INTERESTS must be paid by the investor at the time of sale, with the remainder to be paid within two years of the earlier of the completion of the offering or one year following the effective date of the offering or such shorter period as the ADMINISTRATOR, under the circumstances, deems appropriate.

b. The PROGRAM shall otherwise comply with the provisions of IX.A.1.b. through 3.

COMMENT:

A plan that merely states that money will be invested as installments are received or at specified intervals will not be considered a sufficient business development plan.

3. Warrants or options (or their equivalents) to purchase PROGRAM INTERESTS will be allowed only at the discretion of the ADMINISTRATOR but, in any event, must be identified as such and be accompanied with a clear statement of their nature and effect. PROGRAM INTERESTS acquired by their exercise may not differ from the stated terms of PROGRAM INTERESTS otherwise acquired. Any penalty for non-exercise will ordinarily be viewed with disfavor.

B. *Reserves.* Provision should be made for adequate reserves in the future by retention of a reasonable percentage of proceeds from the offering and regular receipts for normal repairs, replacements and contingencies. Normally, not less than 3% of the offering proceeds will be considered adequate. However, in PROGRAMS that invest in or make mortgage loans, reserves in an amount greater than 1% of the offering proceeds will be considered adequate.

C. Reinvestment of CASH FLOW (excluding proceeds resulting from a disposition or refinancing of property) shall not be allowed. The partnership agreement and the PROSPECTUS shall set forth that reinvestment of proceeds resulting from a disposition or refinancing will not take place unless sufficient cash will be distributed to pay any state or federal income tax (assuming investors are in a specified tax bracket) created by the disposition or refinancing of property. Such a prohibition must be contained in the PROSPECTUS.

D. *Financial Information Required on Application.* In any offering of interests by a PROGRAM, the PROGRAM shall provide as an exhibit to the application the following financial information.

COMMENT:

In the case of PROGRAMS which invest in or make mortgage loans any reinvestment must be structured to terminate when the PROGRAM terminates.

1. Financial Statements of Program. The PROSPECTUS shall include AUDITED FINANCIAL STATEMENTS of the PROGRAM for each of the last three fiscal years (or for the life of the PROGRAM, if less), provided that the only audited balance sheet that shall be required shall be as of the end of the most recent fiscal year of the PROGRAM. When a PROGRAM has operated less than one fiscal year, AUDITED FINANCIAL STATEMENTS are not required unless requested by the ADMINISTRATOR.

2. Balance Sheet of Corporate Sponsor. AUDITED FINANCIAL STATEMENTS consisting only of an audited

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balance sheet for each corporate SPONSOR as of the end of the SPONSOR's most recent fiscal year shall be included in the PROSPECTUS.

3. Other SPONSORS. A balance sheet for each noncorporate SPONSOR (including individual partners or individual joint ventures of a SPONSOR) as of a date not more than one hundred thirtyfive days prior to the date of filing the application shall be submitted. Such balance sheet shall be prepared in accordance with generally accepted accounting principles and reviewed and reported upon by an independent certified public accountant under the review standards set forth by the American Institute of Certified Public Accountants, and shall be signed and sworn to by such SPONSOR. A representation of the amount of such NET WORTH must be included in the PROSPECTUS, or in the alternative, a representation that such SPONSOR meets the NET WORTH requirements of Section II.B. shall be so included.

COMMENT:

It is not intended that financial statements of AFFILIATES of the SPONSOR be required to be disclosed unless appropriate in order to comply with the NET WORTH requirements of Section II.B.

4. Interim Financial Information. Where an audited balance sheet required by this Section IX.D. is as of a date more than 90 days prior to the date of filing, an unaudited balance sheet as of a date not more than 90 days prior to the date of filing shall also be provided. Where the application is made in coordination with a Registration Statement submitted to the Securities and Exchange Commission pursuant to the Securities Act of 1933, an interim unaudited balance sheet as of a date not more than one hundred thirtyfive days prior to the date of filing shall be provided only if the audited balance sheet is as of a date more than 134 days prior to the date of filing. Interim unaudited statements of income, partners' equity, and cash flows shall also be provided with the unaudited balance sheet in instances where such statements are required by this Section IX.D. as part of the AUDITED FINANCIAL STATEMENTS for the last fiscal year. The ADMINISTRATOR may require the interim unaudited information to be included in the Prospectus when the audited information required by this Section must be included.

5. Filing of Other Statements. The ADMINISTRATOR may permit the omission of one or more of the statements required under this Section and the filing (in substitution thereof) of appropriate statements verifying financial information having comparable relevance to an investor in determining whether to invest in the PROGRAM. Such substitution will only be allowed where the ADMINISTRATOR finds this would be consistent with the protection of investors.

E. *Opinions of Counsel.* The application for qualification and registration shall contain a favorable ruling from the Internal Revenue Service or an opinion of independent counsel to the effect that the issuer will be taxed as a "partnership" and not as an "association" for federal income tax purposes. An opinion of counsel shall be in form and substance satisfactory to the ADMINISTRATOR and shall be unqualified except to the extent permitted by the ADMINISTRATOR. However, an opinion of counsel may be based on reasonable assumptions, such as:

(1) facts or proposed operations as set forth in the offering circular or PROSPECTUS and organizational documents; (2) the absence of future changes in applicable laws; (3) the securities offered are paid for; (4) compliance

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with certain procedures such as the execution and delivery of certain documents and the filing of a certificate of limited partnership or an amended certificate; and (5) the continued maintenance of or compliance with certain financial, ownership, or other requirements by the issuer or SPONSOR. The ADMINISTRATOR may request from counsel as supplemental information such supporting legal memoranda and an analysis as he shall deem appropriate under the circumstances. To the extent the opinion of counsel or Internal Revenue Service ruling is based on the maintenance of or compliance with certain requirements or conditions by the issuer or SPONSOR the offering circular or PROSPECTUS shall contain representations that such requirements or conditions will be met and the partnership agreement shall, to the extent practicable, contain provisions requiring such compliance.

There shall be included also an opinion of independent counsel to the effect that the securities being offered are duly authorized or created and validly issued interests in the issuer, and that the liability of the public investors will be limited to their respective total agreed upon investment in the issuer.

The ADMINISTRATOR may request an opinion of counsel concerning tax aspects when this appears necessary for the protection of investors.

F. *Provisions of the Partnership Agreement.* The requirements and/or provisions of appropriate portions of the following sections shall be included in the partnership agreement: I.B.; II.C.; II.D.; II.E.; II.F.; IV.C.; IV.D.; IV.E.; IV.F.; IV.G.; IV.H.; IV.I.; V.A.; V.B.; V.C.; V.D.; V.E.; V.F.; V.G.; V.H.; V.I.; V.K.; V.L.; V.M.; V.N.; VI.C.; VI.D.; VII.A.; VII.B.; VII.C.; VII.D.; VII.E.; VII.F.; VII.H.; VII.J.; VII.K.; IX.A.; IX.B.; and IX.C.

NOTE:

The cross-reference sheet will be amended to include Sections I.B.4., I.B.11. and I.B.18. if Section IX.F. is amended to include Section I.B.

[G. Omitted in the 1986 amendment.--CCH]

H. *General Instructions--NASAA Real Estate Guidelines.*

1. The Cross Reference Sheet should be completed with the Application for Registration.

2. Sections which are not applicable should be noted as such.

3. Provisions of the program which vary from the Guidelines must be explained by footnote; for example, if the program uses a defined term which is different from the Guidelines definition, the variance must be explained. Footnotes should be numbered sequentially in the column designated Footnotes and should be presented on a rider identified as Footnotes with each Footnote on the rider numerically corresponding to the Footnote identified on the Cross Reference Sheet.

4. A section is provided at the bottom of each page of the Cross Reference Sheet for additional or supplemental

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Cross References. Lines are provided in the event additional Cross References are needed with respect to subsections of the Guidelines not specifically identified on the top of the page, or in the event there were insufficient lines to present all relevant cross references with respect to an item appearing on that page.

5. The last page of the Cross Reference Sheet should be executed by preparer.

6. These General Instructions should be *removed* before filing with the State Administrator.

REAL ESTATE GUIDELINES CROSS REFERENCE SHEET

Name of Applicant: -----					
Section Num- ber Partnership Agreement	Page Number Prospectus	Footnote See Instruc- tion 3	Guideli ne Sec- tion		
			I.	B.	Definitions
-	-	-		1.	Acquisition expenses
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-	-	-		2.	Acquisition fee
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-	-	-		4.	Affiliate
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-	-	-		5.	Assessments
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-	-	-	13.	Competitive real estate commission
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-	-	-	14.	Construction fee
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-	-	-	15.	Cross reference sheet
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-	-	-	16.	Development fee
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-	-	-	17.	Financing
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-	-	-	18.	Front-End fees
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-	-	-	19.	Investment in properties
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-	-	-	20.	Major repairs and re-
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-	-	-	21.	Mandatory deferred
-	-	-		payments
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-	-	-	22.	Net worth
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-	-	-	23.	Non-specified property
-	-	-		programs
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-	-	-	24.	Organization and offer-
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-	-	-	25.	Participant
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-	-	-	28.	Program interest
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-	-	-	29. Program management fee
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-	-	-	30. Property management fee
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-	-	-	32. Purchase price
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-	-	-	33. Specified property program
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-	-	-	34. Sponsor
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-	-	-	II. Requirements of Sponsors
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-	-	-	A. Experience
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B. Net worth

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C. Reports to administrators

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D. Liability

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E. Fiduciary duty

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F. Termination

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III. Suitability of the Participant

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A. Standards

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C. Maintenance of records

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IV. Fees-
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Compensation-
-Expenses

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B. Organization & offering expenses

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C. Investment in properties

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D. Program management fee

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E. Promotional interest

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Additional or Supplemental Cross References

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-	-	-	3. Definition of capital contributions and date for commencement of calculating the preferred return
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-	-	-	4. Dissolution and liquidation
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-	-	-	F. Real estate brokerage commissions on resale of property
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-	-	-	G. Property management fee
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-	-	-	H. Insurance services
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-	-	-	I. Mortgage servicing fee

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-	-	-	J. Asset based fee
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-	-	-	3. Limitations
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			V. Conflicts of interest and Investment Restrictions
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-	-	-	2. Sales and leases to sponsor
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-	-	-	3. Dealing with related programs
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-	-	-	B. Exchange of limited partnership interests
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-	-	-	C. Exclusive agreements
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-	-	-	D. Commissions on reinvest-

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-	-	-	E. Services rendered to the
-	-	-	program by the sponsor
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-	-	-	1. a. Expenses
-	-	-	billed to pro-
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-	-	-	b. Annual pro-
-	-	-	gram report
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-	-	-	2. Other services
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-	-	-	F. Rebates, kickbacks and re-
-	-	-	ciprocal arrangements
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-	-	-	G. Commingling of funds
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-	-	-	H. Investments in other pro-
-	-	-	grams
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-	-	-	I. Lending practices
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-	-	-	J. Development or construc-
-	-	-	tion contracts
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-	-	-	K.	Completion bond require-
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-	-	-	L.	Appraisals
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-	-	-	M.	Mortgage loan programs
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-	-	-	N.	Program indebtedness
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Additional or Supplemental Cross References

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VI. Non-Specified Property Programs

-	-	-	A.	Minimum capitalization
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-	-	-	B.	Sponsor experience
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C. Investment Objectives

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1. Unimproved or non-income producing property program

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2. Junior trust deeds

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3. Financing

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4. Joint ventures

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D. Offering period

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E. Multiple programs

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VII. Rights and Obligations of Participants

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A. Meetings

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B. Voting rights

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1. 12(g) programs, quarterly reports

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2. Limited partners tax information

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3. Annual report

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4. Assessment reports

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5. Mandatory deferred payment reports

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D. Access to records

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E. Admission of participants

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1. Original participants

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2. Substitute limited partners

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3. Assignor limited partnership

F. Redemption of program interests

G. Transferability of program interests

H. 1. Assessments

2. Defaults on assessments

I. Dividend Reinvestment Plan

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J. Special reports

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K. Arbitration of disputes.

VIII. Not officially reflected.

IX. Miscellaneous Provisions

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A. Deferred payments

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B. Reserves

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C. Reinvestment of cash flow

Additional or Supplemental Cross References

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Response to this cross reference sheet has been prepared by:

Name: -----

Title: -----

I. A redlined copy of all amendments and supplements to an application shall be filed with the ADMINISTRATOR as soon as the amendment or supplement is available.

Real Estate Investment Subcommittee of the NASAA Merit Regulation Committee

ADVISORY I

adopted on April 23, 1983

[In General] The NASAA Real Estate Investment Subcommittee ("Subcommittee") at its meeting of May 12, 1982, has adopted a procedure whereby the Subcommittee will from time to time issue interpretations of the NASAA Real Estate Guidelines ("Guidelines"). As with the Guidelines themselves, and even to a greater degree with respect to these interpretations, each state administrator will retain the discretion with respect to the interpretations and implementation of the Guidelines. However, for those administrators who are seeking to increase the degree of uniformity of interpretations of the Guidelines and/or seeking additional guidance with respect to the interpretation of the Guidelines, the Subcommittee has prepared the following interpretations:

INTERPRETATION 1 When a sponsor's promotional interest in liquidation proceeds is subordinated to a higher return to the limited partners than is specified under Sections IV.E.1 and IV.E.2 b. of the Guidelines, the compensation permitted the sponsors by this section or other sections of the Guidelines should not be increased as a result of this type of arrangement unless specifically justified under Section I.A.2.

INTERPRETATION 2 When a sponsor takes an increased promotional interest pursuant to Section IV.C.3 of the Guidelines, but subordinates the payment of such fees to a higher return to the investors than is specified under such section, the compensation permitted sponsors by this section or other sections of the Guidelines should not be increased as a result of this type of arrangement unless specifically justified under Section I.A.2.

INTERPRETATION 3

When a sponsor takes a share of cash distributions from operations under Section IV.E.2 a. of the Guidelines, but subordinates this interest to a specified return to the investors (which is not required by the Guidelines), the compensation permitted sponsors by this section or other sections of the Guidelines should not be increased as a result of this type of arrangement unless specifically justified under Section I.A.2.

COMMENT ON INTERPRETATIONS 1 THROUGH 3 ABOVE. The Subcommittee believes that the Guidelines create a substantial opportunity for the sponsor to exchange one form of compensation for another form of

compensation. For example, there is substantial latitude as to the "mix" in the front-end fees permitted, and the front-end fees can be deferred entitling the sponsor to a larger liquidation fee. In addition, the maximum compensation permitted to sponsors under the Guidelines is liberal and sponsors are permitted and in fact do, in many instances, package programs with sponsors' compensation well below the maximum permitted by the Guidelines. Therefore, in general, the Subcommittee does not believe that it is necessary or appropriate to create an additional standard for modification of the compensation based upon the sponsor increasing subordination beyond that specified in Sections IV.E.1, IV.E.2, and IV.C.3 of the Guidelines. The fact that a sponsor may increase the subordination of his share of cash distributions could be meaningful only when an accurate forecast of annual cash distributions from operations and net proceeds from liquidation could be forecasted, and thus show the "real trade-off" involved in a particular arrangement. Nevertheless, even if a very reliable forecast of the future timing and amount of proceeds from operations and the sale of the property could be made, the Subcommittee believes that the sponsor's willingness to subject its return to a higher subordination than is required under the Guidelines should be considered a response to the pressures of the competitive marketplace and not a trade-off in compensation entitling the sponsor to a larger share somewhere else.

INTERPRETATION 4

When applying the suitability standards under Section III.B.4. of the Guidelines to a participant which is an IRA or Keogh plan, the participant for the purposes of suitability is the beneficiary of the IRA or Keogh plan.

COMMENT ON INTERPRETATION 4. Suitability standards for investors are imposed because of factors such as the limited transferability, relative lack of liquidity, degree of risk, and specific tax orientation of a real estate program. When an investment in a real estate program is made through an IRA or Keogh plan the investor or participant is considered to be the beneficiary. The beneficiary is the real investor in interest. The beneficiary is the person who supplies the funds to purchase the partnership interest and is the person at risk on the selection and performance of the investment. In the case of self-directed plans or accounts, the beneficiary makes the investment decision. In a fiduciary account the ability to bear the loss as reflected by the beneficiary's financial status is more relevant to the application of a suitability standard than the trustee's financial status or ability to understand the investment risks to the beneficiary.

INTERPRETATION 5

Section II.E. of the Guidelines prohibits the sponsor from employing or permitting another to employ program funds and assets in any manner except for the exclusive benefit of the program. This section would disallow deposits of funds with affiliated financial institutions, such as banks, savings and loans, or money market funds, and would also prohibit "compensating balance" arrangements for the sponsor's benefit. The administrator may allow certain deposits with affiliated institutions if it can be demonstrated that any conflict of interest between the early investment of program funds and the financial benefits to the affiliated institution could be adequately resolved:

1. Deposits in affiliated money market funds, savings and loans, and banks may be allowed if such deposits from the program do not exceed five percent of all funds held by such money entity. Additionally, any fees, including commissions, advisory fees, or other fees shall not be paid from PROGRAM funds.

2. Compensating balance arrangements for the benefit of other than the program shall not be allowed.

3. The prospectus shall contain separately numbered paragraphs in the Conflicts of Interest section which would discuss any conflicts of interest, including the possible conflict in the timing of deposits and withdrawals and the

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permanent investment of program funds in properties. Such section shall also contain an explicit statement that the sponsor will abide by its obligation not to use program funds except for the exclusive benefit of the program.

4. Funds deposited in affiliated banks, savings and loans, or money market funds shall earn interest and/or dividends at a rate competitive with those available from similar independent depositories.

INTERPRETATION 6 When applying the limitation imposed by Subsection 1 and 2 of Section V.M. of the Guidelines, the phrase "... CAPITAL CONTRIBUTIONS to be raised by the PROGRAM" means the actual amount raised in the offering.

COMMENT ON INTERPRETATION 6. The limitations contained in Subsection 1 and 2 are designed to assure diversification in a real estate program and are based on the premise that diversification lessens the investor's risk. They require a program to invest in at least five properties with five different lenders or borrowers in order to limit to a reasonable degree the risk to the program.

Industry members have pointed out some practical problems in situations where a program does not sell completely or where the sales period is prolonged. Good investment opportunities may present themselves before the final amount of the offering is known and the limitations can be determined. It is impossible for the program to take advantage of these opportunities without the risks of finding that the limitations have been exceeded when sales are completed.

The Subcommittee believes that the language of the provisions is clear and that the limiting percentages apply to the amount actually raised by the program. The Subcommittee also recognizes the problem presented and concludes that the comment following Subsection 6 indicates that the limitations need not be rigidly applied.

A compromise reached by several states appears to the Subcommittee to meet the intent of the guideline section and is suggested as a way to handle this problem. That compromise provides that (1) the limiting percentage will apply to the stated maximum amount of the offering; (2) a minimum of three properties and three lenders or borrowers will be involved; (3) the 85% of value limitation contained in Subsection 5 will be strictly applied to each property; and (4) a risk factor discussing the relationship between the number of properties invested in and the risk to the investor shall be contained in the prospectus. A consideration of higher suitability standards may also be appropriate because of the higher risk involved.

October 9, 1994

I. Introduction.

The North American Securities Administrators Association, Inc. ("NASAA") has determined that the following guidelines relating to the registration of agents allowed to sell Small Corporate Offering Registration ("SCOR") securities are consistent with public investor protection and capital formation. Nothing shall prevent the Securities Administrator from applying different standards from those contained in these guidelines.

II. Discussion.

On April 29, 1989, NASAA adopted SCOR, which represented a significant breakthrough for legitimate small businesses in search of a mechanism to raise capital from individual investors. The securities offered under SCOR may be sold through a broker-dealer that has a licensed sales force or they may be sold directly by the company. Of those SCOR offerings that have been registered throughout the United States, only 10-20% have been marketed by registered broker-dealers. The remaining issuers have attempted to sell the offering through their officers and directors or

employees hired to sell the securities. Most often this is the one and only time these individuals will be selling securities.

According to a survey done by the Small Business Sales Practices Committee in late 1993, the registration requirements for agents selling SCOR securities vary. Some states require agents to take various exams and to obtain surety bonds while other states do not. The guidelines represent an effort to make the registration process more uniform among the states in order to facilitate multi-state small business offerings. The guidelines pertaining to exam requirements are only meant to apply when an officer, director or partner is required to be registered as an agent or broker-dealer in order to sell the SCOR offering.

The text of the guidelines offers alternative approaches on two issues. The first is whether to apply the guidelines to corporate directors. The second is whether to limit the exclusion from the examination requirements to those sellers who receive no sales commissions. The bracketed language in the text sets forth these alternatives.

To summarize, three considerations underlie the guidelines. First it is difficult for SCOR issuers to find broker-dealers to sell their securities. Second, SCOR issuers are not in the business of selling securities. Third, adoption of the guidelines will promote legitimate capital formation.

III. Text of guidelines.

1.

A bona fide officer [or director] of an issuer selling securities registered under SCOR is exempt from the examination requirements for agent or broker-dealer registration as follows:

a.

A bona fide officer [or director] [who will be receiving no sales related compensation] is not required to take any examinations.

[b.A bona fide officer [or director] who will be receiving sales related compensation is required to pass only the Series 63 examination.]

Comment:

If a state decides to adopt just 1a., the introductory sentence and a. would need to be combined.

2.

(If applicable) A bona fide officer [or director] of an issuer selling securities registered under SCOR is exempt from the requirement that agents post surety bonds.

3.

Any officer [or director] who offers or sells securities registered under SCOR must provide a copy of the

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"Consumers Guide to Small Business Investments" to all offerees at or before the time the offering document is required to be delivered.

4.

The registration of any person relying on either or both of the exemptions set forth in section 1 may be suspended or revoked if that person fails to deliver a copy of the "Consumers Guide to Small Business Investments" to any person to whom he or she offers or sells securities pursuant to the SCOR offering for which he or she is being registered.

5.

To qualify for either or both of the exemptions set forth in section 1 and 2 above, a person must submit to the Administrator an affidavit representing that he or she:

a.

Is a bona fide officer [or director] of the SCOR issuer,

b.

Will provide all persons to whom he or she offers or sells securities with a copy of "Consumers Guide to Small Investments,"

c.

(If applicable) Will not be receiving sales related compensation for the sale of the SCOR securities,

d.

Understands that the agent registration will only authorize the offer and sale of securities on behalf of the issuer of the SCOR offering to be carried out pursuant to the registration statement that has been filed with the Administrator, and

e.

Understands that failure to provide all offerees with a copy of the "Consumers Guide to Small Business" is grounds for revocation or suspension of his or her registration.

6.

For purposes of this guideline the following definitions apply:

a.

"Bona fide officer" means the president, vice president in charge of a business unit or division, the secretary, the treasurer, the chief executive officer, the chief financial officer, the chief operating officer, or an officer who performs a principal policy making function for a principal business unit or division.

ADOPTED APRIL 28, 1996

I. Introduction

The following guidelines of the North American Securities Administrators Association, Inc. ("NASAA") provide for the uniform treatment of registrations of small company offerings which are exempt from federal registration under Rule 504 of Regulation D, Regulation A, or Rule 147 of the Securities Act of 1933, and are consistent with public investor protection and in the public interest. The Securities administrator ("administrator") may waive any standard set forth in this Policy Statement and may also impose substantive standards not contained in this Policy Statement.

II. Application

The requirements contained in this Policy Statement shall apply to registrations that utilize Registration Form U-7 and are exempt from federal registration under (1) Rule 504 of Regulation D, (2) Regulation A, or (3) Rule 147 of the Securities Act of 1933.

III. Requirements

Registrations covered in this Policy Statement shall meet the following requirements:

A.

The issuer shall:

1.

be a corporation or centrally managed limited liability company organized under the law of the United States or Canada, or any state, province, or territory or possession thereof, or the District of Columbia, and have its principal place of business in one of the foregoing;

2.

not be subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934;

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3.

not be an investment company registered or required to be registered under the Investment Company Act of 1940;

4.

not be engaged in or propose to be engaged in petroleum exploration and production, mining, or other extractive industries;

5.

not be a development stage company that either has no specific business plan or purpose or has indicated that its business plan is to engage in merger or acquisition with an unidentified company or companies or other entity or person; and

6.

not be disqualified under Section IV of this Policy Statement.

B.

The offering price for common stock or common ownership interests (hereinafter, collectively referred to as common stock), the exercise price for options, warrants, or rights to common stock, or the conversion price for securities convertible into common stock, must be greater or equal to US \$1.00 per share or unit of interest. The issuer must agree with the Administrator that it will not split its common stock, or declare a stock dividend for two years after the effective date of the registration if such action has the effect of lowering the price below US \$1.00.

C.

Commissions, fees, or other remuneration for soliciting any prospective purchaser in connection with the offering in the state are only paid to persons who, if required to be registered or licensed, the issuer believes, and has reason to believe, are appropriately registered or licensed in the state.

D.

Financial statements shall be prepared in accordance with either US or Canadian generally accepted accounting principles. If appropriate, a reconciliation note should be provided. If the Company has not conducted significant

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operations, statements of receipts and disbursements shall be included in lieu of statements of income. Interim financial statements may be unaudited. All other financial statements shall be audited by independent certified public accountants, provided, however, that if each of the following four conditions are met, such financial statements in lieu of being audited may be reviewed by independent certified public accountants in accordance with the Accounting and Review Service Standards promulgated by the American Institute of Certified Public Accountants or the Canadian equivalent;

1.

the Company shall not have previously sold securities through an offering involving the general solicitation of prospective investors by means of advertising, mass mailing, public meetings, "cold call" telephone solicitation, or any other method directed toward the public;

2.

the Company has not been previously required under federal, state, provincial or territorial securities laws to provide audited financial statements in connection with any sale of its securities;

3.

the aggregate amount of all previous sales of securities by the Company (exclusive of debt financing with banks and similar commercial lenders) shall not exceed US \$1,000,000; and

4.

the amount of the present offering does not exceed US \$1,000,000.

E.

The offering shall be made in compliance with Rule 504 of Regulation D, Regulation A, or Rule 147 of the Securities Act of 1933.

F.

The issuer shall comply with the General Instructions to SCOR in Part I of the NASAA SCOR Issuer's Manual.

IV. Disqualification's

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A.

Unless the Administrator determines that it is not necessary under the circumstances that the disqualification under this section be applied, application for registrations referred to in Section II shall be denied if the issuer, any of its officers, directors, ten percent or greater stockholders, promoters, or selling agents or, any officer, director or partner of any selling agent:

1.

has filed an application for registration which is subject to a currently effective stop order entered pursuant to any state or provincial securities laws within five years prior to the filing of the registration statement;

2.

has been convicted, within five years prior to the filing of the current application for registration, of any felony involving fraud or deceit, including, but not limited to, forgery, embezzlement, obtaining money under false pretenses, larceny, or conspiracy to defraud;

3.

is currently subject to any state or provincial administrative enforcement order or judgment entered by that state's or province's securities administrator within five years prior to the filing of the current application for registration;

4.

is subject to any state or provincial administrative enforcement order or judgment in which fraud or deceit, including, but not limited to, making untrue statements of material facts and omitting to state material facts, was found, and the order or judgment was entered within five years prior to the filing of the current application for registration;

5.

is subject to any state or provincial administrative enforcement order or judgment which prohibits, denies, or revokes the use of any exemption from registration in connection with the offer, purchase, or sale of securities;

6.

is currently subject to any order, judgment, or decree of any court of competent jurisdiction that temporarily, preliminarily, or permanently restrains or enjoins such party from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security, or involving the making of any false filing with the state, entered

7.

B.

C.

D.

If yes, what percent is com-

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mission of price to public?
%.

Is there other compensation to selling agent(s)? ☐ Yes ☐ No

Is there a finder's fee or similar payment to any person? ☐ Yes ☐ No

(See Question No. 22)

Is there an escrow of proceeds until minimum is obtained? ☐ Yes ☐ No

(See Question No. 26)

Is this offering limited to members of a special group, such as employees of the Company or individuals? ☐ Yes ☐ No

(See Question No. 25)

Is transfer of the securities restricted? ☐ Yes ☐ No

(See Question No. 25)

In making an investment decision investors must rely on their own examination of the person or entity creating the securities and the terms of the offering, including the merits and risks involved. These securities have not been recommended by any federal or state securities commission or regulatory authority. Furthermore, the foregoing authorities have not confirmed the accuracy or determined the adequacy of this document. Any representation to the contrary is a criminal offense.

This Company:

☐

Has never conducted operations.

☐

Is in the development stage.

☐

Is currently conducting operations.

☐

Has shown a profit in the last fiscal year.

☐

Other (Specify):

(Check at least one, as appropriate)

SEE QUESTION NO. 2 FOR THE RISK FACTORS THAT MANAGEMENT BELIEVES PRESENT THE MOST SUBSTANTIAL RISKS TO AN INVESTOR IN THIS OFFERING.

This offering has been registered for offer and sale in the following states:

State	State File No.	Effective Date

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SIGNATURES

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INVESTMENT IN SMALL BUSINESSES INVOLVES A HIGH DEGREE OF RISK, AND INVESTORS SHOULD NOT INVEST ANY FUNDS IN THIS OFFERING UNLESS THEY CAN AFFORD TO LOSE THEIR INVESTMENT IN ITS ENTIRETY.

THIS DISCLOSURE DOCUMENT CONTAINS ALL OF THE REPRESENTATIONS BY THE COMPANY CONCERNING THIS OFFERING, AND NO PERSON SHALL MAKE DIFFERENT OR BROADER STATEMENTS THAN THOSE CONTAINED HEREIN. INVESTORS ARE CAUTIONED NOT TO RELY UPON ANY INFORMATION NOT EXPRESSLY SET FORTH IN THIS DISCLOSURE DOCUMENT.

This Disclosure Document, together with Financial Statements and other Attachments, consists of _____ pages

THE COMPANY

1.

Exact corporation name:

State and date of incorporation:

Street address of principal office:

Company Telephone Number: ()

Fiscal year:

(month)

(day)

Person(s) to contact at Company with respect to offering:

Telephone Number (if different from above): ()

RISK FACTORS

2.

List in the order of importance the factors which the Company considers to be the most substantial risks to an investor in this offering in view of all facts and circumstances or which otherwise make the offering one of high risk or speculation (i.e., those factors which constitute the greatest threat that the investment will be lost in whole or in part, or not provide an adequate return).

(1)

(2)

(3)

(4)

(5)

(6)

(7)

(8)

Note:

In addition to the above risks, businesses are often subject to risks not foreseen or fully appreciated by management. In reviewing this Disclosure Document potential investors should keep in mind other possible risks that could be important.

BUSINESS AND PROPERTIES

3.

With respect to the business of the Company and its properties:

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(a)

Describe in detail what business the Company does and proposes to do, including what products or goods are or will be produced or services that are or will be rendered.

(b)

Describe how these products or services are to be produced or rendered and how and when the Company intends to carry out its activities. If the Company plans to offer a new product(s), state the present stage of development, including whether or not a working prototype(s) is in existence. Indicate if completion of development of the product would require a material amount of the resources of the Company, and the estimated amount. If the Company is or is expected to be dependent upon one or a limited number of suppliers for essential raw materials, energy or other items, describe. Describe any major existing supply contracts.

(c)

Describe the industry in which the Company is selling or expects to sell its products or services and, where applicable, any recognized trends within that industry. Describe that part of the industry and the geographic area in which the business competes or will compete. Indicate whether competition is or is expected to be by price, service, or other basis. Indicate (by attached table if appropriate) the current or anticipated prices or price ranges for the Company's products or services, or the formula for determining prices, and how these prices compare with those of competitors' products or services, including a description of any variations in product or service features. Name the principal competitors that the Company has or expects to have in its area of competition. Indicate the relative size and financial and market strengths of the Company's competitors in the area of competition in which the Company is or will be operating. State why the Company believes that it can effectively compete with these and other companies in its area of competition.

Note:

Because this Disclosure Document focuses primarily on details concerning the Company rather than the industry in which the Company operates or will operate, potential investors may wish to conduct their own separate investigation of the Company's industry to obtain broader insight in assessing the Company's prospects.

(d)

Describe specifically the marketing strategies the Company is employing or will employ in penetrating its market or in developing a new market. Set forth in response to Question No. 4 below the timing and size of the results of this effort which will be necessary in order for the Company to be profitable. Indicate how and by whom its products or services are or will be marketed (such as by advertising, personal contact by sales representatives, etc.), how its marketing structure operates or will operate and the basis of its marketing approach, including any market studies. Name any customers that account for, or based upon existing orders will account for, a major portion (20% or more) of the Company's sales. Describe any major existing sales contracts.

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(e)

State the backlog of written firm orders for products and/or services as of a recent date (within the last 90 days) and compare it with the backlog of a year ago from that date.

As of: // \$

(a recent date)

As of: // \$

(one year earlier)

Explain the reason for significant variations between the two figures, if any. Indicate what types and amounts of orders are included in the backlog figures. State the size of typical orders. If the Company's sales are seasonal or cyclical, explain.

(e)

State the number of the Company's present employees and the number of employees it anticipates it will have within the next 12 months. Also, indicate the number by type of employee (i.e., clerical, operations, administrative, etc.) the Company will use, whether or not any of them are subject to collective bargaining agreements, and the expiration date(s) of any collective bargaining agreement(s). If the Company's employees are on strike, or have been in the past three years, or are threatening to strike, describe the dispute. Indicate any supplemental benefits or incentive arrangements the Company has or will have with its employees.

(f)

Describe generally the principal properties (such as real estate, plant and equipment, patents, etc.) that the Company owns, indicating also what properties it leases and a summary of the terms under those leases, including the amount of payments, expiration dates and the terms of any renewal options. Indicate what properties the Company intends to acquire in the immediate future, the cost of such acquisitions and the sources of financing it expects to use in obtaining these properties, whether by purchase, lease or otherwise.

(g)

Indicate the extent to which the Company's operations depend or are expected to depend upon patents, copyrights, trade secrets, know-how or other proprietary information and the steps undertaken to secure and protect this intellectual property, including any use of confidentiality agreements, covenants-not-to-compete and the like. Summarize the principal terms and expiration dates of any significant license agreements. Indicate the amounts expended by the Company for research and development during the last fiscal year, the amount expected to be spent this year and what percentage of revenues research and development expenditures were for the last fiscal year.

(h)

If the Company's business products, or properties are subject to material regulation (including environmental

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regulation) by federal, state, or local governmental agencies, indicate the nature and extent of regulation and its effects or potential effects upon the Company.

(j)

State the names of any subsidiaries of the Company, their business purposes and ownership, and indicate which are included in the Financial Statements attached hereto.

(k)

Summarize the development of the Company (including any material mergers or acquisitions) during the past five years, or for whatever lesser period the Company has been in existence. Discuss any pending or anticipated mergers, acquisitions, spin-offs or recapitalizations. If the Company has recently undergone a stock split, stock dividend or recapitalization in anticipation of this offering, describe (and adjust historical per share figures elsewhere in this Disclosure Document accordingly).

4.

(a)

If the Company was not profitable during its last fiscal year, list below in chronological order the events which in management's opinion must or should occur or the milestones which in management's opinion the Company must or should achieve in order for the Company to become profitable, and indicate the expected manner of occurrence or the expected method by which the Company will achieve the milestones.

Event or milestone

Expected manner of occurrence or method of achievement	Date, or number of months after receipt of proceeds, when should be accomplished

(1)

(2)

(3)

(4)

(5)

(6)

(b)

State the probable consequences to the Company of delays in achieving each of the events or milestones within the above time schedule, and particularly the effect of any delays upon the Company's liquidity in view of the Company's then anticipated level of operating costs. (See Question Nos. 11 and 12)

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Note:

After reviewing the nature and timing of each event or milestone, potential investors should reflect upon whether achievement of each within the estimated time frame is realistic and should assess the consequences of delays or failure of achievement in making an investment decision.

OFFERING PRICE FACTORS

If the securities offered are common stock, or are exercisable for or convertible into common stock, the following factors may be relevant to the price at which the securities are being offered.

5.

What were net, after-tax earnings last year? (If losses, show in parenthesis.)

Total \$	Per share based upon number of shares outstanding after this offering if all securities sold: \$

6.

If the Company had profits, show offering price as a multiple of earnings. Adjust to reflect for any stock splits or recapitalization, and use conversion or exercise price in lieu of offering price, if applicable.

Offering Price Per Share	=
Net After-Tax Earnings	(price/earnings multiple)
Last Year Per Share	

7.

(a)

What is the net tangible book value of the Company? (If deficit, show in parenthesis.) For this purpose, net tangible book value means total assets (exclusive of copyrights, patents, goodwill, research and development costs and similar intangible items) minus total liabilities.

\$	Per share based upon number of shares outstanding immediately prior to this offering: \$

If the net tangible book value per share is substantially less than this offering (or exercise or conversion) price per share, explain the reasons for the variation.

(b)

State the dates on which the Company sold or otherwise issued securities during the last 12 months, the amount of such securities sold, the number of persons to whom they were sold, any relationship of such persons to the Company at the time of sale, the price at which they were sold and, if not sold for cash, a concise description of the consideration.

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(Exclude bank debt.)

8.

(a)

What percentage of the outstanding shares of the Company will the investors in this offering have? (Assume exercise of options, warrants or rights and conversion of convertible securities.)

If the maximum is sold: %

If the minimum is sold: %

(b)

What value is management attributing to the entire Company by establishing the price per security set forth on the cover page (or exercise or conversion price if common stock is not offered)? (Total outstanding shares after offering times offering price, or exercise or conversion price if common stock is not offered.)

If maximum is sold: \$

If minimum is sold: \$

(For above purposes, assume convertible securities are converted and outstanding options exercised in determining "shares")

Note:

After reviewing the above, potential investors should consider whether or not the offering price (or exercise or conversion price, if applicable) for the securities is appropriate at the present stage of the Company's development.

USE OF PROCEEDS

9.	If Minimum	%	If Maximum	%
Total Pro-	Sold	100%	Sold	100%
ceeds	Amount		Amount	
Less: Offering	\$		\$	
Expenses				
Commissions				
and				
Finders Fees				
Legal & Ac-	\$		\$	
counting				
Copying &				
Advertising				
Other				
(Specify):				
Net Proceeds	\$	%		

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**from
Offering
Use of Net
Proceeds**

Total Use of	\$	100%	\$	%
Net Proceeds			\$	100%

Note:

After reviewing the portion of the offering allocated to the payment of offering expenses, and to the immediate payment to management and promoters of any fees, reimbursements, past salaries or similar payments, a potential investor should consider whether the remaining portion of his investment, which would be that part available for future development of the Company's business and operations, would be adequate.

9.

(a)

If there are no minimum amount of proceeds that must be raised before the Company may use the proceeds of the offering, describe the order or priority in which the proceeds set forth above in the column "If Maximum Sold" will be used.

10.

(a)

If material amounts of funds from sources other than this offering are to be used in conjunction with the proceeds from this offering, state the amounts and sources of such other funds, and whether funds are firm or contingent. If contingent, explain.

(b)

If any material part of the proceeds is to be used to discharge indebtedness, describe the terms of such indebtedness, including interest rates. If the indebtedness to be discharged was incurred within the current or previous fiscal year, describe the use of the proceeds of such indebtedness.

(c)

If any material amount of the proceeds is to be used to acquire assets, other than in the ordinary course of business, briefly describe and state the cost of the assets and other material terms of the acquisitions. If the assets are to be acquired from officers, directors, employees or principal stockholders of the Company or their associates, give the

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names of the persons from whom the assets are to be acquired and set forth the cost to the Company, the method followed in determining the cost, and any profit to such persons.

(d)

If any amount of the proceeds is to be used to reimburse any officer, director, employee or stockholder for services already rendered, assets previously transferred, monies loaned or advanced, or otherwise, explain:

11.

Indicate whether the Company is having or anticipates having within the next 12 months any cash flow or liquidity problems and whether or not it is in default or in breach of any note, loan, lease or other indebtedness or financing arrangement requiring the Company to make payments. Indicate if a significant amount of the Company's trade payables have not been paid within the stated trade term. State whether the Company is subject to any unsatisfied judgments, liens or settlement obligations and the amounts thereof. Indicate the Company's plans to resolve any such problems.

12.

Indicate whether proceeds from this offering will satisfy the Company's cash requirements for the next 12 months, and whether it will be necessary to raise additional funds. State the source of additional funds, if known.

CAPITALIZATION

13.

Indicate the capitalization of the Company as of the most recent practicable date and as adjusted to reflect the sale of the minimum and maximum amount of securities in this offering and the use of the net proceeds therefrom:

Debt:	As of: // (date)	Amount Outstanding As Adjusted	
		Minimum	Maximum
Short-term debt (average interest rate %)	\$	\$	\$
Long-term debt (average interest rate %)	\$	\$	\$
Total Debt	\$	\$	\$
Stockholders equity (deficit):	\$	\$	\$
Preferred stock-par value x \$ no. of outstanding shares	\$	\$	\$

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(By class of preferred in
order of preferences)

Common stock-par value x no. of outstanding shares	\$	\$
Additional paid in capital	\$	\$
Retained earnings (deficit)	\$	\$
Total stockholders equity (deficit)	\$	\$
Total Capitalization	\$	\$

Number of preferred shares authorized to be outstanding:

Class of Preferred	Number of Shares Authorized	Par Value Per Share

Number of common shares authorized: shares. Par value per share, if any: \$

Number of common shares reserved to meet conversion requirements or for the issuance upon exercise of options, warrants or rights: _____shares.

DESCRIPTION OF SECURITIES

14.

The securities being offered hereby are:

☐

Common Stock

☐

Preferred or Preference Stock

☐

Notes or Debentures

☐

Units of two or more type of securities composed of:

☐

Other:

15.

These securities have:

Yes No

☐

☐ Cumulative voting rights

☐

☐ Other special voting rights

☐

☐ Preemptive rights to purchase in new issues of shares

☐

☐ Preference as to dividends or interest

☐

☐ Preference upon liquidation

☐

☐ Other special rights or preferences (specify):

Explain:

16.

Are the securities convertible? ☐ Yes ☐ No

If so, state conversion price or formula.

Date when conversion becomes effective: / /

Date when conversion expires: / /

17.

(a)

If securities are notes or other types of debt securities:

(1)

What is the interest rate? %

If interest rate is variable or multiple rates, describe:

(2)

What is the maturity date? / /

If serial maturity dates, describe:

(3)

Is there a mandatory sinking fund? ☐ No Describe:

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(4)

Is there a trust indenture? ☐ Yes ☐ No

Name, address and telephone number of Trustee

(5)

Are the securities callable or subject to redemption? ☐ Yes ☐ No Describe, including redemption prices:

(6)

Are the securities collateralized by real or personal property? ☐ Yes ☐ No Describe:

(7)

If these securities are subordinated in right of payment of interest or principal, explain the terms of such subordination.

How much currently outstanding indebtedness of the Company is senior to the securities in right of payment of interest or principal? \$. How much indebtedness shares in right of payment on an equivalent (pari passu) basis? \$.

How much indebtedness is junior (subordinated to the securities)? \$ _____.

(b)

If notes or other types of debt securities are being offered and the Company had earnings during its last fiscal year, show the ratio of earnings to fixed charges on an actual and pro forma basis for that fiscal year. "Earnings" means pre-tax income from continuing operations plus fixed charges and capitalized interest. "Fixed charges" means interest (including capitalized interest), amortization of debt discount, premium and expense, preferred stock dividend requirements of majority owned subsidiary, and such portion of rental expense as can be demonstrated to be representative of the interest factor in the particular case. The pro forma ratio of earnings to fixed charges should include incremental interest expense as a result of the offering of the notes or other debt securities.

	Actual	Last Fiscal Year Pro Forma Minimum	Maximum
"Earnings" =			
"Fixed Charges"			
If no earnings, show "Fixed Charges" only			

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Note:

Care should be exercised in interpreting the significance of the ratio of earnings to fixed charges as a measure of the "coverage" of debt service, as the existence of earnings does not necessarily mean that the Company's liquidity at any given time will permit payment of debt service requirements to be timely made. See Question Nos. 11 and 12. See also the Financial Statements and especially the Statement of Cash Flows.

18.

If securities are Preference or Preferred stock:

Are unpaid dividends cumulative? ☐ Yes ☐ No

Are securities callable? ☐ Yes ☐ No

Explain:

Note:

Attach to this Disclosure Document copies or a summary of the charter, by law or contractual provision or document that gives rise to the rights of holders of Preferred or Preference Stock, notes or other securities being offered.

19.

If securities are capital stock of any type, indicate restrictions on dividends under loan or other financing arrangements or otherwise:

20.

Current amount of assets available for payment of dividends (if deficit must be first made up, show deficit in parenthesis): \$ _____.

PLAN OF DISTRIBUTION

21.

The selling agents (that is, the persons selling the securities as agent for the Company for a commission or other compensation) in this offering are:

Name:

Address:

Telephone ()

Name:

Address:

Telephone ()

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22.

Describe any compensation to selling agents or finders, including cash, securities, contracts or other consideration, in addition to the cash commission set forth as a percent of the offering price on the cover page of this Disclosure Document. Also indicate whether the Company will indemnify the selling agents or finders against liabilities under the securities laws. ("Finders" are persons who for compensation act as intermediaries in obtaining selling agents or otherwise making introductions in furtherance of this offering.)

23.

Describe any material relationships between any of the selling agents or finders and the Company or its management.

Note:

After reviewing the amount of compensation to the selling agents or finders for selling the securities, and the nature of any relationship between the selling agents or finders and the Company, a potential investor should assess the extent to which it may be inappropriate to rely upon any recommendation by the selling agents or finders to buy the securities.

24.

If this offering is not being made through selling agents, the names of persons at the Company through which this offering is being made:

Name:

Name:

Address:

Address:

Telephone ()

Telephone ()

25.

If this offering is limited to a special group, such as employees of the Company, or is limited to a certain number of individuals (as required to qualify under Subchapter S of the Internal Revenue Code) or is subject to any other limitations, describe the limitations and any restrictions on resale that apply:

Will the certificates bear a legend notifying holders of such restrictions? ☐ Yes ☐ No

26.

(a)

Name, address and telephone number of independent bank or savings and loan association or other similar depository institution acting as escrow agent if the proceeds are escrowed until minimum proceeds are raised:

(b)

Date at which funds will be returned by escrow agent if minimum proceeds are not raised:

Will interest on proceeds during escrow period be paid to investors? ☐ Yes ☐ No

27.

Explain the nature of any resale restrictions on presently outstanding shares, and when those restrictions will terminate, if this can be determined:

Note:

Equity investors should be aware that unless the Company is able to complete a further public offering or the Company is able to be sold for cash or merged with a public company that their investment in the Company may be illiquid indefinitely.

DIVIDENDS, DISTRIBUTION AND REDEMPTIONS

28.

If the Company has within the last five years paid dividends, made distributions upon its stock or redeemed any securities, explain how much and when:

OFFICERS AND KEY PERSONNEL OF THE COMPANY

29.

Chief Executive Officer: Title:

Name: Age:

Office Street Address:

Telephone No.: ()

Names of employers, titles and dates of positions held during past five years with an indication of job responsibilities.

Education (degrees, schools, and dates):

Also a Director of the Company? ☐ Yes ☐ No

Indicate amount of time to be spent on Company matters if less than full time:

30.

Chief Operating Officer: Title:

Name: Age:

Office Street Address:

Telephone No.: ()

Names of employers, titles and dates of positions held during past five years with an indication of job responsibilities.

Education (degrees, schools, and dates):

Also a Director of the Company? ☐ Yes ☐ No

Indicate amount of time to be spent on Company matters if less than full time:

31.

Chief Financial Officer: Title:

Name: Age:

Office Street Address:

Telephone No.: ()

Names of employers, titles and dates of positions held during past five years with an indication of job responsibilities.

Education (degrees, schools, and dates):

Also a Director of the Company? ☐ Yes ☐ No

Indicate amount of time to be spent on Company matters if less than full time:

32.

Other Key Personnel:

(A)

Name: Age:

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Title:

Office Street Address:

Telephone No.: ()

Names of employers, titles and dates of positions held during past five years with an indication of job responsibilities.

Education (degrees, schools, and dates):

Also a Director of the Company? ☐ Yes ☐ No

Indicate amount of time to be spent on Company matters if less than full time:

(B)

Name: Age:

Title:

Office Street Address:

Telephone No.: ()

Names of employers, titles and dates of positions held during past five years with an indication of job responsibilities.

Education (degrees, schools, and dates):

Also a Director of the Company? ☐ Yes ☐ No

Indicate amount of time to be spent on Company matters if less than full time:

DIRECTORS OF THE COMPANY

33.

Number of Directors: If Directors are not elected annually, or are elected under a voting trust or other arrangement, explain:

34.

Information concerning outside or other Directors (i.e. those not described above):

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(A)

Name: Age:

Office Street Address:

Telephone No.: ()

Names of employers, titles and dates of positions held during past five years with an indication of job responsibilities.

Education (degrees, schools, and dates):

(B)

Name: Age:

Office Street Address:

Telephone No.: ()

Names of employers, titles and dates of positions held during past five years with an indication of job responsibilities.

Education (degrees, schools, and dates):

(C)

Name: Age:

Office Street Address:

Telephone No.: ()

Names of employers, titles and dates of positions held during past five years with an indication of job responsibilities.

Education (degrees, schools, and dates):

35.

(a)

Have any of the Officers or Directors ever worked for or managed a company (including a separate subsidiary or division of a larger enterprise) in the same business as the Company? ☐ Yes ☐ No

Explain:

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(b)

If any of the Officers, Directors or other key personnel have ever worked for or managed a company in the same business or industry as the Company or in a related business or industry, describe what precautions, if any, (including the obtaining of releases or consents from prior employers) have been taken to preclude claims by prior employer for conversion or theft of trade secrets, know-how or other proprietary information.

(c)

If the Company has never conducted operations or is otherwise in the development stage, indicate whether any of the Officers or Directors has ever managed any other company in the start-up or development stage and describe the circumstances, including relevant dates.

(d)

If any of the Company's key personnel are not employees but are consultants or other independent contractors, state the details of their engagement by the Company.

(e)

If the Company has key man life insurance policies on any of its Officers, Directors or key personnel, explain, including the names of the persons insured, the amount of insurance, whether the insurance proceeds are payable to the Company and whether there are arrangements that require the proceeds to be used to redeem securities or pay benefits to the estate of the insured person or to a surviving spouse.

36.

If a petition under the Bankruptcy Act or any State insolvency law was filed by or against the Company or its Officers, Directors or other key personnel, or a receiver, fiscal agent or similar officer was appointed by a court for the business or property of any such persons, or any partnership in which any of such persons was general partner at or within the past five years, or any corporation or business association of which any such person was an executive officer at or within the past five years, set forth below the name of such persons, and the nature and date of such actions.

Note:

After reviewing the information concerning the background of the Company's Officers, Directors and other key personnel, potential investors should consider whether or not these persons have adequate background and experience to develop and operate this Company and to make it successful. In this regard, the experience and ability of management are often considered the most significant factors in the success of a business.

PRINCIPAL STOCKHOLDERS

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37.

Principal owners of the Company (those who beneficially own directly or indirectly 10% or more of the common and preferred stock presently outstanding) starting with the largest common stockholder. Include separately all common stock issuable upon conversion of convertible securities (identifying them by asterisk) and show average price per share as if conversion has occurred. Indicate by footnote if the price paid was for a consideration other than cash and the nature of any such consideration.

Name:

Office Street Address:

Telephone No. ()

Principal occupation:

Class of Shares	Average Price Per Share	No. of Shares Now Held	% of Total	No. of shares Held After Of- fering, if All Securities Sold	% of Total

Name:

Office Street Address:

Telephone No. ()

Principal occupation:

Class of Shares	Average Price Per Share	No. of Shares Now Held	% of Total	No. of shares Held After Of- fering, if All Securities Sold	% of Total

Name:

Office Street Address:

Telephone No. ()

Principal occupation:

Class of Shares	Average Price Per Share	No. of Shares Now Held	% of Total	No. of shares Held After Of- fering, if All Securities Sold	% of Total

38.

Number of shares beneficially owned by Officers and Directors as a group:

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Before offering: shares

(% of total outstanding)

After offering: a) Assuming minimum securities sold: shares (% of total outstanding) b) Assuming maximum securities sold: shares (% of total outstanding)

(Assume all options exercised and all convertible securities converted.)

MANAGEMENT RELATIONSHIPS, TRANSACTIONS AND REMUNERATION

39.

(a)

If any of the Officers, Directors, key personnel or principal stockholders are related by blood or marriage, please describe.

(b)

If the Company has made loans to or is doing business with any of its Officers, Directors, key personnel or 10% stockholders, or any of their relatives (or any entity controlled directly or indirectly by any of such persons) within the last two years, or proposes to do so within the future, explain. (This includes sales or lease of goods, property or services to or from the Company, employment or stock purchase contracts, etc.) State the principal terms of any significant loans, agreements, leases, financing or other arrangements.

(c)

If any of the Company's Officers, Directors, key personnel or 10% stockholders has guaranteed or co-signed any of the Company's bank debt or other obligations, including any indebtedness to be retired from the proceeds of this offering, explain and state the amounts involved.

40.

(a)

List all remuneration by the Company to Officers, Directors and key personnel for the last fiscal year:

	Cash	Other
Chief Executive Officer	\$	\$
Chief Operating Officer		
Chief Accounting Officer		
Key Personnel:		

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Others:

Total:	\$	\$
Directors as a group (number of persons)	\$	\$

(b)

If remuneration is expected to change or has been unpaid in prior years, explain:

(c)

If any employment agreements exist or are contemplated, describe:

41.

(a)

Number of shares subject to issuance under presently outstanding stock purchase agreements, stock options, warrants or rights: shares (% of total shares to be outstanding after the completion of the offering if all securities sold, assuming exercise of options and conversion of convertible securities). Indicate which have been approved by shareholders. State the expiration dates, exercise prices and other basic terms for these securities:

(b)

Number of common shares subject to issuance under existing stock purchase or option plans but not yet covered by outstanding purchase agreements, options or warrants: _____ shares.

(b)

Describe the extent to which future stock purchase agreements, stock options, warrants or rights must be approved by shareholders.

42.

If the business is highly dependent on the services of certain key personnel, describe any arrangements to assure that these persons will remain with the Company and not compete upon any termination:

Note:

After reviewing the above, potential investors should consider whether or not the compensation to

management and other key personnel directly or indirectly, is reasonable in view of the present stage of the Company's development.

LITIGATION

43.

Describe any past, pending or threatened litigation or administrative action which has had or may have a material effect upon the Company's business, financial condition, or operations, including any litigation or action involving the Company's Officers, Directors or other key personnel. State the names of the principal parties, the nature and current status of the matters, and amounts involved. Give an evaluation by management or counsel, to the extent feasible, of the merits of the proceedings or litigation and the potential impact on the Company's business, financial condition, or operations.

FEDERAL TAX ASPECTS

44.

If the Company is an S corporation under the Internal Revenue Code of 1986, and it is anticipated that any significant tax benefits will be available to investors in this offering, indicate the nature and amount of such anticipated tax benefits and the material risks of their disallowance. Also, state the name, address and telephone number of any tax advisor that has passed upon these tax benefits. Attach any opinion or any description of the tax consequences of an investment in the securities by the tax advisor.

Name of Tax Advisor:

Address:

Telephone No. ()

Note:

Potential investors are encouraged to have their own personal tax consultant contact the tax advisor to review details of the tax benefits and the extent that the benefits would be available and advantageous to the particular investor.

MISCELLANEOUS FACTORS

44.

Describe any other material factors, either adverse or favorable, that will or could affect the Company or its business (for example, discuss any defaults under major contracts, any breach of bylaw provisions, etc.) or which are necessary to make any other information in this Disclosure Document not misleading or incomplete.

FINANCIAL STATEMENTS

46.

Attach reviewed or audited financial statements for the last fiscal year and unaudited financial statements for any interim periods thereafter. If since the beginning of the last fiscal year the Company has acquired another business the assets or net income of which were in excess of 20% of those for the Company, show pro forma combined financial statements as if the acquisition had occurred at the beginning of the Company's last fiscal year.

The Company does hereby agree to provide to investors in this offering for five years (or such longer period as required by law) hereafter annual financial reports containing a balance sheet as of the end of the Company's fiscal year and a statement of income for said fiscal year, all prepared in accordance with generally accepted accounting principles and accompanied by an independent accountant's report. If the Company has more than 100 security holders at the end of the fiscal year, the financial statements shall be audited.

MANAGEMENT'S DISCUSSION AND ANALYSIS'S

47.

If the Company's financial statements show losses from operations, explain the causes underlying these losses and what steps the Company has taken or is taking to address these causes.

48.

Describe any trends in the Company's historical operating results. Indicate any changes now occurring in the underlying economics of the industry or the Company's business which, in the opinion of Management, will have a significant impact (either favorable or adverse) upon the Company's results of operations within the next 12 months, and give a rough estimate of the probable extent of the impact, if possible.

49.

If the Company sells a product or products and has had significant sales during its last fiscal year, state the existing gross margin (net sales less cost of such sales as presented in accordance with generally accepted accounting principles) as a percentage of sales for the last fiscal year: %. What is the anticipated gross margin for next year of operations? Approximately %. If this is expected to change, explain. Also, if reasonably current gross margin figures are available for the industry, indicate these figures and the source or sources from which they are obtained.

50.

Foreign sales as a percent of total sales for last fiscal year: %. Domestic government sales as a percent of total domestic sales for last fiscal year: %. Explain the nature of these sales, including any anticipated changes:

SIGNATURES

A majority of the Directors and the Chief Executive and Financial Officers of the Company shall sign this

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Disclosure Document on behalf of the Company and by so doing thereby certify that each has made diligent efforts to verify the material accuracy and completeness of the information herein contained. By signing this Disclosure Document, the Chief Executive and Chief Financial Officers agree to make themselves, the Company's books and records, copies of any contract, lease or other document referred to in the Disclosure Document, or any other material contract or lease (including stock operations and employee benefit plans), except any proprietary or confidential portions hereof, and a set of the exhibits to this Disclosure Document, available to each investor prior to the time of investment, and to respond to questions and otherwise confirm the information contained herein prior to the making of any investment by such investor.

The Chief Financial Officer signing this form is hereby certifying that the financial statements submitted fairly state the Company's financial position and results of operations, or receipts and disbursements, as of the dates and period(s) indicated, all in accordance with generally accepted accounting principles consistently applied (except as stated in the notes thereto) and (with respect to year-end figures) including all adjustments necessary for fair presentation under the circumstances.

Chief Executive Officer:

Directors:

Title:

Chief Financial Officer:

Title:

I. INTRODUCTION

The North American Securities Administrators Association, Inc. ("NASAA") has determined that the following Guidelines Regarding VIATICAL INVESTMENTS ("Guidelines") are consistent with public investor protection and are in the public interest. Nothing shall prevent the ADMINISTRATOR from applying different standards from those contained in these Guidelines.

There have been questions from investors and the industry regarding VIATICAL INVESTMENTS and their treatment under the Blue Sky Securities Acts. Typically, a VIATICAL INVESTMENT involves the purchase by a VIATICAL INVESTOR of an interest in an insurance policy covering the life of an individual. The purchase may be for a whole or fractional interest in the policy. Some interests may be in a pool of policies insuring the lives of several people. The INSURED receives an amount of money less than the expected death benefit of the policy, while the VIATICAL INVESTOR in turn receives the right to some portion of the face amount of the policy upon the death of the INSURED.

It is the position of NASAA that VIATICAL INVESTMENTS, commonly known as investments in viatical, senior, or life settlement contracts, are securities and must be registered with a state securities division as required by state law. Further, those persons and/or entities selling them must be registered as required by state law.

VIATICAL INVESTMENTS, in general, may not be suitable for many investors. There are risks associated with VIATICAL INVESTMENTS that individual investors may not recognize, and which unscrupulous promoters may misrepresent or fail to disclose. Funds invested in VIATICAL INVESTMENTS are not accessible on the demand of the investor. These factors and others render this type of investment unsuitable for the financial needs and interests of the average individual investor.

The question of whether VIATICAL INVESTMENTS are properly characterized as securities is answered by reference to long-standing principles governing the interpretation of state securities laws by both the state securities administrators and the courts. Conventional analysis as set forth in *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946)

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and its progeny results in the conclusion that VIATICAL INVESTMENTS are securities.

NASAA is mindful of the decision of the D.C. Circuit in *SEC v. Life Partners, Inc.*, 87 F.3d 536, 543 (D.C. Cir. 1996), *pet. for reh. denied*, 102 F.3d 587 (D.C. Cir. 1996). NASAA does not agree with either the rationale or the outcome of this case. State securities regulators are not bound by the interpretation of federal statutes by federal courts, particularly where the rationale does not serve the prophylactic and remedial purposes of the state securities laws. *Life Partners* disregards the premise underlying the *Howey* test--that is, that the statutory definition of "security" "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Howey*, 328 U.S. at 299.

NASAA concludes that VIATICAL INVESTMENTS, regardless of the health status or age of the insured, are securities. All persons involved in the offer and/or sale of VIATICAL INVESTMENTS should be aware of the nature and extent of the registration and antifraud provisions of state securities laws, as well as the applicability of these provisions to every offer and/or sale of a security.

A. Application

The standards contained in these Guidelines apply to the offer and sale of VIATICAL INVESTMENTS. These Guidelines do not apply to investments in a pool of life insurance policies, as those offerings are covered by existing registration guidelines. Applications not conforming to the standards contained herein shall be looked upon with disfavor. However, the ADMINISTRATOR may allow waivers or exceptions from certain standards under these Guidelines, if good cause is shown, or may require different standards based on provisions of statutes or regulations of a state.

B. Definitions

1.

ADMINISTRATOR means the official or agency responsible for administering and enforcing the securities laws and regulations of a state.

2.

AFFILIATE means a PERSON who, directly or indirectly, CONTROLS, is CONTROLLED by, or is under common CONTROL with the PERSON specified herein.

3.

AUDITED FINANCIAL STATEMENTS means financial statements that have been audited and reported upon by independent Certified Public Accountants in accordance with generally accepted auditing standards of the American Institute of Certified Public Accountants.

4.

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BROKER-DEALER means any PERSON meeting the definition of this term under the securities laws of the states where VIATICAL INVESTMENTS are offered for sale.

5.

CONTROL means the power to direct or influence the direction of the management or policies of a PERSON, directly or indirectly, through the ownership of voting securities, by contract or otherwise.

DEFAULT means any failure by the ESCROW AGENT to fulfill any one or more of its obligations or commitments under the escrow agreement, which continues for sixty (60) days without being cured or waived.

7.

ESCROW AGENT means a state or federally regulated financial institution organized under the laws of the United States or any state, whose responsibilities include those set forth in IV. A. 1. of these Guidelines. It may not be affiliated with the VIATICAL ISSUER, its PROMOTERS, or AFFILIATES. A financial institution may not be disallowed to act as an ESCROW AGENT merely because the VIATICAL ISSUER, its PROMOTERS, or AFFILIATES are customers thereof. An ESCROW AGENT may also include an attorney or certified public accountant who: (1) is not affiliated with the VIATICAL ISSUER, its PROMOTERS, or AFFILIATES; (2) is licensed to do business in the state in which s/he practices; and (3) can demonstrate that s/he is adequately insured or can provide a fidelity bond.

8.

GAAP means Generally Accepted Accounting Principles as established by the Financial Accounting Standards Boards (FASB), Accounting Principles Board (APB), Accounting Research Bulletins (ARB) and American Institute of Certified Public Accountants (AICPA).

9.

INSURED means the person covered under the policy which is the subject of a VIATICAL INVESTMENT.

10.

OFFERING CIRCULAR means the disclosure document that provides material information about the offering of VIATICAL INVESTMENTS. The disclosure document may also be identified as a "prospectus."

11.

PERSON means an individual, a corporation, a limited liability company, a partnership, an association,

organization, a government or a political subdivision of a government, or other legal entity.

12.

PROMOTER means:

a.

A PERSON who, alone or in conjunction with one or more PERSONs, directly or indirectly, took the initiative in founding or organizing the VIATICAL ISSUER or CONTROLS the VIATICAL ISSUER;

b.

A PERSON who, directly or indirectly, receives, as consideration for services and/or property rendered, five percent (5%) or more of any class of the VIATICAL ISSUER's equity securities or five percent (5%) or more of the proceeds from the sale of any class of the VIATICAL ISSUER's equity securities;

c.

A PERSON who:

(i)

Is an officer or director for the VIATICAL ISSUER; or

(ii)

Anyone who legally or beneficially owns, directly or indirectly, five percent (5%) or more of any class of the VIATICAL ISSUER's equity securities; or

(iii)

A PERSON who is an AFFILIATE of a PERSON specified in a, b, c(i) or c(ii).

d.

A PROMOTER does not include:

(i)

A PERSON who receives securities or proceeds solely as underwriting compensation if that PERSON falls outside the definition of a, b, or c

(ii)

An unaffiliated institutional investor, who purchased the VIATICAL ISSUER's equity securities more than one year prior to the filing date of the VIATICAL ISSUER's registration statement. An unaffiliated institutional investor who purchased the VIATICAL ISSUER's equity securities on an arm's-length basis within one year prior to the filing date of the VIATICAL ISSUER's registration statement may, at the ADMINISTRATOR's discretion, be excluded from the definition of PROMOTER.

13.

UNDERWRITER-Any PERSON that enters into a contractual agreement with the VIATICAL ISSUER to offer and sell VIATICAL INVESTMENTS on behalf of the VIATICAL ISSUER to VIATICAL INVESTORS. The underwriting agreement between the UNDERWRITER and the VIATICAL ISSUER may specify either a "firm" underwriting in which the UNDERWRITER agrees to purchase all of the VIATICAL INVESTMENTS in an offering for resale to INVESTORS, or a "best efforts" underwriting without an obligation to purchase and resell all of the VIATICAL INVESTMENTS.

14.

VIATICAL INVESTMENT means the contractual right to receive any portion of the death benefit or ownership of a life insurance policy or certificate, for consideration that is less than the expected death benefit of the life insurance policy or certificate. VIATICAL INVESTMENT does not include:

a.

any transaction between a VIATOR and a viatical settlement provider as defined by [reference to state statute or most recent version of the National Association of Insurance Commissioners ("NAIC") Model Viatical Settlement Act];

b.

any transfer of ownership and/or beneficial interest in a life insurance policy from a viatical settlement provider to another viatical settlement provider as defined by [reference to state statute or most recent version of the NAIC Model Viatical Settlement Act] or to any legal entity formed solely for the purpose of holding ownership and/or beneficial interest in a life insurance policy or policies;

c.

the *bona fide* assignment of a life insurance policy to a bank, savings bank, savings and loan association, credit union, or other licensed lending institution as collateral for a loan; or

d.

the exercise of accelerated benefits pursuant to the terms of a life insurance policy issued in accordance with the insurance laws of this state.

[Drafting Note-The definition of VIATICAL INVESTMENT is intended to include transactions in life insurance policies regardless of the age or health of the INSURED. Some states may have adopted insurance laws that modify the NAIC Model Viatical Settlement Act to limit the scope of coverage to insureds who are terminally or chronically ill. States are encouraged to review their respective insurance laws for consistency.]

15.

VIATICAL INVESTOR means any PERSON who purchases or subscribes to purchase a VIATICAL INVESTMENT.

16.

VIATICAL ISSUER means, in the case of a fractional interest in VIATICAL INVESTMENTS, any PERSON who creates, for the purpose of sale, the fractional interest, and in the case of a VIATICAL INVESTMENT that is not fractionalized, any PERSON engaged in the business of effecting transactions in VIATICAL INVESTMENTS to which the VIATOR is not a party. VIATICAL ISSUER does not include a [broker dealer], an [agent], or any PERSON who sells a VIATICAL INVESTMENT to no more than one natural person in a calendar year. A VIATICAL ISSUER pursuant to this section is an issuer within the definition of [reference to statutory definition of issuer].

17.

VIATOR means the owner of a life insurance policy or a certificate holder under a group policy who enters or seeks to enter into a viatical settlement contract, as defined by [reference to state statute or most recent version of the NAIC Model Viatical Settlement Act].

II. REQUIREMENTS OF THE VIATICAL ISSUER

A. Experience

The VIATICAL ISSUER shall be able to demonstrate the knowledge and expertise necessary to conduct the business of the VIATICAL ISSUER.

B. Financial Condition

The VIATICAL ISSUER shall generally be required to demonstrate that it is solvent and will, with reasonable certainty, be able to meet any financial obligations of the VIATICAL ISSUER.

C. Financial Statements of the VIATICAL ISSUER

1.

Financial statements of the VIATICAL ISSUER are required for its three most recent fiscal years preceding the proposed offering of VIATICAL INVESTMENTS and interim financial statements, if applicable, since the end of its last fiscal year. Interim financial statements shall be for a period that ended within 120 days of the date of filing of the application for registration of viatical investments. Interim financial statements may be unaudited. No interim financial statements shall be required if the filing occurs within 120 days after the end of the VIATICAL ISSUER's last fiscal year. The financial statements for the most recent fiscal year of the issuer shall be audited. The financial statements for the two years before the most recent fiscal year of the VIATICAL ISSUER may be reviewed, but the reviewed financial statements should be presented in conformity with GAAP in the same format as the AUDITED FINANCIAL STATEMENTS for the VIATICAL ISSUER's last fiscal year. The financial statements shall include all financial statements and notes required by GAAP as follows:

a.

Balance Sheet (Statement of Financial Condition);

b.

Statement of Income or Operations;

c.

Statement of Equity

d.

Statement of Cash Flows; and

e.

Notes to financial statements to explain accounting policies and provide other disclosures required by GAAP.

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2.

An application for registration by a VIATICAL ISSUER in unsound financial condition may be denied by the Administrator.

3.

A VIATICAL ISSUER shall be deemed to be in unsound financial condition if the financial statements provided in accordance with C.1 above:

a.

Contain a footnote or an explanatory paragraph in the independent auditor's report regarding the issuer's ability to continue as a going concern; or

b.

Otherwise demonstrate that the VIATICAL ISSUER is in unsound financial condition. The ADMINISTRATOR may consider any information material to determining the financial soundness of the VIATICAL ISSUER, including but not limited to any of the following:

1.

An accumulated deficit;

2.

Negative equity;

3.

An inability to satisfy current obligations as they come due; or

4.

Negative cash flow from operations.

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4.

An application for registration by a VIATICAL ISSUER in unsound financial condition may be registered by the ADMINISTRATOR if the chief financial officer of the VIATICAL ISSUER provides pro forma financial data acceptable to the ADMINISTRATOR that:

a.

Demonstrate that the VIATICAL ISSUER's financial condition will improve as a direct result of the offering, or as a proximate result of the offering (as part of a long term business plan);

b.

Demonstrate when profitability is expected to occur; and

c.

Are supported with documentation of and the bases for any assumptions.

5.

In addition to satisfying the requirements of II. C. 4 above, the VIATICAL ISSUER must:

a.

Include in the OFFERING CIRCULAR prominent disclosure that the VIATICAL ISSUER is considered to be in unsound financial condition; and

b.

Include in the OFFERING CIRCULAR the following risk factors as applicable:

1.

The presence of an explanatory paragraph in the independent auditor's report;

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2.

If the VIATICAL ISSUER has not been generating revenues from operations, the means by which the VIATICAL ISSUER has been financing its operations;

3.

The amount of any accumulated deficit;

4.

The presence and amount of any negative equity;

5.

The need for any future financing;

6.

Those services provided by the VIATICAL ISSUER in servicing or monitoring the VIATICAL INVESTMENT that would need to be replaced in the event of a cessation of operations on the part of the VIATICAL ISSUER.

6.

Subject to the requirements of individual states, the VIATICAL ISSUER shall provide upon request its annual AUDITED FINANCIAL STATEMENTS to any VIATICAL INVESTOR whose investment has not matured or to the Administrator while any VIATICAL INVESTMENT sold pursuant to a registration authorized by that ADMINISTRATOR has not matured.

7.

The ADMINISTRATOR may waive any requirement of II. C. 1 through 6 above, upon a showing by the VIATICAL ISSUER that any post investment escrow, tracking, medical evaluation or other investment-related services are to be performed by a PERSON other than the VIATICAL ISSUER.

8.

In the event of a waiver by the ADMINISTRATOR, pursuant to II. C. 7 above, the ADMINISTRATOR may require the VIATICAL ISSUER to supply AUDITED FINANCIAL STATEMENTS, in compliance with II.C.1 through

6 above, for any PERSON performing post investment escrow, tracking, medical evaluation or other investment-related services.

D. Premium Payments

The VIATICAL ISSUER shall demonstrate that there is a reasonable plan for the payment of premiums on life insurance policies underlying the VIATICAL INVESTMENTS, which shall include the notification to VIATICAL INVESTORS of any anticipated inability to pay premiums at least 90 days before premium payments are due.

III. SUITABILITY OF VIATICAL INVESTORS

Sales of VIATICAL INVESTMENTS shall be made only to suitable investors or other PERSONS the VIATICAL ISSUER reasonably believes, after reasonable inquiry, to be suitable investors. A corporation, partnership, or other organization specifically formed for the purpose of acquiring the securities offered by the VIATICAL ISSUER may be a suitable investor only if each of the equity owners of the corporation, partnership, or other organization is a suitable investor. Suitable investors may include the following:

A.

Any PERSON that meets the definition of accredited investor in Regulation D, Rule 501(a) of the Securities Act of 1933 or Qualified Institutional Buyer in Rule 144A of the Securities Act of 1933;

B.

A natural person who, either individually or jointly with the person's spouse, (i) has a minimum net worth of [one hundred fifty thousand dollars (\$150,000)] and had, during the immediately preceding tax year, gross income in excess of [one hundred thousand dollars (\$100,000)] and reasonably expects gross income in excess of [one hundred thousand dollars (\$100,000)] during the current tax year or (ii) has a minimum net worth of [two hundred fifty thousand dollars (\$250,000)]. "Net worth" shall be determined exclusive of home, home furnishings, and automobiles. Other assets included in the computation of net worth shall be valued at fair market value. The aggregate amount of VIATICAL INVESTMENTS of each natural person shall not exceed [10 percent] of their net worth, as defined by this subsection.

IV. ESCROW REQUIREMENTS

A.

General Requirements

1.

There shall at all times be one or more ESCROW AGENTS who are responsible for accepting investor funds, transferring funds in order to purchase policies, paying insurance premiums, and receiving death benefits for all policies where VIATICAL INVESTORS are not the beneficiaries.

2.

The ESCROW AGENT may not receive more than 20% of its total revenue from all sources including its fees for escrow services, from the VIATICAL ISSUER.

3.

The ESCROW AGENT may not lend more than 5% of the value of the premium escrow account to the VIATICAL ISSUER.

B.

The Escrow Agreements

1.

The escrow agreements must be filed with the ADMINISTRATOR and shall become part of the registration statement.

2.

The VIATICAL ISSUER shall demonstrate that the plan for payment of insurance premiums is reasonable to cover future premium obligations.

3.

The escrow agreement governing the receipt of VIATICAL INVESTOR funds shall provide for the transfer of funds into a policy within 90 days of the receipt of those funds. The escrow agreement governing the receipt of death benefits from a life insurance company upon the death of the INSURED shall provide for the distribution to VIATICAL INVESTORS of the death benefits within 30 days of the receipt of those proceeds.

4.

The escrow agreement shall provide that any escrow accounts established by or on behalf of ESCROW AGENTS are not subject to the claims of creditors, excluding VIATICAL INVESTORS, of the VIATICAL ISSUER, its AFFILIATES and PROMOTERS.

5.

The escrow agreement shall provide that if the ESCROW AGENT voluntarily withdraws as ESCROW AGENT, the VIATICAL ISSUER shall designate a successor ESCROW AGENT. The withdrawing ESCROW AGENT may petition a court to appoint a successor ESCROW AGENT. The withdrawing or resigning ESCROW AGENT must continue to perform under the escrow agreement until the successor ESCROW AGENT is designated by the VIATICAL ISSUER or the court.

6.

If the escrow agreement allows the ESCROW AGENT to be terminated by the VIATICAL ISSUER or the VIATICAL INVESTORS, there must be a reasonable procedure set forth in the escrow agreement for replacing the ESCROW AGENT.

7.

The escrow agreement shall provide that the ESCROW AGENT shall provide a report to the VIATICAL INVESTORS if there has been any known DEFAULT under the escrow agreement, within 30 days of such DEFAULT. The report shall disclose the steps the ESCROW AGENT is taking to remedy the DEFAULT.

V. COMPENSATION

A.

The VIATICAL ISSUER shall demonstrate that compensation, fees and expenses paid to all parties are fair, competitive and commercially reasonable.

B.

The registration statement must fully disclose and itemize all compensation, fees and expenses which have been paid in the 12 months of operation preceding the application in connection with the sale of VIATICAL INVESTMENTS, including but not limited to those paid to the VIATICAL ISSUER, the selling agents, the viatical broker, the VIATOR, the ESCROW AGENT, and the medical consultant or reviewer.

C.

The registration statement must fully disclose changes in the VIATICAL ISSUER's business model that may have a material effect on the compensation, fees and expenses disclosed in Section V. B. The registration statement must further disclose those changes in the marketplace the VIATICAL ISSUER reasonable foresees that may have a material effect on compensation, fees and expenses disclosed in Section V. B.

VI. RETENTION OF RECORDS

Subject to the requirements of individual states, the VIATICAL ISSUER, shall, for a minimum of three (3) years from the date of purchase of the VIATICAL INVESTMENTS or one (1) year from the date of maturity of the VIATICAL INVESTMENTS, whichever period is longer, retain copies of all:

1.
prospectuses, pamphlets, circulars, advertisements or other sales literature provided to VIATICAL INVESTORS;
2.
disclosure documents provided to VIATICAL INVESTORS;
3.
purchase agreements;
4.
escrow agreements;
5.
servicing agreements entered into between VIATICAL INVESTORS and IRA administrators;
6.
checks, drafts or other forms of payment received from VIATICAL INVESTORS;
7.
records relating to the payment of premiums on insurance policies underlying the VIATICAL INVESTMENTS;
8.
documents relating to the determination of life expectancy of the INSURED;

9.

documents relating to the monitoring of the INSURED's whereabouts;

10.

documents relating to the monitoring of the INSURED's ongoing medical condition;

11.

written communications with VIATICAL INVESTORS;

12.

written communications with the insurance company that issued the insurance policy underlying the VIATICAL INVESTMENTS;

13.

sales agreements or contracts with sales agents and BROKER-DEALERS;

14.

documents required to be maintained by the VIATICAL ISSUER licensed under the [NAIC Model Viatical Settlement Act or similar viatical regulatory act of the particular state]; and

15.

documents obtained by the VIATICAL ISSUER in performing due diligence on the life insurance policies subject to the VIATICAL INVESTMENTS.

The VIATICAL ISSUER shall provide the above documents upon request of the ADMINISTRATOR and will be subject to examination in accordance with the provisions of [statutory reference].

VII. ANNUAL REPORTS TO VIATICAL INVESTORS

The VIATICAL ISSUER shall provide the following disclosure, if known or reasonably could be known to the VIATICAL ISSUER and subject to federal and state privacy laws, to each VIATICAL INVESTOR at least annually:

1.

The INSURED's current medical condition.

2.

Any change of status of the underlying policy.

3.

The status of premium payments on the policy, the amount currently specifically escrowed to continue to pay such premiums on the underlying policy, and the time period for which remaining escrowed funds will keep the underlying policy in force.

4.

The date of maturity or other disposition of the underlying policy.

VIII. OFFERING CIRCULAR

VIATICAL INVESTORS shall receive all material information necessary to make informed investment decisions, and the VIATICAL ISSUER must provide VIATICAL INVESTORS with a complete OFFERING CIRCULAR at least 48 hours prior to their purchase of VIATICAL INVESTMENTS.

The OFFERING CIRCULAR must be written in clearly understandable language and disclose all relevant and material information that affects or would affect a VIATICAL INVESTOR's decision to purchase the VIATICAL INVESTMENT. The information outlined below is not intended to be all-inclusive and the VIATICAL ISSUER must include other information not specifically listed that would be material to a VIATICAL INVESTOR's understanding of the VIATICAL ISSUER and the VIATICAL INVESTMENT.

The following information must be included in the OFFERING CIRCULAR unless the VIATICAL ISSUER can demonstrate to the ADMINISTRATOR that a particular type of information is not applicable or material to an understanding of the VIATICAL ISSUER or the VIATICAL INVESTMENT.

A. COVER PAGE

1.

Name of the VIATICAL ISSUER.

2.

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Principal address and telephone number of the VIATICAL ISSUER

3.

The estimated gross proceeds to be received from the sale of VIATICAL INVESTMENTS.

4.

A statement that the offering is subject to certain risks and the page number(s) in the OFFERING CIRCULAR where the risk factors are disclosed.

5.

Name, address and telephone number of each ESCROW AGENT.

6.

Name, address and telephone number of the principal UNDERWRITER or BROKER-DEALER assisting with the offering of the VIATICAL INVESTMENTS.

7.

The proposed termination date of the offering and the VIATICAL ISSUER's right to extend the offering, if any.

8.

Date of the OFFERING CIRCULAR.

9.

Any legends that are required by applicable state laws, rules or regulations. The following is a model legend: In making an investment decision, you must rely on your own examination of the terms of the offering, including the merits and risks involved. These VIATICAL INVESTMENTS have not been recommended by any federal or state securities commission or regulatory authority. Furthermore, the foregoing authorities have not confirmed the accuracy or determined the adequacy of this document. Any representation to the contrary is a criminal offense. No person has been authorized to give any information or to make any representations in connection with this offering other than those contained in this OFFERING CIRCULAR, and if given or made, such information or representations must not be relied upon as having been made by the VIATICAL ISSUER. For filings with some ADMINISTRATORS, it may be necessary to add a legend to describe statutory rescission rights that are available to VIATICAL INVESTORS.

10.

Disclose any limitations or conditions of sales to VIATICAL INVESTORS in this State, including but not limited to the suitability requirements set forth in Section III. A table of contents should follow the cover page or it may be placed on the back of the last page to outline and provide page number references for the various sections and subtitles in the OFFERING CIRCULAR.

B. SUMMARY

A summary of narrative and financial information that describes the nature of the investment and highlights the key aspects and risks of the VIATICAL INVESTMENTS, and the financial and operational characteristics of the VIATICAL ISSUER should be presented concisely in the OFFERING CIRCULAR following the cover page or risk factor section. The Summary section should include the disclosure of the VIATICAL ISSUER's proposed estimated use of proceeds, and a summary of the proposed estimated compensation and fees to be paid by or on behalf of the VIATICAL ISSUER in connection with the VIATICAL INVESTMENTS.

C. RISK FACTORS

1.

Format and Use of Risk Factors

a.

Risk factors should immediately follow the Cover Page or the Summary. Consistent with investor protection, a comprehensive listing of the material risks to the potential VIATICAL INVESTORS in the offering should be located at the forefront of the OFFERING CIRCULAR. Potential VIATICAL INVESTORS often focus on the forepart of the document. When comparing potential investment opportunities, consistency in format of complex disclosure documents further assists the VIATICAL INVESTOR.

b.

Risk factor captions should appear in off-set or emphasized type. As a listing of the material risks of the VIATICAL INVESTMENTS, captions should stand out to the eye of the reader. *Italicized*, **bold-faced**, or underlined type assists the reader to quickly comprehend the scope and nature of the particular risk factors, and permits the reader to focus further on the risk factors of most interest to that reader. For the same reason, VIATICAL ISSUERS should avoid lengthy captions.

2.

Specific Risk Factors The VIATICAL ISSUER must describe to potential VIATICAL INVESTORS the risks of investing in the VIATICAL INVESTMENTS. Statements to the effect that little or no risk is involved in VIATICAL

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INVESTMENTS are prohibited, and such statements will be regarded as material misrepresentations. It is important that the VIATICAL ISSUER concisely describe all of the relevant and material risks which may include, if applicable, the following:

a.

The rate of return on your investment cannot be calculated before the insured dies. The longer the insured lives, the **lower** the rate of return on your investment will be.

b.

No one can accurately predict the actual life expectancy of an insured. Some factors that may affect the accuracy of a prediction are: • The experience and qualifications of the PERSONs making the life expectancy prediction. • The nature of the insured's illness. • Future breakthrough treatments and cures. • If the insured has AIDS, the definition of AIDS used by the viatical company.

c.

You may have to pay money in addition to your initial investment. The insurance company will cancel the policy in which you have invested if periodic premium payments are not made to keep the policy in force. The insurance company **will not pay the death benefit** if the policy is not in force. It is likely that a portion of the money you invest will be set aside to pay premiums. However, if the insured lives longer than expected, you may be required to pay **additional** premiums to keep the policy in force.

d.

Being a beneficiary of a policy and not also an owner carries special risks. The person who buys a life insurance policy is the owner of the policy and decides who the beneficiaries of the policy will be - that is, who will receive the death benefit when the owner dies. If the owner **sells** that policy (now called a viator), the investors become the new beneficiaries and therefore are entitled to receive the death benefit when the insured dies. The new **owner** of the policy may be the investors, the viatical company, or the escrow agent. Only an **owner** of a policy, **not a beneficiary**, has the right to make premium payments directly to the insurance company so that the policy will remain in force. If the funds that have been set aside to pay premiums run out, you will be dependent on the viatical company to collect additional premium money from investors and to pay premiums promptly. If that company goes out of business or otherwise fails to collect premiums from investors, you may not be able to pay the premiums yourself if you are only a beneficiary.

e.

Term insurance policies carry special risks. A term policy is issued for a specific time period. The insurance company will not pay the death benefit if the insured outlives that time period. If you purchase a term policy, you will be dependent on the viatical company from which you purchased your viatical investment to renew the policy when the

term expires.

f.

Contestable policies carry special risks. The insurance company may "**contest**" a policy for a two-year period after its issuance if the company finds a reason to cancel the policy. The insurance company **will not pay the death benefit** if: • the insured dies within the contestability period, **and** • the insurance company has a reason to cancel the policy. One example of a reason that an insurance company might cancel a policy is if the insured did not truthfully answer a question on the policy application. The policy may also be cancelled if the insured commits suicide within the two-year contestability period.

g.

Group policies carry special risks. A group policy insures the members of a specific group of people, usually the employees of a company. The biggest risk for someone who invests in a group policy is that the policy can be terminated by the employer or the insurance company. Although the policy may contain a provision allowing conversion to an individual policy, there may be limits or restrictions on the right to convert. Also, the insurance company may charge additional premiums once the policy is converted.

h.

Investing IRA money in a viatical settlement contract carries special risks. *Internal Revenue Code section 408(a)(3)* requires that "no part of trust [IRA] funds will be invested in life insurance contracts." This means that the Internal Revenue Service may not allow you the tax benefits of an IRA if you invest in a viatical settlement contract. Even if such an investment is allowed, you should carefully consider your age, the life expectancy of the insured, and the difficulty in predicting life expectancy before investing IRA funds in a viatical settlement contract. Since death benefits are not paid until the insured dies, **you may encounter a problem taking annual distributions from your IRA that are mandatory beginning at age 70 1/2.** If the funds are not available to take the mandatory distribution, you may be penalized by the IRS.

i.

An investment in a viatical settlement contract is not a liquid investment. The death benefit on a viatical settlement contract will not be paid until the insured dies, and there is no established secondary market for viatical investments. This means that you will probably not be able to sell your contract in an emergency to raise money for your immediate needs.

j.

Check any promises of guarantees carefully. The viatical company from which you purchase your viatical investment may provide a performance or fidelity bond, or another similar instrument, with your purchase. The purpose of these instruments is to "guarantee," or "insure," your investment. Ask exactly what is being guaranteed. Also ask the

salesperson for a copy of the instrument. If the company issuing the "guarantee" does not have the necessary financial resources to make payments under the "guarantee," you will not receive any benefit from the "guarantee." You should do a background check on the company issuing the guarantee instrument. Contact the appropriate regulator to verify that the company exists, is in good standing, and is licensed to do business in the appropriate state(s). Obtain a copy of the company's most recent financial statements. **Be particularly wary if the company is located in a foreign country.** The terms of the contract between the company issuing the "guarantee" and the viatical company may also affect how valuable, or useful, the "guarantee" is to you. Ask for a copy of this agreement.

k.

You could lose some of the death benefit you have purchased if the insurance company that issued the life insurance policy goes out of business. Insurance companies are rated based on their financial safety and soundness. A lower rating means that the company is more likely to go out of business. Each state maintains an insurance guarantee fund for the benefit of policyholders of insurance companies that have gone out of business. The guarantee fund may impose a limit on the amount that can be recovered on each policy. Also, the payment on your viatical settlement contract would be delayed if you needed to seek funds from this guarantee fund or from the receivership of the insurance company. This delay would reduce the rate of return on your investment.

l.

Privacy laws and other factors may limit the information you receive about the insured. Federal and state privacy laws may limit the information you receive about the insured after your investment, such as the insured's current medical condition. In addition, other factors, such as the insured's unwillingness to cooperate, may limit the information you receive after your investment.

m.

You should seek legal advice to help you understand the nature of this investment, the terms and conditions of any contract you are asked to sign, and the tax consequences of your decision to invest. There are many risks and potential risks associated with an investment in a viatical settlement contract. You should be aware that there may be risks related to this type of investment in addition to those discussed above.

D. HISTORY AND OPERATIONS

1.

Provide a brief description of the VIATICAL ISSUER, including the name, address of principal office, state of organization, date of organization, and type of legal entity (corporation, unincorporated, association, etc).

2.

Provide the names, positions held and principal occupations during the past five years of each executive officer of

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the VIATICAL ISSUER. List also the names of the directors, and summarize any material transaction between the VIATICAL ISSUER and any officer, director, or controlling person within the past three years.

3.

Provide a brief history of the VIATICAL ISSUER.

4.

Provide a list of all States in which the VIATICAL ISSUER is licensed to purchase viatical settlement contracts, has an application pending, or has been denied exemption or registration.

5.

Provide a list of all States in which the VIATICAL ISSUER is registered or qualified to sell VIATICAL INVESTMENTS, has an application pending, or has been denied exemption or registration.

6.

Provide the name, address, experience, and qualifications of the PERSON who determines the life expectancy of the INSURED, the type of information on which the life expectancy evaluation is based, and the relationship of the person evaluating the INSURED's life expectancy to the VIATICAL ISSUER and BROKER-DEALER, if any.

7.

Provide the name and address of the PERSON(s) responsible for monitoring the INSURED's whereabouts and/or ongoing medical condition, and the frequency of monitoring the INSURED's condition. Provide an explanation of how this information will be transmitted to the VIATICAL INVESTOR, and of how the insurance company will be notified of the INSURED's death and who will be responsible for filing a claim for benefits with the insurance company.

8.

Provide the name, address and telephone number of the ESCROW AGENT(s).

9.

Provide information regarding whether the VIATICAL INVESTOR will be the owner of the policy, the beneficiary of the policy or have other legal interests in the policy.

10.

Provide the name and address of the PERSON(s) who will receive notice from the insurance company, including, but not limited to, notice of a change in status of the insurance policy, a change in premium payments, a reduction in death benefits or a converted policy and the end of the term for a term life insurance policy.

11.

Provide the name and address of the auditor(s) that audited the financial statements contained in the OFFERING CIRCULAR.

E. USE OF PROCEEDS

1.

The VIATICAL ISSUER's OFFERING CIRCULAR shall disclose, in both tabular and summary form, the percentages and/or dollar amounts of the following, based upon the previous 12 months of operations:

a.

The gross proceeds received from sales of VIATICAL INVESTMENTS;

b.

A description of all direct and indirect offering expenses were paid from the gross proceeds;_____

c.

The net proceeds available to the VIATICAL ISSUER;

d.

An itemized listing of the purposes for which the net proceeds were used by the VIATICAL ISSUER; and

e.

The amount of net proceeds used for each itemized purpose.

2.

The OFFERING CIRCULAR shall disclose, in both tabular and summary form, the percentages and/or dollar amounts of the following:

a.

The estimated gross proceeds to be received from the sale of VIATICAL INVESTMENTS;

b.

A description of all estimated direct and indirect offering expenses that will be paid from the gross proceeds;

c.

The estimated net proceeds that will be available to the VIATICAL ISSUER;

d.

An itemized listing of the purposes for which the net proceeds are to be used by the VIATICAL ISSUER; and

e.

The estimated range of net proceeds to be used for each itemized purpose.

3.

The OFFERING CIRCULAR shall prominently disclose that the disclosures required in VIII E. 2 are estimates only, and that actual amounts may vary depending on the types of policies purchased, market conditions, and other factors.

F. PLAN OF DISTRIBUTION

1.

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Describe the method and manner in which the VIATICAL INVESTMENTS will be offered and sold to VIATICAL INVESTORS, including the methods of solicitation and subscription.

2.

List the names of responsible officials of the VIATICAL ISSUER, other than selling agents, who will answer questions regarding the VIATICAL INVESTMENTS or the VIATICAL ISSUER. Include a description of the compensation to be paid to agents of the VIATICAL ISSUER for providing services in connection with the offering.

3.

Disclose any fees paid or to be paid by or on behalf of the VIATICAL ISSUER to "finders" or "advisers" in connection with the distribution of the VIATICAL INVESTMENTS, and the names of and the services rendered by such PERSONS.

4.

Provide information about the UNDERWRITER and any BROKER-DEALERS that will offer and sell the VIATICAL INVESTMENTS. Include a description of the compensation to be paid to the UNDERWRITERS for providing their services in connection with the offering.

5.

Describe any underwriting or selling agreement between the UNDERWRITER and the VIATICAL ISSUER, including whether such agreement is on a "best efforts" or "firm commitment" basis, whether such arrangements are "exclusive" or "nonexclusive" and whether there are provisions for indemnification of the VIATICAL ISSUER or UNDERWRITER for losses sustained as a result of claims based upon violations of applicable securities laws. Any indemnity provisions pertaining to the ESCROW AGENT shall also be disclosed. The ADMINISTRATOR may prohibit indemnification for claims due to ordinary negligence of the UNDERWRITER, VIATICAL ISSUER or ESCROW AGENT. The OFFERING CIRCULAR shall disclose any indemnification provisions for any PERSONS against liability under securities laws in connection with the offering of VIATICAL INVESTMENTS along with a statement to indicate that the ADMINISTRATOR may deem such indemnification provisions to be against public policy and unenforceable.

6.

Describe the responsibilities of the UNDERWRITER, the VIATICAL ISSUER, and the agents of the VIATICAL ISSUER under the terms of any underwriting agreement. Disclose all past, present and anticipated future dealings with UNDERWRITERS, investment advisers, or financing organizations participating in this offering, including the aggregate remuneration received by such entities. Also disclose whether any executive officer, director or similar leader of the VIATICAL ISSUER is in any way affiliated with the UNDERWRITER or financing organization participating in this offering or with any executive personnel of such organization.

G. LITIGATION AND MATERIAL TRANSACTIONS

1.

Describe any pending or threatened material legal proceeding or proceedings known to be contemplated by governmental authorities, administrative bodies or other PERSONs, to which the VIATICAL ISSUER and/or its leaders, officers, directors or trustees are or may be a party, or to which any of the VIATICAL ISSUER's property is or may be subject. Include the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis alleged to underlie the proceeding and the relief sought.

2.

Disclose any disciplinary actions or legal proceedings related to securities or other material financial matters involving the VIATICAL ISSUER or any officers, directors, trustees or agents of the VIATICAL ISSUER within 5 years of the offering, including civil judgments, state or federal regulatory actions and other judicial actions, including but not limited to any discipline that is disclosable to the public on the Central Registration Depository.

3.

Fully disclose any VIATICAL ISSUER transactions which may materially affect this offering or a VIATICAL INVESTOR's investment decision, and which are not otherwise described above.

H. FINANCIAL STATEMENTS

The ADMINISTRATOR may require financial statements required pursuant to Section II C to be attached as an Appendix to the OFFERING CIRCULAR.

IX. POST SALE DISCLOSURES

The VIATICAL ISSUER or the BROKER-DEALER offering or selling VIATICAL INVESTMENTs shall provide the following disclosure in writing to each VIATICAL INVESTOR no later than at the time of the assignment, transfer or sale of all or a portion of an insurance policy. The burden of proving that the disclosure requirements have been met is on the VIATICAL ISSUER:

A.

A statement of whether the VIATICAL INVESTOR has the right to rescind the purchase of the VIATICAL INVESTMENT under existing state law.

B.

The amount of the investment, the amount the VIATICAL INVESTOR will receive upon the death of the INSURED, the VIATICAL INVESTOR's percentage interest in the life insurance policy, and the total death benefit.

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C.

Whether the VIATICAL INVESTOR is an owner, beneficiary or has some other interest in the policy. The names and addresses of the owner(s), beneficiaries, and all other persons with an interest in the policy, other than the INSURED.

D.

The name, address and rating of the company that issued the life insurance policy, the policy number, and the date of issuance of the policy, as well as the identity of the rating service used.

E.

The type of policy offered or sold, e.g., whole life, term life, universal life or a group policy certificate, any additional benefits contained in the policy and the current status of the policy.

F.

The extent to which premium payments or other costs related to the policy have been escrowed, including the method of calculation of the escrow amount, whether and the extent to which the premiums include premiums for riders, the disposition of premium funds set aside in the event there is a disability waiver of premium payments, and the extent to which the VIATICAL INVESTOR will be responsible for the payment of premiums.

G.

If the policy is term insurance, the date of termination of the policy, renewal and/or conversion rights, and the VIATICAL INVESTOR's responsibility for additional premiums if the INSURED or the current owner continues the policy at the end of the current term.

H.

Whether the policy is contestable and, if so, the date upon which the contestability period ceases.

I.

Whether the insurer that wrote the policy has any additional rights that could negatively affect or extinguish the VIATICAL INVESTOR's rights under the VIATICAL INVESTMENT, what those rights are, and under what conditions those rights are or may be exercised.

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J.

Copies or summaries of all the life expectancy certifications obtained by the VIATICAL ISSUER or its agents in the process of determining the price paid to the VIATOR and in offering the VIATICAL INVESTMENT.

K.

The amount of any fees or other expenses to be charged out of investor funds for payments to sales agents.

L.

All other material facts necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading.

VIATICAL ISSUERS and BROKER-DEALERS offering or selling VIATICAL INVESTMENTS may use the Post-Sale Viatical Disclosure Document attached as Appendix A. **However, the responsibility of disclosure rests with the VIATICAL ISSUER, and using Appendix A does not necessarily mean that this responsibility has been satisfied.**

APPENDIX A ----- Post-Sale Viatical Disclosure Document

Read Immediately Upon Receipt

You are purchasing a **viatical investment**. A **viatical investment** is an agreement for the purchase of an interest in the death benefit of a life insurance policy. The individual whose life insurance policy is being sold is called the **viator**.

Right to rescind

[If there is a right to rescind the purchase under existing state law, the terms of the law shall be summarized herein.]

What you are purchasing

2.

You are investing \$ _____ and will receive \$ _____ upon the death of the **insured**. The life expectancy of the **insured** in whose policy you are investing is _____. The **insured** has the following medical condition: _____

3.

You are purchasing:

☐

_____ % (percent) ownership of a life insurance policy with a \$ _____ death benefit

☐

the entire ownership of a life insurance policy with a \$ _____ death benefit

☐

_____ % (percent) of the death benefit of a life insurance policy with a \$ _____ death benefit

☐

the entire death benefit of a life insurance policy with a \$ _____ death benefit

The insurance policy

4.

The life insurance policy was issued by:

Company: _____

Address: _____

Telephone Number: _____

5.

The most recent A.M. Best rating for this insurance company is: _____

6.

The policy number is: _____

7.

The policy was issued on (date): _____

8.

The policy is (check all that apply):

☐

A term policy

The term of the policy is: _____

☐

A group policy

Name of the Group: _____

Address: _____

Telephone Number: _____

☐

Contestable

The policy is contestable until (date): _____

Ownership

9.

After you make your purchase, you will be:

☐

an owner and beneficiary of a life insurance policy

Other owners of the policy will be: (names and addresses of other investors) -unless disclosure would violate state privacy laws)

☐

a beneficiary **only** of a life insurance policy

The owner(s) of the policy will be: (names, addresses, and telephone numbers)

Other beneficiaries of the policy will be: (names and addresses of other investors)

Premiums

10.

Premiums on the policy are:

☐

Paid up and no additional premium payments will ever be required.

☐

Required to be paid periodically.

Premiums are:

_____ annually

Payments of \$ _____ are due to be paid:

☐

Monthly

☐

Quarterly

☐

Semi-annually

☐

Annually

11.

Term of premium payments

☐

If premium payments are made as required, the policy will be fully paid up on (date) _____

☐

Premium payments must be made until the death of the viator.

12.

Funding of premium payments (check all that apply):

☐

A portion of your investment has been set aside to pay premiums. This amount will fund the payment of premiums until (date) _____

☐

These funds have been placed in an escrow account:

Name of Escrow Agent: _____

Address _____

Telephone Number _____

Bank Name and Acct. No. _____

☐

You will be obligated to pay additional money to fund premium payments after (date) _____
Payments of \$ _____ will be due to be paid:

☐

Monthly

☐

Quarterly

☐

Semi-annually

☐

Annually

☐

Before these additional payments are due, you will be notified of when and to whom to make your premium payments.

Use of your investment funds

13.

Of the amount you are investing:

\$ _____ will be set aside to pay premiums on the policy.

\$ _____ will be used to pay a commission to the person who sold you the policy.

Name of viatical company: _____

Address: _____

Adopted September 10, 1996

Section 402. Exemptions

(a)

The following securities are exempted from sections 301 and 403:

(12)

Securities meeting all of the following conditions:

(i)

The securities are:

(A)

Equity securities except options, warrants, preferred stock, subscription rights, securities convertible into equity securities or any right to subscribe to or purchase such options, warrants, convertible securities or preferred stock;

(B)

Units consisting of equity securities permitted by (A) and warrants to purchase the same equity security being offered in the unit;

(C)

Non-convertible debt securities that are rated in one of the four highest rating categories of Standard and Poor's, Moody's, Dominion Bond Rating Services or Canadian Bond Rating Services or such other rating organization which the Administrator by rule or order may designate. For purposes of this subparagraph, non-convertible debt securities means securities that cannot be converted for at least one year from the date of issuance and then only into equity shares of the issuer or its parent; or

(D)

American Depositary receipt representing securities described in (A), (B) or (C).

COMMENTARY: *The original draft provided on exemption for equity securities other than options, warrants, convertible securities and preferred stock (or right to subscribe to or purchase any of the foregoing) which securities may have restrictions on voting rights if disclosed in writing to the investor prior to purchase. Interim drafts did not permit a World Class Issuer to rely upon the exemption to offer and sell investment grade debt which was either non-convertible or convertible only after one year into the securities of the issuer or its parent. It would appear appropriate to include quality debt securities within the ambit of the exemption. Investment grade is defined as having a nationally recognized statistical rating organization rating the security in one of its four highest rating categories. Current financing appears to favor unit offerings consisting of shares of stock and warrants to purchase those shares. Since this is but a variation on a basic stock offering, it is permitted. These provisions are similar to those in the Multi-*

jurisdictional Disclosure System (MJDS).

(ii)

The issuer is not organized under the laws of the United States, or of any state, territory or possession of the United States, or of the District of Columbia or Puerto Rico.

COMMENTARY: *This provision is designed to ensure the basic foreign nature of the Exemption. Domestic issuers would still have the full range of existing exemptions available to them.*

(iii)

The issuer, at the time an offer or sale is made under this subsection, has been a going concern engaged in continuous business operations for the immediate past five years and during that period, has not been the subject of a proceeding relating to insolvency, bankruptcy, involuntary administration, receivership or similar proceeding. For purposes of this subparagraph, the operating history of any predecessor that represented more than 50% of the value of the assets of the issuer that otherwise would have met the conditions of this section may be used toward the five year requirement.

COMMENTARY: *The provision has been part of the Exemption from the first draft and is designed to ensure the stability of the issuer.*

(iv)

The issuer, at the time an offer or sale is made under this subsection, has public float of US \$1 billion or more. For purposes of this subparagraph:

(A)

Public float means the market value of all outstanding equity shares owned by non-affiliates.

(B)

Equity shares means common shares, non-voting equity shares and subordinate or restricted voting equity shares, but does not include preferred shares.

(C)

An affiliate of a person is anyone who beneficially owns, directly or indirectly, or exercises control or direction over, more than 10% of the outstanding equity shares of such person.

COMMENTARY: This indicator shows the value of freely tradable securities of non-affiliates available to the public for buying and selling. Public float would have the same meaning as under MJDS which is the market value of all outstanding equity shares owned by non-affiliates. An affiliate of a person is anyone who beneficially owns, directly or indirectly, or exercises control or direction over, more than 10% of the outstanding equity shares of such person. This requirement approximates the CDN \$1 billion public float requirement under the proposed Canadian National Policy.

(v)

The market value of the issuer's equity shares, at the time an offer or sale is made under this subsection, is US \$3 billion or more. For purposes of this subparagraph, equity shares means common shares, non-voting equity shares and subordinate or restricted voting equity shares, but does not include preferred shares.

COMMENTARY: The Committee feels that measuring assets, by definition, usually means acceptance of the accounting practices and procedures of the country in which the company is domiciled. By assets, the world's largest companies are the major Japanese banks. Their assets, however, consist of many property loans which are non-performing or under-performing. The proposed Canadian National Policy has determined to establish its eligibility criteria on the public float of the issuer's equity securities and the market capitalization of those equity securities. The market capitalization test is CDN \$3 billion. All of the 200 top foreign companies listed by market value would meet the Canadian market capitalization criteria. This criteria also reflects the market's assessment of a company's value and performance. The Committee feels that market capitalization is a more readily available statistic for broker-dealers to obtain.

(vi)

The issuer, at the time an offer or sale is made under this subsection, has a class of equity securities listed for trading on or through the facilities of a foreign securities exchange or recognized foreign securities market included in Rule 902(a)(1) or successor rule promulgated under the Securities Act of 1933 or designated by the U.S. Securities and Exchange Commission under Rule 902(a)(2) promulgated under the Securities Act of 1933.

COMMENTARY: The Committee feels that, while a listing on a stock exchange should not be the sole determinant in affording an exemption, it did provide for an independent means whereby the market's perception of the issuer could be communicated to public investors. The tie-in to SEC Rule 902 allows the states to be uniform with the SEC where a listing on a foreign securities exchange is used as a condition of the availability of a state registration exemption.

MODEL RULES

Adopted April 3, 2000, Amended April 18, 2004

Rule 202(e)-1. Bonding Requirements for Certain Investment Advisers.

(a)

Any bond required by this Rule shall be issued by a company qualified to do business in this state in the form

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determined by the [Administrator] and shall be subject to the claims of all clients of such investment adviser regardless of the client's state of residence.

(1)

Every investment adviser registered or required to be registered under the Act having custody of or discretionary authority over client funds or securities shall be bonded in an amount determined by the Administrator based upon the number of clients and the total assets under management of the investment adviser.

(2)

Every investment adviser registered or required to be registered under the Act who has custody or discretion of client funds or securities who does not meet the minimum net worth standard in Rule 202(d)-1(a) shall be bonded in the amount of the net worth deficiency rounded up to the nearest \$5,000.

(b)

For purposes of this Rule, "custody" is defined in Rule 102(e)(1)-1(c)(1).

(c)

An investment adviser that has its principal place of business in a state other than this state shall be exempt from the requirements of subsection (a) of this section, provided that the investment adviser is registered as an investment adviser in the state where it has its principal place of business and is in compliance with such state's requirements relating to bonding.

Adopted April 3, 2000, Amended April 18, 2004

Rule 102(e)(1)-1. Custody of Client Funds or Securities by Investment Advisers.

(a)

Safekeeping required. If you are an investment adviser registered or required to be registered, it is unlawful and deemed to be a fraudulent, deceptive, or manipulative act, practice or course of business for you to have custody of client funds or securities unless:

(1)

Notice to Administrator. The investment adviser notifies the Administrator promptly in writing that the investment adviser has or may have custody. Such notification is required to be given on Form ADV;

(2)

Qualified custodian. A qualified custodian maintains those funds and securities;

(i)

In a separate account for each client under that client's name; or

(ii)

In accounts that contain only your clients' funds and securities, under your name as agent or trustee for the clients.

(3)

Notice to clients. If you open an account with a qualified custodian on your client's behalf, either under the client's name or under your name as agent, you notify the client in writing of the qualified custodian's name, address, and the manner in which the funds or securities are maintained, promptly when the account is opened and following any changes to this information.

(4)

Account statements must be sent to clients, either:

(i)

By a qualified custodian. You have reasonable basis for believing that the qualified custodian sends an account statement, at least quarterly, to each of your clients for which it maintains funds or securities, identifying the amount of funds and of each security in the account at the end of the period and setting forth all transactions in the account during that period; or

(ii)

By the adviser.

(A)

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The adviser sends an account statement, at least quarterly, to each client for whom you have custody of funds or securities, identifying the amount of funds and of each security of which you have custody at the end of the period and setting forth all transactions during that period;

(B)

An independent certified public accountant verifies all client funds and securities by actual examination at least once during each calendar year at a time chosen by the accountant without prior notice or announcement to the adviser and that is irregular from year to year, and files a copy of the auditor's report and financial statements with the [Administrator] within 30 days after the completion of the examination, along with a letter stating that it has examined the funds and securities and describing the nature and extent of the examination; and

(C)

The independent certified public accountant, upon finding any material discrepancies during the course of the examination, notifies the [Administrator] within one business day of the finding, by means of a facsimile transmission or electronic mail, followed by first class mail, directed to the attention of the [Administrator];

(iii)

Special rule for limited partnerships and limited liability companies. If you are a general partner of a limited partnership (or managing member of a limited liability company, or hold a comparable position for another type of pooled investment vehicle), the account statements required under paragraphs (a)(4) of this section must be sent to each limited partner (or member or other beneficial owner or their independent representative).

(5)

Independent representatives. A client may designate an independent representative to receive, on his behalf, notices and account statements as required under paragraphs (a)(3) and (a)(4) of this section.

(6)

Direct Fee Deduction. An adviser who has custody as defined in Rule 102(e)(1)-1(c)(1)(ii) by having fees directly deducted from client accounts must also provide the following safeguards:

(i.) Written Authorization. The adviser must have written authorization from the client to deduct advisory fees from the account held with the qualified custodian;

(ii.) Notice of fee deduction. Each time a fee is directly deducted from a client account, the adviser must concurrently:

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(A)

Send the qualified custodian notice of the amount of the fee to be deducted from the client's account; and

(B)

Send the client an invoice itemizing the fee. Itemization includes the formula used to calculate the fee, the amount of assets under managements the fee is based on, and the time period covered by the fee.

(iii.) Notice of Safeguards. The investment adviser notifies the [Administrator] in writing that the investment adviser intends to use the safeguards provided above. Such notification is required to be given on Form ADV.

(iv.) Waiver of Net Worth or Bonding Requirements. An investment adviser having custody solely because it meets the definition of custody as defined in Rule 102(e)(1)-1(c)(1)(ii) and who complies with the safekeeping requirements in Rule 102(e)(1)-1(a)(1)-(6) will not be required to meet the financial requirements for custodial advisers as set forth in Rule 202(d)-1.

(7)

Pooled Investments. An investment adviser who has custody as defined in Rule 102(e)(1)-1(c)(1)(iii) and who does not meet the exception provided under Rule 102(e)(1)-1(b)(3) must, in addition to the safeguards set forth in Rule 102(e)(1)-1(a)(1)-(5) also comply with the following:

(i)

Engage an Independent Party. Hire an independent party to review all fees, expenses and capital withdrawals from the pooled accounts;

(ii)

Review of Fees. Send all invoices or receipts to the independent party, detailing the amount of the fee, expenses or capital withdrawal and the method of calculation such that the independent party can:

(A)

Determine that the payment is in accordance with the pooled investment vehicle standards (generally the partnership agreement or membership agreement) and

(B)

Forward, to the qualified custodian, approval for payment of the invoice with a copy to the investment adviser.

(iii)

For purposes of this rule, an Independent Party means a person that:

(A)

Is engaged by you to act as a gatekeeper for the payment of fees, expenses and capital withdrawals from the pooled investment;

(B)

Does not control and is not controlled by and is not under common control with you; and

(C)

Does not have, and has not had within the past two years, a material business relationship with you.

(iv)

Notice of Safeguards. The investment adviser notifies the [Administrator] in writing that the investment adviser intends to use the safeguards provided above. Such notification is required to be given on Form ADV.

(v)

Waiver of Net Worth or Bonding Requirements. An investment adviser having custody solely because it meets the definition of custody as defined in Rule 102(e)(1)-1(c)(1)(iii) and who complies with the safekeeping requirements in Rule 102(e)(1)-1(a)(1)-(5) and (7) will not be required to meet the financial requirements for custodial advisers as set forth in Rule 202(d)-1

(b)

Exceptions.

(1)

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Shares of mutual funds. With respect to shares of an open-end company as defined in Section 5(a)(1) of the Investment Company Act of 1940 [15 U.S.C. 80a-5(a)(1)] ("mutual fund"), you may use the mutual fund's transfer agent in lieu of a qualified custodian for purposes of complying with paragraph (a) of this section;

(2)

Certain privately offered securities.

(i)

You are not required to comply with Rule 102(e)(1)-1(a) with respect to securities that are:

(A)

acquired from the issuer in a transaction or chain of transactions not involving any public offering;

(B)

uncertificated, and ownership thereof is recorded only on books of the issuer or its transfer agent in the name of the client; and

(C)

transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.

(ii)

Notwithstanding paragraph (b)(2)(i) of this section, the provisions of this paragraph (b)(2) are available with respect to securities held for the account of a limited partnership (or limited liability company, or other type of pooled investment vehicle) only if the limited partnership is audited, the audited financial statements are distributed, as described in paragraph (b)(3) of this section and the investment adviser notifies the [Administrator] in writing that the investment adviser intends to provide audited financial statements, as described above. Such notification is required to be given on Form ADV.

(3)

Limited partnerships subject to annual audit. You are not required to comply with paragraph (a)(3) of this rule with respect to the account of a limited partnership (or limited liability company, or another type of pooled investment vehicle) that is subject to audit at least annually and distributes its audited financial statements prepared in accordance

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with generally accepted accounting principles to all limited partners (or members or other beneficial owners) within 120 days of the end of its fiscal year. The investment adviser must also notify the [Administrator] in writing that the investment adviser intends to employ the use of the audit safeguards described above. Such notification is required to be given on Form ADV.

(4)

Registered investment companies. You are not required to comply with this rule with respect to the account of an investment company registered under the Investment Company Act of 1940 [15 U.S.C. 80a-1 to 80a-64]

(5)

Beneficial Trusts. You are not required to comply with safekeeping requirements of this Rule 102(e)(1)-1(a) or the Net Worth and Bonding Requirements of Rule 202(d)-1 if you have custody solely because you are the trustee for a beneficial trust, if all of the following conditions are met for each trust:

(i)

The beneficial owner of the trust is a parent, a grandparent, a spouse, a sibling, a child or a grandchild of the adviser. These relationships shall include "step" relationships.

(ii)

For each account under paragraph (i) you comply with the following:

(A)

You provide a written statement to each beneficial owner of the account setting forth a description of the requirements of subsection (a) of this rule and the reasons why you will not be complying with those requirements.

(B)

You obtain from each beneficial owner a signed and dated statement acknowledging the receipt of the written statement required under (A) above.

(C)

You maintain a copy of both documents described in subparagraphs (A) and (B) above until the account is closed or you are no longer trustee.

(6)

Any adviser who intends to have custody of client funds or securities but is not able to utilize a Qualified Custodian as defined in Rule 102(e)(1)-1(c) must first obtain approval from the [Administrator] and must comply with all of the applicable safekeeping provisions under Rule 102(e)(1)-1(a) including taking responsibility for those provisions that are designated to be performed by a qualified custodian.

(c)

Definitions. For purposes of this section:

(1)

"Custody" means holding directly or indirectly, client funds or securities, or having any authority to obtain possession of them [or has the ability to appropriate them]. Custody includes:

(i)

Possession of client funds or securities unless received inadvertently and returned to the sender promptly, but in any case within three business days of receiving them;

(ii)

Receipt of checks drawn by clients and made payable to unrelated third parties will not meet the definition of custody if forwarded to the third party within 24 hours of receipt and the adviser maintains the records required under Rule 203(a)2-21;

(iii)

Any arrangement (including a general power of attorney) under which you are authorized or permitted to withdraw client funds or securities maintained with a custodian upon your instruction to the custodian; and

(iv)

Any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives you or your supervised person legal ownership of or access to client funds or securities.

(2)

"Independent representative" means a person who:

(i)

Acts as agent for an advisory client, including in the case of a pooled investment vehicle, for limited partners of a limited partnership, members of a limited liability company, or other beneficial owners of another type of pooled investment vehicle and by law or contract is obliged to act in the best interest of the advisory client or the limited partners, members, or other beneficial owners;

(ii)

Does not control, is not controlled by, and is not under common control with you; and

(iii)

Does not have, and has not had within the past two years, a material business relationship with you.

(3)

"Qualified custodian" means the following independent institutions or entities:

(i)

A bank or savings association that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act;

(ii)

A registered broker-dealer holding the client assets in customer accounts;

(iii)

A registered futures commission merchant register under Section 4f(a) of the Commodity Exchange Act, holding the client assets in customer accounts, but only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; and

(iv)

A foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets.

Adopted April 3, 2000, Amended April 18, 2004

Rule 202(d)-1. Minimum Financial Requirements for Investment Advisers.

(a)

An investment adviser registered or required to be registered under the Act who has custody of client funds or securities shall maintain at all times a minimum net worth of \$35,000 except:

(1)

Advisers having custody solely due to direct fee deduction and complying with the terms described under Rule 102(e)(1)-1(a)6 and related books and records, as described in Rule 203(a)(2), shall not be required to comply with the net worth or bonding requirements of this Rule.

(2)

Advisers having custody solely due to advising pooled investment vehicles and complying with the terms described under Rule 102(e)(1)-1(a)7 or Rule 102(e)(1)-1(b)(3) and related books and records, as described in Rule 203(a)(2), shall not be required to comply with the net worth or bonding requirements of this Rule.

(b)

An investment adviser registered or required to be registered under the Act who has discretionary authority over client funds or securities, but does not have custody of client funds or securities shall maintain at all times a minimum net worth of \$10,000.

(c)

An investment adviser registered or required to be registered under the Act who accepts prepayment of more than \$500 per client and six or more months in advance shall maintain at all times a positive net worth.

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(d)

Unless otherwise exempted, as a condition of the right to transact business in this state, every investment adviser registered or required to be registered under the Act shall by the close of business on the next business day notify the [Administrator] if such investment adviser's net worth is less than the minimum required. After transmitting such notice, each investment adviser shall file by the close of business on the next business day a report with the [Administrator] of its financial condition, including the following:

(1)

A trial balance of all ledger accounts;

(2)

A statement of all client funds or securities which are not segregated;

(3)

A computation of the aggregate amount of client ledger debit balances; and

(4)

A statement as to the number of client accounts.

(e)

For purposes of this Rule, the term "net worth," shall mean an excess of assets over liabilities, as determined by generally accepted accounting principles, but shall not include as assets: prepaid expenses (except as to items properly classified assets under generally accepted accounting principles), deferred charges, goodwill, franchise rights, organizational expenses, patents, copyrights, marketing rights, unamortized debt discount and expense, all other assets of intangible nature; home, home furnishings, automobile(s), and any other personal items not readily marketable in the case of an individual; advances or loans to stockholders and officers in the case of a corporation; and advances or loans to partners in the case of a partnership.

(f)

For purposes of this Rule, "custody" is defined in Rule 102(e)(1)-1(c)(1).

(g)

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For purposes of this Rule an investment adviser shall not be deemed to be exercising discretion when it places trade orders with a broker-dealer pursuant to a third party trading agreement if:

(1)

the investment adviser has executed a separate investment adviser contract exclusively with its client which acknowledges that a third party trading agreement will be executed to allow the investment adviser to effect securities transactions for the client in the client's broker-dealer account, and

(2)

the investment adviser contract specifically states that the client does not grant discretionary authority to the investment adviser and the investment adviser in fact does not exercise discretion with respect to the account, and

(3)

a third party trading agreement is executed between the client and a broker-dealer which specifically limits the investment adviser's authority in the client's broker-dealer account to the placement of trade orders and deduction of investment adviser fees.

(h)

The [Administrator] may require that a current appraisal be submitted in order to establish the worth of any asset.

(i)

Every investment adviser that has its principal place of business in a state other than this state shall maintain only such minimum capital as required by the state in which the investment adviser maintains its principal place of business, provided the investment adviser is licensed in such state and is in compliance with such state's minimum capital requirement.

Adopted August 30, 1990, Amended July 1, 2005

Rule No. 1

Offerings filed on U.S. Securities and Exchange Commission ("SEC") Form F-7, Form F-8, Form F-9 or Form F-10, shall become effective the later of three days after filing, or the effective date with the SEC. This rule is adopted pursuant to [Section 303 (c) (2) of the Act.]

Commentary:

The North American Securities Administrators Association, Inc. initially adopted these model rules August 30, 1990 to

utilize the Multijurisdictional Disclosure System ("MJDS") developed by the SEC. MJDS was originally described in SEC Release 33-6841 and adopted in SEC Release 33-6902. These amended rules are designed to conform to the Uniform Securities Act 2002 ("USA").

Rule No. 1 is designed to permit offerings to become effective in US jurisdictions at the same time they become effective in Canada. When initially adopted this period could be as short as 7 days. Since adoption the period has been reduced. Eligibility is limited to the offerings listed below:

1.

SEC Form F-7 may be used for registration of securities offered for cash upon the exercise of rights granted to existing securities holders.

2.

SEC Form F-8 may be used for registration of securities issued in an exchange offer, merger or other business combination.

3.

SEC Form F-9 may be used for registration of investment grade, non-convertible preferred stock or non-convertible debt. Form F-9 defines non-convertible to include securities not convertible for at least one year.

4.

SEC Form F-10 may be used for registration of securities of companies meeting a continuous reporting requirement and a public float of \$75 million or more.

Authority for Adoption: Section 605 of the USA.

Rule No. 2

Financial statements and financial information for offerings filed under Rule No. 1 shall comply with instructions provided with SEC Form F-7, Form F-8, Form F-9 or Form F-10. This rule is adopted pursuant to [Section [605(c)] of the _____ Act].

Commentary:

The Rule is designed to permit use of financial statements and financial information prepared in accordance with Canadian generally accepted accounting principles to the extent allowed by the SEC.

Rule No. 3

In a Rights Offering, SEC Form F-7 will be accepted in lieu of any state form required to claim an exemption for any transaction pursuant to an offer to existing securities holders.

Commentary:

Under the Uniform Securities Act of 1956 an offering to existing security holders including commissions or other remuneration other than standby commissions, required a filing with the state administrator. This Rule was designed to allow Form F-7 to serve as the filing. Section 202 (15) of USA modifies this exemption.

Rule No. 4.

After the SEC has declared effective an issuer's Form F-8, Form F-9 or Form F-10 registration statement, a non-issuer transaction in any class of the issuer's securities is exempt from registration, whether or not the transaction is effected through a broker dealer.

Commentary:

This Rule is intended to give certain MJDS-registered securities an exemption for subsequent secondary trading.

Whether or not to include securities issued pursuant to a rights offering filed on SEC Form F-7, as well, is at the discretion of each jurisdiction adopting this rule. Non-issuer transactions in these securities may already be exempt under Sections 202(4) and (6) of the USA, preempted for securities of issuers that are reporting companies under the Securities Exchange Act of 1934, or exempt transactions under the state securities act.

Adopted May 3 1999; Amended April 18, 2004

NOTE:

Italicized information is explanatory and not intended for inclusion in the rule text. Language based on the Uniform Securities Act of 1956, as amended.

Rule 203(a)2 (ALTERNATIVE 1): [RECORDKEEPING REQUIREMENTS FOR INVESTMENT ADVISERS.]

(a)

Every investment adviser registered or required to be registered under the Act shall make and keep true, accurate and current the following books, ledgers and records:

1.

A journal or journals, including cash receipts and disbursements records, and any other records of original entry forming the basis of entries in any ledger.

2.

General and auxiliary ledgers (or other comparable records) reflecting asset, liability, reserve, capital, income

and expense accounts.

3.

A memorandum of each order given by the investment adviser for the purchase or sale of any security, of any instruction received by the investment adviser from the client concerning the purchase, sale, receipt or delivery of a particular security, and of any modification or cancellation of any such order or instruction. The memoranda shall show the terms and conditions of the order, instruction, modification or cancellation; shall identify the person connected with the investment adviser who recommended the transaction to the client and the person who placed the order; and shall show the account for which entered, the date of entry, and the bank, broker-dealer by or through whom executed where appropriate. Orders entered pursuant to the exercise of discretionary power shall be so designated.

4.

All check books, bank statements, canceled checks and cash reconciliations of the investment adviser.

5.

All bills or statements (or copies of), paid or unpaid, relating to the investment adviser's business as an investment adviser.

6.

All trial balances, financial statements prepared in accordance with generally accepted accounting principles, and internal audit working papers relating to the investment adviser's business as an investment adviser. For purposes of this subsection, "financial statements" shall mean a balance sheet prepared in accordance with generally accepted accounting principles, an income statement, a cash flow statement and a net worth computation, if applicable, as required by Rule 202(d)-1 of this Act.

7.

Originals of all written communications received and copies of all written communications sent by the investment adviser relating to (A) any recommendation made or proposed to be made and any advice given or proposed to be given, (B) any receipt, disbursement or delivery of funds or securities, or (C) the placing or execution of any order to purchase or sell any security, provided, however, (i) that the investment adviser shall not be required to keep any unsolicited market letters and other similar communications of general public distribution not prepared by or for the investment adviser, and (ii) that if the investment adviser sends any notice, circular or other advertisement offering any report, analysis, publication or other investment advisory service to more than 10 persons, the investment adviser shall not be required to keep a record of the names and addresses of the persons to whom it was sent; except that if the notice, circular or advertisement is distributed to persons named on any list, the investment adviser shall retain with the copy of the notice, circular or advertisement a memorandum describing the list and its source.

8.

A list or other record of all accounts which list identifies the accounts in which the investment adviser is vested with any discretionary power with respect to the funds, securities or transactions of any client.

9.

A copy of all powers of attorney and other evidences of the granting of any discretionary authority by any client to the investment adviser.

10.

A copy in writing of each agreement entered into by the investment adviser with any client, and all other written agreements otherwise relating to the investment adviser's business as an investment adviser.

11.

A file containing a copy of each notice, circular, advertisement, newspaper article, investment letter, bulletin, or other communication including by electronic media that the investment adviser circulates or distributes, directly or indirectly, to two or more persons (other than persons connected with the investment adviser), and if the notice, circular, advertisement, newspaper article, investment letter, bulletin, or other communication including by electronic media recommends the purchase or sale of a specific security and does not state the reasons for the recommendation, a memorandum of the investment adviser indicating the reasons for the recommendation.

12.

(A) A record of every transaction in a security in which the investment adviser or any advisory representative (as hereinafter defined) of the investment adviser has, or by reason of any transaction acquires, any direct or indirect beneficial ownership, except

i.

transactions effected in any account over which neither the investment adviser nor any advisory representative of the investment adviser has any direct or indirect influence or control; and

ii.

transactions in securities which are direct obligations of the United States. The record shall state the title and

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amount of the security involved; the date and nature of the transaction (i.e. purchase, sale or other acquisition or disposition); the price at which it was effected; and the name of the broker-dealer or bank with or through whom the transaction was effected. The record may also contain a statement declaring that the reporting or recording of any transaction shall not be construed as an admission that the investment adviser or advisory representative has any direct or indirect beneficial ownership in the security. A transaction shall be recorded not later than 10 days after the end of the calendar quarter in which the transaction was effected.

(B)

For purposes of this subdivision (12) the following definitions will apply. The term "advisory representative" shall mean any partner, officer or director of the investment adviser; any employee who participates in any way in the determination of which recommendations shall be made; any employee who, in connection with his duties, obtains any information concerning which securities are being recommended prior to the effective dissemination of the recommendations; and any of the following persons who obtain information concerning securities recommendations being made by the investment adviser prior to the effective dissemination of the recommendations:

i.

any person in a control relationship to the investment adviser,

ii.

any affiliated person of a controlling person and

iii.

any affiliated person of an affiliated person.

"Control" shall mean the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company. Any person who owns beneficially, either directly or through one or more controlled companies, more than 25 % of the voting securities of a company shall be presumed to control such company.

(C)

An investment adviser shall not be deemed to have violated the provisions of this subdivision (12) because of the failure to record securities transactions of any advisory representative if the investment adviser establishes that it instituted adequate procedures and used reasonable diligence to obtain promptly reports of all transactions required to be recorded.

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13.

(A) Notwithstanding the provisions of subdivision (12) above, where the investment adviser is primarily engaged in a business or businesses other than advising investment advisory clients, a record must be maintained of every transaction in a security in which the investment adviser or any advisory representative (as hereinafter defined) of the investment adviser has, or by reason of any transaction acquires, any direct or indirect beneficial ownership, except

i.

transactions effected in any account over which neither the investment adviser nor any advisory representative of the investment adviser has any direct or indirect influence or control; and

ii.

transactions in securities which are direct obligations of the United States.

The record shall state the title and amount of the security involved; the date and nature of the transaction (i.e. purchase, sale, or other acquisition or disposition); the price at which it was effected; and the name of the broker-dealer or bank with or through whom the transaction was effected. The record may also contain a statement declaring that the reporting or recording of any transaction shall not be construed as an admission that the investment adviser or advisory representative has any direct or indirect beneficial ownership in the security. A transaction shall be recorded not later than 10 days after the end of the calendar quarter in which the transaction was effected.

(B)

An investment adviser is "primarily engaged in a business or businesses other than advising investment advisory clients" when, for each of its most recent three fiscal years or for the period of time since organization, whichever is lesser, the investment adviser derived, on an unconsolidated basis, more than 50% of

i.

its total sales and revenues, and

ii.

its income (or loss) before income taxes and extraordinary items, from such other business or businesses.

(C)

For purposes of this subdivision (13) the following definitions will apply. The term "advisory representative", when used in connection with a company primarily engaged in a business or businesses other than

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advising investment advisory clients, shall mean any partner, officer, director or employee of the investment adviser who participates in any way in the determination of which recommendation shall be made, or whose functions or duties relate to the determination of which securities are being recommended prior to the effective dissemination of the recommendations; and any of the following persons, who obtain information concerning securities recommendations being made by the investment adviser prior to the effective dissemination of such the recommendations or of the information concerning the recommendations:

i.

any person in a control relationship to the investment adviser,

ii.

any affiliated person of a controlling person and

iii.

any affiliated person of an affiliated person.

"Control" shall mean the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company. Any person who owns beneficially, either directly or through one or more controlled companies, more than 25 percent of the voting securities of a company shall be presumed to control such company.

(D)

An investment adviser shall not be deemed to have violated the provisions of this subdivision (13) because of the failure to record securities transactions of any advisory representative if the investment adviser establishes that it instituted adequate procedures and used reasonable diligence to obtain promptly reports of all transactions required to be recorded.

14.

A copy of each written statement and each amendment or revision, given or sent to any client or prospective client of the investment adviser in accordance with the provisions of Rule 203(b)1 of this Act, and a record of the dates that each written statement, and each amendment or revision, was given, or offered to be given, to any client or prospective client who subsequently becomes a client.

15.

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For each client that was obtained by the adviser by means of a solicitor to whom a cash fee was paid by the adviser

(A)

evidence of a written agreement to which the adviser is a party related to the payment of such fee;

(B)

a signed and dated acknowledgment of receipt from the client evidencing the client's receipt of the investment adviser's disclosure statement and a written disclosure statement of the solicitor; and,

(C)

a copy of the solicitor's written disclosure statement. The written agreement, acknowledgment and solicitor disclosure statement will be considered to be in compliance if such documents are in compliance with Rule 275.206(4)-3 of the Investment Advisers Act of 1940.

For purposes of this rule, the term "solicitor" shall mean any person or entity who, for compensation, acts as an agent of an investment adviser in referring potential clients.

16.

All accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of all managed accounts or securities recommendations in any notice, circular, advertisement, newspaper article, investment letter, bulletin, or other communication including but not limited to electronic media that the investment adviser circulates or distributes, directly or indirectly, to two or more persons (other than persons connected with the investment adviser); provided, however, that, with respect to the performance of managed accounts, the retention of all account statements, if they reflect all debits, credits, and other transactions in a client's account for the period of the statement, and all worksheets necessary to demonstrate the calculation of the performance or rate of return of all managed accounts shall be deemed to satisfy the requirements of this paragraph.

17.

A file containing a copy of all written communications received or sent regarding any litigation involving the investment adviser or any investment adviser representative or employee, and regarding any written customer or client complaint

18.

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Written information about each investment advisory client that is the basis for making any recommendation or providing any investment advice to such client.

19.

Written procedures to supervise the activities of employees and investment adviser representatives that are reasonably designed to achieve compliance with applicable securities laws and regulations.

20.

A file containing a copy of each document (other than any notices of general dissemination) that was filed with or received from any state or federal agency or self regulatory organization and that pertains to the registrant or its investment adviser representatives as that term is defined in subdivision (a)(12)(A) of this Rule, which file should contain, but is not limited to, all applications, amendments, renewal filings, and correspondence.

21.

Copies, with original signatures of the investment adviser's appropriate signatory and the investment adviser representative, of each initial Form U-4 and each amendment to Disclosure Reporting Pages (DRPs U-4) must be retained by the investment adviser (filing on behalf of the investment adviser representative) and must be made available for inspection upon regulatory request.

22.

Where the adviser inadvertently held or obtained a client's securities or funds and returned them to the client within three business days or has forwarded third party checks within 24 hours the adviser will be considered as not having custody but shall keep the following records relating to the inadvertent custody:

A ledger or other listing of all securities or funds held or obtained, including the following information:

(A)

Issuer;

(B)

Type of security and series;

(C)

Date of issue;

(D)

For debt instruments, the denomination, interest rate and maturity date;

(E)

Certificate number, including alphabetical prefix or suffix;

(F)

Name in which registered;

(G)

Date given to the adviser;

(H)

Date sent to client or sender;

(I)

Form of delivery to client or sender, or copy of the form of delivery to client or sender; and

(J)

Mail confirmation number, if applicable, or confirmation by client or sender of the fund's or security's return.

23.

If an investment adviser obtains possession of securities that are acquired from the issuer in a transaction or chain of transactions not involving any public offering that comply with the exception from custody under NASAA Model Rule 102(e)((1)-1(b)(2), the adviser shall keep the following records;

(A)

A record showing the issuer or current transfer agent's name address, phone number and other applicable contract information pertaining to the party responsible for recording client interests in the securities; and

(B)

A copy of any legend, shareholder agreement or other agreement showing that those securities that are transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.

(b)

1. If an investment adviser has custody, as that term is defined in Rule 102(e)(1)-1(c)(1) of the NASAA Custody Rules, the records required to be made and kept under paragraph (a) above shall include:

(A)

A copy of any and all documents executed by the client (including a limited power of attorney) under which the adviser is authorized or permitted to withdraw a client's funds or securities maintained with a custodian upon the adviser's instruction to the custodian.

(B)

A journal or other record showing all purchases, sales, receipts and deliveries of securities (including certificate numbers) for all accounts and all other debits and credits to the accounts.

(C)

A separate ledger account for each client showing all purchases, sales, receipts and deliveries of securities, the date and price of each purchase and sale, and all debits and credits.

(D)

Copies of confirmations of all transactions effected by or for the account of any client.

(E)

A record for each security in which any client has a position, which record shall show the name of each client

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having any interest in each security, the amount or interest of each client, and the location of each security.

(F)

A copy of each of the client's quarterly account statements, as generated and delivered by the qualified custodian. If the adviser also generates a statement that is delivered to the client, the adviser shall also maintain copies of such statements along with the date such statements were sent to the clients.

(G)

If applicable to the adviser's situation, a copy of the auditor's report and financial statements and letter verifying the completion of the examination by an independent certified public accountant and describing the nature and extent of the examination.

(H)

A record of any finding by the independent certified public accountant of any material discrepancies found during the examination.

(I)

If applicable, evidence of the client's designation of an independent representative.

2.

If an investment adviser has custody because it advises a pooled investment vehicle, as defined in Rule 102(e)(1)-1(c)(iii), the adviser shall also keep the following records:

(A)

True, accurate and current account statements;

(B)

Where the adviser complies with Rule 102(e)(1)-1(b)(3) the records required to be made and kept shall include:

i.

the date(s) of the audit;

ii.

a copy of the audited financial statements; and

iii.

evidence of the mailing of the audited financial to all limited partners, members or other beneficial owners within 120 days of the end of its fiscal year.

(C)

Where the adviser complies with rule 102(e)(1)-1(a)(7) the records required to be made and kept shall include:

i.

A copy of the written agreement with the independent party reviewing all fees and expenses, indicating the responsibilities of the independent third party.

ii.

Copies of all invoices and receipts showing approval by the independent party for payment through the qualified custodian.

3.

If an investment adviser has custody because it is acting as the trustee for a beneficial trust as it is described in Rule 102(e)(1)-1(b)(5) the investment adviser shall also keep the following records until the account is closed or the adviser is no longer acting as trustee.

(A)

A copy of the written statement given to each beneficial owner setting forth a description of the requirements of Rule 102(e)(1)-1(a) and the reason why the adviser will not be complying with those requirements; and

(B)

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A written acknowledgement signed and dated by each beneficial owner, and evidencing receipt of the statement required under subsection (A) above.

(c)

Every investment adviser subject to subsection (a) of this Rule who renders any investment supervisory or management service to any client shall, with respect to the portfolio being supervised or managed and to the extent that the information is reasonably available to or obtainable by the investment adviser, make and keep true, accurate and current:

1.

Records showing separately for each client the securities purchased and sold, and the date, amount and price of each purchase and sale.

2.

For each security in which any client has a current position, information from which the investment adviser can promptly furnish the name of each the client, and the current amount or interest of the client.

(d)

Any books or records required by this Rule may be maintained by the investment adviser in such manner that the identity of any client to whom the investment adviser renders investment supervisory services is indicated by numerical or alphabetical code or some similar designation.

(e)

Every investment adviser subject to subsection (a) of this rule shall preserve the following records in the manner prescribed:

1.

All books and records required to be made under the provisions of paragraph (a) to (c)(1), inclusive, of this Rule (except for books and records required to be made under the provisions of paragraphs (a)(11) and (a)(16) of this Rule), shall be maintained and preserved in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on record, the first two years in the principal office of the investment adviser.

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2.

Partnership articles and any amendments, articles of incorporation, charters, minute books, and stock certificate books of the investment adviser and of any predecessor, shall be maintained in the principal office of the investment adviser and preserved until at least three years after termination of the enterprise.

3.

Books and records required to be made under the provisions of paragraphs (a)(11) and (a)(16) of this Rule shall be maintained and preserved in an easily accessible place for a period of not less than five years, the first two years in an the principal office of the investment adviser, from the end of the fiscal year during which the investment adviser last published or otherwise disseminated, directly or indirectly, the notice, circular, advertisement, newspaper article, investment letter, bulletin, or other communication including by electronic media.

4.

Books and records required to be made under the provisions of paragraphs (a)(17)-(20), inclusive, of this Rule shall be maintained and preserved in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in the principal office of the investment adviser, or for the time period during which the investment adviser was registered or required to be registered in the state, if less.

5.

Notwithstanding other record preservation requirements of this Rule, the following records or copies shall be required to be maintained at the business location of the investment adviser from which the customer or client is being provided or has been provided with investment advisory services: (A) records required to be preserved under paragraphs (a)(3),(a)(7)-(10), (a)(14)-(15), (a)(17)-(19), (b) and (c) inclusive, of this Rule, and (B) the records or copies required under the provision of paragraphs (a)(11) and (a)(16) of this Rule which records or related records identify the name of the investment adviser representative providing investment advice from that business location, or which identify the business locations' physical address, mailing address, electronic mailing address, or telephone number. The records will be maintained for the period described in subdivision (e) of this Rule.

(f)

An investment adviser subject to subsection (a) of this Rule, before ceasing to conduct or discontinuing business as an investment adviser shall arrange for and be responsible for the preservation of the books and records required to be maintained and preserved under this Rule for the remainder of the period specified in this Rule, and shall notify the [Administrator] in writing of the exact address where the books and records will be maintained during the period.

(g)

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1. The records required to be maintained and preserved pursuant to this Rule may be immediately produced or reproduced by photograph on film or, as provided in paragraph (g)2. below, on magnetic disk, tape or other computer storage medium, and be maintained and preserved for the required time in that form. If records are produced or reproduced by photographic film or computer storage medium, the investment adviser shall:

(A)

arrange the records and index the films or computer storage medium so as to permit the immediate location of any particular record,

(B)

be ready at all times to provide, and promptly provide, any facsimile enlargement of film or computer printout or copy of the computer storage medium which the [Administrator] by its examiners or other representatives may request,

(C)

store separately from the original one other copy of the film or computer storage medium for the time required,

(D)

with respect to records stored on computer storage medium, maintain procedures for maintenance and preservation of, and access to, records so as to reasonably safeguard records from loss, alteration, or destruction, and

(E)

with respect to records stored on photographic film, at all times have available for the [Administrator's] examination of its records pursuant to section 203(e) of the Act, facilities for immediate, easily readable projection of the film and for producing easily readable facsimile enlargements.

2.

Pursuant to paragraph (g)1. an adviser may maintain and preserve on computer tape or disk or other computer storage medium records which, in the ordinary course of the adviser's business, are created by the adviser on electronic media or are received by the adviser solely on electronic media or by electronic data transmission.

(h)

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For purposes of this Rule, "investment supervisory services" means the giving of continuous advice as to the investment of funds on the basis of the individual needs of each client; and "discretionary power" shall not include discretion as to the price at which or the time when a transaction is or is to be effected, if, before the order is given by the investment adviser, the client has directed or approved the purchase or sale of a definite amount of the particular security.

(i)

Any book or other record made, kept, maintained and preserved in compliance with Rules 17a-3 [17 C.F.R. 240.17a-3] and 17a-4 [17 C.F.R. 240.17a-4] under the Securities Exchange Act of 1934, which is substantially the same as the book or other record required to be made, kept, maintained and preserved under this Rule, shall be deemed to be made, kept, maintained and preserved in compliance with this Rule.

(j)

Every investment adviser registered or required to be registered in this state and that has its principal place of business in a state other than this state shall be exempt from the requirements of this section, provided the investment adviser is licensed in such state and is in compliance with such state's recordkeeping requirements.

Rule 203(a)2 [RUSA Rule 209e-2] (ALTERNATIVE 2 (language for states which incorporate by reference Rule 204-2 of the Investment Advisers Act of 1940)):

[RECORDKEEPING REQUIREMENTS FOR INVESTMENT ADVISERS.]

(a)

[Every investment adviser registered or required to be registered under this Act shall make and keep true, accurate and current the following books, ledgers and records:]

13.

For investment advisers who have custody, as that term is defined in Rule 102(e)(1)-1(c)(1), of client funds or securities, all records and evidence of compliance required by Rule 206(4)-2 under the Investment Advisers Act of 1940.

(b)

Every investment adviser subject to subsection (a) of this rule shall preserve for the period described in subdivision (e) of this Rule the following records in the manner prescribed:

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1.

Books and records required to be made under the provisions of paragraph (a)(1) of this Rule shall be maintained and preserved in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in the principal office of the investment adviser.

2.

Books and records required to be made under the provisions of paragraphs (a)(2)-(a)(13), inclusive, of this Rule shall be maintained and preserved in an easily accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in the principal office of the investment adviser, or for the time period during which the investment adviser was registered or required to be registered in the state, if less.

3.

Notwithstanding other record preservation requirements of this Rule, the following records or copies shall be required to be maintained at the business location of the investment adviser from which the customer or client is being provided or has been provided with investment advisory services:

(A)

records required to be preserved under

i.

paragraphs (a)(3), (a)(7)-(10), (a)(14)-(15), (b) and (c) inclusive, of SEC Rule 204-2 of the Investment Advisers Act of 1940 (*17 C.F.R. 275.204-2 (1996)*),

ii.

paragraphs (a)(9)-(11) of this Rule; and

(B)

the records or copies required under the provision of paragraphs (a)(11) and (a)(16) of this Rule which records or related records identify the name of the investment adviser representative providing investment advice from that business location, or which identify the business locations' physical address, mailing address, electronic mailing address, or telephone number.

(c)

To the extent that the U.S. Securities and Exchange Commission promulgates changes to the above-referenced rules of the Investment Advisers Act of 1940, investment advisers in compliance with such rules as amended shall not be subject to enforcement action by the [Administrator] for violation of this Rule to the extent that the violation results solely from the investment adviser's compliance with the amended rule.

(d)

Every investment adviser that has its principal place of business in a state other than this state shall be exempt from the requirements of this section, provided the investment adviser is licensed in such state and is in compliance with the state's recordkeeping requirements.

Adopted April 27, 1997; Amended April 18, 2004

Rule 102(a)(4)-1. Unethical Business Practices of Investment Advisers

A person who is an investment adviser or a federal covered adviser is a fiduciary and has a duty to act primarily for the benefit of its clients. The provisions of this subsection apply to federal covered advisers to the extent that the conduct alleged is fraudulent, deceptive, or as otherwise permitted by the National Securities Markets Improvement Act of 1996 (Pub. L. No. 104-290). While the extent and nature of this duty varies according to the nature of the relationship between an investment adviser and its clients and the circumstances of each case, an investment adviser or a federal covered adviser shall not engage in unethical business practices, including the following:

1.

Recommending to a client to whom supervisory, management or consulting services are provided the purchase, sale or exchange of any security without reasonable grounds to believe that the recommendation is suitable for the client on the basis of information furnished by the client after reasonable inquiry concerning the client's investment objectives, financial situation and needs, and any other information known by the investment adviser.

2.

Exercising any discretionary power in placing an order for the purchase or sale of securities for a client without obtaining written discretionary authority from the client within ten (10) business days after the date of the first transaction placed pursuant to oral discretionary authority, unless the discretionary power relates solely to the price at which, or the time when, an order involving a definite amount of a specified security shall be executed, or both.

3.

Inducing trading in a client's account that is excessive in size or frequency in view of the financial resources, investment objectives and character of the account in light of the fact that an adviser in such situations can directly benefit from the number of securities transactions effected in a client's account. The rule appropriately forbids an

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excessive number of transaction orders to be induced by an adviser for a "customer's account."

4.

Placing an order to purchase or sell a security for the account of a client without authority to do so.

5.

Placing an order to purchase or sell a security for the account of a client upon instruction of a third party without first having obtained a written third-party trading authorization from the client.

6.

Borrowing money or securities from a client unless the client is a broker-dealer, an affiliate of the investment adviser, or a financial institution engaged in the business of loaning funds.

7. Loaning money to a client unless the investment adviser is a financial institution engaged in the business of loaning funds or the client is an affiliate of the investment adviser.

8. To misrepresent to any advisory client, or prospective advisory client, the qualifications of the investment adviser or any employee of the investment adviser, or to misrepresent the nature of the advisory services being offered or fees to be charged for such service, or to omit to state a material fact necessary to make the statements made regarding qualifications, services or fees, in light of the circumstances under which they are made, not misleading.

9. Providing a report or recommendation to any advisory client prepared by someone other than the adviser without disclosing that fact. (This prohibition does not apply to a situation where the adviser uses published research reports or statistical analyses to render advice or where an adviser orders such a report in the normal course of providing service.)

10. Charging a client an unreasonable advisory fee.

11. Failing to disclose to clients in writing before any advice is rendered any material conflict of interest relating to the adviser or any of its employees which could reasonably be expected to impair the rendering of unbiased and objective advice including:

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(a) Compensation arrangements connected with advisory services to clients which are in addition to compensation from such clients for such services; and

(b) Charging a client an advisory fee for rendering advice when a commission for executing securities transactions pursuant to such advice will be received by the adviser or its employees.

12. Guaranteeing a client that a specific result will be achieved (gain or no loss) with advice which will be rendered.

13. Publishing, circulating or distributing any advertisement which does not comply with Rule 206 (4)-1 under the Investment Advisers Act of 1940.

14. Disclose the identity, affairs, or investments of any client unless required by law to do so, or unless consented to by the client.

15. Taking any action, directly or indirectly, with respect to those securities or funds in which any client has any beneficial interest, where the investment adviser has custody or possession of such securities or funds when the adviser's action is subject to and does not comply with the requirements of Rule 102(e)(1)-1. and any subsequent amendments.

16. Entering into, extending or renewing any investment advisory contract unless such contract is in writing and discloses, in substance, the services to be provided, the term of the contract, the advisory fee, the formula for computing the fee, the amount of prepaid fee to be returned in the event of contract termination or nonperformance, whether the contract grants discretionary power to the adviser and that no assignment of such contract shall be made by the investment adviser without the consent of the other party to the contract.

17. Failing to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information contrary to the provisions of Section 204A of the Investment Advisers Act of 1940.

18. Entering into, extending, or renewing any advisory contract contrary to the provisions of section 205 of the Investment Advisers Act of 1940. This provision shall apply to all advisers registered or required to be registered under this Act, notwithstanding whether such adviser would be exempt from federal registration pursuant to section 203 (b) of the Investment Advisers Act of 1940.

19. To indicate, in an advisory contract, any condition, stipulation, or provisions binding any person to waive

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compliance with any provision of this act or of the Investment Advisers Act of 1940, or any other practice contrary to the provisions of section 215 of the Investment Advisers Act of 1940.

20. Engaging in any act, practice, or course of business which is fraudulent, deceptive, or manipulative in contrary to the provisions of section 206 (4) of the Investment Advisers Act of 1940, notwithstanding the fact that such investment adviser is not registered or required to be registered under section 203 of the Investment Advisers Act of 1940.

21. Engaging in conduct or any act, indirectly or through or by any other person, which would be unlawful for such person to do directly under the provisions of this act or any rule or regulation thereunder. The conduct set forth above is not inclusive. Engaging in other conduct such as nondisclosure, incomplete disclosure, or deceptive practices shall be deemed an unethical business practice. The federal statutory and regulatory provisions referenced herein shall apply to investment advisers and federal covered advisers, to the extent permitted by the National Securities Markets Improvement Act of 1996 (Pub. L. No. 104-290).

As amended May 7, 2007 (originally adopted Nov. 20, 1986 and amended April 22, 1988)

I. INTRODUCTION.

A. Application:

1. The rules contained in these guidelines apply to qualification, and registration of PROGRAMS formed to own equipment and either (a) lease it to non-AFFILIATES, or (b) operate the equipment themselves or through AFFILIATES. While applications not conforming to the standards contained herein shall be looked upon with disfavor, where good cause is shown, certain guidelines may be modified or waived by the ADMINISTRATOR.

COMMENT:

The purpose of the guidelines is to establish uniform and consistent standards to be applied by the various state securities ADMINISTRATORS throughout the country. These standards are primarily designed for public programs which acquire and own and either lease or operate equipment of any kind. Excluded shall be PROGRAMS formed to acquire or develop and operate a business and eventually dispose of the business as a whole rather than dispose of identified pieces of equipment. In such PROGRAMS, actual ownership and operation of equipment is incidental to the business of the PROGRAM. An example of this exclusion would be a PROGRAM formed to acquire, develop and operate cable television systems, where the purchase of equipment is incidental to the business. Among other things, the guidelines apply to drilling rig PROGRAMS, service and supply PROGRAMS, and cable television PROGRAMS which do not fall within the above exclusion.

2. Where the individual characteristics of specific PROGRAMS warrant modification from these standards, they will be accommodated insofar as possible while still being consistent with the spirit of these guidelines. When required

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by the ADMINISTRATOR, a CROSS REFERENCE SHEET shall be furnished with the application.

3. Where these guidelines conflict with disclosure requirements of the Securities and Exchange Commission, the guidelines will not apply.

B. *Definitions*: Where terms used in the PROSPECTUS are subject to more than one interpretation and such terms are material to PROGRAM provisions, the PROSPECTUS shall contain a glossary of such terms. Any discrepancies between the definitions set forth in these GUIDELINES and the definitions set forth in the glossary shall be indicated in the application filed with the ADMINISTRATOR.

1. *ACQUISITION EXPENSES*: expenses including but not limited to legal fees and expenses, travel and communication expenses, costs of appraisals, accounting fees and expenses, and miscellaneous expenses relating to selection and acquisition of equipment, whether or not acquired.

2. *ACQUISITION FEE*: the total of all fees and commissions paid by any party in connection with the initial purchase or manufacture of equipment acquired by a PROGRAM. Included in the computation of such fees or commissions shall be any commission, selection fee, construction supervision fee, financing fee, non-recurring management fee, or any fee of a similar nature, however designated.

3. *ADMINISTRATOR*: the official or agency administering the securities law of a State.

4. *AFFILIATE*: (a) any PERSON directly or indirectly controlling, controlled by or under common control with another PERSON (b) any PERSON owning or controlling 10% or more of the outstanding voting securities of such other PERSON (c) any officer, director, or partner of such PERSON and (d) if such other PERSON is an officer, director or partner, any company for which such PERSON acts in such capacity.

5. *ASSESSMENTS*: additional amounts of capital which may be mandatorily required of or paid at the option of a PARTICIPANT beyond his subscription commitment.

6. *CAPITAL CONTRIBUTION*: the gross amount of investment in a PROGRAM by a PARTICIPANT, or all PARTICIPANTS, as the case may be.

COMMENT:

Funds reinvested pursuant to Subsections VIII.D and E of these GUIDELINES are not considered to be "investments" in the PROGRAM for purposes of calculating CAPITAL CONTRIBUTIONS.

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7. *CARRIED INTEREST*: an interest taken in a program by a PERSON, other than the promotional interest provided for in Sections IV.C. 3 and IV.D., for which full consideration has neither been paid nor is to be paid.

8. *CASH AVAILABLE FOR DISTRIBUTION*: CASH FLOW plus cash funds available for distribution from PROGRAM reserves less amounts set aside for restoration or creation of reserves.

9. *CASH FLOW*: PROGRAM cash funds provided from operations, without deduction for depreciation, but after deducting cash funds used to pay all other expenses, debt payments, capital improvements and replacements (other than cash funds withdrawn from reserves).

COMMENT:

The PROGRAM agreement should contain appropriate language to effectuate this provision.

10. *COMPETITIVE EQUIPMENT SALE COMMISSION*: that brokerage fee paid for services rendered in connection with the purchase or sale of equipment which is reasonable, customary and competitive in light of the size, type and location of the equipment.

11. *CROSS REFERENCE SHEET*: a compilation of the Guideline sections, referenced to the page of the PROSPECTUS, PROGRAM agreement, or other exhibits, and justification for any deviation from the Guidelines.

12. *EQUIPMENT MANAGEMENT*: personnel and services necessary to the leasing activities of the PROGRAM, including but not limited to, leasing and re-leasing of PROGRAM equipment, arranging for necessary maintenance and repair of the equipment, collecting revenues, paying operating expenses, determining that the equipment is used in accordance with all operative contractual arrangements and providing clerical and bookkeeping services necessary to the operation of PROGRAM equipment.

13. *FRONT-END FEES*: fees and expenses paid by any party for any services rendered during the PROGRAM'S organizational or acquisition phase including ORGANIZATION AND OFFERING EXPENSES, LEASING FEES, ACQUISITION FEES, ACQUISITION EXPENSES, and any other similar fees, however designated by the SPONSOR. FRONT-END FEES shall not include any ACQUISITION FEES or ACQUISITION EXPENSES paid by a manufacturer of equipment to any of its employees unless such PERSONS are AFFILIATES of the SPONSOR.

COMMENT:

It is anticipated that fees and expenses covered by the last sentence may be incorporated into the purchase price, and these are not to be construed as FRONT-END FEES. The general approach in these definitions and the limits contained in Section IV. is that there should be no duplication of fees.

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14. *FULL PAYOUT LEASES*: leases under which the non-cancellable rental payments due during the initial term of the lease are sufficient to recover the PURCHASE PRICE OF EQUIPMENT.

15. *INDEPENDENT EXPERT*: A PERSON with no current material or prior business or personal relationship with the SPONSOR who is engaged to a substantial extent in the business of rendering opinions regarding the value of assets of the type held by the PROGRAM, and who is qualified to perform such work.

16. *INVESTMENT IN EQUIPMENT*: the amount of CAPITAL CONTRIBUTIONS actually paid or allocated to the purchase, manufacture, or renovation of equipment acquired by the PROGRAM, including the purchase of equipment, working capital reserves allocable thereto (except that working capital reserves in excess of 3% shall not be included), and other cash payments such as interest and taxes but excluding FRONT-END FEES.

17. *LEASING FEE*: the total of all fees and commissions paid by any party in connection with the initial lease of equipment acquired by a PROGRAM.

18. *NET DISPOSITION PROCEEDS*: the proceeds realized by the PROGRAM from sale, refinancing or other disposition of PROGRAM EQUIPMENT, including insurance proceeds or lessee indemnity payments arising from the loss or destruction of the EQUIPMENT, less all PROGRAM liabilities.

19. *NET LEASE PROVISIONS*: contractual arrangements under which the lessee assumes responsibility for, and bears the cost of, insurance, taxes, maintenance, repair and operation of the leased asset and where the non-cancellable rental payments under the lease are absolutely net to the lessor.

COMMENT:

A lease may be deemed to contain NET LEASE PROVISIONS even if some minor costs or responsibilities remain with the lessor or if the lessor retains the option to require and pay for a higher standard of care or a greater level of maintenance or insurance, than would be imposed upon the lessee under the terms of the lease.

20. *NET WORTH*: the excess of total assets over total liabilities as determined by generally accepted accounting principles, except that if any of such assets have been depreciated, then the amount of depreciation relative to any particular asset may be added to the depreciated cost of such asset to compute total assets. The amount of depreciation may be added only to the extent that the amount resulting after adding such depreciation does not exceed the fair market value of such asset.

21. *OPERATING LEASES*: leases which will return to the lessor less than the PURCHASE PRICE OF

EQUIPMENT from rentals payable during the initial term of the lease.

22. *ORGANIZATIONAL AND OFFERING EXPENSES*: expenses incurred in connection with preparing a PROGRAM for registration and subsequently offering and distributing it to the public, including sales commissions paid to broker-dealers in connection with the distribution of PROGRAM INTERESTS and all advertising expenses except advertising expenses related to the leasing of the PROGRAM's equipment.

23. *PARTICIPANT*: the holder of a PROGRAM INTEREST.

24. *PERSON*: any natural person, partnership, corporation, association, or other legal entity.

25. *PROGRAM*: a limited or general partnership, joint venture, unincorporated association or similar organization, other than a corporation formed and operated for the primary purpose of investment in and the operation of or gain from an interest in equipment.

26. *PROGRAM INTEREST*: the limited partnership unit or other indicia of ownership in a PROGRAM.

27. *PROSPECTUS*: shall have the meaning given to that term by Section 2(10) of the Securities Act of 1933, including a preliminary PROSPECTUS; provided, however, that such term as used herein shall also include an offering circular as described in Rule 256 of the General Rules and Regulations under the Securities Act of 1933, or, in the case of an intrastate offering, any document by whatever name known, utilized for the purpose of offering and selling securities to the public.

28. *PURCHASE PRICE OF EQUIPMENT*: the price paid upon the purchase or sale of a particular item of equipment, including the amount of ACQUISITION FEES and all liens and mortgages on the equipment, but excluding points and prepaid interest.

29. *ROLL UP*: a transaction involving the acquisition, merger, conversion, or consolidation either directly or indirectly of the PROGRAM and the issuance of securities of a ROLL-UP ENTITY. Such term does not include:

(a) a transaction involving securities of a PROGRAM that have been for at least 12 months listed on a national securities exchange or traded through the National Association of Securities Dealers Automated Quotation National Market System; or

(b) a transaction involving the conversion to corporate, trust or association form of only the PROGRAM if, as a consequence of the transaction, there will be no significant adverse change in any of the following:

- (i) PARTICIPANT'S voting rights;
- (ii) the term of existence of the PROGRAM;
- (iii) SPONSOR compensation; or
- (iv) the PROGRAM'S investment objectives.

30. *ROLL-UP ENTITY*: the partnership, corporation, trust, or other entity that would be created or would survive after the successful completion of a proposed ROLL-UP transaction.

31. *SPECIFIED EQUIPMENT PROGRAM*: a PROGRAM where, at the time a securities registration is ordered effective, at least 75% of the net proceeds from the sale of PROGRAM INTERESTS are allocable to the purchase or renovation of identified equipment or one specified type of identified equipment. Reserves shall not be included in the 75%.

COMMENT:

Identified equipment means items of equipment (not types of equipment) actually specified in the Prospectus at the date of effectiveness.

One specified type of identified equipment is narrowly defined. For example, one specified type of equipment would be commercial aircraft, marine containers or computer software. A broader category, e.g. transportation or computer equipment will not be considered to be one specified type of identified equipment.

32. *SPONSOR*: any PERSON directly or indirectly instrumental in organizing, wholly or in part, a PROGRAM or any PERSON who will manage or participate in the management of a PROGRAM, and any AFFILIATE of any such person. SPONSOR does not include a PERSON whose only relation with the PROGRAM is that of an independent equipment manager and whose only compensation is as such. SPONSOR does not include wholly independent third parties such as attorneys, accountants, and underwriters whose only compensation is for professional services rendered in connection with the offering of PROGRAM interests.

II. REQUIREMENTS OF SPONSORS.

A. *Experience.* The SPONSOR, the general partner, or their chief operating officers, shall have at least three years relevant equipment leasing or other experience which demonstrates sufficient knowledge and experience to acquire and manage the type of equipment the PROGRAM will purchase. Any of the foregoing or any AFFILIATE providing services to the PROGRAM shall have had not less than three years relevant experience in the kind of service being rendered or must otherwise demonstrate sufficient knowledge and experience to perform the services proposed.

B.

1. NET WORTH Requirement of SPONSOR.

The financial condition of the SPONSOR liable for the debts of the PROGRAM must be commensurate with any financial obligations assumed in the offering and in the operation of the PROGRAM. At a minimum, such SPONSOR shall have an aggregate financial NET WORTH, exclusive of home, automobile and home furnishings, of the greater of either \$50,000 or an amount at least equal to 5% of the gross amount of all direct participation offerings sold within the prior 12 months plus 5% of the gross amount of the current offering, to an aggregate maximum NET WORTH of such SPONSOR of one million dollars. In determining NET WORTH for this purpose, contingent liabilities and the use of promissory notes will be evaluated by the ADMINISTRATOR to determine the appropriateness of their inclusion in NET WORTH computation.

COMMENT:

The ADMINISTRATOR may want to consider the terms of the note, including whether the note is demand or recourse, as well as the maker's ability to honor the note through the use of liquid assets.

2. Financial Information Required. The SPONSOR shall provide as an exhibit to the application the following financial information in support of its NET WORTH:

a. Corporate SPONSORS shall submit a balance sheet as of the end of their most recent fiscal year, prepared in accordance with generally accepted accounting principles and examined and reported upon by an independent certified public accountant in accordance with generally accepted auditing standards. A balance sheet for the prior fiscal year which meets the above qualifications shall be used if the most recent fiscal year has ended not more than ninety days prior to the date of filing, and an unaudited balance sheet as of a date not more than one hundred thirty-five days prior to the date of filing should also be prepared. Such statements shall be included in the PROSPECTUS.

b. Where the NET WORTH requirement of this section cannot be met by corporate SPONSORS, a balance sheet for each non-corporate SPONSOR (including individual partners or individual joint ventures of a SPONSOR) as of a date not more than one hundred thirty-five days prior to the date of filing an application shall be submitted. Such balance sheet shall be prepared in accordance with generally accepted accounting principles and reviewed and reported upon by an independent certified public accountant under the review standards set forth by the American Institute of

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Certified Public Accountants. In such case, a representation of the amount of such NET WORTH must be included in the PROSPECTUS, or in the alternative, a representation that such SPONSOR meets the NET WORTH requirements of this section.

C. *Tax Ruling or Opinion.* The SPONSOR must have a tax ruling from the U.S. Internal Revenue Service or an opinion of qualified tax counsel concerning the flow-through of tax benefits and other tax consequences to the PARTICIPANT. An opinion of counsel shall be in form and substance satisfactory to the ADMINISTRATOR and shall be unqualified except to the extent permitted by the ADMINISTRATOR.

COMMENT:

An opinion meeting the requirements of ABA Formal Opinion 346 (Revised) of the American Bar Association Standing Committee on Ethics and Professional Responsibility and any applicable law shall be deemed satisfactory.

D. *Reports to ADMINISTRATOR.* The SPONSOR shall submit to the ADMINISTRATOR any other information which the ADMINISTRATOR requires, including, but not limited to, reports and statements required to be distributed to PARTICIPANTS.

E. *Liability and Indemnification.*

1. The PROGRAM shall not provide for indemnification of the SPONSOR for any liability or loss suffered by the SPONSOR, nor shall it provide that the SPONSOR be held harmless for any loss or liability suffered by the PROGRAM, unless all of the following conditions are met:

a. The SPONSOR has determined, in good faith, that the course of conduct which caused the loss or liability was in the best interests of the PROGRAM, and

b. the SPONSOR was acting on behalf of or performing services for the PROGRAM, and

c. such liability or loss was not the result of negligence or misconduct by the SPONSOR, and

d. such indemnification or agreement to hold harmless is recoverable only out of the assets of the PROGRAM and not from the limited partners.

For purposes of this section, AFFILIATES must be performing services on behalf of the PROGRAM and acting within the scope of the general partner's authority.

2. Indemnification of the SPONSORS will not be allowed for any liability imposed by judgment, and costs associated therewith, including attorney's fees, arising from or out of a violation of state or federal securities laws associated with the offer and sale of partnership units. Indemnification will be allowed for settlements and related expenses of lawsuits alleging securities law violations, and for expenses incurred in successfully defending such lawsuits, provided that a court either:

- a. approves the settlement and finds that indemnification of the settlement and related costs should be made, or
- b. approves indemnification of litigation costs if a successful defense is made. Every application for registration must contain an undertaking that such parties seeking indemnification will apprise the court of the positions of the ADMINISTRATOR and the SEC with respect to indemnification for securities laws violations, before seeking court approval for indemnification.

3. The PROGRAM may not incur the cost of that portion of liability insurance which insures the SPONSOR for any liability as to which the SPONSOR is prohibited from being indemnified under this section.

III. SUITABILITY OF PARTICIPANTS

A. General Policy.

1. The SPONSOR shall establish minimum income and net worth standards for PERSONS who purchase PROGRAM INTERESTS.

2. The SPONSOR shall propose minimum income and net worth standards which are reasonable given the type of PROGRAM and the risks associated with the purchase of PROGRAM INTERESTS. PROGRAMS with greater investor risk shall have minimum standards with a substantial NET WORTH requirement. The ADMINISTRATOR shall evaluate the standards proposed by the SPONSOR when the PROGRAM'S application for registration is reviewed. In evaluating the proposed standards, the ADMINISTRATOR may consider the following:

- a. the PROGRAM'S use of leverage;
- b. tax implications;

c. mandatory deferred payments;

d. assessments;

e. balloon payment financing;

f. potential variances in cash distributions;

g. potential PARTICIPANTS;

h. relationship between potential PARTICIPANTS and the SPONSOR;

i. liquidity of PROGRAM INTERESTS;

j. performance of the SPONSOR'S prior programs;

k. financial condition of the SPONSOR;

l. potential transactions between the PROGRAM and the SPONSOR; and

m. any other relevant factors.

B. Income and Net Worth Standards.

1. Unless the ADMINISTRATOR determines that the risks associated with the PROGRAM would require lower or higher standards, each PARTICIPANT shall have:

a. a minimum annual gross income of \$70,000 and a minimum NET WORTH of \$70,000; or

b. a minimum NET WORTH of \$250,000.

2. NET WORTH shall be determined exclusive of home, home furnishings, and automobiles.

3. In the case of sales to fiduciary accounts, these minimum standards shall be met by the beneficiary, the fiduciary account, or by the donor or grantor who directly or indirectly supplies the funds to purchase the PROGRAM INTERESTS if the donor or grantor is the fiduciary.

4. The SPONSOR shall set forth in the final PROSPECTUS:

a. the investment objectives of the PROGRAM;

b. a description of the type of PERSON who might benefit from an investment in the PROGRAM; and

c. the minimum standards imposed on each PARTICIPANT in the PROGRAM.

C. Determination that Sale to PARTICIPANT is Suitable and Appropriate.

1. The SPONSOR and each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM shall make every reasonable effort to determine that the purchase of PROGRAM INTERESTS is a suitable and appropriate investment for each PARTICIPANT.

2. In making this determination, the SPONSOR or each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM shall ascertain that the prospective PARTICIPANT:

a. meets the minimum income and net worth standards established for the PROGRAM;

b. can reasonably benefit from the PROGRAM based on the prospective PARTICIPANT'S overall investment objectives and portfolio structure;

c. is able to bear the economic risk of the investment based on the prospective PARTICIPANT'S overall financial situation; and

d. has apparent understanding of:

(1) the fundamental risks of the investment;

(2) the risk that the PARTICIPANT may lose the entire investment;

(3) the lack of liquidity of PROGRAM INTERESTS;

(4) the restrictions on transferability of PROGRAM INTERESTS;

(5) the background and qualifications of the SPONSOR or the PERSONS responsible for directing and managing the PROGRAM; and

(6) the tax consequences of the investment.

3. The SPONSOR or each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM will make this determination on the basis of information it has obtained from a prospective PARTICIPANT. Relevant information for this purpose will include at least the age, investment objectives, investment experience, income, NET WORTH, financial situation, and other investments of the prospective PARTICIPANT, as well as any other pertinent factors.

4. The SPONSOR or each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM shall maintain records of the information used to determine that an investment in PROGRAM INTERESTS is suitable and appropriate for each PARTICIPANT. The SPONSOR or each PERSON selling PROGRAM INTERESTS on behalf

of the SPONSOR or PROGRAM shall maintain these records for at least six years.

5. The SPONSOR shall disclose in the final PROSPECTUS the responsibility of the SPONSOR and each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM to make every reasonable effort to determine that the purchase of PROGRAM INTERESTS is a suitable and appropriate investment for each PARTICIPANT, based on information provided by the PARTICIPANT regarding the PARTICIPANT'S financial situation and investment objectives.

D. Subscription Agreements.

1. The ADMINISTRATOR may require that each PARTICIPANT complete and sign a written subscription agreement.

2. The SPONSOR may require that each PARTICIPANT make certain factual representations in the subscription agreement, including the following:

a. The PARTICIPANT meets the minimum income and net worth standards established for the PROGRAM.

b. The PARTICIPANT is purchasing the PROGRAM INTERESTS for his or her own account.

c. The PARTICIPANT has received a copy of the PROSPECTUS.

d. The PARTICIPANT acknowledges that the investment is not liquid.

3. The PARTICIPANT must separately sign or initial each representation made in the subscription agreement. Except in the case of fiduciary accounts, the PARTICIPANT may not grant any PERSON a power of attorney to make such representations on his or her behalf.

4. The SPONSOR and each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM shall not require a PARTICIPANT to make representations in the subscription agreement which are subjective or unreasonable and which:

a. might cause the PARTICIPANT to believe that he or she has surrendered rights to which he or she is entitled under federal or state law; or

b. would have the effect of shifting the duties regarding suitability, imposed by law on broker-dealers, to the PARTICIPANT.

5. Prohibited representations include, but are not limited to the following:

a. The PARTICIPANT understands or comprehends the risks associated with an investment in the PROGRAM.

b. The investment is a suitable one for the PARTICIPANT.

c. The PARTICIPANT has read the PROSPECTUS.

d. In deciding to invest in the PROGRAM, the PARTICIPANT has relied solely on the PROSPECTUS, and not on any other information or representations from other PERSONS or sources.

6. The SPONSOR may place the content of the prohibited representations in the subscription agreement in the form of disclosures to the PARTICIPANT. The SPONSOR may not place these disclosures in the PARTICIPANT representation section of the subscription agreement.

E. Completion of Sale.

1. The SPONSOR or any person selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM may not complete a sale of PROGRAM INTERESTS to a PARTICIPANT until at least five business days after the date the PARTICIPANT receives a final prospectus.

2. The SPONSOR or the PERSON designated by the SPONSOR shall send each PARTICIPANT a confirmation of his or her purchase.

F. *Minimum Investment.* The ADMINISTRATOR may require a minimum initial and subsequent cash investment amount.

III. COMPENSATION AND EXPENSES.

A. *Introduction.* All forms of fees, reimbursement, compensation and remuneration paid to the SPONSOR from any source in connection with the PROGRAM shall be reasonable, taken as a whole, and shall be presumed reasonable if permitted by these Guidelines. Any other form of remuneration may be permitted if fully justified, supported and permitted by the ADMINISTRATOR. All such remuneration shall be disclosed in the PROSPECTUS.

B. *Organizational and Offering Expenses.* ORGANIZATIONAL AND OFFERING EXPENSES shall be reasonable and shall comply with all statutes, rules and regulations imposed in connection with the offering of other securities in the State. Compensation of broker-dealers and agents for selling PROGRAM INTERESTS or assisting in the organization of the PROGRAM shall be in cash.

C. *Investment in Equipment.*

1. The SPONSOR shall be required to commit a substantial portion of the PROGRAM's CAPITAL CONTRIBUTIONS toward INVESTMENT IN EQUIPMENT. The remaining CAPITAL CONTRIBUTIONS may be used to pay FRONT-END FEES. If CAPITAL CONTRIBUTIONS are paid on an installment basis, the FRONT-END FEES shall be paid to the SPONSOR pro rata as installments are paid.

2. The SPONSOR shall commit a percentage of CAPITAL CONTRIBUTIONS to INVESTMENT IN EQUIPMENT which is equal to the greater of:

a. 80% of the CAPITAL CONTRIBUTIONS reduced by .0625% for each 1% of indebtedness encumbering PROGRAM equipment; or

b. 75% of CAPITAL CONTRIBUTIONS.

3. If the SPONSOR enters into an INVESTMENT IN EQUIPMENT commitment in excess of that specified in paragraph 2. above, the following mutually exclusive forms of compensation are viewed as reasonable alternatives to

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FRONT-END FEES:

a. For each 1% of CAPITAL CONTRIBUTIONS committed to INVESTMENT IN EQUIPMENT in excess of the minimum amount required the SPONSOR may take an additional promotional interest equal to 1% of all distributions from CASH AVAILABLE FOR DISTRIBUTION and NET DISPOSITION PROCEEDS remaining after PARTICIPANTS have received a cash return of 100% of their CAPITAL CONTRIBUTIONS; or

b. The SPONSOR may take a fully participating CARRIED INTEREST equal to 1% for the first 2.5% of additional INVESTMENT IN EQUIPMENT, 1% for the next 2% of additional INVESTMENT IN EQUIPMENT, and 1% for each 1% of additional INVESTMENT IN EQUIPMENT thereafter.

4. Except as permitted by paragraph 3. above, no CARRIED INTEREST in the PROGRAM shall be allowed.

COMMENT:

The purpose of this section is to require the SPONSOR to invest a specified percentage of CAPITAL CONTRIBUTIONS in the acquisition of equipment and use the balance for FRONT-END FEES or defer a portion of the FRONT-END FEES for an additional promotional interest or CARRIED INTEREST.

This will avoid the necessity of having to attempt to establish the reasonableness of the various FRONT-END FEES on an individual basis. However, the formula continues the tradition of other NASAA guidelines by allowing the SPONSOR's fee to increase as leverage is employed to acquire equipment. The PROSPECTUS should include an example demonstrating the mechanics of the formula.

To calculate the percent of indebtedness encumbering PROGRAM EQUIPMENT in paragraph 2., divide the amount of indebtedness by the PURCHASE PRICE OF EQUIPMENT, excluding FRONT-END FEES. The Quotient is multiplied by .0625% to determine the percentage to be deducted from 80%.

The following are examples of application of the formula:

(1) No indebtedness--80% to be committed to INVESTMENT IN EQUIPMENT.

(2) 50% indebtedness-- $50\% \times .0625\% = 3.125\%$
 $80\% - 3.125\% = 76.875\%$ to be committed to INVESTMENT IN EQUIPMENT.

(3) 80% indebtedness-- $80\% \times .0625\% = 5\%$
 $80\% - 5\% = 75\%$ to be committed to INVESTMENT IN EQUIPMENT.

D. *Promotional Interest:* An interest in the PROGRAM will be allowed as a promotional interest provided that the amount or percentage of such interest is reasonable. Such an interest will be presumed reasonable if it is within the limitations expressed below:

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1. An interest equal to:

a. 5% of all distributions from CASH AVAILABLE FOR DISTRIBUTION and 1% of all distributions from NET DISPOSITION PROCEEDS until such time as the PARTICIPANTS have received a return of their CAPITAL CONTRIBUTIONS plus an amount equal to 8% of CAPITAL CONTRIBUTIONS per annum cumulative; thereafter the SPONSOR's interest in all distributed CASH AVAILABLE FOR DISTRIBUTION plus distributed NET DISPOSITION PROCEEDS may increase to 15%. For each 1% less taken in the unsubordinated CASH AVAILABLE FOR DISTRIBUTION under subparagraph 1.a., the subordinated interest may increase by 1%, or,

COMMENT:

This provision would allow the SPONSOR an interest only in CASH AVAILABLE FOR DISTRIBUTION prior to satisfaction of the subordination requirements except for the 1% interest in NET DISPOSITION PROCEEDS.

b. 20% of all distributed CASH AVAILABLE FOR DISTRIBUTION and distributed NET DISPOSITION PROCEEDS after a return to the PARTICIPANTS of their CAPITAL CONTRIBUTIONS plus an amount equal to 8% of CAPITAL CONTRIBUTIONS per annum cumulative.

2. For purposes of this paragraph, the cumulative return to each PARTICIPANT shall commence no later than the end of the calendar quarter in which the PARTICIPANT'S CAPITAL CONTRIBUTION is made.

COMMENT:

Income earned on impounded funds and distributed to PARTICIPANTS may be used to satisfy the cumulative return requirement.

3. For the purposes of this paragraph, the CAPITAL CONTRIBUTIONS of the PARTICIPANTS shall be reduced only by distributions from CASH AVAILABLE FOR DISTRIBUTION, and distributions from NET DISPOSITION PROCEEDS.

COMMENT:

Only CASH AVAILABLE FOR DISTRIBUTION and NET DISPOSITION PROCEEDS actually paid to PARTICIPANTS, as opposed to allocations for bookkeeping purposes, may be used to satisfy the subordination requirements of Section IV.D. The PROSPECTUS should include an example of how the PARTICIPANT's 8% cumulative return is calculated upon a decreasing base of CAPITAL CONTRIBUTIONS. For example, on a \$100 investment, a \$10 distribution would result in a \$2.00 reduction in CAPITAL CONTRIBUTIONS, leaving a \$98 base upon which the 8% return would be calculated in year two. The \$2.00 reduction consists of \$2.00 in distributions in excess of that required to satisfy the cumulative return requirement.

E. *Equipment Management Fee.* If the SPONSOR performs the services as described below, the fees paid to the SPONSOR shall be the lesser of the maximum fees set forth below in paragraphs 1. through 4., whichever is applicable,

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or the fees which are competitive for similar services for similar equipment. Except for the fee provided in paragraph 3. below, included in these fees shall be fees paid by the PROGRAM to PERSONS who are not AFFILIATES.

1. The SPONSOR may charge the PROGRAM an annual fee for EQUIPMENT MANAGEMENT, not exceed 5% of gross rental payments for OPERATING LEASES; or

2. The SPONSOR may charge the PROGRAM an annual fee for EQUIPMENT MANAGEMENT not to exceed 2% of gross rental payments in the case of FULL PAYOUT LEASES which contain NET LEASE PROVISIONS; or

3. The SPONSOR may receive a fee of 1% of gross rental payments if it arranges for and actively supervises the performance of the services in paragraph 1. above by non-AFFILIATES; or

4. If the SPONSOR provides both EQUIPMENT MANAGEMENT and additional services relating to the continued and active operation of PROGRAM equipment, such as on-going marketing and re-leasing of equipment, hiring or arranging for hiring of crews or operating personnel for PROGRAM equipment and similar services, it may charge the PROGRAM a fee not to exceed 7% of gross rental payments from equipment operated by the PROGRAM.

COMMENT (1):

This subparagraph 4 is not intended to limit the costs or PROGRAM personnel hired to operate equipment so long as such costs do not include salaries, fringe benefits, travel expenses, and other administrative items incurred or allocated to any controlling persons (as defined in Section V.G.1.b. of these Guidelines) of the SPONSOR. Further, the terms "executive management" used in Section V.G.1.b. do not include those individuals who provide EQUIPMENT MANAGEMENT services to the PROGRAM and who are not involved in executive policy making decisions, regardless of title.

If maintenance and repair of the equipment is required, that cost should be borne by the lessee, or the service may be provided by the SPONSOR as permitted by Section V.G.2. of these Guidelines.

COMMENT (2):

The distinction between the first three limitations on fees and the fourth limitation concerns the level of services provided by the SPONSOR who operates the equipment on behalf of the PROGRAM. The 7% fee should only be allowed where the PROGRAM equipment is actually being operated on behalf of the PROGRAM by PROGRAM personnel, and not when its simply leased out under OPERATING LEASES or FULL PAYOUT LEASES. It should be noted that a syndicator who has the necessary facilities to provide maintenance, repair and storage services to PROGRAM equipment and provides extensive marketing efforts in order to reemploy PROGRAM equipment may be considered to be operating equipment on behalf of the PROGRAM. A PROGRAM which enters into vendor leasing agreements with manufacturers of equipment will not be considered to be operating equipment on behalf of the PROGRAM.

F. Resale Fee.

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1. In SPECIFIED EQUIPMENT PROGRAMS, the total compensation paid to the SPONSOR for the sale of PROGRAM equipment shall be limited to one-half of the COMPETITIVE EQUIPMENT SALE COMMISSION, subordinated as in Section D.1.b. above. If such amount exceeds 3% of the contract sales price, the SPONSOR shall state the current COMPETITIVE EQUIPMENT SALE COMMISSION, the basis upon which such was determined, and the method to be used in establishing the COMPETITIVE EQUIPMENT SALE COMMISSION at the time of sale. The total of all such commissions paid to all PERSONS shall not exceed the COMPETITIVE EQUIPMENT SALE COMMISSION.

2. In all other PROGRAMS, the total compensation paid to the SPONSOR for the sale of PROGRAM equipment shall be limited to one-half of a COMPETITIVE EQUIPMENT SALE COMMISSION, not to exceed 3% of the contract sales price and subordinated as in Section D.1.b. above. In no event shall total commissions paid to all persons exceed the COMPETITIVE EQUIPMENT SALE COMMISSION. If the SPONSOR participates with an independent broker on resale, the subordination requirement shall apply only to the commission earned by the SPONSOR.

G. *Re-Leasing Services.* Subject to the provisions of Section V.G.2.b. and 3., the SPONSOR may provide re-leasing services to the PROGRAM if all of the following conditions are met:

1. The SPONSOR represents that it has and will maintain adequate staff which it will utilize in rendering such services to the PROGRAM.

2. The services will be provided at a price that does not exceed the lesser of the competitive rate for comparable services for similar equipment or 2% of gross rental payments derived from the re-lease of such equipment after the time that the re-lease of such equipment has been consummated as a result of the efforts of the SPONSOR. Such payment for services shall be paid as each rental payment is made over the term of the lease.

3. The SPONSOR may not be paid or reimbursed for re-leasing services where the equipment is re-leased to a previous lessee of AFFILIATES of such lessee.

4. The SPONSOR has rendered substantial re-leasing services in connection with such re-lease.

5. The SPONSOR is compensated for rendering EQUIPMENT MANAGEMENT services pursuant to paragraphs 1., 2., or 3. of section IV.E.

V. CONFLICTS OF INTEREST AND INVESTMENT RESTRICTIONS.*A. Sales and Leases to or from PROGRAM.*

1. Notwithstanding the provisions of paragraph 2. the SPONSOR may purchase equipment in its own name (and assume loans in connection therewith) and hold title thereto on a temporary or interim basis (generally not in excess of six months) for the purpose of facilitating the acquisition of such equipment or the borrowing of money or obtaining of financing for the PROGRAM, or any other purpose related to the business of the PROGRAM, provided: (a) it is in the best interest of the PROGRAM; (b) such equipment is purchased by the PROGRAM for a price no greater than the cost of such equipment to the SPONSOR, except compensation in accordance with Section IV. of these Guidelines; (c) there is no difference in interest terms of the loans secured by the equipment at the time acquired by the SPONSOR and the time acquired by the PROGRAM; and (d) no other benefit arises out of such transaction to the SPONSOR apart from compensation otherwise permitted by these Guidelines.

COMMENT:

"Cost" is interpreted to mean the reasonable, necessary and actual expenses incurred by the SPONSOR or its AFFILIATES, as determined in accordance with generally accepted accounting principles, in holding title to equipment on a temporary or interim basis.

2. The PROGRAM shall not purchase or lease equipment from nor sell or lease equipment to, the SPONSOR, including equipment in which the SPONSOR has an interest, except that the PROGRAM may lease equipment to the SPONSOR under a lease arrangement made at the outset and on terms no more favorable to the SPONSOR than those offered other PERSONS and fully described in the PROSPECTUS. Notwithstanding the foregoing, the PROGRAM may purchase new equipment from the SPONSOR if such PERSON is in the business of manufacturing and selling such equipment to PERSONS not affiliated with the PROGRAM, the transaction occurs at the formation of a SPECIFIED EQUIPMENT PROGRAM and the terms thereof are fully described in the PROSPECTUS, the equipment is sold at the lower of manufacturer's cost without mark-up or fair market value, and the equipment is subject to a prearranged lease. Such equipment may not be leased to the SPONSOR.

COMMENT:

The term "manufacturer's cost without mark-up", is used to insure that profits, if any, to be earned by the manufacturer should come from the promotional interest of the manufacturer/SPONSOR/

The prohibition in the last sentence of this section is based on the significant conflict of interest which exists where a SPONSOR manufacturers equipment, sells it to a limited partnership of which it is the general partner, and then leases it to an operating AFFILIATE.

3. If the PROGRAM has been formed for the primary purpose of financing equipment to be ultimately used by the SPONSOR in its business, the SPONSOR shall have the right to purchase the equipment at the time of sale at fair market value as determined in a commercially reasonable manner. Such purchase price shall be not less than that established by an independent appraiser. However, the sale may not take place until any applicable investment tax credit is no longer subject to recapture from PARTICIPANTS unless the SPONSOR indemnifies the PROGRAM.

B. *Loans.* No loans may be made by the PROGRAM to the SPONSOR.

C. *Dealings with Related PROGRAMS.* A PROGRAM shall not acquire equipment from a PROGRAM in which the SPONSOR has an interest.

D. *Exchange of PROGRAM INTERESTS.* The PROGRAM may not acquire equipment in exchange for PROGRAM INTERESTS, except for equipment which is described in the PROSPECTUS which will be exchanged immediately upon effectiveness. In addition, such exchange shall meet the following conditions:

1. A provision for such exchange must be set forth in the PROGRAM agreement, and appropriate disclosure as to tax effects of such exchange must be set forth in the PROSPECTUS;

2. The equipment to be acquired must come within the objectives of the PROGRAM;

3. The purchase price assigned to the equipment shall be no higher than the value supported by an appraisal prepared by an independent qualified appraiser;

4. Each PROGRAM interest must be valued at no less than market value if there is a market or if there is no market, fair market value of the PROGRAM's assets as determined by an independent appraiser within the last 90 days, less its liabilities, divided by the number of PROGRAM INTERESTS outstanding;

5. No more than one-half of the PROGRAM INTERESTS issued by the PROGRAM shall have been issued in exchange for equipment;

6. No securities sales or underwriting commissions shall be paid in connection with such exchange.

E. *Exclusive Agreement.* A PROGRAM shall not give the SPONSOR an exclusive right to sell or exclusive employment to sell equipment for the PROGRAM.

F. *Commissions on Financing, Refinancing, Reinvestment or Distribution.* A PROGRAM shall not pay, directly or

indirectly, a commission or fee (except as permitted under Section IV.) to a SPONSOR in connection with the reinvestment or distribution of CASH AVAILABLE FOR DISTRIBUTION or of the proceeds of the resale, exchange, or refinancing of PROGRAM equipment.

G. Services Rendered to the PROGRAM by the SPONSOR.

1. Expenses of the PROGRAM.

a. All expenses of the PROGRAM shall be billed directly to and paid by the PROGRAM. The SPONSOR may be reimbursed for the actual cost of goods and materials used for or by the PROGRAM and obtained from entities unaffiliated with the SPONSOR. The SPONSOR may be reimbursed for the administrative services necessary to the prudent operation of the PROGRAM provided that the reimbursement shall be at the lower of the SPONSOR'S actual cost or the amount the PROGRAM would be required to pay to independent parties for comparable administrative services in the same geographic location. No reimbursement shall be permitted for services for which the SPONSOR is entitled to compensation by way of a separate fee. Excluded from the allowable reimbursement (except as permitted under Section IV.C) shall be:

(1) rent or depreciation, utilities, capital equipment, other administrative items; and

(2) salaries, fringe benefits, travel expenses, and other administrative items incurred or allocated to any controlling person of the SPONSOR.

b. Controlling PERSON, for purposes of this subsection, includes but is not limited to, all PERSONS, whatever their titles, who perform functions for the SPONSOR similar to those of:

(1) Chairman or member of the Board of Directors;

(2) Executive Management, such as the

(a) President,

(b) Vice-President or Senior Vice-President,

(c) Corporate Secretary,

(d) Treasurer;

(3) Senior Management, such as the Vice-President of an operating division who reports directly to Executive Management; or

(4) Those holding 5% or more equity interest in the SPONSOR or a PERSON having the power to direct or cause the direction of the SPONSOR, whether through the ownership of voting securities, by contract, or otherwise.

c. The annual PROGRAM report must contain a breakdown of the costs reimbursed to the SPONSOR. Within the scope of the annual audit of the SPONSOR's financial statements, the independent certified public accountants must issue a special report on the allocation of such costs to the PROGRAM in accordance with the PROGRAM agreement. The special report shall at minimum provide:

(1) A review of the time records of individual employees, the costs of whose services were reimbursed;

(2) A review of the specific nature of the work performed by each such employee.

The special report shall be in accordance with the American Institute of Certified Public Accountants United States Auditing standards relating to special reports. The additional costs of such special report will be itemized by said accountants on a PROGRAM by PROGRAM basis and may be reimbursed to the SPONSOR by the PROGRAM in accordance with this subparagraph only to the extent that such reimbursement, when added to the cost for administrative services rendered does not exceed the competitive rate for such services as determined above.

COMMENT:

The following is an illustration of a report prepared by ABC Accountants expressing an opinion on reimbursed costs of XYZ Program:

We have examined the schedule of costs reimbursed as defined in the PROGRAM Agreement dated _____ of XYZ Program for the year ended 12-31-_____. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the schedule of costs reimbursed referred to above presents fairly the costs reimbursed of XYZ Program for the year ended 12-31-_____, on the basis specified in the PROGRAM agreement referred to above.

d. The PROSPECTUS must disclose in tabular form an estimate of such proposed expenses for the next fiscal year together with a breakdown by year of such expenses reimbursed in each of the last five public programs formed by the SPONSOR.

COMMENT:

This section permits the SPONSOR to be reimbursed for a portion of the costs incurred in performing certain administrative functions for the PROGRAM provided the SPONSOR is both qualified to perform such functions and does so at a cost no greater to the PROGRAM than that which an unaffiliated PERSON would charge the PROGRAM. Regardless of the capacity in which controlling persons of the SPONSOR serve the PROGRAM, their salaries may not be allocated to the PROGRAM.

2. Other Services. The SPONSOR may provide other services for the PROGRAM, if necessary. At a minimum, self-dealing arrangements must meet the following criteria:

a. The compensation, price or fee charged for providing such services must be comparable and competitive with the compensation, price or fee of any other PERSON who is rendering comparable services or selling or leasing comparable goods and materials which could reasonably be made available to the PROGRAM, and

b. The fees and other terms of the contract shall be fully disclosed, and

c. The SPONSOR must be independently engaged in the business of providing such services to other than AFFILIATES and at least 75% of the PERSON's gross revenue from providing such services must be derived from other than the SPONSOR.

3. Contracts for Goods and Services. All services or goods for which the SPONSOR is to receive compensation shall be embodied in a written contract which precisely describes the services to be rendered and all compensation to be paid. The contract may only be modified by vote of a majority of the then outstanding PROGRAM INTERESTS. The contract shall contain a clause allowing termination without penalty on 60 days notice.

H. Rebates, Kickbacks and Reciprocal Arrangements.

1. No rebates or give-ups may be received by the SPONSOR nor may the SPONSOR participate in any reciprocal business arrangements which would circumvent these guidelines. Furthermore, the PROSPECTUS and PROGRAM charter documents shall contain language prohibiting the above as well as language prohibiting reciprocal business arrangements which would circumvent the restrictions against dealing with AFFILIATES.

2. No SPONSOR shall directly or indirectly pay or award any commissions or other compensation to any PERSON engaged by a potential investor for investment advice as an inducement to such advisor to advise the purchaser of interests in a particular PROGRAM; provided, however, that this clause shall not prohibit the normal sales commissions payable to a registered broker-dealer or other properly licensed PERSON for selling PROGRAM INTERESTS.

I. *Commingling of Funds.* The funds of a PROGRAM shall not be commingled with the funds of any other PERSON. Nothing contained in this Section shall prohibit a SPONSOR from establishing a master fiduciary account pursuant to which separate subtrust accounts are established for the benefit of affiliated limited partnerships, provided, that PROGRAM funds are protected from claims of such other partnerships and/or creditors. The prohibition of this Section shall not apply to investments meeting the requirements of Section V.J.

J. *Investments in Other PROGRAMS.*

1. Investments in limited partnership interests of another PROGRAM shall be prohibited; however, nothing herein shall preclude the investment in general partnerships or ventures which own and operate specific equipment provided the PROGRAM acquires a controlling interest in such other ventures or general partnerships and the non-controlling interest is owned by a non-AFFILIATE. In such event, duplicate fees shall not be permitted.

2. Notwithstanding the foregoing, the PROGRAM shall be permitted to invest in joint venture arrangements with other PROGRAMS formed by the SPONSOR, if such action is in the best interest of all PROGRAMS and if all of the following conditions are met:

- a. The PROGRAMS have substantially identical investment objectives;
- b. There are no duplicate fees;
- c. The SPONSOR compensation should be substantially identical in each PROGRAM;
- d. The PROGRAM must have a right of first refusal to buy if another PROGRAM desires to sell equipment held in the joint venture;
- e. The investment of each PROGRAM is on substantially the same terms and conditions;

f. The joint venture is done either for the purpose of effecting appropriate diversification for such PROGRAMS or for the purpose of relieving the SPONSOR from a commitment entered into pursuant to Section V.A.1;

g. The PROSPECTUS must disclose the potential risk of impasse on joint venture decisions since neither PROGRAM controls and the potential risk that while one PROGRAM may buy the equipment from the other joint venturer in the event of a sale, it may not have the resources to do so.

COMMENT:

In certain situations, it would be to the advantage of the PROGRAM to be able to invest in a joint venture with other PROGRAMS when no PROGRAM has sufficient money to make the entire investment even if the PROGRAM does not acquire a controlling interest. However, in order to provide the necessary protections, there is a need not only to require full disclosure of the joint venture arrangements, but also to set out substantive standards that must be adhered to in order to assure these protections.

K. *Lending Practices.* When financing is made available to the PROGRAM by the SPONSOR, the SPONSOR may not receive interest and other financing charges or fees in excess of the amounts which would be charged by unrelated lending institutions on comparable loans for the same purpose. The SPONSOR shall be prohibited from providing permanent financing for the PROGRAM. For purposes of this section, permanent financing shall mean any financing with a term in excess of twelve months.

L. *Minimum Capitalization.* Before commencing business all PROGRAMS, other than SPECIFIED EQUIPMENT PROGRAMS, shall provide for gross proceeds from the offering of not less than \$1,000,000 after payment of all ORGANIZATIONAL and OFFERING EXPENSES. An escrow of funds may be required to guarantee this minimum.

M. *Statement of Investment Objectives.* The PROSPECTUS must state specific investment objectives of the PROGRAM. It should indicate whether the primary objective is to obtain current income, tax benefits or capital appreciation for its PARTICIPANTS. The PROSPECTUS shall state the general types of equipment to be acquired and shall indicate whether the equipment will be leased under FULL PAYOUT LEASES or OPERATING LEASES or whether the PROGRAM will operate the equipment itself. The size, scope and risk factors of such investment shall be consistent with the objectives of the PROGRAM.

N. *Multiple Programs.* SPONSORS are prohibited from offering for sale PROGRAM INTERESTS in more than one PROGRAM simultaneously unless the PROGRAMS have different investment objectives or are SPECIFIED EQUIPMENT PROGRAMS. The method for allocating investment opportunities among PROGRAMS of the SPONSOR seeking to acquire similar types of equipment shall be reasonable. The method shall be described in the PROSPECTUS.

COMMENT:

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This section should not be read so as to prohibit the serial offering of PROGRAMS pursuant to a single SEC Registration Statement.

O. Period of Offering and Expenditure of Proceeds. The offering period of PROGRAM interests in a PROGRAM may not exceed one year from the date of effectiveness unless permitted by the ADMINISTRATOR. While the proceeds of an offering are awaiting investment in equipment, the proceeds may be temporarily placed into short-term, highly liquid investments which afford appropriate safety of principal, such as U.S. Treasury Bonds or Bills. Any proceeds of the offering of PROGRAM INTERESTS not committed for investment within two (2) years from the date of effectiveness (except for necessary operating capital) shall be distributed pro rata to the PARTICIPANTS as a return of capital.

COMMENT:

For purposes of this section the date of effectiveness is generally considered the date of SEC effectiveness for the initial partnership in a series PROGRAM. For subsequent partnerships in the series, the date of effectiveness will be when the partnership commences its offering.

P. Assessments, Installment Payments, Warrants, Options, or Other Staged or Deferred Payments. Plans calling for assessments, installment payments, warrants, options, or other staged or deferred payments shall not be allowed in other than SPECIFIED EQUIPMENT PROGRAMS.

Q. Distributions in Kind. Distributions in kind shall not be permitted except upon dissolution and liquidation, and then only to a liquidating trust which has been established for the purpose of the liquidation of the assets of the PROGRAM, and the distribution of cash in accordance with the terms of the PROGRAM agreement.

R. Appraisal and Compensation.

1. In connection with a proposed ROLL-UP, an appraisal of all PROGRAM assets shall be obtained from a competent, INDEPENDENT EXPERT. If the appraisal will be included in a PROSPECTUS used to offer the securities of a ROLL-UP ENTITY, the appraisal shall be filed with the SEC and the states as an Exhibit to the Registration Statement for the offering. Accordingly, an issuer using the appraisal shall be subject to liability for violation of Section 11 of the Securities Act of 1933 and comparable provisions under state laws for any material misrepresentations or material omissions in the appraisal. PROGRAM assets shall be appraised on a consistent basis. The appraisal shall be based on an evaluation of all relevant information, and shall indicate the value of the PROGRAM'S assets as of a date immediately prior to the announcement of the proposed ROLL-UP transaction. The appraisal shall assume an orderly liquidation of PROGRAM assets over a 12 month period. The terms of the engagement of the INDEPENDENT EXPERT shall clearly state that the engagement is for the benefit of the PROGRAM and its PARTICIPANTS. A summary of the independent appraisal, indicating all material assumptions underlying the appraisal, shall be included in a report to the PARTICIPANTS in connection with a proposed ROLL-UP.

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2. In connection with a proposed ROLL-UP, the PERSON sponsoring the ROLL-UP shall offer to PARTICIPANTS who vote "no" on the proposal the choice of:

(a) accepting the securities of the ROLL-UP ENTITY offered in the proposed ROLL-UP; or

(b) one of the following:

(i) remaining as PARTICIPANTS in the PROGRAM, and preserving their interests therein on the same terms and conditions as existed previously; or

(ii) receiving cash in an amount equal to the PARTICIPANTS' pro-rata share of the appraised value of the net assets of the PROGRAM.

COMMENT:

With respect to the options specified in Subsection V.R.2.(b), the PERSON sponsoring the ROLL-UP needs only offer one of these alternatives to dissenting investors who do not wish to accept the security of the ROLL-UP ENTITY.

3. The PROGRAM shall not participate in any proposed ROLL-UP which would result in PARTICIPANTS having democracy rights in the ROLL-UP ENTITY which are less than those provided for under Sections VI.A. and VI.B. of these Guidelines. If the ROLL-UP ENTITY is a corporation, the voting rights of PARTICIPANTS shall correspond to the voting rights provided for in these Guidelines to the greatest extent possible.

4. The PROGRAM shall not participate in any proposed ROLL-UP which includes provisions which would operate to materially impede or frustrate the accumulation of shares by any purchaser of the securities of the ROLL-UP ENTITY (except to the minimum extent necessary to preserve the tax status of the ROLL-UP ENTITY). The PROGRAM shall not participate in any proposed ROLL-UP which would limit the ability of a PARTICIPANT to exercise the voting rights of its securities of the ROLL-UP ENTITY on the basis of the number of PROGRAM INTERESTS held by that PARTICIPANT.

5. The PROGRAM shall not participate in any proposed ROLL-UP in which PARTICIPANTS' rights of access to the records of the ROLL-UP ENTITY will be less than those provided for under Section VI.D. of these Guidelines.

6. The PROGRAM shall not participate in any proposed ROLL-UP in which any of the costs of the transaction would be borne by the PROGRAM if the ROLL-UP is not approved by PARTICIPANTS.

VI. RIGHTS AND OBLIGATIONS OF PARTICIPANTS.

A. *Meetings.* Meetings of the PROGRAM may be called by the SPONSOR or the PARTICIPANTS holding more than 10% of the then outstanding PROGRAM INTERESTS, for any matters for which the PARTICIPANTS may vote as set forth in the PROGRAM agreement. Upon receipt of a written request, either in person or by registered mail, stating the purpose(s) of the meeting, the SPONSOR shall provide all PARTICIPANTS within ten days after receipt of said request, written notice (either in person or by certified mail) of a meeting and the purpose of such meeting to be held on a date not less than fifteen nor more than sixty days after distribution of such notice, at the time and place specified in the request, or if none, at a time and place convenient to PARTICIPANTS.

B. *Voting Rights of PARTICIPANTS.* The limited partnership agreement must provide that a majority of the then outstanding PROGRAM INTERESTS may, without the necessity of concurrence by the SPONSOR, vote to (1) amend the limited partnership agreement, (2) dissolve the PROGRAM, (3) remove the SPONSOR and elect a new SPONSOR, (4) approve or disapprove the sale of all or substantially all of the assets of the PROGRAM except pursuant to a plan disclosed in the final PROSPECTUS. The agreement should provide for a successor SPONSOR where the only SPONSOR of the PROGRAM is an individual. With respect to any PROGRAM INTERESTS owned by the SPONSOR, the SPONSOR may not vote or consent on matters submitted to the PARTICIPANTS regarding the removal of the SPONSOR or regarding any transaction between the PROGRAM and the SPONSOR. In determining the requisite percentage in interest of PROGRAM INTERESTS necessary to approve a matter on which the sponsor may not vote or consent, any PROGRAM INTERESTS owned by the SPONSOR shall not be included.

COMMENT:

The exercise of voting rights by PARTICIPANTS shall not be restricted or subject to satisfaction of conditions prior to the exercise of the rights.

C. *Reports.* The PROGRAM agreement shall provide that the SPONSOR shall prepare and distribute to PARTICIPANTS the following reports:

1. For other than SPECIFIED EQUIPMENT PROGRAMS, a report of equipment acquisitions made during each quarter shall be sent to all PARTICIPANTS within sixty days following the end of each quarter, until the proceeds of the offering are fully invested or returned to the PARTICIPANTS, as set out in Section V.O. of these Guidelines. Such reports shall include, by way of illustration and not limitation, a statement of the actual PURCHASE PRICE OF EQUIPMENT, including terms of the purchase, a statement of the total amount of cash expended by the PROGRAM to acquire such items of equipment (including and itemizing all commissions, fees, expenses and the name of each payee), and a statement of the amount of proceeds in the PROGRAM which remain unexpended or uncommitted.

2. In the case of a PROGRAM registered under Section 12(g) of the Securities Exchange Act of 1934, within sixty days after the end of each quarter of the PROGRAM, a report containing the same financial information contained in the PROGRAM's Quarterly Report on Form 10-Q filed by the PROGRAM under the Securities Exchange Act of 1934.

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3. In the case of all other PROGRAMS, within sixty days of the end of the first six months of each fiscal year, a report, prepared on the same accounting basis to be utilized in the annual reports, containing:

- a. a condensed balance sheet, which may be unaudited;
- b. a condensed statement of income for the period then ended, which may be unaudited;
- c. a CASH FLOW statement for the period then ended, which may be unaudited; and
- d. other pertinent material regarding the PROGRAM and its activities during the quarter covered by the report.

4. In the case of all PROGRAMS, within seventy-five days after the end of each PROGRAM's fiscal year, all information necessary for the preparation of the PARTICIPANTS' federal income tax returns.

5. In the case of all PROGRAMS, within 120 days after the end of each PROGRAM's year, an annual report containing: (i) a balance sheet as of the end of its fiscal year and statements of income, partners' equity, and changes in financial position and a CASH FLOW statement, for the year then ended, all of which, except the CASH FLOW statement, shall be prepared in accordance with generally accepted accounting principles and accompanied by an auditor's report containing an opinion of an independent certified public accountant, (ii) where forecasts have been provided to the holders of PROGRAM interests, a table comparing the forecasts previously provided with the actual results during the period covered by the report, and (iii) a breakdown of distributions to PARTICIPANTS for the period covered thereby separately identifying distributions from: (1) CASH FLOW from operations during the period, (2) CASH FLOW from operations during a prior period which had been held as reserves, (3) proceeds from disposition of equipment and investments, and (4) reserves from the gross proceeds of the offering originally obtained from the PARTICIPANTS.

For each piece of equipment acquired by the PROGRAM which individually represents at least 10% of the PROGRAM's total investment in equipment, the SPONSOR shall include a status report as part of the annual report, which status report shall indicate: (i) condition of equipment, (ii) how equipment is being utilized as of the end of year (leased, operated, held for lease, repair, or sale), (iii) remaining term of leases, (iv) projected use of equipment for next year (renew lease, lease, retire, or sell), and (v) such other information relevant to the value or utilization of the equipment as the SPONSOR deems appropriate. The status report shall describe the method used or basis for valuation.

6. If ASSESSMENTS have been made during any period covered by any report required by paragraphs 2., 3., and 5.

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hereof, then such report shall contain a detailed statement of such ASSESSMENTS and the application of the proceeds derived from such ASSESSMENTS.

7. If any SPONSOR receives fees for services, it shall, within sixty days of the end of each quarter wherein such fees were received, send to each PARTICIPANT a detailed statement setting forth the services rendered, or to be rendered, by such SPONSOR and the amount of the fees received. This requirement may not be circumvented by lump-sum payments to management companies or other entities who then disburse the funds.

8. The SPONSOR shall undertake to make any of the reports required by paragraphs 1. through 7. available to the ADMINISTRATOR upon request.

D. *Access to Records.* Any PARTICIPANT and any designated representative thereof shall be permitted access to all records of the PROGRAM at all reasonable times, and may inspect and copy any of them. The limited partnership agreement, by-laws, or other PROGRAM agreement shall include the following provisions regarding access to the list of PARTICIPANTS:

1. An alphabetical list of the names, addresses, and business telephone numbers of the PARTICIPANTS of the PROGRAM along with the number of PROGRAM INTERESTS held by each of them (the "PARTICIPANT List") shall be maintained as a part of the books and records of the PROGRAM and shall be available for inspection by any PARTICIPANT or its designated agent at the home office of the Program upon the request of the PARTICIPANT;

2. The PARTICIPANT List shall be updated at least quarterly to reflect changes in the information contained therein;

3. A copy of the PARTICIPANT List shall be mailed to any PARTICIPANT requesting the PARTICIPANT List within ten days of the request. The copy of the PARTICIPANT List shall be printed in alphabetical order, on white paper, and in a readily readable type size (in no event smaller than 10-point type). A reasonable charge for copy work may be charged by the PROGRAM;

4. The purposes for which a PARTICIPANT may request a copy of the PARTICIPANT List include, without limitation, matters relating to PARTICIPANTS' voting rights under the PROGRAM agreement, and the exercise of PARTICIPANTS' rights under federal proxy laws; and

5. If the SPONSOR of the PROGRAM neglects or refuses to exhibit, produce, or mail a copy of the PARTICIPANT List as requested, the SPONSOR shall be liable to any PARTICIPANT requesting the list for the costs, including

attorneys' fees, incurred by that PARTICIPANT for compelling the production of the PARTICIPANT List, and for actual damages suffered by any PARTICIPANT by reason of such refusal or neglect. It shall be a defense that the actual purpose and reason for the requests for inspection or for a copy of the PARTICIPANT List is to secure such list of PARTICIPANTS or other information for the purpose of selling such list or copies thereof, or of using the same for a commercial purpose other than in the interest of the applicant as a PARTICIPANT relative to the affairs of the PROGRAM. The SPONSOR may require the PARTICIPANT requesting the PARTICIPANT List to represent that the list is not requested for a commercial purpose unrelated to the PARTICIPANT'S interest in the PROGRAM. The remedies provided hereunder to PARTICIPANTS requesting copies of the PARTICIPANT List are in addition to, and shall not in any way limit, other remedies available to PARTICIPANTS under federal law, or the laws of any state.

E. ASSESSMENTS and Defaults.

1. **ASSESSMENTS.** In appropriate cases there may be a provision for voluntary assessability in SPECIFIED EQUIPMENT PROGRAMS, provided however, that the maximum amount for such voluntary ASSESSMENTS shall not exceed 100% of initial CAPITAL CONTRIBUTIONS. The ASSESSMENTS shall be made solely for or relating to equipment already acquired, when the SPONSOR has determined that the additional expenditures are allowed and in the best interests of the PROGRAM. Examples of expenditures which may be merited include expenditures for extraordinary repairs when such expenditures will not exceed the value of benefits to be derived from the equipment after repair or when anticipated CASH FLOW from equipment is not sufficient to pay taxes and/or special assessments imposed by governmental or quasi-governmental units.

2. **Defaults.** In the event of a default in the payment of ASSESSMENTS by PARTICIPANTS, their interests shall not be subject to forfeiture, but they may be subject to a reasonable penalty for failure to meet their commitments. This may take the form of reducing their proportionate interests in the PROGRAM, subordinating their interests to that of non-defaulting PARTICIPANTS, a forced sale complying with applicable procedures for notice and sale, the lending of the amount necessary to meet their commitment(s) by the other PARTICIPANTS or a fixing of the value of their interests by independent appraisal or other suitable formula with provision for a delayed payment to them for their interests for a reasonable period. A debt security issued for such interest(s) should not have a claim prior to that of the other PARTICIPANTS in the event of liquidation.

F. Admission of PARTICIPANTS. Admission of PARTICIPANTS to the PROGRAM shall be subject to the following:

1. **Admission of Original PARTICIPANTS.** Upon the original sale of PROGRAM INTERESTS, the purchasers should be admitted as PARTICIPANTS not later than 15 days after the release from impound of the purchaser's funds to the PROGRAM. Thereafter, purchasers should be admitted into the PROGRAM not later than the last day of the calendar month following the date their subscription was accepted by the PROGRAM. Subsequent subscriptions shall be accepted or rejected by the PROGRAM within 30 days of their receipt; if rejected, all subscription monies should be returned to the subscriber immediately.

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2. Admission of Substituted PARTICIPANTS and Recognition of Assignees. The PROGRAM shall amend the PROGRAM agreement at least once each calendar quarter to effect the substitution of substituted PARTICIPANTS, although the SPONSOR may elect to do so more frequently.

In the case of assignments where the assignee does not become a substituted PARTICIPANT, the PROGRAM shall recognize the assignment not later than the last day of the calendar month following receipt of notice of assignment and required documentation..

3. Except where deemed inappropriate by the ADMINISTRATOR, PERSONS holding PROGRAM INTERESTS by assignment from entities holding limited partnership interests in a PROGRAM for the purpose of assigning all or a portion of such interests to PERSONS investing in such PROGRAM (hereinafter the "Assignor") shall be expressly granted the same rights as if they were limited partners except as prohibited by applicable law, including but not limited to, the rights enumerated under Article VI of this Statement of Policy.

The assignment agreement and PROSPECTUS shall provide that the Assignor's management shall have fiduciary responsibility for the safekeeping and use of all funds and assets of the assignees, whether or not in the Assignor management's possession or control, and that the management of the Assignor shall not employ, or permit another to employ such funds or assets in any manner except for the exclusive benefit of the assignees. In addition, the agreement shall not permit the assignees to contract away the fiduciary duty owed to the assignees by the Assignor's management under the common law of agency.

G. *Redemption of PROGRAM INTERESTS.* Ordinarily, the PROGRAM and the SPONSOR are not obligated to redeem or repurchase any of the PROGRAM INTERESTS. However, the PROGRAM and the SPONSOR are not precluded from voluntarily repurchasing or redeeming the PROGRAM INTERESTS if such repurchase or redemption does not impair the capital or operations of the PROGRAM. A PROGRAM may provide for mandatory redemption rights under the following circumstances:

1. death or legal incapacity of the owner; or,

2. a substantial reduction in the owner's NET WORTH or income provided that (i) the PROGRAM has sufficient cash to make the purchase, (ii) the purchase will not be in violation of applicable legal requirements and (iii) not more than 15% of the outstanding units are purchased in any year.

A penalty may be assessed on the redemption of the interest if the penalty accrues to the benefit of the PROGRAM. The SPONSOR is prohibited from receiving a fee on the redemption of PROGRAM INTERESTS by the PROGRAM.

COMMENT:

This will not preclude the PROGRAM, the SPONSOR or the PARTICIPANTS from purchasing these interests at a reduced cost for their own account so long as the method for repurchase is fully disclosed in the PROSPECTUS and the PROGRAM agreement. This section applies to both voluntary and mandatory redemptions.

H. *Transferability of PROGRAM INTEREST.* Restrictions on assignment of limited partnership interests or a substitution of limited partners are generally disfavored and such restrictions will be allowed only to the extent necessary to preserve the tax status of the partnership or the characterization or treatment of income or loss. Any restriction must be affirmatively supported by an Opinion of Counsel. A charge may be imposed by the PROGRAM to cover its actual, necessary and reasonable administrative and filing expenses incurred in connection with a transfer. Such a charge shall be disclosed in the PROSPECTUS.

VII. DISCLOSURE AND MARKETING REQUIREMENTS.

A. Sales Promotional Efforts.

1. Sales Literature. Sales literature, sales presentations (including prepared presentations to prospective PARTICIPANTS at group meetings) and advertising used in the offer or sale of PROGRAM INTERESTS shall conform in all applicable respects to requirements of filing, disclosure and adequacy currently imposed on sales literature, sales presentations and advertising used in the sale of securities other than PROGRAM INTERESTS.

2. Group Meetings. All advertisements of and oral or written invitations to "seminars" or other group meetings at which PROGRAM INTERESTS are to be described, offered or sold shall clearly indicate that the purpose of such meetings is to offer such PROGRAM INTERESTS for sale, the minimum purchase price thereof, and the name of the SPONSOR, underwriter or selling agent. No cash, merchandise or other item of value shall be offered as an inducement to any prospective PARTICIPANTS to attend any such meeting. In connection with the offer or sale of PROGRAM INTERESTS, no general offer shall be made of "free" or "bargain price" trips to view equipment in which the PROGRAM has invested or intends to invest. All written or prepared audiovisual presentations (including scripts prepared in advance for oral presentations) to be made at such meetings must be submitted in advance to the ADMINISTRATOR not less than five business days prior to the use thereof. The foregoing restrictions shall not apply to meetings consisting only of representatives of securities broker-dealers.

B. PROSPECTUS and Its Contents.

1. Prospectus. A PROSPECTUS which is not part of a Registration Statement declared effective by the Securities and Exchange Commission pursuant to the Securities Act of 1933 shall generally conform to the disclosure requirements which would apply if the offering were so registered. The format and information requirements of Guide 5 promulgated by the Securities and Exchange Commission shall be followed, with appropriate adjustments made for the different business of the PROGRAM.

2. *Forecasts.*

a. Use of Forecasts. The presentation of predicted future results of operations of equipment PROGRAMS shall be permitted but not required for SPECIFIED EQUIPMENT PROGRAMS and shall be prohibited for all other PROGRAMS. The covers of the PROSPECTUS must contain in bold face language one of the following statements:

(1) for SPECIFIED EQUIPMENT PROGRAMS: "FORECASTS ARE CONTAINED IN THIS PROSPECTUS (OFFERING CIRCULAR). ANY PREDICTIONS AND REPRESENTATIONS, WRITTEN OR ORAL, WHICH DO NOT CONFORM TO THOSE CONTAINED IN THE PROSPECTUS (OFFERING CIRCULAR) SHALL NOT BE PERMITTED."

(2) for all other PROGRAMS: "THE USE OF FORECASTS IN THIS OFFERING IS PROHIBITED. ANY REPRESENTATIONS TO THE CONTRARY AND ANY PREDICTIONS, WRITTEN OR ORAL, AS TO THE AMOUNT OR CERTAINTY OF ANY PRESENT OR FUTURE CASH BENEFIT OR TAX CONSEQUENCE WHICH MAY FLOW FROM AN INVESTMENT IN THIS PROGRAM IS NOT PERMITTED."

b. Content of Forecasts. Forecasts for SPECIFIED EQUIPMENT PROGRAMS shall be included in the PROSPECTUS, offering circular or sales material of the PROGRAM only if they comply with the following requirements:

(1) General. Forecasts shall be realistic in their predictions and shall clearly identify the assumptions made with respect to all material features of the presentation. Forecasts should be examined by an independent certified public accountant in accordance with the Guide for Prospective Financial Statements and the Statement on Standards for Accountant's Services on Prospective Financial Information as promulgated by the American Institute of Certified Public Accountants. The report of the independent certified public accountant must be included in the PROSPECTUS. No forecasts shall be permitted in any sales literature which do not appear in the PROSPECTUS or offering circular. If any forecasts are included in the sales literature, all forecasts must be presented.

COMMENT:

If predicted future results of operations are used, they shall be prepared in the form of a forecast.

(2) Material Information. Forecasts shall include all the following information:

(a) Annual predicted revenue by source;

(b) Annual predicted expenses;

(c) Debt obligation--annual payments for principal and interest, points and financing fees, shown as dollars, not percentages;

(d) The required percentage of equipment on lease in order to meet debt service and all expenses;

(e) Predicted annual CASH FLOW, stating forecasted percentage of equipment on lease;

(f) Predicted annual depreciation and amortization with full description of methods to be used;

(g) Predicted annual taxable income or loss and a simplified explanation of the tax treatment of such results (assumed tax brackets may be used); and

(h) Accounting policies--e.g., with respect to points, financing costs and depreciation.

c. Presentation.

(1) Caveat. Forecasts shall prominently display a statement to the effect that they represent a mere prediction of future events based on assumptions which may or may not occur and should not be relied upon to indicate the actual results which will be obtained.

(2) Explanatory Notes. Explanatory notes describing assumptions made and referring to risk factors should be integrated with tabular and numerical information.

(3) Sale-leasebacks. When a sale-leaseback is employed, a statement that the seller is assuming the operating risk and consequently may have charged a higher price for the equipment must be included.

d. Additional Disclosures and Limitations.

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(1) Forecasts shall be for a period equivalent to the anticipated holding period for the equipment, or 5 years, whichever is shorter.

(2) Adequate disclosure shall be made of the changing economic effects upon the PARTICIPANTS resulting principally from federal income tax consequences over the life of the PROGRAM equipment, e.g., substantial tax losses in early years followed by increasing amounts of taxable income in later years.

(3) Forecasts shall disclose possible undesirable tax consequences of an early sale of the PROGRAM equipment (such as depreciation recapture or the failure to sell the equipment at a price which would return sufficient cash to meet resulting tax liabilities of the PARTICIPANTS).

(4) In computing the return to investors, no appreciation, so called "equity buildup", or any other benefits from unrealized gains or value shall be shown or included.

(5) Forecasts of a resale occurrence shall be permitted.

VIII. MISCELLANEOUS PROVISIONS.

A. *Fiduciary Duty.* The PROGRAM agreement shall provide that the SPONSOR shall have fiduciary responsibility for the safekeeping and use of all funds and assets of the PROGRAM, whether or not in its immediate possession or control. The SPONSOR shall not employ, or permit another to employ such funds or assets in any manner except for the exclusive benefit of the PROGRAM.

In addition, the PROGRAM shall not permit the PARTICIPANT to contract away the fiduciary duty owed to the PARTICIPANT by the SPONSOR under the common law.

B. *Deferred Payments.* Arrangements for deferred payments on account of the purchase price of PROGRAM INTERESTS may be allowed when warranted by the investment objectives of the PROGRAM. Such arrangements shall be subject to the following conditions:

1. The period of deferred payments shall coincide with the anticipated cash needs of the PROGRAM;
2. Selling commissions paid upon deferred payments are collectible when payment is made on the note;

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3. Deferred payments shall be evidenced by a promissory note of the investor. Such notes shall be with recourse and shall not be negotiable and shall be assignable only subject to defenses of the maker. Such notes shall not contain a provision authorizing a confession of judgment;

4. The PROGRAM shall not sell or assign the deferred obligation notes at a discount to meet financing needs of the PROGRAM;

5. In the event of a default in the payment of deferred payments by PARTICIPANTS, their interests may be subjected to a reasonable penalty, as set forth in Section VI.E.2. of these Guidelines.

C. *Reserves.* Provisions should be made for adequate reserves in the future by retention of a reasonable percentage of proceeds from the offering and regular receipts for normal repairs, replacements and contingencies. Normally, not less than 1% of the offering proceeds will be considered adequate.

D. *Reinvestment of CASH AVAILABLE FOR DISTRIBUTION.* Reinvestment of CASH AVAILABLE FOR DISTRIBUTION will be allowed if:

1. The PROGRAM's structure requires that CASH AVAILABLE FOR DISTRIBUTION be reinvested for all PARTICIPANTS upon the same terms.

COMMENT:

This prohibition is designed to prevent the creation of differing classes of limited partnership interests resulting from inequitable allocations of tax or economic benefits.

2. The cumulative return requirement in subsection IV.D shall be compounded daily. This policy should be contained in the PROSPECTUS.

E. *Reinvestment of Proceeds on Disposition of Equipment.* Reinvestment of proceeds resulting from the sale or refinancing of PROGRAM equipment may take place if sufficient cash will be distributed to pay state and federal income tax, if any, (assuming investors are in a specified tax bracket) created by the sale or refinancing of such equipment. This policy should be contained in the PROSPECTUS.

COMMENT:

Funds reinvested pursuant to Subsections VIII.D. and E. are not considered to be "investments" in the PROGRAM for purposes of calculating CAPITAL CONTRIBUTIONS.

F. *Payments to Terminated Sponsors.* Upon the occurrence of a terminating event, the partnership may be required to pay to the terminated SPONSOR all amounts then accrued and owing to the terminated SPONSOR. Additionally, the partnership may terminate the SPONSOR'S interest in partnership income, losses, distributions, and capital by payment of an amount equal to the then present fair market value of the terminated SPONSOR'S interest determined by agreement of the terminated SPONSOR and the partnership, or, if they cannot agree, by arbitration in accordance with the then current rules of the American Arbitration Association. The expense of arbitration shall be borne equally by the terminated SPONSOR and the partnership.

The method of payment to the terminated SPONSOR must be fair and must protect the solvency and liquidity of the partnership. When the termination is voluntary, the method of payment will be presumed to be fair if it provides for a non-interest bearing unsecured promissory note with principal payable, if at all, from distributions which the terminated SPONSOR otherwise would have received under the partnership agreement had the SPONSOR not terminated. When the termination is involuntary, the method of payment will be presumed to be fair if it provides for an interest bearing promissory note maturing in not less than five years with equal installments each year.

G. *Provisions of PROGRAM Agreement.* The requirements and/or provisions of appropriate portions of the following sections shall be included in the PROGRAM agreement: II.D; IV.D; IV.E; IV.F; IV.G; V.A; V.B; V.C; V.D; V.E; V.F; V.G; V.H; V.I; V.J; V.K; V.M; V.O; V.P; V.Q; VI.A; VI.B; VI.C; VI.D; VI.E; VI.F; VI.G; VIII.A; VIII.B.4; VIII.C; VIII.D; VIII.E; VIII.F.

Adopted September 22, 1976

North American Securities Administrators Association, Inc., amended October 12, 1977, October 31, 1979, April 23, 1983, July 1, 1984, September 3, 1987, and September 14, 1989; amended October 24, 1991; amended May 7, 2007

1. INTRODUCTION.

A. Application.

1. These guidelines apply to the registration and qualification of oil and gas programs, as defined in Section I.B.23 below, and will be applied by analogy to oil and gas programs in other forms, including but not limited to multi-tier structures. While applications not conforming to the standards contained herein shall be looked upon with disfavor, where good cause is shown certain guidelines may be modified or waived by the Administrator.

2. Where the individual characteristics of specific programs warrant modification from these standard, they will be accommodated, insofar as possible, while still being consistent with the spirit of the guidelines.

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B. *Definitions.* As used in the guidelines, the following terms mean:

1. *Administrative Costs:* All customary and routine expenses incurred by the conduct of program administration, including: legal, finance, accounting, secretarial travel, office rent, telephone, data processing and other items of a similar nature.

2. *Administrator:* The official or agency administering the securities laws of a state.

3. *Affiliate:* An affiliate of a specified person means (a) any person directly or indirectly owning, controlling, or holding with power to vote 10 percent or more of the outstanding voting securities of such specified person; (b) any person 10 percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such specified person; (c) any person directly or indirectly controlling, controlled by, or under common control with such specified person; (d) any officer, director, trustee or partner of such specified person, and (e) if such specified person is an officer, director, trustee or partner, any person for which such person acts in any such capacity.

4. *Assessments:* Additional amounts of capital which may be mandatorily required of or paid voluntarily by a participant beyond his subscription commitment.

5. *Capital Contributions:* The total investment, including the original investment, assessments and amounts reinvested, in a program by a participant or by all participants, as the case may be.

6. *Capital Expenditures:* Those cost associated with property acquisition and the drilling and completion of oil and gas wells which are generally accepted as capital expenditures pursuant to the provisions of the Internal Revenue Code.

7. *Carried Interest:* An equity interest in a program issued to a person without consideration, in the form of cash or tangible property, in an amount proportionately equivalent to that received from the participants.

8. *Cost:* When used with respect to property in Section VI, means (a) the sum of the prices paid by the seller to an unaffiliated person for such property, including bonuses; (b) title insurance or examination costs, brokers' commissions, filing fees, recording costs, transfer taxes, if any, and like charges in connection with the acquisition of such property; (c) a pro rata portion of seller's actual necessary and reasonable expenses for seismic and geophysical services; and (d) rentals and ad valorem taxes paid by the seller with respect to such property to the date of its transfer to the buyer, interest and points actually incurred on funds used to acquire or maintain such property, and such portion of the seller's

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reasonable, necessary and actual expenses for geological, engineering, drafting, accounting legal and other like services allocated to the property cost in conformity with generally accepted accounting principles and industry standards, except for expenses in connection with the past drilling of wells which are not producers of sufficient quantities of oil and gas to make commercially reasonable their continued operations, and provided that the expenses enumerated in this subsection (d) hereof shall have been incurred not more than 36 months prior to the purchase by the program; provided that such period may be extended, at the discretion of the Administrator, upon proper justification. When used with respect to services, "cost" means the reasonable, necessary and actual expenses incurred by the seller on behalf of the program in providing such services, determined in accordance with generally accepted accounting principles. As used elsewhere, "cost" means the price paid by the seller in an arm's-length transaction.

9. *Development Well*: A well drilled within the proved area of an oil or gas reservoir to the depth of a stratigraphic horizon known to be productive.

10. *Direct Costs*: All actual and necessary costs directly incurred for the benefit of the program and generally attributable to the goods and services provided to the program by parties other than the sponsor or its affiliates. Direct costs shall not include any cost otherwise classified as organization and offering expenses, administrative costs, or property costs. Direct costs may include the cost of services provided by the sponsor or its affiliates if such services are provided pursuant to written contracts and in compliance with Section V.B.8 of these guidelines.

11. *Exploratory Well*: A well drilled to find commercially productive hydrocarbons in an unproved area, to find a new commercially productive horizon in a field previously found to be productive of hydrocarbons at another horizon, or to significantly extend a known prospect.

12. *Farmout*: An agreement whereby the owner of the leasehold or working interest agrees to assign his interest in certain specific acreage to the assignees, retaining some interest such as an overriding royalty interest, an oil and gas payment, offset acreage or other type of interest, subject to the drilling of one or more specific wells or other performance as a condition of the assignment.

13. *Horizon*: A zone of a particular formation; that part of a formation of sufficient porosity and permeability to form a petroleum reservoir.

14. *Independent Expert*: A person with no material relationship to the sponsor who is qualified and who is in the business of rendering opinions regarding the value of oil and gas properties based upon the evaluation of all pertinent economic, financial, geologic and engineering information available to the sponsor.

15. *Landowner's Royalty Interest*: An interest in production, or the proceeds therefrom, to be received free and clear of all costs of development, operation, or maintenance, reserved by a landowner upon the creation of an oil and

gas lease.

16. *Non-Capital Expenditures*: Those expenditures associated with property acquisition and the drilling and completion of oil and gas wells that under present law are generally accepted as fully deductible currently for federal income tax purposes.

17. *Operating Costs*: Expenditures made and costs incurred in producing and marketing oil or gas from completed wells, including, in addition to labor, fuel, repairs, hauling, materials, supplies, utility charges and other costs incident to or therefrom, ad valorem and severance taxes, insurance and casualty loss expense, and compensation to well operators or others for services rendered in conducting such operations.

18. *Organization and Offering Expenses*: All costs of organizing and selling the offering, including but not limited to, total underwriting and brokerage discounts and commissions (including fees of the underwriters' attorneys), expenses for printing, engraving, mailing, salaries of employees while engaged in sales activity, charges of transfer agents, registrars, trustees, escrow holders, depositories, engineers and their experts, expenses of qualification of the sale of the securities under Federal and State law, including taxes and fees, accountants' and attorneys' fees and other front-end fees.

19. *Overriding Royalty Interest*: An interest in the oil and gas produced pursuant to a specified oil and gas lease or leases, or the proceeds from the sale thereof, carved out of the working interest, to be received free and clear of all costs of development, operation, or maintenance.

20. *Participant*: The purchaser of a unit in the oil and gas program.

21. *Person*: Any natural person, partnership, corporation, association, trust or other legal entity.

22. *Production Purchase or Income Program*: Any program whose investment objective is to directly acquire, hold, operate and/or dispose of producing oil and gas properties. Such a program may acquire any type of ownership interest in a producing property, including but not limited to, working interests, royalties, or production payments. A program which spends at least 90% of capital contributions and funds borrowed (excluding offering and organizational expenses) in the above described activities is presumed to be a production purchase or income program.

23. *Program*: One or more limited or general partnerships or other investment vehicles formed, or to be formed, for the primary purpose of exploring for oil, gas and other hydrocarbon substances or investing in or holding any property interests which permit the exploration for or production of hydrocarbons or the receipt of such production or

the proceeds thereof (a prospectus may offer a series of programs with individual programs being formed in sequence).

24. *Prospect*: An area covering lands which are believed by the sponsor to contain subsurface structural or stratigraphic conditions making it susceptible to the accumulations of hydrocarbons in commercially productive quantities at one or more horizons. The area, which may be different for different horizons, shall be designated by the sponsor in writing prior to the conduct of program operations and shall be enlarged or contracted from time to time on the basis of subsequently acquired information to define the anticipated limits of the associated hydrocarbon reserves and to include all acreage encompassed therein. A "prospect" with respect to a particular horizon may be limited to the minimum area permitted by state law or local practice, whichever is applicable, to protect against drainage from adjacent wells if the well to be drilled by the program is to a horizon containing proved reserves.

25. *Proved Reserves*: Those quantities of crude oil, natural gas, and natural gas liquids which, upon analysis of geologic and engineering data, appear with reasonable certainty to be recoverable in the future from known oil and gas reservoirs under existing economic and operating conditions. Proved reserves are limited to those quantities of oil and gas which can be expected, with little doubt, to be recoverable commercially at current prices and costs, under existing regulatory practices and with existing conventional equipment and operating methods. Depending upon their status of development, such proved reserves shall be subdivided into the following classifications:

(a) *Proved Developed Reserves*. These are proved reserves which can be expected to be recovered through existing wells with existing equipment and operating methods. This classification shall include:

(1) *Proved Developed Producing Reserves*. These are proved developed reserves which are expected to be produced from existing completion interval(s) now open for production in existing well, and

(2) *Proved Developed Non-Producing Reserves*. These are proved developed reserves which exist behind the casing of existing wells, or at minor depths below the present bottom of such wells, which are expected to be produced through these wells in a predictable future, where the cost of making such oil and gas available for production should be relatively small compared to the cost of a new well.

Additional oil and gas expected to be obtained through the application of fluid injection or other improved recovery techniques for supplementing the natural forces and mechanisms of primary recovery should be included as "Proved Developed Reserves" only after testing by a pilot project or after the operation of an installed program has confirmed through production response that increased recovery will be achieved.

(b) *Proved Undeveloped Reserves*. These are proved reserves which are expected to be recovered from new wells or undrilled acreage, or from existing wells where a relatively major expenditure is required for recompletion. Reserves on undrilled acreage shall be limited to those drilling units offsetting productive units, which are virtually certain of production when drilled. Proved reserves for other undrilled units can be claimed only where it can be demonstrated with certainty that there is continuity of production from the existing productive formation.

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Under no circumstances should estimates for proved undeveloped reserves be attributable to any acreage for which an application of fluid injection or other improved recovery technique is contemplated, unless such techniques have been proved effective by actual tests in the area and in the same reservoir. If warranted, however, a narrative discussion can be provided to point out those areas where future drilling or other operations may develop oil and gas production which at the time of filing is considered too uncertain to be expressed as numerical estimates for proved reserves.

26. *Roll-Up*: A transaction involving the acquisition, merger, conversion, or consolidation, either directly or indirectly, of the program and the issuance of securities of a roll-up entity. Such term does not include:

(a) a transaction involving securities of the program that have been listed for at least 12 months on a national exchange or traded through the National Association of Securities Dealers Automated Quotation National Market System; or

(b) a transaction involving the conversion to corporate, trust or association form of only the program if, as a consequence of the transaction, there will be no significant adverse change in any of the following:

(1) voting rights;

(2) the term of existence of the program;

(3) sponsor compensation; or

(4) the program's investment objectives.

27. *Roll-Up Entity*: A partnership, trust, corporation or other entity that would be created or survive after the successful completion of a proposed roll-up transaction.

28. *Sponsor*: Any person directly or indirectly instrumental in organizing, wholly or in part, a program or any person who will manage or is entitled to manage or participate in the management or control of a program. "Sponsor" includes the managing and controlling general partner(s) and any other person who actually controls or selects the person who controls 25% or more of the exploratory, developmental or producing activities of the program, or any segment thereof, even if that person has not entered into a contract at the time of formation of the program. "Sponsor" does not include wholly independent third parties such as attorneys, accountants, and underwriters whose only

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compensation is for professional services rendered in connection with the offering of units. Whenever the context of these guidelines so requires, the term "sponsor" shall be deemed to include its affiliates.

29. *Subordinate Interest*: An equity interest in a program issued to a person, without payment of full consideration, after the attainment of certain specified performance by the program.

30. *Working Interest*: An interest in an oil and gas leasehold which is subject to some portion of the costs of development, operation, or maintenance.

II. REQUIREMENTS OF SPONSOR.

A. *Experience* The sponsor or its chief operating officers shall have at least three years' relevant oil and gas experience demonstrating the knowledge and experience to carry out the stated program policies and to manage the program operations. Additionally, the sponsor or any affiliate providing services to the program shall have had not less than four years' relevant experience in the kind of service being rendered, or otherwise must demonstrate sufficient knowledge and experience to perform the services proposed. If any managerial responsibility for the program is to be rendered by persons other than the sponsor, then such persons must be identified in the prospectus, their experience must be similar to that required of a sponsor and must be set out in the prospectus, and a contract setting forth the basis of their relationship with the program must be filed with and not disapproved by the Administrator.

B. *Net Worth*:

1. The financial condition of the sponsor must be commensurate with any financial obligations assumed by it in connection with the offering and the operation of the program.

(a) For limited partnership offerings, the general partner must specifically have a minimum aggregate net worth at all times equal to 5% of participants' capital in all existing programs organized by the general partner plus 5% of total subscriptions in the program being offered, but such minimum required net worth shall in no case be less than \$200,000 nor shall net worth in excess of \$2 million be required.

(b) For general partnership offerings and other offerings in which investors are not provided statutory protection against unlimited liability, the managing or controlling general partner's net worth should be of a sufficient amount to adequately protect the participants against unreasonable exposure to program liabilities. Unless the Administrator establishes a different amount based upon mitigating factors, \$5 million will be considered a presumptively reasonable net worth.

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2. For purposes of computing a managing or controlling general partner's net worth, 70% of the standardized measure of discounted future net cash flows relating to the proved oil and gas reserves, as determined by a qualified independent petroleum consultant, of a managing or controlling general partner may be used as an alternative to the stated value of the associated oil and gas properties on the sponsor's balance sheet. Reserves, notes and accounts receivables from all programs, interests in all programs, and all contingent liabilities will be scrutinized carefully to determine the appropriateness of their inclusion in the net worth computation. If an individual managing or controlling general partner's net worth is used in complying with the above requirements, a statement as to such net worth shall be included in the prospectus.

3. If more than one person acts or serves as managing or controlling general partner of a program, the net worth requirements may be met by aggregating the net worth of all such persons. In addition, the net worth of any guarantor of the managing or controlling general partner's obligations to or for the program may be included in the net worth computation, but only if the guarantor's liability is co-extensive with that of the managing or controlling general partner and the financial statements of the guarantor, prepared in accordance with the requirements of Section II.C of the guidelines, are furnished to the Administrator and made available to participants.

C. Financial Statements.

1. Managing or controlling general partners, other than individuals, shall provide to the Administrator and make available to participants, upon request, audited financial statements for the most recent fiscal year and unaudited financial statements for any interim period ending not more than 90 days prior to the date of filing the application; provided however, if the application is made in coordination with a Securities and Exchange Commission filing, the date of the financial statements may be not more than 135 days prior to the date of filing the registration application. The financial statements shall include, at a minimum, a balance sheet and a statement of operations. The statements shall be prepared in accordance with generally accepted accounting principles and the statements for the most recent fiscal year shall be accompanied by an audit report from an independent certified public accountant.

2. Individual managing or controlling general partners, whose net worth is being relied upon for purposes of demonstrating compliance with Section II.B of these guidelines, shall provide the Administrator and make available to participants a statement of financial condition as of a date not more than 90 days prior to the date of filing the application. The statement of financial condition shall be prepared in accordance with generally accepted accounting principles and accompanied by a review report from an independent certified public accountant.

D. Additional Requirements for General Partnership and Working Interests Programs. For offerings in which investors are not provided statutory protection against unlimited liability:

1. The sponsor shall agree to fully indemnify each participant against all program related liabilities which exceed

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the participant's interest in the undistributed net assets of the program. This indemnification shall be included in the program agreement.

2. Unless the Administrator establishes different terms, the sponsor shall obtain insurance coverage protecting the program and the participants against potential liabilities. The coverage should include public liability insurance with limits, including umbrella policy limits, of at least two times the program's capitalization but in no event less than \$10 million. Coverage limits in excess of \$50 million will not be required unless there are extraordinary circumstances. Other insurance policies, such as well control, environmental damage and workers compensation, should also be obtained if the program is going to engage directly in operating activities or will otherwise be exposed to potential losses in these areas. The program agreement must require the sponsor to notify the participants thirty days prior to the effective date of any adverse material change in the program's insurance coverage. If the insurance coverage is to be materially reduced, the program agreement must provide the participants a right to convert their program interests from general partnership or working interests to limited partnership interests prior to such reduction, or in the alternative, the program agreement may require the cessation of all drilling activity until the required insurance coverage can be obtained.

3. The prospectus shall disclose the terms of the indemnification agreement and shall also disclose the types and amounts of insurance coverage to be obtained for the benefit of the program and the participants along with the insurance claims history of the sponsor in the area where the program anticipates drilling wells, if such information is material. The Administrator may establish different requirements for the protection of participants based on the specific circumstances surrounding the program's proposed activities. In establishing such requirements, the Administrator may consider factors such as the net worth of the sponsor and any other person who has agreed to indemnify the participants, the insurance claims history of the sponsor and its previous programs, the availability and cost to the program of the insurance, the extent to which the drilling to be conducted by the program may include exploratory drilling, the geological and other characteristics of the formations to be developed by the program, and other procedures or policies implemented by the sponsor which may increase or decrease the potential risk of loss or liability to the program or the potential magnitude of loss or liability to the program.

E. Tax Ruling or Opinion. If a significant feature for federal income or excise tax purposes of a program is either deductions in excess of income from the program being available in a year to reduce income from other sources in that year or credits in excess of the tax attributable to the income from the investment being available within a year to offset taxes on income from other sources in that year, then the sponsor must receive a tax ruling from the Internal Revenue Service or an opinion of qualified tax counsel in a form acceptable to the Administrator concerning the status of the program for federal income tax purposes and an opinion of qualified tax counsel in a form acceptable to the Administrator indicating whether it is more likely than not that an investor will prevail on the merits of each material tax issue respecting which there is a reasonable possibility that the Internal Revenue Service will challenge the tax effect disclose in the prospectus.

F. Investment in Program. In appropriate cases, in order to create an identity of interest with the participants, the Administrator may require that the sponsor purchase for cash up to 5.0% of the program units.

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G. *Reports.* The Sponsor shall agree to file with the Administrator, if he so requests it, concurrently with their transmittal to participants, a copy of each report made pursuant to Section VIII.B of these guidelines.

H. *Fiduciary Duty.*

1. The program agreement and prospectus shall provide that the sponsor shall have a fiduciary responsibility for the safekeeping and use of all funds and assets of the program, whether or not in the sponsor's possession or control, and that the sponsor shall not employ, or permit another to employ, such funds or assets in any manner except for the exclusive benefit of the program.

2. Except as provided in Section II.H.3, neither the program agreement nor any other agreement between the sponsor and the program shall contractually limit any fiduciary duty owed to the participants by the sponsor under any applicable law.

3. The program agreement may contractually limit fiduciary duties owed to the participant by the sponsor as follows:

(a) The program may indemnify and hold harmless the sponsor and its affiliates as provided in Section II.I

(b) The sponsor may be required to devote only so much of its time as is necessary to manage the affairs of the program.

(c) The sponsor and its affiliates may conduct business with the program in a capacity other than as sponsor but only in compliance with Sections V and VI of these guidelines.

(d) Except as otherwise provided in Section VI of these guidelines, the sponsor and any of its affiliates may pursue business opportunities that are consistent with the program's investment objectives for their own account only after they have determined that such opportunity either cannot be pursued by the program because of insufficient funds or because it is not appropriate for the program under the existing circumstances.

(e) The sponsor may manage multiple programs simultaneously.

I. Liability and Indemnification of the Sponsor.

1. The program shall not provide for indemnification of the sponsor, or its affiliates performing services on behalf of the program for any liability or loss suffered by the sponsor or affiliate, nor shall it provide that the sponsor or affiliate be held harmless for any loss or liability suffered by the program, unless all of the following conditions are met:

(a) The sponsor has determined, in good faith, that the course of conduct which caused the loss of liability was in the best interests of the program, and

(b) the sponsor or affiliate was acting on behalf of or performing services for the program, and

(c) such liability or loss was not the result of negligence or misconduct by the sponsor or affiliate, and

(d) payments arising from such indemnification or agreement to hold harmless are recoverable only out of the tangible net assets of the program.

2. Notwithstanding anything to the contrary contained in Section II.I.1., the sponsor, its affiliates and any person acting as a broker-dealer shall not be indemnified for any losses, liabilities or expenses arising from or out of an alleged violation of federal or state securities laws by such party unless the following conditions are met:

(a) There has been a successful adjudication on the merits of each count involving alleged securities law violations as to the particular indemnitee, or

(b) such claims have been dismissed with prejudice on the merits by a court of competent jurisdiction as to the particular indemnitee, or

(c) a court of competent jurisdiction approves a settlement of the claims against a particular indemnitee and finds that indemnification of the settlement and the related costs should be made, and the court considering the request for indemnification has been advised of the position of the Securities and Exchange Commission and of the position of any state securities regulatory authority in which securities of the program were offered or sold as to indemnification for violations of securities laws; provided however, the court need only be advised of the positions of the securities regulatory authorities of those states (i) which are specifically set forth in the program agreement and (ii) in which plaintiffs claim they were offered or sold program units.

3. The program may not incur the cost of that portion of liability insurance which insures the sponsor for any liability as to which the sponsor is prohibited from being indemnified under this Section II.I; provided however, that this Section II.I.3 shall not preclude the program from purchasing and paying for such types of insurance, including extended coverage liability, casualty and workers' compensation, as in customary in the oil and gas industry.

4. The advancement of program funds to a sponsor or its affiliates for legal expenses and other costs incurred as a result of any legal action for which indemnification is being sought is permissible only if the program has adequate funds available and the following conditions are satisfied:

(a) The legal actions related to acts or omissions with respect to the performance of duties or services on behalf of the program, and

(b) The legal action is initiated by a third party who is not a participant, or the legal action is initiated by a participant and a court of competent jurisdiction specifically approves such advancement, and

(c) The sponsor or its affiliates undertake to repay the advances funds to the program, together with the applicable legal rate of interest thereon, in cases in which such party is found not to be entitled to indemnification.

J. Arbitration Provisions. The program agreement may contain provisions relating to the use of arbitration as a means of dispute resolution; provided however, it may not require arbitration for allegations involving breach of contract, negligence, violations of state and federal securities laws, breach of fiduciary duty or other misconduct by the sponsor, nor shall it provide for mandatory venue. Program agreements which contain arbitration provisions shall prominently disclose such fact on the cover page of the program agreement. Allocation of the cost of arbitration may be made a matter for determination in the proceedings. This Section II.J. should not be interpreted to prohibit separate arbitration agreements between sponsors and participants if the agreements are not a condition of making an investment in the program.

III. SELLING OF UNITS AND SALES MATERIALS.

A. Sales of Units

1. Compensation to all broker-dealers shall be a cash commission. Compensation of an indeterminate nature to broker-dealers for sales of program units, or for services of any kind rendered in connection with or related to the

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distribution of program units, including, but not necessarily limited to, a percentage of a management fee, a profit sharing arrangement, overriding royalty interest, net profits interest, percentage of revenues, reversionary interest, working interest or other similar incentive items shall be prohibited.

2. Compensation to wholesale dealers must be a cash commission, must be reasonable and must be fully disclosed.

3. Sales commissions based on assessment of units or unfunded capital contributions are prohibited.

4. The sale of units in a program together with shares, options to purchase shares or other securities issued by the sponsor or another issuer will not be permitted unless such other securities, viewed separately, satisfy the requirements otherwise applicable to their registration.

B. Sales Material.

1. Supplementary materials (including prepared presentations for group meetings) must be submitted to the Administrator in advance of use, and its use must either be preceded by or accompanied with an effective prospectus.

2. *Sales Literature:* Sales literature, including without limitation, books, pamphlets, movies, slides, article reprints, and television and radio commercials, sales presentations (including prepared presentations to prospective participants at group meetings) and all other advertising used in the offer or sale of units shall conform in all applicable aspects to filing, disclosure and adequacy requirements currently imposed on the sale of corporate securities under applicable regulations. When periodic or other reports, except those required by and filed with the Securities and Exchange Commission, furnished to participants in prior programs are furnished to prospective participants in a program not yet sold, such reports will be treated as sales literature subject to the above requirements. Statements made in sales literature may not conflict with, or significantly modify, risk factors or other statements made in the prospectus. Sales literature shall not be so excessive in size or amount as to detract from the prospectus, nor shall any sales literature be used by securities broker-dealers or agents unless such literature has been approved by the sponsor in writing and incorporates, if the Administrator so requests, disclosure of the participant suitability standards imposed by Section IV of these guidelines.

3. *Group Meetings:* All advertisements of, and oral or written invitations to "seminars" or other group meetings at which units are to be described, offered or sold shall clearly indicate that the purpose of such meeting is to offer such units for sale, the minimum purchase price thereof, the suitability standards to be employed, and the name of the person selling the units. No cash, merchandise or other items of value shall be offered as an inducement to any prospective participants to attend any such meeting. All written or prepared audio-visual presentations (including scripts prepared in advance for oral presentations) to be made at such meetings must be submitted to the Administrator within a prescribed review period. The provisions of this section shall not apply to meetings consisting only of representatives of securities

broker-dealers.

4. *Prohibited Representations:*

(a) In connection with the offering and sale of interests in a program, neither the sponsor(s) nor the underwriter(s) may, in writing or otherwise, directly or indirectly, represent or imply that an Administrator has approved the merits of the investment or any aspects thereof.

(b) Any reference to the program's compliance with these guidelines or any provisions herein which connotes or implies such approval shall be deemed to be in noncompliance with paragraph (a) of this subsection.

IV. SUITABILITY OF PARTICIPANTS

A. *General Policy.*

1. The sponsor shall establish minimum income and net worth standards for persons who purchase program interests.

2. The sponsor shall propose minimum income and net worth standards which are reasonable given the type of program and the risks associated with the purchase of program interests. Programs with greater investor risk shall have minimum standards with a substantial net worth requirement. The Administrator shall evaluate the standards proposed by the sponsor when the program's application for registration is reviewed. In evaluating the proposed standards, the Administrator may consider the following:

(a) the program's use of leverage;

(b) tax implications;

(c) mandatory deferred payments;

- (d) assessments;
- (e) potential variances in cash distributions;
- (f) potential participants;
- (g) relationship between potential participants and the sponsor;
- (h) liquidity of program interests;
- (i) performance of sponsor's prior programs;
- (j) financial condition of the sponsor;
- (k) potential transactions between the program and the sponsor; and
- (l) any other relevant factors.

B. Income and Net Worth Standards.

1. For income programs or programs that utilize at least 90% of capital contributions and funds borrowed (excluding organization and offering expenses) in providing completion financing, debt financing, or making other types of oil and gas investments, unless the Administrator determines that the risk associated with the program would require lower or higher standards, each participant shall have:

- (a) a minimum annual gross income of \$70,000 and a minimum net worth of \$70,000; or
- (b) a minimum net worth of \$250,000.

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2. For drilling programs which provide the participant with statutory protection against unlimited liability, unless the Administrator determines the risks associated with the program would require lower or higher standards, each participant shall have:

(a) a minimum annual gross of income of \$85,000 and a minimum net worth of \$85,000; or

(b) a minimum net worth of \$330,000.

3. For drilling programs which do not provide the participant with statutory protection against unlimited liability, unless the Administrator determines that the risks associated with the program would require lower or higher standards, each participant shall have

(a) a minimum net worth of \$330,000, without regard to the investment in the program, and a minimum annual gross income of \$150,000 for the current year and for the two previous years; or

(b) a minimum net worth in excess of \$1,000,000, inclusive of home, home furnishings and automobiles; or

(c) a minimum net worth of \$750,000; or

(d) a minimum annual gross income of \$200,000 in the current year and the two previous years.

4. Unless otherwise specified, net worth shall be determined exclusive of home, home furnishings, and automobiles.

5. In the case of sales to fiduciary accounts, these minimum standards shall be met by the beneficiary, the fiduciary account, or by the donor or grantor who directly or indirectly supplies the funds to purchase the program interests if the donor or grantor is the fiduciary.

6. The sponsor shall set forth in the final prospectus:

- (a) the investment objectives of the program;
- (b) a description of the type of person who might benefit from an investment in the program; and
- (c) the minimum standards imposed on each participant in the program.

C. Determination that Sale to Participant is Suitable and Appropriate.

1. The sponsor and each person selling program interests on behalf of the sponsor or program shall make every reasonable effort to determine that the purchase of program interests is a suitable and appropriate investment for each participant.

2. In making this determination, the sponsor and each person selling program interests on behalf of the sponsor or program shall ascertain that the prospective participant:

- (a) meets the minimum income net worth standard established for the program;
- (b) can reasonably benefit from the program based on the prospective participant's overall investment objectives and portfolio structure;
- (c) is able to bear the economic risk of the investment based on the prospective participant's overall financial situation; and
- (d) has apparent understanding of:
 - (1) the fundamental risks of the investment;
 - (2) the risk that the participant may lose the entire investment;

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- (3) the lack of liquidity of program interests;
- (4) the restrictions on transferability of program interests;
- (5) the background and qualifications of the sponsor or the persons responsible for directing and managing the program;
- (6) the tax consequences of the investment; and
- (7) the unlimited liability associated with working interest or general partnership offerings.

3. The sponsor or each person selling program interests on behalf of the sponsor or program will make this determination on the basis of information it has obtained from a prospective participant. Relevant information for this purpose will include at least the age, investment objectives, investment experience, income, net worth, financial situation, and other investments of the prospective participant, as well as any other pertinent factors.

4. The sponsor or each person selling program interests on behalf of the sponsor or program shall maintain records of the information used to determine that an investment in program interests is suitable and appropriate for each participant. The sponsor or each person selling program interests on behalf of the sponsor or program shall maintain these records for at least six years.

5. The sponsor shall disclose in the final prospectus the responsibility of the sponsor and each person selling program interests on behalf of the sponsor or program to make every reasonable effort to determine that the purchase of program interests is a suitable and appropriate investment for each participant, based on information provided by the participant regarding the participant's financial situation and investment objectives.

D. Subscription Agreements.

1. The Administrator may require that each participant complete and sign a written subscription agreement.

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2. The sponsor may require that each participant make certain factual representations in the subscription agreement, including the following:

- (a) The participant meets the minimum income and net worth standards established for the program.
- (b) The participant is purchasing the program interests for his or her own account.
- (c) The participant has received a copy of the prospectus.
- (d) The participant acknowledges that the investment is not liquid.

3. The participant must separately sign or initial each representation made in the subscription agreement. Except in the case of fiduciary accounts, the participant may not grant any person a power of attorney to make such representations on his or her own behalf.

4. The sponsor and each person selling program interests on behalf of the sponsor or program shall not require a participant to make representations in the subscription agreement which are subjective or unreasonable and which:

- (a) might cause the participant to believe that he or she has surrendered rights to which he or she is entitled under federal or state law; or
- (b) would have the effect of shifting the duties regarding suitability, imposed by law on broker-dealers, to the participant.

5. Prohibited representations include, but are not limited to the following:

- (a) The participant understands or comprehends the risks associated with an investment in the program.
- (b) The investment is a suitable one for the participant.

(c) The participant has read the prospectus.

(d) In deciding to invest in the program, the participant has relied solely on the prospectus, and not on any other information or representations from other persons or sources.

6. The sponsor may place the content of the prohibited representations in the subscription agreement in the form of disclosures to the participant. The sponsor may not place these disclosures in the participant representation section of the subscription agreement.

E. Completion of Sale.

1. The sponsor or any person selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM may not complete a sale of PROGRAM INTERESTS to a PARTICIPANT until at least five business days after the date the PARTICIPANT receives a final prospectus.

2. The sponsor or the person designated by the sponsor shall send each participant a confirmation of his or her purchase.

F. Minimum Investment.

The Administrator may require a minimum initial and subsequent cash investment amount.

V. FEES, COMPENSATION AND EXPENSES.

A. Organization and Offering Expenses, and Management Fees.

1. All organization and offering expenses incurred in order to sell program units shall be reasonable, and the total of those organization and offering expenses, which may be charged to the program, plus any management fee, which may be charged by the sponsor, shall not exceed 15% of the initial subscriptions.

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2. Commissions payable on the sale of program units shall be paid in cash solely on the amount of initial subscriptions. Payment of commissions in the form of overriding royalties, net profit interests or other interests in production will not be approved, except that no objection will be raised to the payment of commissions in the form of interests in the program, provided the amount does not exceed that purchasable by applying the aggregate cash commission allowable to the unit offering price.

3. All items of compensation to underwriters or dealers, including, but not limited to, selling commissions, expenses, rights of first refusal, consulting fees, finders' fees and all other items of compensation of any kind or description paid by the program, directly or indirectly, shall be taken into consideration in computing the amount of allowable selling commissions.

B. *Compensation.* The participation in program revenues by the sponsor and any affiliate shall be reasonable, taking into account all relevant factors. Overriding royalty interests will be looked upon with disfavor. Subject to Section II.F.1 of these guidelines, the sponsors' interests in revenues will be considered reasonable if they meet the standards set forth below. Any other combination of fees, carried interests, or interests subordinate to pay out to the public investors, which can be demonstrated to provide participants equal or more favorable terms of participation in the program, may also be considered reasonable by the Administrator.

1. *Drilling Programs: Functional Allocation.*

(a) Where the sponsor agrees to pay the capital expenditures of the program, but in any case at least 10% of the capital contributions to the program (including any capital contributions from the sponsor or any of its affiliates), its share of revenues will be determined by the following formula: (1) If the agreement is to pay capital expenditures but in any case a sum of not less than 10% of the capital contributions to the program (including any capital contributions from the sponsor or any of its affiliates), the sponsor will be entitled to receive 25% of program revenues; (2) the sponsor's revenue sharing may be increased in additional increments of 1% for each additional 1% increase in the percentage of capital contributions to the program (including any capital contributions from the sponsor or any of its affiliates) actually made by the sponsor up to a maximum of 50% of revenues subject to sponsor's agreement to pay in any case all capital expenditures.

(b) The aforesaid arrangement to pay capital expenditures refers to and includes capital expenditures for the drilling and completing of wells during the life of the program, but does include capital expenditures for facilities downstream of a wellhead. If the sponsor should enter into a farmout or other arrangements through which only the sponsor is relieved of its obligations to pay for such capital expenditures, then the sponsor's share of revenue shall be proportionately reduced, the amount to be determined on an individual basis.

(c) In order to elect a sharing agreement as above provided, the sponsor must have a net worth of \$300,000 or 10% of the total contributions to the program by the participants, whichever is greater, and must be under a contractual obligation to pay its share of expenses as such expenses are paid by the program and to complete its minimum financial

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commitment to the program by the payment of cash by the end of the first fiscal year succeeding the fiscal years in which the program commenced operations. Any additional contributions made by the sponsor will be used to pay program expenses which would otherwise be charged to the participants; provided however, the sponsor may receive credit for the amount of such payments against any subsequent capital expenditure incurred by the program and allocated to the sponsor.

(d) For the purposes of this subsection, if a well is not abandoned within 60 days following the commencement of production, then it shall be deemed to be a commercial well insofar as the program is concerned and the sponsor may not recapture its capital expenditures from the program, which otherwise would be treated as noncapital expenditures upon abandonment. As used herein, production shall refer to the commencement of the commercial marketing of oil and gas and shall not include any spot sales of oil or gas produced as a result of testing procedures. All revenues from a well abandoned under this subsection shall be allocated pro rata to those persons bearing the costs of such well.

(e) The sharing arrangement set forth in this subsection shall not be considered presumptively reasonable: (1) in the case of sharing arrangements in which the sponsor pays all development costs and exploratory wells are drilled on prospects which cannot reasonably be expected to require developmental drilling if the exploratory drilling is successful, or (2) in the case of sharing arrangements where the sponsor does not pay its share or category of costs on a current basis.

2. *Drilling Programs: Subordinate Interest.* As an alternative to sharing revenues on a basis related to costs paid, it will be considered reasonable for a sponsor of a drilling program to receive a promotional interest in the form of a subordinated interest in program distributions. A subordinated interest will be considered presumptively reasonable if it does not exceed 25% of program distributions after the participants have been distributed an amount equal to their capital contribution.

At such time as the sponsor is entitled to receive its promotional interest, it shall also be allocated and pay program costs in the same ratio as its participants in program revenues.

3. *Drilling Programs: Other Alternatives.* A sponsor who is allocated and pays at least 1% of all program costs as incurred (excluding organizational and offering expenses, and management fees) may receive 11% of program revenues plus an additional percentage of program revenues equal to the additional percentage of program costs which it pays in excess of 1%, up to a maximum of 50% of program revenues. The sponsor must be allocated and pay operating expenses, direct costs and administrative costs in the same ratio as they participate in program revenues.

4. *Prospect Origination Services of the Sponsor.* The sharing arrangements for drilling programs set forth in Section V.B. shall not be considered presumptively reasonable for a sponsor who does not actively participate in obtaining a significant portion of the program's prospects and who does not assume management responsibility for drilling, completing, equipping and operating a significant portion of a program's wells, unless such sponsor shall satisfactorily demonstrate that its compensation together with the costs of procuring such services for the program from third parties does not exceed the permissible compensation to the sponsor set forth in this Section V.B. For purposes of these guidelines, a sponsor shall be deemed to be actively participating in obtaining a significant portion of a program's

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prospects if the sponsor has in-house or under contract the technical capability of originating and/or fully evaluating the prospects to be acquired by that program. "Prospect origination" is the process of formulating a geological or geophysical concept and negotiating for the acquisition of a sufficient acreage interest in the area to warrant drilling and testing. "Prospect evaluation" is the process of determining the viability of a prospect which has been originated by a third party.

A sponsor must describe in adequate detail in the offering documents the nature of the sponsor's capability to originate and/or evaluate the prospects the sponsor intends to transfer to a program. If the capability is in-house, the "Operation" Section of the offering documents should have a full discussion of the process by which such origination and evaluation will take place and the "Management" Section of those documents should include a biographical discussion of the key personnel of the sponsor performing these activities. If the capability is to be provided by third parties under contract to the sponsor, the third parties should be identified, their qualifications described, and the contractual nature of the arrangement between the sponsor and the third party should be fully disclosed. This should include a detailed discussion of the administrative process involved in the relationship. It will be deemed presumptively unreasonable, in the latter instance, if the contracts do not provide the program with comparable capabilities to those that would be provided if the sponsor's capability was in-house, including, among other things, availability of technical expertise and the provisions of adequate response time. Unless the sponsor can adequately demonstrate the availability of such capability, it will not be permitted to elect any of the sharing costs and revenues described in the guidelines.

5. *Income or Production Purchase Programs.* An interest in the program will be allowed as a promotional interest provided that the amount or percentage of such interest is reasonable. Such an interest will generally be presumed reasonable if it is within the limitations expressed below:

(a) Where the sponsor does not maintain a technical staff which has the necessary capability and experience to originate, evaluate and consummate property acquisitions without substantial third party assistance, the sponsor may take a fully participating 3% carried interest until participants have received cash distributions in an amount equal to their capital contributions after which the sponsor may take up to a fully participating 5% carried interest.

(b) Where the sponsor maintains a technical staff which has the necessary capability and experience and will in fact originate, evaluate and consummate property acquisitions without substantial third party assistance, the sponsor may take:

(1) a fully participating 10% carried interest, or

(2) a fully participating 1% carried interest until participants have received cash distributions in an amount equal to their capital contributions after which the sponsor may take up to a fully participating 20% carried interest.

6. *Operator Services.* If the sponsor or one of its affiliates reserves the right to be designated as operator of any property acquired by the program, the prospectus must disclose the extent of the sponsor's or affiliate's operating

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experience and capabilities. Operator services may not be provided unless the sponsor or the affiliate has substantial operating experience. If the sponsor or an affiliate is designated as operator of any property acquired by the program, such services must be performed pursuant to a model form operating agreement issued by the American Association of Petroleum Landmen and an accounting procedure for joint operations issued by the Council of Petroleum Accountants Societies of North America, or other form of agreement acceptable to the Administrator, all in a form which is customary and usual for the geographic area in which the properties are located. In no event shall any consideration received for operator services be in excess of the competitive rate or duplicative of any consideration or reimbursements received pursuant to the program agreement. The sponsor may not benefit by interpositioning itself between the program and the actual provider of operator services.

7. *Drilling Contractor Services.* If the sponsor or one of its affiliates reserves the right to act as contractor in connection with the drilling of program wells, the prospectus must disclose the extent of the sponsor's or affiliate's contracting experience and capabilities. Contracting services may not be provided unless the sponsor or the affiliate, or their principals, has substantial contracting experience. The prospectus must disclose the material terms pursuant to which contractor services may be provided and if there is a separate contract to be utilized in connection with such services a copy of the form of such contract must accompany the registration application. Turnkey drilling contracts or other contracts with the sponsor or an affiliate of the sponsor that establish a fixed price for drilling services shall not be permitted. The sponsor or affiliate may guarantee cost estimates of subcontractors or provide indemnification against cost overruns, provided no additional compensation is received by the sponsor or affiliate as a result of such guarantees or indemnification. The rates charged for drilling contractor services must be competitive with the rates charged by unaffiliated contractors in the same geographic region. With respect to subcontractor services provided by the sponsor or affiliate, there must be documentation, maintained for the life of the program, demonstrating compliance with Section V.B.8 below. The sponsor may not benefit by interpositioning itself between the program and the actual provider of drilling contractor services.

8. *Equipment, Supplies and Services.*

(a) Neither the sponsor nor any affiliate shall render to the program any oil field, equipage or other services nor sell or lease to the program any equipment or supplies unless:

(1) such entity is engaged, independently of the program and as an ordinary and ongoing business, in the business of rendering such services or selling or leasing such equipment and supplies to a substantial extent to other persons in the industry in addition to programs in which the sponsor or its affiliates have an interest; and

(2) the compensation, price or rental therefor is competitive with the compensation, price or rental of other persons in the area engaged in the business of rendering comparable services or selling or leasing comparable equipment and supplies which could reasonably be made available to the program.

(b) If such entity is not engaged in the business as required by Section V.B.8(a)(1) above, then such

compensation, price or rental shall be the cost of such services, equipment or supplies to such entity, or the competitive rate which could be obtained in the area, whichever is less.

9. *Written Contracts.* All services for which the sponsor or any affiliate is to receive compensation shall be embodied in a written contract (which may be the program agreement) that specifically describes each service to be rendered and all compensation to be paid.

C. Program Expenses.

1. Administrative costs and other charges for goods and services must be fully supportable as to the necessity thereof and the reasonableness of the amount charged. All actual and necessary expenses incurred by the program may be paid out of capital contributions and out of program revenues.

2. Direct costs shall be billed directly to and paid by the program to the extent practicable.

3. The sponsor may be reimbursed for administrative costs, provided such costs are reasonably allocated to the program on the basis of assets, revenues, time records or other method conforming with generally accepted accounting principles. No portion of the salaries, benefits, compensation or remuneration of controlling persons shall be reimbursed as administrative costs. Controlling persons include directors, executive officers and those holding 5% or more equity interest in the sponsor or a person having power to direct or cause the direction of the sponsor, whether through the ownership of voting securities, by contract, or otherwise.

A description of the method to be used for allocating costs shall be clearly described in the prospectus and such allocations must be audited annually by the sponsor's independent certified public accountants. The program agreement shall require the independent certified public accountants to provide written attestation annually, to be included as part of the program's annual report, that the method used to make allocations was consistent with the method described in the prospectus and that the total amount of costs allocated did not materially exceed the amounts incurred by the sponsor. If the sponsor subsequently decides to allocate expenses in a manner different from that described in the prospectus, such change must be reported to the participants together with an explanation of why such change was made and the basis used for determining the reasonableness of the new allocation method.

4. The program shall disclose in tabular form and estimate of expenses to be charged to the program showing direct costs and administrative costs separately, and the sponsor must demonstrate that it has a reasonable basis for such estimates. The estimate of direct costs and administrative costs shall be broken down into various types of services and costs. The following is the type of tabular disclosure which will be considered reasonable for disclosing estimated direct costs and administrative costs:

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The sponsor estimates that direct costs and administrative costs allocable to the program for the first twelve months of operation will be approximately \$_____ if the minimum program capital is received (representing _____% of program capital) and approximately \$_____ if the maximum program capital is received (representing _____% of program capital). The sponsor estimates that the components of such allocable amounts will be as follows:

	Minimum Program	Maximum Program
<i>Administrative Costs:</i>		
Legal.....	\$.....	\$.....
	.	.
Accounting.....		
Geological.....		
Secretarial.....		
Travel.....		
Office Rent.....		
Telephone.....		
Data Processing.....		
Other (list).....		
<i>Direct Costs:</i>		
External Legal.....		
Audit Fees.....		
Independent Engineering Reports.....		
Outside Computer Services.....		
Other (list).....		
TOTAL.....	\$.....	\$.....
	.	.

The procedures followed to determine the amounts of administrative costs to be allocated to the program are enumerated as follows:

- 1.
- 2.
- 3.
4. etc.

5. The prospectus shall disclose in tabular form for each program formed in the last three years the dollar amount of direct costs and administrative costs incurred, and the percentage of subscriptions raised reflected thereby.

6. The sponsor shall bear a percentage of direct costs and administrative costs equal to its percentage of revenue participation. A subordinate interest shall bear its percentage of direct costs and administrative costs from the time that the sponsor becomes eligible to receive its subordinated interest.

VI. PROPERTY TRANSACTIONS WITH AFFILIATES AND OTHER RESTRICTED ACTIVITIES.

A. Sales and Purchase of Properties

1. *Sales to Drilling Programs.* Neither the sponsor nor any affiliate, including an affiliated program, shall sell, transfer or convey any property to a drilling program, directly or indirectly, except pursuant to transactions that are fair and reasonable to the participants of the program and then subject to the following conditions:

(a) The prospectus discloses the possibility that the sponsor or an affiliate may sell, transfer or convey property to the program and whether or not the property may be sold from an existing inventory.

(b) The property is sold, transferred or conveyed to the program at cost, unless the seller or transferor has cause to believe that cost is materially more than the fair market value of such property, in which case such sale should be made for a price not in excess of its fair market value; provided however, if the sale, transfer or conveyance is from an affiliated program that has held the property for more than two years and in which program the interest of the sponsor is substantially similar to, or less than, its interest in the subject program, the sale, transfer or conveyance may be made at fair market value.

(c) If the sponsor or an affiliate sells, transfers or conveys any oil, gas or other mineral interests or property to the program, it must, at the same time, sell to the program an equal proportionate interest in all its other property in the same prospect.

(d) During a period of five years from the date of formation of the program, if the sponsor or any of its affiliates proposes to acquire an interest, from an unaffiliated person, in a prospect in which the program possesses an interest or in a prospect in which the program's interest has been terminated without compensation within one year preceding such proposed acquisition, the following conditions shall apply:

(1) If the sponsor or the affiliate does not currently own property in the prospect separately from the program, then neither the sponsor nor the affiliate shall be permitted to purchase an interest in the prospect.

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(2) If the sponsor or the affiliate currently own a proportionate interest in the prospect separately from the program, then the interest to be acquired shall be divided between the program and the sponsor or the affiliate in the same proportion as in the other property in the prospect; provided however, if cash or financing is not available to the program to enable it to consummate a purchase of the additional interest to which it is entitled, then neither the sponsor nor the affiliate shall be permitted to purchase any additional interest in the prospect.

(e) If the area constituting a program's prospect is subsequently enlarged to encompass any area wherein the sponsor or an affiliate of the sponsor owns a separate property interest, such separate property interest or a portion thereof shall be sold, transferred or conveyed to the program in accordance with this Section VI.A.1 if the activities of the program were material in establishing the existence of proved undeveloped reserves which are attributable to such separate property interest.

(f) A sale, transfer or conveyance of less than all of the ownership of the sponsor or any of its affiliates in any lease interest or property is prohibited unless the interest retained by the sponsor or affiliate is a proportionate working interest, the respective obligations of the sponsor or affiliate and the program are substantially the same after the sale of the interest by the sponsor or affiliate and its interest in revenues does not exceed the amount proportionate to its retained working interest. The sponsor or affiliate may not retain any overrides or other burden on the interest conveyed to the program.

(g) For purposed of Section VI.A.1(c), (d), (e) and (f) above, the terms "sponsor" and "affiliate" shall not include another program in which the interest of the sponsor is substantially similar to or less than its interest in the subject program.

(h) If the program acquires property pursuant to a farmout or joint venture from an affiliated program, the sponsor's and/or its affiliates aggregate compensation associated with the property and any direct and indirect ownership interest in the property may not exceed the lower of the compensation and ownership interest the sponsor and/or its affiliates could receive if the property were separately owned or retained by either on of the programs.

2. *Sales to Production Purchase or Income Programs.* Neither the sponsor nor the affiliate, including an affiliated program, shall sell, transfer or convey any property to a production purchase or income program, directly or indirectly, except pursuant to transactions that are fair and reasonable to the participants of the program and then subject to the following conditions:

(a) The prospectus discloses the possibility that the sponsor or an affiliate may sell property to the program and whether the property may be sold from an existing inventory.

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(b) If the property has been held for less than two years and there have not been significant expenditures made in connection with the property, the sale, transfer or conveyance to the program from the sponsor or an affiliate, other than an affiliated program in which the interest of the sponsor is substantially similar to or less than its interest in the subject program, must be at cost as adjusted for intervening operations, unless the sponsor has cause to believe that such adjusted cost is materially more than the fair market value of such property, in which case such sale must be made at fair market value.

(c) If the property has been held for less than six month and there have not been significant expenditures made in connection with the property, the sale, transfer or conveyance to the program from an affiliated program, in which the interest of the sponsor is substantially similar to or less than its interest in the subject program, must be at cost as adjusted for intervening operations, unless the sponsor has cause to believe that such adjusted cost is materially more than the fair market value of such property, in which case such sale must be made at fair market value.

(d) In all other circumstances, the sale, transfer or conveyance to the program from the sponsor or an affiliate, including an affiliated program, must be made at not more than fair market value.

3. *Purchases from All Programs.* Neither the sponsor nor any affiliate, including affiliated programs, may purchase or acquire any property from the program, directly or indirectly, except pursuant to transactions that are fair and reasonable to the participants of the program and then subject to the following conditions:

(a) A sale, transfer or conveyance, including a farmout, of an undeveloped property from the program to the sponsor or an affiliate, other than an affiliated program, must be made at the higher of cost or fair market value.

(b) A sale, transfer or conveyance of a developed property from the program to the sponsor or an affiliate, other than an affiliated program in which the interest of the sponsor is substantially similar to or less than its interest in the subject program, shall not be permitted except in connection with the liquidation of the program and then only at fair market value.

(c) Except in connection with farmouts or joint ventures made in compliance with Section VI.A.1(h) above, a transfer of an undeveloped property from a program to an affiliated drilling program must be made fair market value if the property has been held for more than two years. Otherwise, if the sponsor deems it to be in the best interest of the program, the transfer may be made at cost.

(d) Except in connection with farmouts or joint ventures made in compliance with Section VI.A.1(h) above, a transfer of any type is of property from a program to an affiliated production purchase or income program must be made at fair market value if the property has been held for more than six months or there have been significant expenditures made in connection with the property. Otherwise, if the sponsor deems it to be in the best interest of the program, the

transfer may be made at cost as adjusted for intervening operations.

4. *Determination of Fair Market Value.* A determination of fair market value as required by the provisions of this Section VI must be supported by an appraisal from an independent expert. Such opinion and any associated supporting information must be maintained in the program's records for at least six years.

B. Custody of Program Funds and Properties.

1. Funds of a program must not be commingled with funds of any other entity and the prospectus and program agreement must clearly prohibit any such commingling. Notwithstanding the above, the sponsor may establish a master fiduciary account pursuant to which separate subtrust accounts are maintained for the benefit of affiliated programs, provided, the program's funds are protected from the claims of such other programs and their creditors. The prohibition of this Section VI.B.1 shall not apply to investments meeting the requirements of Section VI.B.4 below.

2. Advance payments to the sponsor or its affiliates are prohibited, except where necessary to secure tax benefits of prepaid drilling costs. These payments, if any, shall not include nonrefundable payments for completion costs prior to the time that a decision is made that the well or wells warrant a completion attempt.

3. Program properties may be held in the names of nominees temporarily to facilitate the acquisition of properties and for similar valid purposes. On a permanent basis, program properties may be held in the name of a special nominee entity organized by the sponsor provided the nominee's sole purpose is the holding of record title for oil and gas properties and it engages in no other business and incurs no other liabilities. If properties are held in the name of a special nominee, either a ruling from the Internal Revenue Service or an opinion of qualified tax counsel shall be obtained to the effect that such arrangement shall not change the ownership status of the program for federal income tax purposes.

4. Program funds may not be invested in the securities of another person except in the following instances:

(a) investments in working interests or undivided lease interests made in the ordinary course of the program's business;

(b) temporary investments made in compliance with Section VI.B.5;

(c) multi-tier arrangements meeting the requirements of Section VI.C.1;

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(d) investments involving less than 5% of program capital which are a necessary and incidental part of a property acquisition transaction; and

(e) investments in entities established solely to limit the program's liabilities associated with the ownership or operation of property or equipment, provided, in such instances duplicative fees and expenses shall be prohibited.

5. Until proceeds from the public offering are invested in the program's operations, such proceeds may be temporarily invested in income producing short-term, highly liquid investments, where there is appropriate safety of principal, such as U.S. Treasury Bills. Any such income shall be allocated pro rata to the participants providing such capital contributions.

6. Any proceeds of the public offering of a drilling program not used, or committed for use, as evidenced by a written agreement, in the program's operations within one year of the closing of the offering, except for necessary operating capital, must be distributed pro rata to the participants as a return of capital, and the sponsor shall reimburse the participants for selling, management fees and offering expenses allocable to the return of capital.

7. If a production purchase program sponsor has not used, or committed for use, as evidenced by a written agreement, an amount equal to 100% of the net proceeds of the public offering for property acquisitions within two years of the closing of the offering, any excess proceeds, except for necessary operating capital and amounts reserved for identified activities, must be distributed pro rata to the participants as a return of capital, and the sponsor shall reimburse the participants for selling, management fees and offering expenses allocable to the return of capital.

C. Other Restricted and Prohibited Activities.

1. Programs structured to participate in other partnerships or joint ventures (multi-tier arrangements) shall be permitted provided that the terms of any such arrangements do not result in the circumvention of any of the requirements or prohibitions contained in these guidelines. In particular, all such program agreements shall accompany the prospectus and shall contain provisions which assure:

(a) that there will be no duplication or increase in organization and offering expenses, sponsor's compensation, program expenses or other fees and costs;

(b) there will be no substantive alteration in the fiduciary and contractual relationship between the sponsor and

the participants; and

(c) there will be no diminishment in the voting rights of the participants.

2. A sponsor or affiliate shall not take any action with respect to the assets or property of the program which does not primarily benefit the program, including among other things;

(a) the utilization of program funds as compensating balances for its own benefit, and

(b) the commitment of future production.

3. All benefits from marketing arrangements or other relationships affecting property of the sponsor or affiliate and the program shall be fairly and equitably apportioned according to the respective interests of each

4. Any agreements or arrangements which bind the program must be fully disclosed in the prospectus.

5. Anything to the contrary notwithstanding, a sponsor or affiliate may never profit by drilling in contravention of his fiduciary obligation to the participants.

6. No loans may be made by the program to the sponsor or any affiliate of the sponsor.

7. On loans made available to the program by the sponsor or affiliate, the sponsor or affiliate may not receive interest in excess of its interest costs, nor may the sponsor or affiliate receive interest in excess of the amounts which would be charged the program (without reference to the sponsor's financial abilities or guaranties) by unrelated banks on comparable loans for the same purpose, and the sponsor or affiliate shall not receive points or other financing charges or fees, regardless of the amount.

8. No rebates or give-ups may be received by the sponsor or any affiliate nor may the sponsor or any affiliate participant in any reciprocal business arrangements which would circumvent these guidelines.

VII. FARMOUTS, SPECIAL DISCLOSURE REQUIREMENTS.

A. The prospectus shall contain the definition of farmout and no other term shall be used to describe a farmout transaction.

B. The prospectus shall state the circumstances under which the sponsor may farmout a prospect or lease, the ability to farmout to other public programs of the sponsor or its affiliates and any limitations on the ability to farmout to such public programs.

C. The prospectus shall state that no program lease will be farmed out, sold or otherwise disposed of unless the sponsor, exercising the standard of a prudent operator, determines:

1. the program lacks sufficient funds to drill on the leases and cannot obtain suitable alternative financing for such drilling; or

2. the leases have been downgraded by events occurring after assignment to the program so that drilling would no longer be desirable for the program; or

3. drilling on the leases would result in an excessive concentration of program funds creating in the sponsor's opinion undue risk to the program; or

4. the best interests of the program would be served by the farmout.

D. The prospectus shall state that the decision with respect to making a farmout and the terms of a farmout to a program involve conflicts of interest, as the sponsor may benefit from cost savings and reduction of risk, and in the event of a farmout to an affiliated public program, the sponsor will represent both partnerships.

E. Except as required by Section VI.A.1, the prospectus shall state that the program shall acquire only those leases that are reasonably acquired for the stated purpose of the program and no leases shall be acquired for the purpose of subsequent sale or farmout, unless the acquisition of such leases by the program is made after a well has been drilled to a depth sufficient to indicate that such an acquisition is believed to be in the best interests of the program.

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F. The prospectus shall state that the sponsor shall not farmout a lease for the primary purpose of avoiding payment of sponsor's costs relating to drilling a lease or prospect.

VIII. RIGHTS AND OBLIGATIONS OF PARTICIPANTS.

A. *Meetings.* Meetings of the participants may be called by the sponsor or by participants holding 10% or more of the then outstanding units for any matters for which the participants may vote as set forth in the program agreement. Such call for a meeting shall be deemed to have been made upon receipt by the sponsor of a written request from holders of the than 60 days after the date of mailing of said notice, at a reasonable time and place. Provided however, that the date for notice of such a meeting may be extended for a period of up to 60 days, if in the opinion of the sponsor such additional time is necessary to permit preparation of proxy or information statements or other documents required to be delivered in connection with such meeting by the Securities and Exchange Commission or other regulatory authorities. Participants shall be granted the right to vote in person or by proxy.

B. *Annual and Periodic Reports.* The program agreement shall provide for the transmittal to each participant of an annual report within 120 days after the close of the fiscal year, and commencing with the year following investment of substantially all the. program subscriptions, a report within 75 days after the end of the first six months of its fiscal year, containing, except as otherwise indicated, at least the following information:

(a) Financial statements, including a balance sheet and statements of operations, partners' equity and cash flows prepared in accordance with generally accepted accounting principles and accompanied by a report of an independent certified public accountant stating that his audit was made in accordance with generally accepted auditing standards and that in his opinion such financial statements present fairly the financial position, results of operations, partners' equity and cash flows in accordance with generally accepted accounting principles, except that semiannual reports need not be audited.

(b) A summary itemization, by type and/or classifications of the total fees and compensation, including any administrative cost reimbursements and operating fees, paid by the program, or indirectly on behalf of the program, to the sponsor and affiliates of the sponsor together with the accountant's attestation as required by Section V.C of these guidelines. If compensation is paid on a subordinated interest, a reconciliation of all such payments to the conditions precedent and limitations thereto.

(c) A description of each property in which the program owns an interest, including the cost, location, number of acres under lease and the interest owned therein by the program, except succeeding reports need contain only material changes, if any, regarding such property.

(d) If a drilling program, a list of the wells drilled or abandoned by such program during the period of the report

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(indicating whether each of such wells has or has not been completed), and a statement of the cost of each well completed or abandoned. Justification shall be included for wells abandoned after production has commenced.

(e) A description of all farmouts, farmins and joint ventures, made during the period of the report, including sponsor's justification for the arrangement and a description of the material terms.

(f) If assessments have been made during any period covered by the report, then such report shall contain a detailed statement of such assessments and the application of the proceeds derived from such assessments.

(g) With respect to a program which compensated the sponsor on a basis related to certain costs paid by the sponsor; (1) a schedule reflecting the total program costs, and where applicable, the costs pertaining to each prospect, the costs paid by the sponsor and the costs paid by the participants, (2) the total program revenues, the revenues received or credited to the sponsor and the revenues or credited to the participants, and (3) a reconciliation of such expenses and revenues to the limitations prescribed.

(h) Annually, beginning with the fiscal year succeeding the fiscal year in which the program commenced operations, a computation of the total oil and gas proved reserves of the program and dollar value thereof at then existing prices and of each participant's interest in such reserve value. The reserve computations shall be based upon engineering reports prepared by qualified independent petroleum consultants. In addition, there shall be included an estimate of the time required for the extraction of such services and the present worth of such reserves, with a statement that, because of the time period required to extract such reserves, the present value of revenues to be obtained in the future is less than if immediately receivable. In addition to the annual computation and estimate required, as soon as possible, and in no event more than 90 days after the occurrence of an event leading to reduction of such reserves of the program of 10% or more, excluding reduction as a result of normal production, sales of reserves or product price changes, a computation and estimate shall be sent to each participant.

2. By March 15 of each year, the general partner must furnish a report to each participant containing such information as is pertinent for tax purposes.

3. Programs which agree to make all relevant financial and engineering reports available to participants on request, will not be required to transmit to participants reports other than:

(a) the annual reports required under subsection (1) above,

(b) the reports for tax purposes required by subsection (2) above, and

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(c) a quarterly cash receipts and disbursements statement after the program commences its operational phase.

C. Access to Program Records.

1. The participants and/or their accredited representatives shall be permitted access to all records, of the program, after adequate notice, at any reasonable time and may inspect and copy any of them. The sponsor shall maintain and preserve during the term of the program and for four (4) years thereafter all accounts, books and other relevant program documents. Notwithstanding the foregoing, the sponsor may keep logs, well reports and other drilling data confidential for a reasonable period of time.

2. The limited partnership agreement, by-laws or other program agreement shall include the following provisions regarding access to the list of participants:

(a) An alphabetical list of the names, addresses and business telephone numbers of the participants of the program along with the number of program units held by each of them (the "participant list") shall be maintained as a part of the books and records of the program and shall be available for the inspection by any participant or its designated agent at the home office of the program upon the request of the participant;

(b) The participant list shall be updated at least quarterly to reflect changes in the information contained therein;

(c) A copy of the participant list shall be mailed to any participant requesting the participant list within ten days of the request. The copy of the participant shall be printed in alphabetical order, on white paper, and in a readily readable type size (in no event smaller than 10-point type). A reasonable charge for copy work may be charged by the program;

(d) The purposes for which a participant may request a copy of the participant list include, without limitation, matters relating to participant's voting rights under the program agreement and the exercise of participants' rights under federal proxy laws; and

(e) If the sponsor of the program neglects or refuses to exhibit, produce, or mail a copy of the participant list as requested, the sponsor shall be liable to any participant requesting the list for the costs, including attorneys fees, incurred by that participant for compelling the production of the participant list, and for actual damages suffered by any participant by reason of such refusal or neglect. It shall be a defense that the actual purpose and reason for the requests for inspection or for a copy of the participant list is to secure the list of participants or other information for the purpose

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of selling such list or information or copies thereof, or of using the same for a commercial purpose other than in the interest of the applicant as a participant relative to the affairs of the program. The sponsor may require the participant requesting the participant list to represent that the list is not requested for a commercial purpose unrelated to the participant's interest in the program. The remedies provided hereunder to participants requesting copies of the participant list are in addition to, and shall not in any way limit, other remedies available to participants under federal law, or the laws of any state.

D. Admission of Participants.

1. Upon the original sale of program units, the participants should be admitted as unit holders not later than 15 days after the release from escrow of participants' funds to the program, and thereafter participants should be admitted into the program not later than the last day of the calendar month in which their subscriptions were accepted by the program. Subscriptions shall be accepted or rejected by the program within 30 days of their receipt, if rejected, all funds shall be returned to the subscriber immediately.

2. The program shall amend its records at least once each calendar quarter to effect the substitution of substituted participants, although the sponsor may elect to do so more frequently. In the case of assignments; where the assignee does not become a substituted participant, the program shall recognize the assignment not later than the last day of the calendar month following receipt of notice of assignment and required documentation.

Restrictions on the assignment of units or the substitution of participants are generally disfavored and will be allowed only to the extent necessary to preserve the tax status of the partnership or the classification of program income for tax purposes and any restrictions must be supported by opinion of counsel as to its legal necessity.

E. Assessability and Defaults.

1. In appropriate cases there may be a provision for assessability; provided however, that the maximum amount voluntary assessments shall not exceed 100% of initial subscriptions and for mandatory assessments shall not exceed 25% of initial subscriptions, and provided further, that in no case shall the total of all assessments exceed 100% of initial subscriptions. All assessments shall be made solely for the purpose of conducting subsequent operations on prospects upon which evaluation had begun during a program's initial operations, or on leases sufficiently related to such prospects as to merit, in the sponsor's judgement, additional operations to fully develop those prospects. In such cases, the aggregate offering price of the units as set forth in the application for qualification shall include and show separately the basic unit offering price and the maximum amount of the assessment.

2. In the event of a default in all or a portion of the payment of assessments, the participant's percentage interest in the program represented by his unite should not be subject to forfeiture, but may be subject to a reasonable reduction for the failure of the participant to meet his commitment. Unless the sponsor agrees to pay all defaulted assessments, the nondefaulting limited partners shall have the first option to pay any defaulted assessments. Provisions which conform to

the following will be considered reasonable.

(a) For voluntary assessments,

(1) A proportionate reduction of the participant's percentage interest in revenues derived from the wells drilled and/or completed with the proceeds of the assessments based on the ratio of the participant's unpaid assessment to all capital contributions and assessments used for such drilling and/or completion, or

(2) A subordination of the defaulting participant's right to receive revenues from the wells drilled and/or completed with the proceeds of the assessments until those nondefaulting participants who have paid the defaulting participant's assessment have received an amount of revenues from revenues of the program from such wells equal to 300% of the proportionate amount of the defaulted assessment which they paid.

(b) For mandatory assessments,

(1) A proportionate reduction of the participant's percentage interest in program revenues, based on the ratio of his unpaid assessment to all capital contributions and assessments, or

(2) A subordination of the defaulting participant's right to receive revenues from the program until those nondefaulting participants who have paid the defaulting participant's assessment have received an amount of revenues from all revenues of the program equal to 300% of the proportionate amount of the defaulted assessment which they paid, or

(3) Personal liability of a participant as to the amount defaulted upon. The sponsor may enforce such personal liability through a lien on the participant's program interest, which permits the sponsor to withhold and apply all revenues attributable to the participant to the payment of any delinquent assessment. For purposes of this subsection, voluntary assessments which a participant has committed to pay will be considered mandatory assessments.

(c) In order to make any assessment, the sponsor shall include with the call for such assessment a statement of the purpose and intended use of the proceeds from such assessment, a statement of the reduction to be imposed for failure of the participant to meet the assessment, and to the extent practicable, a summary of pertinent geological data on the relevant properties to which the assessments relate and any other information material to a participant's decision to fund the assessment.

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(d) The above alternatives, set forth in (a) and (b), are not exclusive and other provisions demonstrated to be essentially equivalent to these alternatives may be permitted by the Administrator.

F. Voting Rights of Participants.

1. To the extent the law of the state of organization is not inconsistent, the program agreement must provide that a majority, in interest of the then outstanding unit holders may, without the necessity for concurrence by the sponsor, vote to:

(a) Amend the program agreement; provided however, any such amendment may not increase the duties or liabilities of any participant or sponsor or increase or decrease the profit or loss sharing or required capital contribution of any participant or sponsor without the approval of such participant or sponsor. Furthermore, any such amendment may not affect the classification of program income and loss for federal income tax purposes without the unanimous approval of all participants;

(b) Dissolve the program;

(c) Remove the sponsor and elect a new sponsor;

(d) Elect a new sponsor if the sponsor elects to withdraw from the program;

(e) Approve or disapprove the sale of all or substantially all of the assets of the program; and

(f) Cancel any contract for services with the sponsor or any affiliate without penalty upon 60 days notice.

2. With respect to any program units owned by the sponsor, the sponsor may not vote or consent on matters submitted to the participants regarding the removal of the sponsor or regarding any transaction between the program and the sponsor. In determining the requisite percentage in interest of program units necessary to approve a matter on which the sponsor may not vote or consent, any program units owned by the sponsor shall not be included.

G. Removal or Withdrawal of the Sponsor.

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1. In the event the sponsor is removed in accordance with subsection F above, the incoming sponsor and the removed sponsor shall, by mutual agreement, select an independent expert to value the removed sponsor's interest in the program. In determining the value of the sponsor's interest, the independent expert will take into account appropriate discount factors in light of the risk of recovery of oil and gas reserves, and, in any event, will utilize a risk factor discount no less than that utilized in the most recent offer extended pursuant to Section IX.C of these guidelines (relating to cash redemptions), if any. The incoming sponsor, or the program, shall have the option to purchase at least 20% of the interests of the removed sponsor for the value determined by the expert.

The method of payment for such interest must be fair and must protect the solvency and liquidity of the program. Where the termination is voluntary, the method of payment will be deemed presumptively fair where it provides for a non-interest bearing unsecured promissory note with principal payable, if at all, from distributions which the terminated sponsor otherwise would have received under the program agreement had the sponsor not been terminated. Where the termination is involuntary, the method of payment will be deemed presumptively fair where it provides for an interest bearing promissory note coming due in no less than five years with equal installments each year.

2. If the sponsor withdraws as sponsor and the participants elect to continue the program, the valuation procedure outlined in subsection 1 hereof applies. The sponsor may not voluntarily withdraw from the program prior to the program's completion of its primary drilling and/or acquisition activities, and then only after giving 120 days written notice. The sponsor may not partially withdraw its property interests held by the program unless such withdrawal is necessary to satisfy the bona fide request of its creditors or approved by a majority in interest vote of the participants. The sponsor must fully indemnify the program against any additional expenses which may result from a partial withdrawal of property interests and such withdrawal may not result in a greater amount of direct costs or administrative costs being allocated to the participants. The withdrawing sponsor shall pay all expenses incurred as a result of its withdrawal.

IX. MISCELLANEOUS PROVISIONS.

A. Minimum Program Capital. The minimum amount of funds to activate a program shall be sufficient to accomplish the objectives of the program, including "spreading the risk". Any minimum less than 1,000,000 will be presumed to be inadequate to spread the risk of the public investors. In those instances where it appears unlikely that the stated objectives of the program can be achieved with the minimum subscriptions, the Administrator may require a greater amount or a reduction of the stated objectives of the program. Provision must be made for the return to public investors of one hundred percent (100%) of paid subscriptions in the event that the established minimum to activate the program is not reached. All funds received prior to activation of the program must be deposited in an interest bearing account with an independent custodian, trustee, or escrow agent whose name and address shall be disclosed in the prospectus.

B. Deferred Payment. Arrangements for deferred payments on account of the purchase price of program interests may be allowed when warranted by the investment objectives of the partnership, but in any event such arrangements shall be subject to the following conditions:

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1. The period of deferred payments shall coincide with the anticipated cash needs of the program, but the full amount of the purchase price shall be paid within nine (9) months of the date on which the program commences operations.
2. Selling commissions paid upon deferred payments are collectible when such payment is made.
3. The program shall not sell or assign the deferred payments.
4. Such deferred payments shall be contractually binding obligations of the buyer whether or not a promissory note is taken.
5. In the event of a default in the payment of any deferred payment when due, the participant's percentage interests in the program shall not be subject to forfeiture but may be subject to a reasonable reduction for failure of the participant to meet his commitment. Reduction provisions will be considered reasonable if they conform to the reduction provisions provided for in Section VIII.E.2(b) of these guidelines, relating to defaults of mandatory assessments.

C. Cash Redemptions.

1. When cash redemption values of units are computed, such values must be supported by an appraisal of properties prepared by an independent petroleum consultant within 120 days of the commencement date of such cash redemptions. Any evaluation by company personnel must be based on such independent appraisal. Any redemption must be for cash. No redemption shall be considered effective until after cash payments have been paid to the participants.
2. Provisions in the program agreement or other documents which require a participant to sell his unit or give the program or any other person the right to repurchase such unit, irrespective of the desire of the participant to sell, will not be approved unless the participant made misrepresentations which jeopardize the legal or tax status of the program.

D. Appraisal and Compensation

1. In connection with a proposed roll-up; an appraisal of all program assets shall be obtained from a competent independent expert. If the appraisal will be included in a prospectus used to offer the securities of a roll-up entity, the appraisal shall be filed with the Securities and Exchange Commission and the Administrator as an Exhibit to the

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Registration Statement for the offering. Accordingly, an issuer using the appraisal shall be subject to liability for violation of Section 11 of the Securities Act of 1933 and comparable provisions under State law for any material misrepresentations or material omissions in the appraisal. Program assets shall be appraised on a consistent basis. The appraisal shall be based on all relevant information, including current reserve estimates prepared by an independent petroleum consultant, and shall indicate the value of the program's assets as of a date immediately prior to the announcement of the proposed roll-up transaction. The appraisal shall assume an orderly liquidation of program assets over a 12 month period. The terms of the engagement of the independent expert shall clearly state that the engagement is for the benefit of the program and its participants. A summary of the independent appraisal, indicating all material assumptions underlying the appraisal, shall be included in a report to the participants in connection with a proposed roll-up.

2. In connection with a proposed roll-up, the person sponsoring the roll-up shall offer the participants who vote "no" on the proposal the choice of:

(a) accepting the securities of the roll-up entity offered in the proposed roll-up; or

(b) one of the following:

(1) remaining as participants in the program and preserving their interests therein on the same terms and, conditions as existed previously; or

(2) receiving cash in an amount equal to the participants' pro-rata share of the appraised value of the net assets of the program.

3. The program shall not participate in any proposed roll-up which would result in the participants having democracy rights in the roll-up entity which are less than those provided under Sections VIII.A and VIII.F of these guidelines. If the roll-up entity is a corporation, the democracy rights provided for in these guidelines to greatest extent possible.

4. The program shall not participate in any proposed roll-up which includes provisions which would operate materially impede or frustrate the accumulation of shares by any purchaser of the securities of the roll-up entity (except to the minimum extent necessary to preserve the tax status of the roll-up entity). The program shall not participate in any proposed roll-up which would limit the ability of a participant to exercise the voting rights of its securities of the roll-up entity on the basis of the number of program units held by that participant.

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5. The program shall not participate in any proposed roll-up in which participants' rights of access to the records of the roll-up entity will be less than those provided for under Section VIII.C of these guidelines,

6. The program shall not participate in any proposed roll-up in which any of the costs of the transaction would be borne by the program if the roll-up is not approved by participants.

E. Reinvestment Plans.

1. No offering will be approved by the Administrator that includes a provision which requires that the participant reinvest his share of distributable cash distributions.

2. If permitted under applicable securities laws, a program may make available to its participants a voluntary plan for systematic reinvestments in such program or in any other program if the terms of the plan are fair and reasonable to the participants.

3. To the extent it is economically feasible, money held for reinvestment must be placed in an income-producing account which provides an appropriate safety for the principal, and must be subject to withdrawal by the participant upon not less than 10 days notice. If the funds are not reinvested within 180 days of the date of distribution, they must be distributed, with such income, if any, to the participants.

4. No sales commissions may be deducted directly or indirectly from the reinvested funds.

F. Distribution of Revenues. From time to time and not less often than quarterly, the sponsor must review the program's accounts to determine whether cash distributions are appropriate. The program shall distribute pro rata to the participants funds received by the program and allocated to their accounts which the sponsor deems unnecessary to retain in the program. In no event, however, shall funds be advanced or borrowed for purposes of distributions, if the amount of such distributions would exceed the partnership's accrued and received revenues for the previous four quarters, less paid and accrued operating costs with respect to such revenues. The determination of such revenues and costs shall be made in accordance with generally accepted accounting principles, consistently applied. Cash distributions from the program to the sponsor shall only be made in conjunction with distributions to participants and only out of funds properly allocated to the sponsor's account.

G. Distributions in Kind. The program agreement shall provide that any in kind property distributions to the participants will be made to a liquidating trust or similar entity for the benefit of the participants, unless at the time of the distribution:

(1) the sponsor shall offer the individual participants the election of receiving in kind property distributions and the participants, accept such offer after being advised of the risks associated with such direct ownership; or

(2) there are alternative arrangements in place which assure the participants that they will not, at any time, be responsible for the operation or disposition of program properties.

X. PROSPECTUS DISCLOSURE.

A. Offerings Registered with the Securities and Exchange Commission. With respect to offerings registered with the Securities and Exchange Commission under the Securities Act of 1933, as amended, and registered or qualified with the Administrator, a prospectus which is part of a registration statement which has been declared effective by said Commission shall be deemed to comply with all requirements as to form; provided, however, the Administrator reserves the right to require additional disclosure in his discretion.

B. Offerings Not Registered with the Securities and Exchange Commission.

1. A prospectus which is not part of a registration statement filed with the Securities and Exchange Commission pursuant to the Securities Act of 1933 shall generally conform to the disclosure requirements which would apply if the offering was registered with the Securities and Exchange Commission. The format and information requirements of Guides Two and Four promulgated by the Securities and Exchange Commission should be followed, with appropriate adjustments made for the different business objectives of the program.

2. At the minimum and in addition to the specific disclosures required by Sections II, III, IV, V, VI, VII and VIII of these guidelines, the following topics shall be thoroughly covered in the prospectus:

(a) the definition of technical terms;

(b) the suitability requirements of participants;

(c) risk factors;

- (d) sponsor experience;
- (e) sponsor compensation;
- (f) use of proceeds;
- (g) proposed activities;
- (h) deferred payment and/or assessment policies;
- (i) property descriptions (if applicable);
- (j) prior performance information as required by Section X.C;
- (k) federal tax consequences;
- (l) plan of distribution;
- (m) legal proceedings involving the program, the sponsor or affiliates, if material;
- (n) conflicts of interest and possible transactions between the program and the sponsor or its affiliates; and
- (o) financial statements are required by Section X.B.3.

3. *Financial Statements.*

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(a) *The Program.* If the program is operational at the time the offering commences, the prospectus shall include complete financial statements prepared in accordance with generally accepted accounting principles and accompanied by an audit report from an independent certified public accountant. The financials shall include a balance sheet and statements of operations, partner's or shareholder's equity and cash flows. The statements must show financial results for the three most recent fiscal years (or period of existence, if less), and if the most recent fiscal year ended as of a date more than 90 days prior to the filing of the registration application, supplemental unaudited statements shall be included which show financial results for an interim period ending not more than 90 days prior to the filing of the application.

(b) *The Sponsor.* The financial statements of the managing or controlling general partner and any guarantor, as, required by Section II.C of these guidelines, shall be included in the prospectus, except that individual managing or controlling general partners will not be required to disclose their statement of financial condition if the prospectus contains a representation of the amount of the individual's net worth and the prospectus discloses that the statement of financial condition is available for review by participants upon request.

C. *Prior Performance.* The prospectus shall contain a narrative summary of the "track record" or prior performance of programs sponsored by the sponsor and its affiliates containing at least the information set forth below.

The prior performance tables should be preceded by a narrative introduction with appropriate cross references. The narrative summary in the text should explain the significance of the track record disclosed in the tables and explain where additional information can be obtained.

Each table should be introduced by a brief narrative explaining the objective of the table and what it covers so that the investor will be able to understand the significance of the information presented. There also should be set forth with or in each table any further material information that may be necessary to make the required tabular data, in light of the circumstances under which it is presented, not misleading. Information should be given for each prior program, public or nonpublic, with investment objectives similar to those of the program offered by the prospectus. If the sponsor has not sponsored at least five such programs, then information must be given for each prior program, public or nonpublic, even if the investment objectives for those programs are not similar to those of the program in question. In that case, programs with investment objectives, that are not similar to those of the program should be grouped together according to the investment objective and information about those programs presented separately.

1. *Experience in Raising Funds.* Information presented shall include at least the following:

(a) the date each program commenced operations;

(b) the gross amount of capital raised by each program;

(c) the number of participants in each program; and

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(d) the amount of the investment of the sponsor, if any.

2. *Experience in Investing Funds.* Information presented shall include at least the following:

(a) if the program is a drilling program, the drilling results of the program, including the number and classification (i.e., exploratory or development) of gross and net wells drilled and completed or abandoned;

(b) if the program is a production purchase program, the costs incurred in connection with the property acquisitions and the period during which the program was engaged in property acquisitions; or

(c) if the program has other investment objectives, then a description of the investments made or assets acquired and the period during which the program was engaged in making investments or acquiring assets.

3. *Operating Results and Prior Programs.* Information should be presented on the basis of generally accepted accounting principles. However, where information about non-public programs is included, such information may be presented on a tax basis if the program's books have not been kept in accordance with generally accepted accounting principles. If there are any significant differences between these methods in the operating results, they should be explained. This explanation should provide the reader with any additional information about the particular program presented that may be necessary to make the information contained in the table not materially misleading in light of the circumstances under which the information is given.

Information presented shall include the following:

(a) any borrowings by the program;

(b) total program revenues allocated;

(c) total expenditures of the program for other than operating costs, administrative costs and direct costs;

(d) total operating costs, administrative costs and direct costs, separately;

(e) total cash distributed on a cumulative basis and for the last three months for which information is presented; and

(f) the discounted present value, at a 10% discount rate, of future net cash flow associated with program reserves, if available, prepared by an independent petroleum consultant, in accordance with the Statement of Financial Accounting Standards (SFAS) Number 69, before tax, as of the latest practicable date, but in any event not more than 15 months prior to the date of the prospectus. The disclosure should also show the expected timing of revenues to be recognized from the sale of the reserves.

|D.| |sic|

E. Demonstration of Guideline Compliance in Program Agreement. The requirements and/or provisions of appropriate portions of the following sections shall be included in the program agreement: I.B. (Definitions); II.D., F., H., I. and J. (Sponsor Requirements); IV.F. (Participant Suitability Records); V.A.-C. (Fees, Compensation and Expenses); VI.A.-C. (Affiliated Transactions and Restricted Activities); V111.A--G. (Rights and Obligations of Participants); IX.B., C., D., E., F. and G. (Miscellaneous Provisions).

Adopted on September 21, 1983, effective January 1, 1984; amended and adopted May 7, 2007

I. INTRODUCTION

A. Application

1. The standards contained in these Guidelines pertain to the offer and sale of securities by commodity pool limited partnerships or analogous corporate entities and are designed to establish uniform and consistent standards to be applied by the various state securities ADMINISTRATORS. The primary focus of the Guidelines is on the securities related aspects of commodity pool limited partnerships or analogous corporate entities rather than the technical aspects of futures trading. The Guidelines do not purport to supplant existing or future rules and regulations promulgated by the Commodity Futures Trading Commission or the National Futures Association.

2. The ADMINISTRATOR may modify or waive the guidelines if the object sought to be achieved thereby is accomplished by other means. Where the individual characteristics of specific PROGRAMS warrant modification from these standards, they will be accommodated, insofar as possible, while still being consistent with the spirit of these Guidelines.

COMMENT:

In granting modifications or waivers from these Guidelines, the ADMINISTRATOR may take into consideration such factors as (i) the experience and prior performance of the SPONSOR and/or

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ADVISOR: (ii) reduction of ORGANIZATIONAL AND OFFERING EXPENSES, management, advisory or incentive fees, brokerage commissions, other fees, costs and expenses below the limits set forth in Section IV: and (iii) more

3. Where applicable, the ADMINISTRATOR may require compliance with the jurisdiction's guidelines for corporate securities and may not allow a security with different rights and privileges to be issued unless there is a jurisdiction therefor.

4. When required by the ADMINISTRATOR, a CROSS REFERENCE SHEET shall be furnished with the application.

B. Definitions. As used in these Guidelines, the following terms shall mean:

1. ADMINISTRATOR--The official or agency administering the securities laws of a state.

2. ADVISOR--Any PERSON who for any consideration engages in the business of advising others, either directly or indirectly, as to the value, purchase, or sale of COMMODITY CONTRACTS or commodity options.

3. AFFILIATE--An AFFILIATE of a PERSON means (a) any PERSON directly or indirectly owning, controlling or holding with power to vote 10% or more of the outstanding voting securities of such PERSON; (b) any PERSON 10% or more of whose outstanding voting securities are directly or indirectly owned, controlled or held with power to vote, by such PERSON; (c) any PERSON, directly, or indirectly, controlling, controlled by, or under common control of such PERSON; (d) any officer, director or partner of such PERSON; or (e) if such PERSON is an officer, director or partner, any PERSON for which such PERSON acts in any such capacity.

4. CAPITAL CONTRIBUTIONS--The total-investment in a PROGRAM by a PARTICIPANT or by all PARTICIPANTS, as the case may be.

5. COMMODITY BROKER--Any PERSON who engages in the business of effecting transactions in COMMODITY CONTRACTS for the account of others or for his own account.

6. COMMODITY CONTRACT--A contract or option thereon providing for the delivery or receipt at a future date of a specified amount and grade of a traded commodity at a specified price and delivery point.

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7. CROSS REFERENCE SHEET--A compilation of the Guideline sections, referenced to the page of the prospectus; PROGRAM agreement, or other exhibits, and justification of any deviation from the Guidelines.

8. NET ASSETS--The total assets, less total liabilities, of the PROGRAM determined on the basis of generally accepted accounting principles. NET ASSETS shall include any unrealized profits or losses on open positions, and any fee or expense including NET ASSET fees accruing to the PROGRAM.

9. NET ASSET VALUE PER PROGRAM INTEREST--The NET ASSETS divided by the number of PROGRAM INTERESTS outstanding.

10. NET WORTH--The excess of total assets over total liabilities as determined by generally accepted accounting principles. NET WORTH shall be determined exclusive of home, home furnishings and automobiles.

11. NEW TRADING PROFITS--The excess, if any, of NET ASSETS at the end of the period over NET ASSETS at the end of the highest previous period or NET ASSETS at the date trading commences, whichever is higher, and as further adjusted to eliminate the effect on NET ASSETS resulting from new CAPITAL CONTRIBUTIONS, redemptions, or capital distributions, if any, made during the period decreased by interest or other income, not directly related to trading activity, earned on PROGRAM assets during the period, whether the assets are held separately or in margin account.

12. ORGANIZATIONAL AND OFFERING EXPENSES--All expenses incurred by the PROGRAM in connection with and in preparing a PROGRAM for registration and subsequently offering and distributing it to the public, including, but not limited to, total underwriting and brokerage discounts and commissions (including fees of the underwriter's attorneys), expenses for printing, engraving, mailing, salaries of employees while engaged in sales activity, charges of transfer agents, registrars, trustees, escrow holders, depositories, experts, expenses of qualification of the sale of its PROGRAM INTEREST under federal and state law, including taxes and fees, accountants' and attorneys' fees.

13. PARTICIPANT--The holder of a PROGRAM INTEREST.

14. PERSON--Any natural PERSON, partnership, corporation, association or other legal entity.

15. PIT BROKERAGE FEE-- PIT BROKERAGE FEE shall include floor brokerage, clearing fees, National

Futures Association fees, and exchange fees.

16. PROGRAM--A Limited partnership, joint venture, corporation, trust or other entity formed and operated for the purpose of investing in COMMODITY CONTRACTS.

17. PROGRAM BROKER--A COMMODITY BROKER that effects trades in COMMODITY CONTRACTS for the account of a PROGRAM.

18. PROGRAM INTEREST--A limited partnership interest or other security representing ownership in a PROGRAM.

19. PYRAMIDING--A method of using all or a part of an unrealized profit in a COMMODITY CONTRACT position to provide margin for any additional COMMODITY CONTRACTS of the same or related commodities.

20. SPONSOR--Any PERSON directly or indirectly instrumental in organizing a PROGRAM or any PERSON who will manage or participate in the management of a PROGRAM, including a COMMODITY BROKER who pays any portion of the ORGANIZATIONAL EXPENSES of the PROGRAM, and the general partner(s) and any other PERSON who regularly performs or selects the PERSONS who perform services for the PROGRAM. SPONSOR does not include wholly independent third parties such as attorneys, accountants, and underwriters whose only compensation is for professional services rendered in connection with the offering of the units. The term "SPONSOR" shall be deemed to include its AFFILIATES.

21. VALUATION DATE--The date as of which the NET ASSETS of the PROGRAM are determined.

22. VALUATION PERIOD--A regular period of time between VALUATION DATES.

II. REQUIREMENTS OF THE SPONSOR

A. *Experience.* Both the SPONSOR and the ADVISOR must be able to demonstrate sufficient knowledge and experience to carry out the PROGRAM policies and objectives and to manage PROGRAM operations. Ordinarily a minimum of three years of relevant experience will be deemed sufficient.

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B. *Financial Condition.* The financial condition of the Sponsor must be commensurate with any financial obligations assumed in the operation of the PROGRAM. At a minimum, the NET WORTH of the general partner shall be:

1. An amount equal to 5% of CAPITAL CONTRIBUTIONS in all existing PROGRAMS in which the SPONSOR has potential liability as a general partner plus 5% of the PROGRAM INTERESTS being offered.

2. For this section, the minimum required NET WORTH shall in no case be less than \$50,000 nor shall NETWORTH in excess of \$1,000,000 be required.

3. Evaluation will be made of contingent liabilities and the use of promissory notes to determine the appropriateness of their treatment in the computation of NET WORTH. If stock subscriptions or promissory notes are used, the ADMINISTRATOR may request that the SPONSOR demonstrate that the prospective subscriber or maker have sufficient NET WORTH to fund its obligation for the maximum amount of PROGRAM INTERESTS being offered. A currently enforceable contract shall exist that will require the prospective subscriber or maker to honor its obligation upon CAPITAL CONTRIBUTION to the PROGRAM.

COMMENT:

See Section VI.C.4.(b) for specific Requirements relating to the balance sheet of the SPONSOR.

C. *Investment in the PROGRAM.* The SPONSOR must make a permanent investment in the PROGRAM equal to the greater of 1% of CAPITAL CONTRIBUTIONS or \$25,000. The SPONSOR'S investment should be made prior to the commencement of trading and shall be maintained throughout the existence of the PROGRAM. In appropriate cases, the ADMINISTRATOR may require the SPONSOR to purchase for cash additional interests in the PROGRAM.

D. *Reports.* The SPONSOR shall submit to the ADMINISTRATOR any information required to be filed with the ADMINISTRATOR, including, but not limited to, reports and statements required to be distributed to PARTICIPANTS.

E. *Tax Ruling or Opinion.* If the PROGRAM is organized as a limited partnership, the SPONSOR must obtain a favorable tax ruling from the Internal Revenue Service or an opinion of qualified tax counsel in a form acceptable to the ADMINISTRATOR concerning the tax status of a limited partnership.

F. *Liability and Indemnification.*

1. The PROGRAM shall not provide for indemnification of the SPONSOR (which shall include AFFILIATES

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only if such AFFILIATES are performing services on behalf of the PROGRAM) for any liability or loss suffered by the SPONSOR, nor shall it provide that the SPONSOR be held harmless for any loss or liability suffered by the PROGRAM, unless all of the following conditions are met:

(a) The SPONSOR has determined, in good faith, that the course of conduct which caused the loss or liability was in the best interests of the PROGRAM, and

(b) The SPONSOR was acting on behalf of or performing services for the PROGRAM, and

(c) such liability or loss was not the result of negligence or misconduct by the SPONSOR, and

(d) such indemnification or agreement to hold harmless is recoverable only out of the assets of the PROGRAM and not from the PARTICIPANTS.

2. Notwithstanding anything to the contrary contained in Section II.F.1., the SPONSOR and any PERSON acting as a broker-dealer shall not be indemnified for any losses, liabilities or expenses arising from or out of an alleged violation of federal or state securities laws unless the following conditions are met:

(a) There has been a successful adjudication on the merits of each count involving alleged securities law violations as to the particular indemnitee, or

(b) such claims have been dismissed with prejudice on the merits by a court of competent jurisdiction as to the particular indemnitee, or

(c) a court of competent jurisdiction approves a settlement of the claims against a particular indemnitee and finds that indemnification of the settlement and related costs should be made, and

(d) in the case of subparagraph (c), the court of law considering the request for indemnification has been advised of the position of the Securities and Exchange Commission and the position of any state securities regulatory authority where PROGRAM INTERESTS were offered or sold as to indemnification for violations of securities laws; provided that the court need only be advised and consider the positions of the securities regulatory authorities of those states (i) which are specifically set forth in the PROGRAM agreement and (ii) in which plaintiffs claim they were offered or sold PROGRAM INTERESTS.

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3. The PROGRAM may not incur the cost of that portion of liability insurance which insures the SPONSOR for any liability as to which the SPONSOR is prohibited from being indemnified under this section.

4. The provision of advancement from PROGRAM funds to a SPONSOR or its AFFILIATES for legal expenses and other costs incurred as a result, of any legal action is permissible if the following conditions are satisfied:

(a) the legal action relates to acts or omissions with respect to the performance of duties or services on behalf of the PROGRAM;

(b) the legal action is initiated by a third party who is not a PARTICIPANT, or the legal action is initiated by a PARTICIPANT and a court of competent jurisdiction specially approves such advancement; and

(c) the SPONSOR or its AFFILIATES undertake to repay the advanced funds to the PROGRAM together with the applicable legal rate of interest thereon, in cases in which such PERSON is not entitled to indemnification under Section II.F.1.

G. *Removal or Withdrawal of General Partner(s).* In PROGRAMS organized as limited partnerships, the general partner(s) may not voluntarily withdraw from the partnership without 120 days prior written notice thereof to the limited partners. If a general partner withdraws as general partner and the limited partners or remaining general partners elect to continue the partnership, the withdrawing general partner shall pay all expenses incurred as a result of its withdrawal. In the event of removal or withdrawal, the general partner shall be entitled to a redemption of its interest in the partnership at its NET ASSET value on the next VALUATION DATE following the date of removal or withdrawal.

H. *Proper Registration.* A SPONSOR and ADVISOR must be in compliance with applicable registration requirements under the COMMODITY EXCHANGE ACT as amended.

III. SUITABILITY OF PARTICIPANTS

A. *General Policy*

1. The SPONSOR shall establish minimum income and net worth standards for PERSONS who purchase PROGRAM INTERESTS.

2. The SPONSOR shall propose minimum income and net worth standards which are reasonable given the type of PROGRAM and the risks associated with the purchase of PROGRAM INTERESTS. PROGRAMS with greater investor risk shall have minimum standards with a substantial NET WORTH requirement. The ADMINISTRATOR shall evaluate the standards proposed by the SPONSOR when the PROGRAM'S application for registration is reviewed. In evaluating the proposed standards, the ADMINISTRATOR may consider the following:

- (a) potential volatility in net asset value;
- (b) potential PARTICIPANTS;
- (c) relationships among potential PARTICIPANTS, SPONSOR, and ADVISOR;
- (d) liquidity of PROGRAM INTERESTS;
- (e) prior performance of SPONSOR, ADVISOR, and, if applicable, PROGRAM;
- (f) financial condition of the SPONSOR;
- (g) potential transactions between the PROGRAM and the SPONSOR; and
- (h) any other relevant factors.

B. Income and Net Worth Standards.

1. Unless the ADMINISTRATOR determines that the risks associated with the PROGRAM would require lower or higher standards, each PARTICIPANT shall have:

- (a) a minimum annual gross income of \$70,000 and a minimum NET WORTH of \$70,000; or

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(b) a minimum NET WORTH of \$ 250,000

2. NET WORTH shall be determined exclusive of home, home furnishings, and automobiles.

3. In the case of sales to fiduciary accounts, these minimum standards shall be met by the beneficiary, the fiduciary account, or by the donor or grantor who directly or indirectly supplies the funds to purchase the PROGRAM INTERESTS if the donor or grantors is the fiduciary.

4. The SPONSOR shall set forth in the final prospectus:

(a) the investment objectives of the PROGRAM;

(b) a description of the type of PERSON who might benefit from an investment in the PROGRAM; and

(c) the minimum standards imposed on each PARTICIPANT in the PROGRAM.

C. Determination that Sale to PARTICIPANT is Suitable and Appropriate.

1. The SPONSOR and each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM shall make every reasonable effort to determine that the purchase of PROGRAM INTERESTS is a suitable and appropriate investment for each PARTICIPANT.

2. In making this determination, the SPONSOR and each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PRGRAM shall ascertain that the prospective PARTICIPANT:

(a) meets the minimum income and net worth standards established for the PROGRAM;

(b) can reasonably benefit from the PROGRAM based on the prospective PARTICIPANT'S overall investment

objectives and portfolio structure;

(c) is able to bear the economic risk of the investment based on the prospective PARTICIPANT'S overall financial situation; and

(d) has apparent understanding of:

(1) the fundamental risks of the investment;

(2) the risk that the PARTICIPANT may lose the entire investment;

(3) the restrictions on the liquidity of PROGRAM INTERESTS;

(4) the restrictions on transferability of PROGRAM INTERESTS;

(5) the background and qualifications of the SPONSOR and ADVISOR; and

(6) the tax consequences of the investment.

3. The SPONSOR or each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM will make this determination on the basis of information it has obtained from a prospective PARTICIPANT. Relevant information for this purpose will include at least the age, investment objectives, investment experience, income, NET WORTH, financial situation, and other investments of the prospective PARTICIPANT, as well as any other pertinent factors.

4. The SPONSOR or each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM shall maintain records of the information used to determine that an investment in PROGRAM INTERESTS is suitable and appropriate for each PARTICIPANT. The SPONSOR or each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM shall maintain these records for at least six years.

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5. The SPONSOR shall disclose in the final prospectus the responsibility of the SPONSOR and each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM to make every reasonable effort to determine that the purchase of PROGRAM INTERESTS is a suitable and appropriate investment for each PARTICIPANT, based on information provided by the PARTICIPANT regarding the PARTICIPANT'S financial situation and investment objectives.

D. Subscription Agreements.

1. The ADMINISTRATOR may require that each PARTICIPANT complete and sign a written subscription agreement.

2. The SPONSOR may require that each PARTICIPANT make certain factual representations in the subscription agreement, including the following:

(a) The PARTICIPANT meets the minimum income and net worth standards established for the PROGRAM.

(b) The PARTICIPANT is purchasing the PROGRAM INTERESTS for his or her own account.

(c) The PARTICIPANT has received a copy of the prospectus.

(d) The PARTICIPANT acknowledges that the investment is not liquid except for limited redemption provisions.

3. The PARTICIPANT must separately sign or initial each representation made in the subscription agreement. Except in the case of fiduciary accounts, the PARTICIPANT may not grant any PERSON a power of attorney to make such representations on his or her behalf.

4. The SPONSOR and each PERSON selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM shall not require a PARTICIPANT to make representations in the subscription agreement which are subjective or unreasonable and which:

(a) might cause the PARTICIPANT to believe that he or she has surrendered rights to which he or she is entitled

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under federal or state law; or

(b) would have the effect of shifting the duties regarding suitability, imposed by law on broker-dealers, to the PARTICIPANT.

5. Prohibited representations include, but are not limited to the following:

(a) The PARTICIPANT understands or comprehends the risks associated with an investment in the PROGRAM.

(b) The investment is a suitable one for the PARTICIPANT.

(c) The PARTICIPANT has read the prospectus.

(d) In deciding to invest in the PROGRAM, the PARTICIPANT has relied solely on the prospectus, and not on any other information or representations from other PERSONS or sources.

6. The SPONSOR may place the content of the prohibited representations in the subscription agreement in the form of disclosures to the PARTICIPANT. The SPONSOR may not place these disclosures in the PARTICIPANT representation section of the subscription agreement.

E. Completion of Sale.

1. The SPONSOR or any PERSON selling PROGRAM INTERESTS ON behalf of the SPONSOR or PROGRAM may not complete a sale of PROGRAM INTERESTS to a PARTICIPANT until at least five business days after the date the PARTICIPANT receives a final prospectus.

2. The SPONSOR or the PERSON designated by the SPONSOR shall send each PARTICIPANT a confirmation of his or her purchase.

F. Minimum Investment. The ADMINISTRATOR may require a minimum initial and subsequent cash investment

amount.

IV. FEES, COMPENSATION AND EXPENSES

A. Organizational and Offering Expenses

1. All ORGANIZATIONAL AND OFFERING EXPENSES, including commissions, and any other compensation for sales of PROGRAM INTERESTS shall be reasonable. In no event shall these expenses exceed 15% of the CAPITAL CONTRIBUTIONS of the offering, regardless of the source of payment. Any interest paid by the PROGRAM on deferred ORGANIZATIONAL AND OFFERING EXPENSES shall comply with Section VI.C.2.(e). Included in ORGANIZATIONAL AND OFFERING EXPENSES shall be the redemption fees as set forth in Section VII.B.

5. No SPONSOR shall directly or indirectly pay or award any commissions or other compensation to any PERSON engaged to sell PROGRAM INTERESTS or give investment advice to a potential PARTICIPANT; provided, however, that this clause shall not prohibit the payment to a registered broker-dealer or other properly licensed PERSON of normal sales commissions for selling PROGRAM INTERESTS.

COMMENT:

Compensation paid to sales agents from a percentage of commodity brokerage commissions (trail commissions) will not be considered objectionable offering expenses under Section IV.A.

B. Expenses of the PROGRAM. All expenses of the PROGRAM shall be billed directly to and paid by the PROGRAM. The SPONSOR shall not be allowed (other than for ORGANIZATIONAL AND OFFERING EXPENSES) to allocate to the PROGRAM any portion of its indirect expenses incurred in connection with the administration of the PROGRAM, including but not limited to salaries, rent, travel expenses and such other items generally falling under the category of SPONSOR overhead expense. All customary and routine administrative expenses of the PROGRAM, except for the actual cost of legal and audit services provided by third parties, shall be subject to the limitations imposed by Section IV.C.1. of these Guidelines. The prospectus shall contain a separate estimate of the amount of legal and audit fees to be charged to the PROGRAM during the first full year of its operations based on minimum and maximum offering sizes.

C. Compensation.

1. NET ASSET Fee--Management fees, advisory fees and all other fees, except for incentive fees and commodity brokerage commissions, when added to the customary and routine administrative expenses of the PROGRAM shall not exceed $\frac{1}{2}$ of 1% of NET ASSETS per month (not to exceed 6% annually). For the purpose of this limitation, customary

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and routine administrative expenses shall include all expenses of the PROGRAM other than commodity brokerage commissions, incentive fees, the actual cost of legal and audit services and extraordinary expenses. The SPONSOR shall not receive a NET ASSET fee if it receives, directly or indirectly, any portion of the brokerage commissions under Section IV.C.3. If necessary, the SPONSOR shall reimburse the PROGRAM, no less frequently than quarterly, for the amount by which such aggregate fees and expenses exceed the limitations herein provided during the period for which reimbursement is made up to an amount not exceeding the aggregate compensation received by the SPONSOR, including direct or indirect participation in commodity brokerage commissions charged to the PROGRAM. If reimbursement is required or extraordinary expenses are incurred, the SPONSOR shall include in the PROGRAM'S next regular report to the PARTICIPANTS a discussion of the circumstances or events which resulted in the reimbursement or extraordinary expenses.

2. Incentive Fees.

(a) The aggregate incentive fee paid by the PROGRAM shall not exceed 15% of the NEW TRADING PROFITS of the PROGRAM, calculated not more often than quarterly on the VALUATION DATE, over the highest previous VALUATION DATE. For purposes of this calculation, PROGRAM losses shall be carried forward but shall not be carried back. In no event may a modification of ADVISOR compensation result in such compensation exceeding the limitations provided herein. Furthermore, any new contract with an existing ADVISOR must carry toward all losses attributable to that ADVISOR.

(b) The SPONSOR or ADVISOR will be entitled to an additional 2% incentive fee for each 1% by which the PROGRAM'S NET ASSET fee as set forth in IV.C.I. is reduced below 6% annually.

(c) Multi-ADVISOR PROGRAMS. The prospectus must clearly disclose, in both the prospectus summary and text of the prospectus, that incentive fees may be paid to an ADVISOR for a given period despite aggregate PROGRAM losses for such period.

(d) The prospectus shall contain a sample calculation of how incentive fees will be determined.

3. Brokerage Commissions.

(a) The round turn commission to be initially charged to the PROGRAM for each commodity on each exchange on which the PROGRAM is expected to trade shall be disclosed immediately following the compensation table in the prospectus. An estimated range of such round turn commission shall be included in the prospectus summary section. Such round turn commission shall include all fees charged for each brokerage transaction; including, but not limited to, PIT BROKERAGE FEES. An estimate of the round turn commission should be included where a flat rate or asset based commission will be utilized.

(b) The prospectus must clearly disclose, in both the prospectus summary and the text of the prospectus, an estimate of what the brokerage rate will equal as a percentage of average NET ASSETS annually.

(c) The PROGRAM shall seek the best price and services available in its commodity futures brokerage transactions in COMMODITY CONTRACTS with any COMMODITY BROKER affiliated directly or indirectly with the SPONSOR or with any ADVISOR providing the SPONSOR with, research information, recommendations or other services which might be of value to the SPONSOR, unless such transactions are effected at competitive rates. In no event will the PROGRAM be allowed to enter into any exclusive brokerage contract. Brokerage commission charges will be presumptively reasonable if they satisfy one of the following maximum rates:

- i. 80% of the published retail rate plus PIT BROKERAGE FEES, or
- ii. 14% annually of the average NET ASSETS excluding the PROGRAM assets not directly related to trading activity. This 14% limitation shall include PIT BROKERAGE FEES.

The prospectus must state that the brokerage commissions to be charged will not exceed the limitations set forth herein. The ADMINISTRATOR may require the PROGRAM to file periodic reports concerning all brokerage transactions.

4. Other income.

(a) Any interest or other income derived from any portion of the PROGRAM assets whether held in the PROGRAM'S margin account or otherwise shall accrue solely to the benefit of the PROGRAM except as set forth below:

(1) Interest income may be used to reimburse the SPONSOR for "deferred" ORGANIZATIONAL AND OFFERING EXPENSES. Such compensation must be within the overall limits set by Section IV.A.1.

(2) Not more than 20% of interest income derived from PROGRAM assets may be allocated to the PROGRAM BROKER. However, any interest income allocated to the PROGRAM BROKER must be included in determining: whether the limitations imposed by Section IV.C.3.(c) have been satisfied.

(a) Any interest or other income derived from any portion of the PROGRAM assets accruing to the benefit of the SPONSOR or PROGRAM BROKER pursuant to Sections (1) or (2) herein, must be clearly disclosed as

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compensation. The prospectus must include a statement regarding the disposition of any interest or other income earned by any portion of the PROGRAM assets.

(b) A SPONSOR shall not take any action with respect to the assets or property of the PROGRAM which does not benefit the PROGRAM. Such a prohibited action, among others, would be the utilization of PROGRAM funds as compensating balances for the SPONSOR'S exclusive benefit.

(Ed Note: Former IV.B.5. is replaced by IV.B.)

5. Only those items of compensation permitted herein will be allowed. Any variance must be adequately justified to the ADMINISTRATOR.

V. RIGHTS AND OBLIGATIONS OF PARTICIPANTS.

A. *Meetings.* Meetings of the PARTICIPANTS may be called by the general partner or by PARTICIPANTS holding more than 10% of the then outstanding PROGRAM INTERESTS for any matters for which the PARTICIPANTS may vote as set forth in a limited partnership agreement or charter document. Such call for a meeting shall be deemed to have been made upon receipt of the general partner of a written request, either in PERSON or by certified mail from holders of the requisite percentage of PROGRAM INTERESTS stating the purpose of the meeting. The general partner shall, within 15 days after receipt of said request, provide written notice, either in PERSON or by certified mail, to all PARTICIPANTS of the meeting and the purpose of such meeting which shall be held on a date not less than 30 or more than 60 days after the date of receipt of said notice at a reasonable time and place.

B. *Voting Rights of Limited Partners.* To the extent permitted by the law of the state of formation, the PROGRAM agreement shall provide that a majority of the outstanding PROGRAM INTERESTS may, without necessity for concurrence by the general partner, vote to (1) amend the PROGRAM agreement, (2) remove the general partner(s), (3) elect a new general partner(s), (4) cancel any contract for services with the SPONSOR without penalty upon 60 days written notice, and (5) dissolve the PROGRAM. Without concurrence of a majority of the outstanding PROGRAM INTERESTS, the general partner(s) may not (i) amend the PROGRAM agreement except for amendments which do not adversely affect the rights of PARTICIPANTS, (ii) appoint a new general partner(s), or (iii) dissolve the PROGRAM. Any amendment to the PROGRAM agreement which modifies the compensation or distributions to which a general partner is entitled or which affects the duties of a general partner may be conditioned upon the consent of the general partner. If the law of the state of formation provides that the PROGRAM will dissolve upon termination of a general partner(s) unless the remaining general partner(s) continues the existence of the PROGRAM, the PROGRAM agreement shall obligate the remaining general partner(s) to continue the PROGRAM'S existence; and if there will be no remaining general partner(s), the termination of the last general partner shall not be effective for a period of at least 120 days during which time a majority of the outstanding PROGRAM INTERESTS shall have the right to elect a general partner who shall agree to continue the existence of the PROGRAM. The PROGRAM agreement shall provide for a successor general partner where the only general partner of the PROGRAM is an individual.

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C. (Formerly Section VI.C.4.) *Material Changes*. Any material changes in the PROGRAM'S basic investment policies or structure shall require prior written approval by a majority of PROGRAM INTERESTS held by PARTICIPANTS.

D. *Access to PROGRAM Records*

1. The SPONSOR shall maintain at the principal office of the PROGRAM a list of the names and addresses of an PROGRAM INTERESTS owned by all PARTICIPANTS. Such list shall be made available for the review by any PARTICIPANT or his representative at reasonable times, and upon request, either in PERSON or by mail the SPONSOR shall furnish a copy of such list to any PARTICIPANT or his representative upon payment, in advance, of the reasonable cost of reproduction and mailing.

2. The PARTICIPANTS and their representatives shall be permitted access to all records of the PROGRAM, after adequate notice, at any reasonable time. The SPONSOR shall maintain and preserve such records for a period of not less than five years.

E. *Annual and Periodic Reports*. [Compliance with the provisions of CFTC regulations for Reporting to Pool PARTICIPANTS, 17 C.F.R. § 4.22 will be considered sufficient to comply with this Section E.]

1. The partnership agreement shall provide for the transmittal to each PARTICIPANT of an annual report within 120 days after the close of the fiscal year containing at least the following information:

(a) A balance sheet as of the end of the PROGRAM'S fiscal year and statements of income, partners' equity, and cash flows for the year then ended, all of which shall be prepared in accordance with generally accepted accounting principles and accompanied by an auditor's report containing an opinion of an independent certified public accountant or independent public accountant.

(b) A statement showing the total fees, compensation, brokerage commissions and expenses paid by the PROGRAM, segregated as to type, and stated both in aggregate dollar terms and as a percentage of NET ASSETS.

(c) The average round turn rate for the fiscal year shall be computed within the scope of the annual audit. Such rate shall be disclosed in the annual report.

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2. A SPONSOR shall be requires to furnish PARTICIPANTS with quarterly reports, which may be unaudited, containing the same information as in (a) and (b) above within 60 days after the end of the quarter.

3. A SPONSOR shall provide to all PARTICIPANTS, not later than March 15th of each year, all information necessary for the preparation of the PARTICIPANT'S income tax returns.

4. The SPONSOR shall calculate the NET ASSETS of the fund daily and shall make available upon the request of a PARTICIPANT, the NET ASSET VALUE PER PROGRAM INTEREST.

F. Transferability of PROGRAM INTERESTS.

1. Restrictions on assignment of PROGRAM INTERESTS or on the substitution of a limited partner are generally disfavored and such restrictions will be allowed only if (1) they are necessary to comply with the safe harbor provisions of Internal Revenue Service Notice 88-75 (or other safe harbors adopted by the Internal Revenue Service that protect against treatment as a publicly traded partnership) or (2) they are necessary to preserve the tax status of the partnership or the characterization or treatment of income or loss. In the case of (2), any restriction must be affirmatively supported by an opinion of counsel. The PROGRAM agreement shall require the SPONSOR to eliminate or modify any restriction on substitution or assignment at such time as the restriction is no longer necessary.

2. No transfers may be made where, after the transfer, either the transferee or the transferor would hold less than the minimum number of PROGRAM INTERESTS equivalent to an initial minimum purchase, except for transfers by gift, inheritance, intrafamily transfers, family dissolutions, and transfers to AFFILIATES.

G. PARTICIPANT Liability. A PROGRAM shall be structured so that a public investor cannot be exposed to liability in excess of the amount of the remaining balance of his capital account excluding partial redemptions, distributions consisting of a return of capital and accumulated profits.

H. ASSESSMENTS. Assessments of any kind shall be prohibited.

VI. DISCLOSURE AND MARKETINT REQUIREMENTS.

A. Minimum PROGRAM Capital. The minimum amount of funds to activate a PROGRAM shall be sufficient to accomplish the objectives of the PROGRAM, including "spreading the risk." Any minimum less than \$500,000, after deduction of all front end charges, will be presumed to be inadequate to spread the risk of the public investors.

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Provision must be made for the return of 100% of paid subscriptions in the event that the established minimum to activate the PROGRAM is not reached. All funds received prior to activation of the PROGRAM must be deposited with an independent custodian, trustee or escrow agent whose name and address shall be disclosed in the prospectus.

COMMENT:

The purpose of this requirement is to assure the adequate diversification of the investments of the PROGRAM.

B. *Sales Literature.* Sales literature, sales presentation (including prepared presentations to prospective investors at group meetings) and advertising used in the offer or sale of PROGRAM INTERESTS shall conform in all applicable respects to requirements of filing, disclosure and adequacy currently imposed on sales literature, sales presentations and advertising used in the sale of corporate securities.

C. *Contents of the Prospectus.*

1. Prospectus. A prospectus which is not part of a registration statement declared effective by the Securities and Exchange Commission pursuant to the Securities Act of 1933 shall generally conform to the disclosure requirements which would apply if the offering were so registered.

2. Conflicts of Interest and Transactions with AFFILIATES.

(a) Any conflicts of interest between the PROGRAM and any SPONSOR, ADVISOR, COMMODITY BROKER or any AFFILIATE thereof, must be fully disclosed.

(b) Unless specifically provided by these Guidelines the SPONSOR shall not receive compensation or reimbursements for providing goods and services to the PROGRAM.

(c) The SPONSOR shall also be required to disclose the steps that will be taken to alleviate any real or potential conflict of interest.

(d) Prohibitions. Certain conflicts of interest are presumed to be materially sufficient to render the proposed PROGRAM incapable of accomplishing its stated objectives in the best interest of the PARTICIPANTS and shall be controlled as follows:

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- (1) It shall be presumptively unreasonable for the ADVISOR to be affiliated with the PROGRAM BROKER.
- (2) It shall be presumptively unreasonable for the ADVISOR to be affiliated with the SPONSOR if the SPONSOR receives, directly or indirectly, any portion of the brokerage commissions, including trail commissions, from PROGRAM operations.
- (3) Unless the issuer can overcome the presumptions outlined in (1) and (2) above, the prospectus shall state that at no time will the above affiliations exist.
- (4) No loans may be made by the PROGRAM to the SPONSOR or any other PERSON.
- (5) The funds of a PROGRAM shall not be commingled with the funds of any other PERSON. Funds used to satisfy margin requirements will not be considered commingled.
- (6) No rebates or giveups may be received by the SPONSOR nor may the SPONSOR participate in any reciprocal business arrangements which could circumvent these guidelines. Furthermore, the prospectus and PROGRAM charter documents shall contain language prohibiting the above as well as language prohibiting reciprocal business arrangements which would circumvent the restrictions against dealing with AFFILIATES or other interested parties.
- (7) A PROGRAM'S charter document shall prohibit the commodity trading ADVISOR or any other PERSON acting in such capacity from receiving a NET ASSET fee under Section IV.C.1. if he shares or participates, directly or indirectly, in any commodity brokerage commissions generated by the PROGRAM.
- (8) The maximum period covered by any contract of the partnership with the ADVISOR or SPONSOR shall not exceed one year. The agreement must be terminable without penalty upon 60 days' written notice by the PROGRAM.
- (9) Any other agreement, arrangement or transactions, proposed or contemplated, may be restricted in the discretion of the ADMINISTRATOR if it would be considered unfair to the PARTICIPANTS in the PROGRAM.
- (10) A PROGRAM shall not engage in PYRAMIDING.

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(11) All of the foregoing restrictions shall be disclosed in the prospectus and contained in the partnership agreement or charter document.

(e) On loans made available to the PROGRAM by the SPONSOR, the SPONSOR may not receive interest in excess of its interest costs, nor may the SPONSOR receive interest in excess of the amounts which would be charged the PROGRAM (without reference to the SPONSOR'S financial abilities or guarantees) by unrelated banks on comparable loans for the same purpose and the SPONSOR shall not receive points or other financing charges or fees regardless of the amount.

3. Notification.

(a) Notice shall be sent to each PARTICIPANT within seven business days from the date of:

(i) any decline in the NET ASSET VALUE PER UNIT to less than 50% of the NET ASSET VALUE on the last VALUATION DATE

(ii) any material change in contracts with ADVISORS, including any change in ADVISORS or any modification in connection with the method of calculating the incentive fee;

(iii) any other material change affecting the compensation of any party.

(b) No material change related to brokerage commissions shall be made until notice is given and PARTICIPANTS, based on such notice, have the opportunity to redeem pursuant to Section VII.B.

(c) Included in the required notification shall be a description of the PARTICIPANT'S redemption rights pursuant to VII.B. and C. and voting rights pursuant to V.B. and a description of any material effect such changes may have on the interests of PARTICIPANTS.

4. Financial Information Required on Application. The SPONSOR or the PROGRAM shall provide as an exhibit to the application or where indicated below shall provide as part of the prospectus, the following financial statements:

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(a) Balance Sheet of the PROGRAM. A balance sheet of the PROGRAM as of the end of its most-recent fiscal year, prepared in accordance with generally accepted accounting principles and accompanied by an independent auditor's report containing no material qualification or explanatory paragraph relating to material uncertainties or going concern issues, and an unaudited balance sheet as of a date not more than 135 days prior to the date of filing. Such balance sheets shall be included in the prospectus.

(b) Balance Sheet of the SPONSOR

(1) Corporate SPONSOR. A balance sheet of any corporate SPONSOR as of the end of its most recent fiscal year, prepared in accordance with generally accepted accounting principles and accompanied by an independent auditor's report containing no material qualification or explanatory paragraph relating to material uncertainties or going concern issues, and an unaudited balance sheet as of a date not more than 135 days prior to the date of filing. Such balance sheets shall be included in the prospectus.

(2) Individual SPONSOR. A statement of financial condition as of a time not more than 135 days prior to the date of filing an application. Such statement of financial condition shall be prepared in accordance with generally accepted accounting principles and reviewed and reported upon by an independent certified public accountant or independent public accountant under the review standards as set forth by the American Institute of Certified Public Accountants. A representation of the amount of such NET WORTH must be included in the prospectus.

(c) Filing of Other Statements. The ADMINISTRATOR may, where consistent with the protection of investors, request additional financial statements of the SPONSOR, ADVISOR, PROGRAM BROKER or any AFFILIATE thereof, or permit the omission of one or more of the statements required under this section and the filing, and substitution thereof, of appropriate statements verifying financial information having comparable relevance to an investor in determining whether he should invest in the PROGRAM.

VII. MISCELLANEOUS PROVISIONS.

A. *Fiduciary Duty*. The PROGRAM agreement shall provide that the SPONSOR shall have fiduciary responsibility for the safekeeping and use of all funds and assets of the PROGRAM, whether or not in his immediate possession or control, and that he shall not employ, or permit another to employ such funds or assets in any manner except for the exclusive benefit of the PROGRAM.

In addition, the PROGRAM shall not permit the PARTICIPANT to contract away the fiduciary obligation owed to the PARTICIPANT by the SPONSOR under common law.

B. *Redemptions*. The PROGRAM shall provide for the redemption of PROGRAM interests at least quarterly except

that redemption need not be offered until six months after the commencement of trading. Redemption charges for units redeemed during the first, second, third, and fourth, six month periods following the commencement of trading, shall not exceed 4%, 3%, 2%, and 1% of the NET ASSET OF VALUE PER PROGRAM INTEREST respectively. The SPONSOR shall state the VALUATION DATE in the prospectus. A PARTICIPANT must notify the SPONSOR in writing at least 10 days prior to the VALUATION DATE of his wish to redeem his PROGRAM INTERESTS. The SPONSOR must redeem such PROGRAM INTERESTS at the NET ASSET value on the VALUATION DATE unless the number of redemptions would be detrimental to the tax status of the PROGRAM; in which case, the SPONSOR shall select by lot so many redemptions as will, in its judgment, not impair the PROGRAM'S status. PARTICIPANTS shall be notified in writing within 10 days after the VALUATION DATE whether or not their PROGRAM INTERESTS have been redeemed. Payment for the redeemed PROGRAM INTERESTS shall be made within 30 days after the VALUATION DATE. The SPONSOR may provide that redemptions may be temporarily suspended if, in the SPONSOR'S judgment, additional redemptions would impair the ability of the PROGRAM to meet its objectives.

C. *Special Redemption.* A Special Redemption period shall be established whenever a PROGRAM experiences a decline in the NET ASSET VALUE PER PROGRAM INTEREST as of the close of business on any business day to less than 50% of the NET ASSET VALUE PER PROGRAM INTEREST on the last VALUATION DATE. PROGRAM trading shall be temporarily suspended during such special redemption period.

As revised and adopted by the NASAA membership on May 7, 2007

I. INTRODUCTION

A. Application

1. This Statement of Policy applies to qualifications and registrations of Real Estate Investment Trusts (REITS)
2. While applications not conforming to the standards contained herein shall be looked upon with disfavor, where good cause is shown, certain guidelines may be modified or waived by the Administrator.

B. Definitions

1. ADMINISTRATOR: The official or agency administering the Securities laws of a jurisdiction.
2. ACQUISITION EXPENSES: Expenses including but not limited to legal fees and expenses, travel and communications expenses, cost of appraisals, nonrefundable option payments on property not acquired, accounting fees

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and expenses, title insurance, and miscellaneous expenses related to selection and acquisition of properties, whether or not acquired.

3. ACQUISITION FEE: The total of all fees and commissions paid by any party to any party in connection with making or investing in mortgage loans or the purchase, development or construction of property by a REIT. Included in the computation of such fees or commissions shall be any real estate commission, selection fee, DEVELOPMENT FEE, CONSTRUCTION FEE, nonrecurring management fee, loan fees or points or any fee of a similar nature, however designated. Excluded shall be DEVELOPMENT FEES and CONSTRUCTION FEES paid to PERSONS not affiliated with the SPONSOR in connection with the actual development and construction of a project.

4. ADVISOR: The PERSON responsible for directing or performing the day-to-day business affairs of a REIT, including a PERSON to which an Advisor subcontracts substantially all such functions. To the extent the provisions of this Statement of Policy are germane they shall apply to self-administered REITS.

5. AFFILIATE: An AFFILIATE of another PERSON includes any of the following:

a. any PERSON directly or indirectly owning, controlling, or holding, with power to vote ten percent or more of the outstanding voting securities of such other PERSON.

b. any PERSON ten percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held, with power to vote, by such other PERSON.

c. any PERSON directly or indirectly controlling, controlled by, or under common control with such other PERSON.

d. any executive officer, director, trustee or general partner of such other PERSON.

e. any legal entity for which such PERSON acts as an executive officer, director, trustee or general partner.

6. AVERAGE INVESTED ASSETS: For any period the average of the aggregate book value of the assets of the Trust invested, directly or indirectly, in equity interests in and loans secured by real estate, before reserves for depreciation or bad debts or other similar non-cash reserves computed by taking the average of such values at the end of each month during such period.

7. **COMPETITIVE REAL ESTATE COMMISSION:** Real estate or brokerage commission paid for the purchase or sale of a property which is reasonable, customary and competitive in light of the size, type and location of such property.

8. **CONTRACT PRICE FOR THE PROPERTY:** The amount actually paid or allocated to the purchase, development, construction or improvement of a property exclusive of **ACQUISITION FEES** and **ACQUISITION EXPENSES**.

9. **CONSTRUCTION FEE:** A fee or other remuneration for acting as general contractor and/or construction manager to construct improvements, supervise and coordinate projects or to provide **MAJOR REPAIRS OR REHABILITATION** on a REITS property.

10. **CROSS REFERENCE SHEET:** A compilation of the **STATEMENT OF POLICY** sections, referenced to the page of the **PROSPECTUS** and **DECLARATION OF TRUST**, or other exhibits, and justification for any deviation from the **STATEMENT OF POLICY**. Such compilation shall comply with the provisions set forth on the **CROSS REFERENCE SHEET**.

11. **DECLARATION OF TRUST:** The declaration of trust, by-laws, certificate, articles of incorporation or other governing instrument pursuant to which a REIT is organized.

12. **DEVELOPMENT FEE:** A fee for the packaging of a REIT'S property, including negotiating and approving plans, and undertaking to assist in obtaining zoning and necessary variances and necessary financing for the specific property, either initially or at a later date.

13. **INDEPENDENT EXPERT:** A PERSON with no material current or prior business or personal relationship with the **ADVISOR** or **TRUSTEES** who is engaged to a substantially extent in the business of rendering opinions regarding the value of assets of the type held by the REIT.

14. **INDEPENDENT TRUSTEE(S):** The **TRUSTEE(S)** of a REIT who are not associated and have not been associated within the last two years, directly or indirectly, with the **SPONSOR** or **ADVISOR** of the REIT.

a. A **TRUSTEE** shall be deemed to be associated with the **SPONSOR** or **ADVISOR** if he or she:

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- i. owns an interest in the SPONSOR, ADVISOR, or any of their AFFILIATES; or
 - ii. is employed by the SPONSOR, ADVISOR or any of their AFFILIATES; or
 - iii. is an officer or director of the SPONSOR, ADVISOR, or any of their AFFILIATES; or
 - iv. performs services, other than as a TRUSTEE, for the REIT; or
 - v. is a TRUSTEE for more than three REITS organized by the SPONSOR or advised the ADVISOR; or
 - vi. has any material business or professional relationship with the .SPONSOR, ADVISOR, or any of their AFFILIATES.
- b. For purposes of determining whether or not the business or professional relationship is material, the gross revenue derived by the prospective INDEPENDENT TRUSTEE from the SPONSOR and ADVISOR and AFFILIATES shall be deemed material *per se* if it exceeds 5% of the prospective INDEPENDENT TRUSTEE'S:
- i. annual gross revenue, derived from all sources, during either of the last two years; or
 - ii. net worth, on a fair market value basis.
- c. An indirect relationship shall include circumstances in which a TRUSTEE'S spouse, parents, children, siblings, mothers- or fathers-in-law, sons-or daughters-in-law, or brothers- or sisters-in-law is or has been associated with the SPONSOR, ADVISOR, any of their AFFILIATES, or the REIT

15. INITIAL INVESTMENT: That portion of the initial capitalization of the REIT contributed by the SPONSOR or: its AFFILIATES pursuant to Section II.A of this Statement of Policy.

16. LEVERAGE: The aggregate amount of indebtedness of a REIT for money borrowed (including purchase

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money mortgage loans) outstanding at any time, both secured and unsecured.

17. NET ASSETS: The total assets (other than intangibles) at cost before deducting depreciation or other non-cash reserves less total liabilities, calculated at least quarterly on a basis consistently applied.

18. NET INCOME: For any period total revenues applicable to such period, less the expenses applicable to such period other than additions to reserves for depreciation or bad debts or other similar non-cash reserves. If the ADVISOR receives an incentive fee, NET INCOME, for purposes of calculating TOTAL OPERATING EXPENSES in Section IV.D shall exclude the gain from the sale of the REIT'S assets.

19. ORGANIZATION AND OFFERING EXPENSES: All expenses incurred by and to be paid from the assets of the REIT in connection with and in preparing a REIT for registration and subsequently offering and distributing it to the public, including, but not limited to, total underwriting and brokerage discounts and commissions (including fees of the underwriters' attorneys), expenses for printing, engraving, mailing, salaries of employees while engaged in sales activity, charges of transfer agents, registrars, trustees, escrow holders, depositaries, experts, expenses of qualification of the sale of the securities under Federal and State laws, including taxes and fees, accountants' and attorneys' fees.

20. PERSON: Any natural persons, partnership, corporation, association, trust, limited liability company or other legal entity.

21. PROSPECTUS: Shall have the meaning given to that term by Section 2(10) of the Securities Act of 1933, including a preliminary Prospectus; provided, however, that such term as used herein shall also include an offering circular as described in Rule 256 of the General Rules and Regulations under the Securities Act of 1933 or, in the case of an intrastate offering, any document by whatever name known, utilized for the purpose of offering and selling securities 'to the public.

22. REAL ESTATE INVESTMENT TRUST ("REIT"): A corporation, trust, association or other legal entity (other than a real estate syndication) which is engaged primarily in investing in equity interests in real estate (including fee ownership and leasehold interests) or in loans secured by real estate or both.

23. ROLL-UP: A transaction involving the acquisition, merger, conversion, or consolidation either directly or indirectly of the REIT and the issuance of securities of a ROLL-UP ENTITY. Such term does not include:

a. a transaction involving securities of the REIT that have been for at least 12 months listed on a national securities exchange or traded through the National Association of Securities Dealers Automated Quotation National

Market System; or

b. a transaction involving the conversion to corporate, trust, or association form of only the REIT if, as a consequence of the transaction there will be no significant adverse change in any of the following:

i. SHAREHOLDERS' voting rights;

ii. The term of existence of the REIT;

iii. SPONSOR or ADVISOR compensation;

iv. The REIT'S investment objectives.

24. ROLL-UP ENTITY: A partnership, real estate investment trust, corporation, trust, or other entity that would be created or would survive after the successful completion of a proposed ROLL-UP transaction.

25. SHARES: Shares of beneficial interest or of common stock of a REIT of the class that has the right to elect the Trustees of such REIT.

26. SHAREHOLDERS: The registered holders of a REIT'S SHARES.

27. SPECIFIED ASSET REIT: A PROGRAM where, at the time a securities registration is ordered effective, at least 75% of the net proceeds from the sale of SHARES are allocable to the purchase, construction, renovation, or improvement of individually identified assets. Reserves shall not be included in the 75%.

28. SPONSOR: Any PERSON directly or indirectly instrumental in organizing, wholly or in part, a REIT or any PERSON who will control, manage or participate in the management of a REIT, and any AFFILIATE of such PERSON. Not included is any PERSON whose only relationship with the REIT is as that of an independent property manager of REIT assets, and whose only compensation is as such. SPONSOR does not include wholly independent third parties such as attorneys, accountants and underwriters whose only compensation is for professional services. A PERSON may also be deemed a SPONSOR of the REIT by:

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a. taking the initiative, directly or indirectly, in founding or organizing the business or enterprise of the REIT; either alone or in conjunction with one or more other PERSONS;

b. receiving a material participation in the REIT in connection with the founding or organizing of the business of the REIT, in consideration of services or property, or both services and property;

c. having a substantial number of relationships and contacts with the REIT;

d. possessing significant rights to control REIT properties;

e. receiving fees for providing services to the REIT which are paid on a basis that is not customary in the industry; or

f. providing goods or services to the REIT on a basis which was not negotiated at arms length with the REIT.

29. TOTAL OPERATING EXPENSES: Aggregate expenses of every character paid or incurred by the REIT as determined under Generally Accepted Accounting Principles, including ADVISORS' fees, but excluding:

a. the expenses of raising capital such as ORGANIZATION AND OFFERING EXPENSES, legal, audit, accounting, underwriting, brokerage, listing, registration and other fees, printing and other such expenses, and tax incurred in connection with the issuance, distribution, transfer, registration, and stock exchange listing of the REIT'S SHARES;

b. interest payments;

c. taxes;

d. non-cash expenditures such as depreciation, amortization and bad debt reserves;

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e. incentive fees paid in compliance with Section IV.F., notwithstanding Section I.B.29.(f);

f. ACQUISITION FEES, ACQUISITION EXPENSES, real estate commissions on resale on property and other expenses connected with the acquisition, disposition, and ownership of real estate interests, mortgage loans, or other property, (such as the costs of foreclosure, insurance premiums, legal services, maintenance, repair, and improvement of property).

COMMENT:

The Exclusion from TOTAL OPERATING EXPENSES for costs related directly to asset acquisition, operation and disposition is intended to allow exclusion of expenses incurred on the individual property level but not to allow the exclusion of expenses incurred on the REIT level.

30. TRUSTEE(S): The members of the board of trustees or directors or other body which manages the REIT.

31. UNIMPROVED REAL PROPERTY: The real property of a REIT which has the following three characteristics:

a. an equity interest in real property which has not acquired for the purpose of producing rental or other operating income;

b. has no development or construction in process on such land; and

c. no development or construction on such land is planned in good faith to commence on such land within one year.

II. REQUIREMENTS OF SPONSOR, ADVISOR, TRUSTEES AND ANY AFFILIATE

A. Minimum Capital

1. Prior to the initial public offering, the SPONSOR, or any AFFILIATE, shall contribute to the REIT an amount not less than the lesser of:

a. 10% of the total net assets upon completion of the offering, or

b. \$200,000 as an INITIAL INVESTMENT.

2. The SPONSOR or any AFFILIATE may not sell this INITIAL INVESTMENT while the SPONSOR remains a SPONSOR but may transfer the shares to other AFFILIATES.

B. Number and Election of TRUSTEES

1. The REIT shall have a minimum of three TRUSTEES, each of whom (other than a TRUSTEE elected to fill the unexpired term of another TRUSTEE) is elected by the SHAREHOLDERS of the REIT and who shall serve for a term of one year.

2. Nothing in this section shall prohibit a TRUSTEE from being reelected by the SHAREHOLDERS.

3. A majority of the TRUSTEES shall INDEPENDENT TRUSTEES.

4. INDEPENDENT TRUSTEES shall nominate replacements for vacancies amongst the INDEPENDENT TRUSTEES' positions.

5. the TRUSTEES may establish such committees they deem appropriate (provided the majority of the members of each committee are INDEPENDENT TRUSTEES).

C. Duties of TRUSTEES

1. At, or before, the first meeting of the TRUSTEES, the DECLARATION OF TRUST shall be reviewed and ratified by a majority vote of the TRUSTEES and of the INDEPENDENT TRUSTEES. The PROSPECTUS shall disclose that such ratification is required.

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2. The TRUSTEE shall establish written policies on investments and borrowing and shall monitor the administrative procedures, investment operations and performance of the REIT and the ADVISOR to assure that such policies are carried out.

3. A majority of the INDEPENDENT TRUSTEES must approve matters to which this Section and Sections II.A., II.F., II.G., IV.A., IV.B., IV.C., IV.D., IV.E., IV.F., IV.G., V.E., V.H., V.J., VI.A., VI.B.4, and VI.G., of this Statement of Policy.

COMMENT:

The special obligations of the INDEPENDENT TRUSTEES should not be interpreted to lessen in any way the obligations of the affiliated TRUSTEES.

D. Experience of TRUSTEES

A TRUSTEE shall have had at least three years of relevant experience demonstrating the knowledge and experience required to successfully acquire and manage the type of assets being acquired by the REIT. At least one of the INDEPENDENT TRUSTEES shall have three years of relevant real estate experience.

COMMENT:

"Relevant real estate experience" shall mean actual direct experience by the TRUSTEE in acquiring or managing the type of real estate to be acquired by the REIT for his or her own account or as an agent. For example, if the REIT will acquire commercial real estate, i.e. office buildings or shopping centers, "relevant real estate experience" would not include experience in buying and selling houses because it is apparent that a different level of sophistication and knowledge is required.

E. Fiduciary Duty

The TRUSTEES and ADVISOR of the REIT shall be deemed to be in a fiduciary relationship to the REIT and the SHAREHOLDERS. The TRUSTEES of the REIT shall also have a fiduciary duty to the SHAREHOLDERS to supervise the relationship of the REIT with the ADVISOR.

F. Advisory Contract

1. It shall be the duty of the TRUSTEES to evaluate the performance of the ADVISOR before entering into or renewing an advisory contract. The criteria used in such evaluation shall be reflected in the minutes of such meeting.

2. Each contract for the services of an ADVISOR entered into by the TRUSTEES shall have a term of no more than one year.

3. Each advisory contract shall be terminable by a majority of the INDEPENDENT TRUSTEES, or the ADVISOR on sixty (60) days written notice without cause or penalty. In the event of the termination of such contract, the ADVISOR will cooperate with the REIT and take all reasonable steps requested to assist the TRUSTEES in making an orderly transition of the advisory function.

4. The qualifications of the ADVISOR shall be set forth in the PROSPECTUS relating to the initial public offering of the SHARES of the REIT and the TRUSTEES shall determine that any successor ADVISOR possesses sufficient qualifications to:

- a. perform the advisory function for the REIT; and
- b. justify the compensation provided for in its contract with the REIT.

G. Liability and Indemnification

1. The REIT shall not provide for indemnification of the TRUSTEES, ADVISORS or AFFILIATES for any liability loss suffered by the TRUSTEES, ADVISORS or AFFILIATES, nor shall it provide that the TRUSTEES, ADVISORS or AFFILIATES be held harmless for any loss or liability suffered by the REIT, unless all of the following conditions are met:

a. The TRUSTEES, ADVISORS or AFFILIATES have determined, in good faith, that the course of conduct which caused the loss or liability was in the best interests of the REIT.

b. The TRUSTEES, ADVISORS or AFFILIATES were acting on behalf of or performing services for the REIT.

c. Such liability or loss was not the result of:

i. negligence or misconduct by the TRUSTEES, excluding the INDEPENDENT TRUSTEES, ADVISORS or AFFILIATES; or

ii. gross negligence or willful misconduct by the INDEPENDENT TRUSTEES.

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d. Such indemnification or agreement to hold harmless is recoverable only out of REIT net assets and not from SHAREHOLDERS.

2. Notwithstanding anything to the contrary contained in Section II.G.1, the TRUSTEES, ADVISORS or AFFILIATES and any persons acting as a broker-dealer shall not be indemnified by the REIT for any losses, liabilities or expenses arising from or out of an alleged violation of federal or state securities laws by such party unless one or more of the following conditions are met:

a. There has been a successful adjudication on the merits of each count involving alleged securities law violations as to the particular indemnitee.

b. Such claims have been dismissed with prejudice on the merits by a court of competent jurisdiction as to the particular indemnitee.

c. A court of competent jurisdiction approves a settlement of the claims against a particular indemnitee and finds that indemnification of the settlement and the related costs should be made, and the court considering the request for indemnification has been advised of the position of the Securities and Exchange Commission and of the published position of any state securities regulatory authority in which securities of the REIT were offered or sold as to indemnification for violations of securities laws.

3. The advancement of REIT funds to the TRUSTEES, ADVISORS or AFFILIATES for legal expenses and other costs incurred as a result of any legal action for which indemnification is being sought is permissible only if all of the following conditions are satisfied:

a. The legal action relates to acts or omissions with respect to the performance of duties or services on behalf of the REIT.

b. The legal action is initiated by a third party who is not a SHAREHOLDER or the legal action is initiated by a SHAREHOLDER acting in his or her capacity as such and a court of competent jurisdiction specifically approves such advancement.

c. The TRUSTEES, ADVISORS or AFFILIATES undertake to repay the advanced funds to the REIT, together with the applicable legal rate of interest thereon, in cases in which such TRUSTEES, ADVISORS or AFFILIATES are

found not to be entitled to indemnification.

H. Arbitration Provisions

The DECLARATION OF TRUST may contain provisions relating to the use of arbitration as a means of dispute resolution; provided, however, it may not require arbitration for allegations involving breach of contract, negligence, violations of state or federal securities laws, breach of fiduciary duty or other misconduct by the TRUSTEES or ADVISOR, nor shall it provide for mandatory venue. A DECLARATION OF TRUST which contains arbitration provisions shall prominently disclose such fact on the cover page of the DECLARATION OF TRUST. Allocation of the cost of arbitration may be made a matter for determination in the proceedings. This Section is not intended to prohibit arbitration agreements entered into as a condition for opening or maintaining an account with a broker-dealer, who may also be a SPONSOR. In addition, this Section should not be interpreted to prohibit separate arbitration agreements between SPONSORS and SHAREHOLDERS if the agreements are not a condition of making an investment in the REIT.

III. SUITABILITY OF SHAREHOLDERS

A. General Policy

1. The SPONSOR shall establish minimum income and net worth standards for PERSONS who purchase SHARES in a REIT for which there is not likely to be a substantial and active secondary market.

2. The SPONSOR shall propose a minimum income and net worth standards which are reasonable given the type of REIT and the risks associated with the purchase of SHARES. REITS with greater investor risk shall have minimum standards with a substantial NET WORTH requirement. The ADMINISTRATOR shall evaluate the standards proposed by the SPONSOR when the REIT'S application for registration is reviewed. In evaluating the proposed standards, the ADMINISTRATOR may consider the following:

a. the REIT'S use of leverage;

b. tax implications;

c. balloon payment financing;

- d. potential variances in cash distributions;
- e. potential SHAREHOLDERS;
- f. relationship among potential SHAREHOLDERS, the SPONSOR and ADVISOR;
- g. liquidity of REIT SHARES;
- h. prior performance of SPONSOR and ADVISOR;
- i. financial condition of the SPONSOR;
- j. potential transactions between the REIT and the SPONSOR and ADVISOR; and
- k. any other relevant factors.

B. Income and Net Worth Standards

1. Unless the ADMINISTRATOR determines that the risks associated with the REIT would require lower or higher standards, SHAREHOLDERS shall have:
 - a. a minimum annual gross income of \$70,000 and a minimum NET WORTH of \$70,000; or
 - b. a minimum NET WORTH of \$250,000.
2. NET WORTH shall be determined exclusive of home, home furnishings, and automobiles.

3. In the case of sales to fiduciary accounts, these minimum standards shall be met by the beneficiary, the fiduciary, account, or, by the donor or grantor, who directly or indirectly supplies the funds to purchase the SHARES if the donor or grantor is the fiduciary.

4. The SPONSOR shall set forth in the final PROSPECTUS:

- a. the investment objectives of the REIT;
- b. a description of the type of PERSON who might benefit from an investment in the REIT; and
- c. the minimum standards imposed on each SHAREHOLDER in the REIT.

C. Determination that Sale to SHAREHOLDER is Suitable and Appropriate

1. The SPONSOR and each PERSON selling SHARES on behalf of the SPONSOR or REIT shall make every reasonable effort to determine that the purchase of SHARES is a suitable and appropriate investment for each SHAREHOLDER.

2. In making this determination, the SPONSOR or each PERSON selling SHARES on behalf of the SPONSOR or REIT shall ascertain that the prospective SHAREHOLDER:

- a. meets the minimum income and net worth standards established for the REIT;
- b. can reasonably benefit from the REIT based on the prospective SHAREHOLDER'S overall investment objectives and portfolio structure.
- c. is able to bear the economic risk of the investment based on the prospective SHAREHOLDER'S overall financial situation; and

d. has apparent understanding of:

i. the fundamental risks of the investment;

ii. the risk that the SHAREHOLDER may lose the entire investment;

iii. the lack of liquidity of REIT SHARES;

iv. the restrictions on transferability of REIT SHARES;

v. tax consequences of the investment.

3. The SPONSOR or each PERSON selling SHARES on behalf of the SPONSOR or REIT will make this determination on the basis of information it has obtained from a prospective SHAREHOLDER. Relevant information for this purpose will include at least the age, investment objectives, investment experience, income, NET WORTH, financial situation, and other investments of the prospective SHAREHOLDERS, as well as any other pertinent factors.

4. The SPONSOR or each PERSON selling SHARES on behalf of the SPONSOR or REIT shall maintain records of the information used to determine that an investment in SHARES is suitable and appropriate for a SHAREHOLDER. "The SPONSOR or each PERSON selling SHARES on behalf of the SPONSOR or REIT shall maintain these records for at least six years.

5. The SPONSOR shall disclose in the final PROSPECTUS the responsibility of the SPONSOR and each PERSON selling SHARES on behalf of the SPONSOR or REIT to make every reasonable effort to determine that the purchase of SHARES is a suitable and appropriate investment for each SHAREHOLDER, based on information provided by the SHAREHOLDER regarding the SHAREHOLDER'S financial situation and investment objectives.

D. Subscription Agreements

1. The ADMINISTRATOR may require that each SHAREHOLDER complete and sign a written subscription agreement.

2. The SPONSOR may require that each SHAREHOLDER make certain factual representations in the subscription agreement, including the following:

- a. The SHAREHOLDER meets the minimum income and net worth standards established for the REIT.
- b. The SHAREHOLDER is purchasing the SHARES for his or her own account.
- c. The SHAREHOLDER has received a copy of the PROSPECTUS.
- d. The SHAREHOLDER acknowledges that the SHARES are not liquid.

3. The SHAREHOLDER must separately sign or initial each representation made in the subscription agreement. Except in the case of fiduciary accounts, the SHAREHOLDER may not grant any PERSON a power of attorney to make such representations on his or her behalf.

4. The SPONSOR and each PERSON selling SHARES on behalf of the SPONSOR or REIT shall not require SHAREHOLDERS to make representations in the subscription agreement which are subjective or unreasonable and which:

- a. might cause the SHAREHOLDER to believe that he or she has surrendered rights to which he or she is entitled under federal or state law; or
- b. would have the effect of shifting the duties regarding suitability, imposed by law on broker-dealers, to the SHAREHOLDERS.

5. Prohibited representations include, but are not limited to the following:

- a. The SHAREHOLDER understands or comprehends the risks associated with an investment in the REIT.

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b. The investment is a suitable one for the SHAREHOLDER.

c. The SHAREHOLDER has read the PROSPECTUS.

d. In deciding to invest in the REIT, the SHAREHOLDER has relied solely on the PROSPECTUS, and not on any other information or representations from other PERSONS or sources.

6. The SPONSOR may place the content of the prohibited representations in the subscription agreement in the form of disclosures to SHAREHOLDERS. The SPONSOR may not place these disclosures in the SHAREHOLDER representation section of the subscription agreement.

E. Completion of Sale

1. The SPONSOR or any PERSON selling SHARES on behalf of the SPONSOR or REIT may not complete a sale of .SHARES to a SHAREHOLDER until at least five business days after the date the SHAREHOLDER receives a final PROSPECTUS.

2. The SPONSOR or the PERSON designated by the SPONSOR shall send each SHAREHOLDER a confirmation of his or her purchase.

F. Minimum Investment

The ADMINISTRATOR may require minimum initial and subsequent cash investment amounts.

IV. FEES, COMPENSATION AND EXPENSES

A. Introduction

1. The PROSPECTUS must fully disclose and itemize all consideration which may be received in connection with REIT activities directly or indirectly by the SPONSOR, TRUSTEES, ADVISOR and underwriters, what the consideration is for and how and when it will be paid. This shall be set forth in one location in tabular form.

2. The INDEPENDENT TRUSTEES will determine, from time to time but at least annually, that the total fees and expenses of the REIT are reasonable in light of the investment performance of the REIT, its NET ASSETS, its NET INCOME, and the fees and expenses of other comparable unaffiliated REITS. Each such determination shall be reflected in the minutes of the meeting of the Trustees.

B. ORGANIZATION AND OFFERING EXPENSES

The ORGANIZATION AND OFFERING EXPENSES paid in connection with the REIT'S formation or the syndication of its shares shall be reasonable and shall in no event exceed an amount equal to 15% of the proceeds raised in an offering.

C. ACQUISITION FEES and ACQUISITION EXPENSES

1. The total of all ACQUISITION FEES and ACQUISITION EXPENSES shall be reasonable, and shall not exceed an amount equal to 6% of the contract price of the property, or in the case of a mortgage loan, 6% of the funds advanced.

2. Notwithstanding the above, a majority of the TRUSTEES (including a majority of the INDEPENDENT TRUSTEES) not otherwise interested in the transaction may approve fees in excess of these limits if they determine the transaction to be commercially competitive, fair and reasonable to the REIT.

D. TOTAL OPERATING EXPENSES

1. The TOTAL OPERATING EXPENSES of the REIT shall (in the absence of a satisfactory showing to the contrary) be deemed to be excessive if they exceed in any fiscal year the greater of 2% of its AVERAGE INVESTED ASSETS or 25% of its NET INCOME for such year. The INDEPENDENT TRUSTEE shall have the fiduciary responsibility of limiting such expenses to amounts that do not exceed such limitations unless such INDEPENDENT TRUSTEES shall have made a finding that, based on such unusual and non-recurring factors which they deem sufficient, a higher level of expenses is justified for such year. Any such findings and the reasons in support thereof shall be reflected in the minutes of the meeting of the TRUSTEES.

2. Within 60 days after the end of any fiscal quarter of the REIT for which TOTAL OPERATING EXPENSES (for the twelve (12) months then ended) exceeded 2% of AVERAGE INVESTED ASSETS or 25% of NET INCOME, whichever is greater, there shall be sent to the SHAREHOLDERS of the REIT a written disclosure of such fact, together with an explanation of the factors the INDEPENDENT TRUSTEES considered in arriving at the conclusion

that such higher operating expenses were justified.

3. In the event the INDEPENDENT TRUSTEES do not determine such excess expenses are justified, the ADVISOR shall reimburse the REIT at the end of the twelve month period the amount by which the aggregate annual expenses paid or incurred by the REIT exceed the limitations herein provided.

E. Real Estate Commissions on Resale of Property

If an ADVISOR, TRUSTEE, SPONSOR or any AFFILIATE provides a substantial amount of the services in the effort to sell the property of the REIT, then that PERSON may receive up to one-half of the brokerage commission paid but in no event to exceed an amount equal to 3% of the contracted for sales price. In addition, the amount paid when added to the sums paid to unaffiliated parties in such a capacity shall not exceed the lesser of the COMPETITIVE REAL ESTATE COMMISSION or an amount equal to 6% of the contracted for sales price.

F. Incentive Fees

1. An interest in the gain from the sale of assets of the REIT, for which full consideration is not paid in cash or property of equivalent value, shall be allowed provided the amount or percentage of such interest is reasonable. Such an interest gain from the sale of REIT assets shall be considered presumptively reasonable if it does not exceed 15% of the balance of such net proceeds remaining after payment to SHAREHOLDERS, in the aggregate, of an amount equal to 100% of the original issue price of REIT SHARES, plus an amount equal to 6% of the original issue price of the REIT shares per annum cumulative. For purposes of this Section, the original issue price of the REIT SHARES may be reduced by prior cash distributions to SHAREHOLDERS of net proceeds from the sale of REIT assets.

2. In the case of multiple ADVISORS, ADVISORS and any AFFILIATE shall be allowed incentive fees provided such fees are distributed by a proportional method reasonably designed to reflect the value added to REIT assets by each respective ADVISOR or any AFFILIATE.

COMMENT:

Distribution of incentive fees to ADVISORS/AFFILIATES, in proportion to the length time served as ADVISOR while such property was held by the REIT or in ratio to the fair market value of the asset at the time of the ADVISOR'S termination, and the fair market value of the asset upon its disposition by the REIT shall be considered reasonable methods by which to apportion incentive fees.

G. Advisor Compensation

The INDEPENDENT TRUSTEES shall determine from time to time and at least annually that the compensation which the REIT contracts to pay to the ADVISOR is reasonable in relation to the nature and quality of services performed and that such compensation is within the limits prescribed by this Statement of Policy. The INDEPENDENT TRUSTEES shall also supervise the performance of the ADVISOR and the compensation paid to it by

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the REIT to determine that the provisions of such contract are being carried out. Each such determination shall be based on the factors set forth below and all other factors such INDEPENDENT TRUSTEES may deem relevant and the findings of such TRUSTEES on each of such factors shall be recorded in the minutes of the TRUSTEES:

1. The size of the advisory fee in relation to the size, composition and profitability of the portfolio of the REIT.
2. The success of the ADVISOR in generating opportunities that meet the investment objectives of the REIT.
3. The rates charged to other REIT's and to investors other than REIT'S by advisors performing similar services.
4. Additional revenues realized by the ADVISOR and any AFFILIATE through their relationship with the REIT, including loan, administration, underwriting or broker commissions, servicing, engineering, inspection and other fees, whether paid by the REIT or by others with whom the REIT does business.
5. The quality and extent of service and advice furnished by the ADVISOR.
6. The performance of the investment portfolio of the REIT, including income, conservation or appreciation of capital, frequency of problem investments and competence in dealing with distress situations.
7. The quality of the portfolio of the REIT in relationship to the investments generated by the ADVISOR for its own account.

V. CONFLICTS OF INTEREST AND INVESTMENT RESTRICTIONS

A. Sales and Leases to REIT

The REIT shall not purchase property from the SPONSOR, ADVISOR, TRUSTEE, or any AFFILIATE thereof, unless a majority of TRUSTEES (including a majority of INDEPENDENT TRUSTEES) not otherwise interested in such transaction approve the transaction as being fair and reasonable to the REIT and at a price to the REIT no greater than the cost of the asset to such SPONSOR, ADVISOR, TRUSTEE or any AFFILIATE thereof, or if the price to the REIT is in excess of such cost, that substantial justification for such excess exists and such excess is reasonable. In no event shall the cost of such asset to the REIT exceed its current appraised value.

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B. Sales and Leases to SPONSOR, ADVISOR, TRUSTEES or any AFFILIATE

1. A SPONSOR, ADVISOR, TRUSTEE or any AFFILIATE thereof shall not acquire assets from the REIT unless approved by a majority of TRUSTEES (including a majority of INDEPENDENT TRUSTEES), not otherwise interested in such transaction, as being fair and reasonable to the REIT.

2. A REIT may lease assets to a SPONSOR, ADVISOR, TRUSTEE or any AFFILIATE thereof only if approved by a majority of TRUSTEES (including a majority of INDEPENDENT TRUSTEES), not otherwise interested in such transaction, as being fair and reasonable to the REIT.

C. Loans

1. No loans may be made by the REIT to the SPONSOR, ADVISOR, TRUSTEE or any AFFILIATE thereof except as provided under Section V.K.3 or to wholly owned subsidiaries of the REIT.

2. The REIT may not borrow money from the SPONSOR, ADVISOR, TRUSTEE, or any AFFILIATE thereof, unless a majority of TRUSTEES (including a majority of INDEPENDENT TRUSTEES) not otherwise interested in such transaction approve the transaction as being fair, competitive, and commercially reasonable and no less favorable to the REIT than loans between unaffiliated parties under the same circumstances.

D. Investments

1. The REIT shall not invest in joint ventures with the SPONSOR, ADVISOR, TRUSTEE, or any AFFILIATE thereof, unless a majority of TRUSTEES (including a majority of INDEPENDENT TRUSTEES) not otherwise interested in such transactions, approve the transaction as being fair and reasonable to the REIT and on substantially the same terms and conditions as those received by the other joint venturers.

2. The REIT shall not invest in equity, securities unless a majority of. TRUSTEES (including a majority of INDEPENDENT TRUSTEES) not otherwise interested in such transaction approve the transaction as being fair, competitive, and commercially reasonable.

E. Statement of Objectives

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1. The PROSPECTUS must state specific investment objectives of the REIT. It should indicate whether the primary objective is to obtain current income, tax benefits, or capital appreciation for its SHAREHOLDERS.

2. The INDEPENDENT TRUSTEES shall review the investment policies of the REIT with sufficient frequency and at least annually to determine that the policies being followed by the REIT at any time are in the best interests of its SHAREHOLDERS. Each such determination and the basis therefor shall be set forth in the minutes of the TRUSTEES.

F. Multiple PROGRAMS

The method for the allocation of the acquisition of properties by two or more PROGRAMS of the same SPONSOR or ADVISOR seeking to acquire similar types of assets shall be reasonable. The method shall be described in the PROSPECTUS. It shall be the duty of the TRUSTEES (including the INDEPENDENT TRUSTEES) to insure such method is applied fairly to the REIT.

G. Other Transactions

All other transactions between the REIT and the SPONSOR, ADVISOR, TRUSTEE or any AFFILIATE thereof, shall require approval by a majority of the TRUSTEES (including a majority of INDEPENDENT TRUSTEES) not otherwise interested in such transactions as being fair and reasonable to the REIT and on terms and conditions not less favorable to the REIT than those available from unaffiliated third parties.

H. Appraisal of Real Property

The consideration paid for real property acquired by the REIT shall ordinarily be based on the fair market value of the property as determined by a majority of the TRUSTEES. In cases in which a majority of the INDEPENDENT TRUSTEES so determine, and in all cases in which assets are acquired from the ADVISORS, TRUSTEES, SPONSORS or AFFILIATES thereof, such fair market value shall be as determined by an INDEPENDENT EXPERT selected by the INDEPENDENT TRUSTEES.

I. Roll-Up Transaction

1. In connection with a proposed ROLL-UP, an appraisal of all REIT assets shall be obtained from a competent, INDEPENDENT EXPERT. If the appraisal will be included in a PROSPECTUS used to offer the securities of a ROLL-UP ENTITY, the appraisal shall be filed with the SEC and the states as an Exhibit to the Registration Statement for the offering. Accordingly, an issuer using the appraisal shall be subject to liability for violation of Section 11 of the Securities Act of 1933 and comparable provisions under state laws for any material misrepresentations or material omissions in the appraisal. REIT assets shall be appraised on a consistent basis. The appraisal shall be based on an evaluation of all relevant information, and shall indicate the value of the REIT'S assets as of a date immediately prior to

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the announcement of the proposed ROLL-UP transaction. The appraisal shall assume an orderly liquidation of REIT assets over a 12 month period. The terms of the engagement of the INDEPENDENT EXPERT shall clearly state that the engagement is for the benefit of the REIT and its investors. A summary of the independent appraisal, indicating all material assumptions underlying the appraisal, shall be included in a report to the investors in connection with a proposed ROLL-UP.

2. In connection with a proposed ROLL-UP, the PERSON sponsoring the ROLL-UP shall offer to SHAREHOLDERS who vote "no" on the proposal the choice of:

- a. accepting the securities of the ROLL-UP ENTITY offered in the proposed ROLL-UP; or
- b. one of the following:
 - i. remaining as SHAREHOLDERS of the REIT and preserving their interests therein on the same terms and conditions as existed previously; or
 - ii. receiving cash in an amount equal to the SHAREHOLDERS' pro-rata share of the appraised value of the net assets of the REIT.

COMMENT:

With respect to the options specified in Subsection V.I.2.(b), the PERSON sponsoring the ROLL-UP needs only offer one of these alternatives to dissenting investors who do not wish to accept the security of the ROLL-UP ENTITY.

3. The REIT shall not participate in any proposed ROLL-UP which would result in SHAREHOLDERS having democracy rights in the ROLL-UP ENTITY that are less than those provided for under Sections VI.A., VI.B., VI.C., VI.D., VI.E of these Guidelines.

4. The REIT shall not participate in any proposed ROLL-UP which includes provisions which would operate to materially impede or frustrate the accumulation of shares by any purchaser of the securities of the ROLL-UP ENTITY (except to the minimum extent necessary to preserve the tax status of the ROLL-UP ENTITY). The REIT shall not participate in any proposed ROLL-UP which would limit the ability of an investor to exercise the voting rights of its securities of the ROLL-UP ENTITY on the basis of the number of REIT SHARES held by that investor.

5. The REIT shall not participate in any proposed ROLL-UP in which investors' rights of access to the records of the ROLL-UP ENTITY will be less than those provided for under Section VI.E of these Guidelines.

6. The REIT shall not participate in any proposed ROLL-UP in which any of the costs of the transaction would be borne by the REIT if the ROLL-UP is not approved by the SHAREHOLDERS.

J. Leverage

The PROSPECTUS shall include an explanation of the borrowing policies of the REIT. The aggregate borrowings of the REIT, secured and unsecured, shall be reasonable in relation to the NET ASSETS of the REIT and shall be reviewed by the TRUSTEES at least quarterly. The maximum amount of such borrowings in relation to the NET ASSETS shall, in the absence of a satisfactory showing that higher level of borrowing is appropriate, not exceed 300%. Any excess in borrowing over such 300% level shall be approved by a majority of the INDEPENDENT TRUSTEES and disclosed to SHAREHOLDERS in the next quarterly report of the REIT, along with justification for such excess.

K. Other Limitations. The REIT may not:

1. Invest more than 10% of its total assets in UNIMPROVED REAL PROPERTY or mortgage loans on UNIMPROVED REAL PROPERTY.

2. Invest in commodities or commodity future contracts. Such limitation is not intended to apply to future contracts, when used solely for hedging purposes in connection with the REIT's ordinary business of investing in real estate assets and mortgages.

3. Invest in or make mortgage loans unless an appraisal is obtained concerning the underlying property except for those loans insured or guaranteed by a government or government agency. In cases in which a majority of the INDEPENDENT TRUSTEES so determine, and in all cases in which the transaction is with the ADVISOR, TRUSTEES, SPONSOR or AFFILIATES thereof, such an appraisal must be obtained from an INDEPENDENT EXPERT concerning the underlying property. This appraisal shall be maintained in the REIT's records for at least five years, and shall be available for inspection and duplication by any SHAREHOLDER. In addition to the appraisal, a mortgagee's or owner's title insurance policy or commitment as to the priority of the mortgage or the condition of the title must be obtained. Further, the ADVISOR and TRUSTEES shall observe the following policies in connection with investing in or making mortgage loans:

a. The REIT shall not invest in real estate contracts of sale, otherwise known as land sale contracts, unless such contracts of sale are in recordable form and appropriately recorded in the chain of title.

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b. The REIT shall not make or invest in mortgage loans, including construction loans, on any one property if the aggregate amount of all mortgage loans outstanding on the property, including the loans of the REIT, would exceed an amount equal to 85% of the appraised value of the property as determined by appraisal unless substantial justification exists because of the presence of other underwriting criteria. For purposes of this subsection, the "aggregate amount of all mortgage loans outstanding on the property, including the loans of the REIT," shall include all interest (excluding contingent participation in income and/or appreciation in value of the mortgaged property), the current payment of which may be deferred pursuant to the terms of such loans, to the extent that deferred interest on each loan exceeds 5% per annum of the principal balance of the loan;

COMMENT:

Section V.K.3(b) provides certain minimum standards in connection with the investment in or making of mortgage loans by a REIT. The standards may be exceeded for a particular registration if the mortgage loans are supported by sound underwriting criteria, such as the net worth of the borrower; the credit rating of the borrower based historical financial performance, or collateral adequate to justify waiver from application of this section. The standards may also be exceeded where program mortgage loans are or will be insured or guaranteed by a government or a government Agency; where the loan is secured by the pledge or assignment of other real estate or another real estate mortgage; where rents are assigned under a lease where a tenant or tenants have demonstrated through historical net worth and cash flow the ability to satisfy the terms of the lease; or where similar criteria is presented satisfactory to the ADMINISTRATOR.

c. The REIT shall not make or invest in any mortgage loans that are subordinate to any mortgage or equity interest of the ADVISOR, TRUSTEES, SPONSORS or any AFFILIATE of the REIT.

4. Issue redeemable equity securities.

5. Issue debt securities unless the historical debt service coverage (in the most recently completed fiscal year) as adjusted for known changes is sufficient to properly service that higher level of debt.

6. Issue options or warrants to purchase its SHARES to the ADVISOR, TRUSTEES, SPONSORS or any AFFILIATE thereof except on the same terms as such options or warrants are sold to the general public. The REIT may issue options or warrants to persons not so connected with the REIT but not at exercise prices less than the fair market value of such securities on the date of grant and for consideration (which may include services) that in the judgement of the INDEPENDENT TRUSTEES, has a market value less than the value of such option on the date of grant. Options or warrants issuable to the ADVISOR, TRUSTEES, SPONSORS or any AFFILIATE thereof shall not exceed an amount equal to 10% of the outstanding SHARES of the REIT on the date of grant of any options or warrants.

7. Issue its shares on a deferred payment basis or other similar arrangement.

VI. RIGHTS AND OBLIGATIONS OF SHAREHOLDERS

A. Meetings

1. There shall be an annual meeting of the SHAREHOLDERS of the REIT upon reasonable notice and within a reasonable period (not less than 30 days) following delivery of the annual report. The TRUSTEES, including the INDEPENDENT TRUSTEES, shall be required to take reasonable steps to insure that this requirement is met.

2. Special meetings of the SHAREHOLDERS may be called by the chief executive officer, by a majority of the TRUSTEES or by a majority of the INDEPENDENT TRUSTEES, and shall be called by an officer of the REIT upon written request of SHAREHOLDERS holding in the aggregate not less than 10% of the outstanding SHARES of the REIT entitled to vote at such meeting. Upon receipt of a written request, either in person or by mail, stating the purpose(s) of the meeting, the SPONSOR shall provide all SHAREHOLDERS within ten days after receipt of said request, written notice, either in person or by mail, of a meeting and the purpose of such meeting to be held on a date not less than fifteen nor more than sixty days after the distribution of such notice, at a time and place specified in the request, or if none is specified, at a time and place convenient to SHAREHOLDERS.

B. Voting Rights of SHAREHOLDER

1. A public offering of equity securities of a REIT other than voting shares will be looked upon with disfavor.

2. The voting rights per share of equity securities of the REIT (other than the publicly held equity securities of the REIT) sold in a private offering shall not exceed voting rights which bear the same relationship to the voting rights of the publicly held shares of the REIT as the consideration paid to the REIT for each privately offered REIT share bears to the book value of each outstanding publicly held share.

3. The DECLARATION OF TRUST must provide that a majority of the then outstanding SHARES may, without the necessity for concurrence by the TRUSTEES, vote to:

a. amend the DECLARATION OF TRUST;

b. terminate the REIT;

c. remove the TRUSTEES.

4. The DECLARATION OF TRUST must provide that a majority of SHAREHOLDERS present in person or by proxy at an Annual Meeting at which a quorum is present, may, without the necessity for concurrence by the TRUSTEES, vote to elect the TRUSTEES. A quorum shall be 50% of the then outstanding shares.

5. Without concurrence of a majority of the outstanding SHARES, the TRUSTEES may not:

a. amend the DECLARATION OF TRUST, except for amendments which do not adversely affect the rights, preferences and privileges of SHAREHOLDERS including amendments to provisions relating to, TRUSTEE qualifications, fiduciary duty, liability and indemnification, conflicts of interest, investment policies or investment restrictions;

b. sell all or substantially all of the REIT's assets other than in the ordinary course of the REIT'S business or in connection with liquidation and dissolution;

c. cause the merger or other reorganization of the REIT; or

d. dissolve or liquidate the REIT, other than before the initial investment in property.

COMMENT:

A sale of all or substantially all of The REIT's assets shall mean the sale of two-thirds Or more of the REIT's assets based on the total number of properties and mortgages, or the current fair market value of these assets.

6. With respect to SHARES owned by the ADVISOR, the TRUSTEES, or any AFFILIATE, neither the ADVISOR, nor the TRUSTEES, nor any AFFILIATE may vote or consent on matters submitted to the SHAREHOLDERS regarding the removal of the ADVISOR, TRUSTEES or any AFFILIATE or any transaction between the REIT and any of them. In determining the requisite percentage in interest of SHARES necessary to approve a matter on which the ADVISOR, TRUSTEES and any AFFILIATE may not vote or consent, any SHARES owned by any of them shall not be included.

C. Liability of SHAREHOLDERS

The DECLARATION OF TRUST shall provide that:

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1. The SHARES of the REIT shall be non-assessable by the REIT whether a trust, corporation or other entity.
2. The SHAREHOLDERS of the REIT which is not a corporation shall not be personally liable on account of any of the contractual obligations undertaken by the REIT.
3. All written contracts to which the REIT which is not a corporation is a party shall include a provision that the SHAREHOLDER shall not be personally liable thereon.

D. Reports

1. The DECLARATION OF TRUST shall provide that the REIT shall cause to be prepared and mailed or delivered to each SHAREHOLDER as of a record date after the end of the fiscal year and each holder of other publicly held securities of the REIT within 120 days after the end of the fiscal year to which it relates an annual report for each fiscal year ending after the initial public offering of its securities which shall include:
 - a. financial statements prepared in accordance with generally accepted accounting principles which are audited and reported on by independent certified public accountants;
 - b. the ratio of the costs of raising capital during the period to the capital raised;
 - c. the aggregate amount of advisory fees and the aggregate amount of other fees paid to the ADVISOR and any AFFILIATE of the ADVISOR by REIT and including fees or charges paid to the ADVISOR and any AFFILIATE of the ADVISOR by third parties doing business with the REIT;
 - d. the TOTAL OPERATING EXPENSES of the REIT, stated as a percentage of AVERAGE INVESTED ASSETS and as a percentage of its NET INCOME;
 - e. a report from the INDEPENDENT TRUSTEES that the policies being followed by the REIT are in the best interests of its SHAREHOLDERS and the basis for such determination; and

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f. separately stated, full disclosure of all material terms, factors, and circumstances surrounding any and all transactions involving the REIT, TRUSTEES, ADVISORS, SPONSORS and any AFFILIATE thereof occurring in the year for which the annual report is made. INDEPENDENT TRUSTEES shall be specifically charged with a duty to examine and comment in the report on the fairness of such transactions;

COMMENT:

A partial enumeration of such transactions would include the lease or purchase of property by the REIT to or from any TRUSTEE, ADVISOR, SPONSOR or AFFILIATE; and loan Transactions involving, directly or indirectly, the REIT and any TRUSTEE, ADVISOR, SPONSOR or AFFILIATE; and any joint venture involving the REIT and a TRUSTEE, ADVISOR, SPONSOR or AFFILIATE thereof.

2. The TRUSTEES, including the INDEPENDENT TRUSTEES, shall be required to take reasonable steps to insure that the above requirements are met.

COMMENT:

The above section is not intended to Be exhaustive of the type and extent of information. to be presented to SHAREHOLDERS in an annual

E. Access to Records

Any SHAREHOLDER and any designated representative thereof shall be permitted access to all records of the REIT at all reasonable times, and may inspect and copy any of them. Inspection of the REIT books and records-by the ADMINISTRATOR shall be provided upon reasonable notice and during normal business hours. The DECLARATION OF TRUST shall include the following provisions regarding access to the list of SHAREHOLDERS:

1. An alphabetical list of the names, addresses, and telephone numbers of the SHAREHOLDERS of the REIT along with the number of SHARES held by each of them (the "SHAREHOLDER List") shall be maintained as part of the books and records of the REIT and shall be available for inspection by any SHAREHOLDER or the SHAREHOLDER'S designated agent at the home office of the REIT upon the request of the SHAREHOLDER;

2. The SHAREHOLDER List shall be updated at least quarterly to reflect changes in the information contained therein.

3. A copy of the SHAREHOLDER List shall be mailed to any SHAREHOLDER requesting the SHAREHOLDER List within ten days of the request. The copy of the SHAREHOLDER List shall be printed in alphabetical order, on white paper, and in a readily readable type size (in no event smaller than 10-point type). A reasonable charge for copy work may be charged by the REIT.

4. The purposes for which a SHAREHOLDER may request a copy of the SHAREHOLDER List include, without limitation, matters relating to SHAREHOLDERS' voting rights under the REIT agreement, and the exercise of

SHAREHOLDERS' rights under federal proxy laws; and

5. If the ADVISOR or TRUSTSES of the REIT neglects or refuses to exhibit; produce, or mail a copy of the SHAREHOLDER List as requested, the ADVISOR, and the TRUSTEES shall be liable to any SHAREHQLDER requesting the list for the costs, including attorneys' fees, incurred by that SHAREHOLDER for compelling the production of the SHAREHOLDER List, and for actual damages suffered by any SHAREHOLDER by reason of such refusal or neglect. It shall be a defense that the actual purpose and reason for the requests for inspection or for a copy of the SHAREHOLDER List is to secure such list of SHAREHOLDERS or other information for the purpose of selling such list or copies thereof, or of using the same for a commercial purpose other than in the interest of the applicant as a SHAREHOLDER relative to the affairs of the REIT. The REIT may require the SHAREHOLDER requesting the SHAREHOLDER List to represent that the list is not requested for a commercial purpose unrelated to the SHAREHOLDER'S interest in the REIT. The remedies provided hereunder to SHAREHOLDERS requesting copies of the SHAREHOLDER List are in addition to, and shall not in any way limit, other remedies available to SHAREHOLDERS under federal law, or the laws of any state.

F. Repurchase of SHARES

Ordinarily, the REIT is not obligated to repurchase any of the SHARES. However, the REIT is not precluded from voluntarily repurchasing the SHARES if such repurchase does not impair the capital or operations of the REIT. The REIT may have excess share provisions that provide for mandatory redemption. The SPONSOR, ADVISOR, TRUSTEES or AFFILIATES are prohibited from receiving a fee on the repurchase of the SHARES by the REIT.

G. Distribution Reinvestment Plans

All Distribution Reinvestment Plans shall, at the minimum provide for the following:

1. All material information regarding the distribution to the SHAREHOLDER and the effect of reinvesting such distribution, including the tax consequences thereof, shall be provided to the SHAREHOLDER at least annually.

2. Each SHAREHOLDER participating in the plan shall have a reasonable opportunity to withdraw from the plan at least annually after receipt of the information required in subparagraph (1) above.

H. Distributions

The DECLARATION OF TRUST shall state the manner in which distributions to SHAREHOLDERS are to be determined.

I. Distributions in Kind

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Distributions in kind shall not be permitted, except for;

1. distributions of readily marketable securities;
2. distributions of beneficial interests in a liquidating trust established for the dissolution of the REIT and the liquidation of its assets in accordance with the terms of the DECLARATION OF TRUST; or
3. distributions of in-kind property which meet all of the following conditions:
 - a. The TRUSTEES advise each SHAREHOLDER of the risks associated with direct ownership of the property.
 - b. The TRUSTEES offer each SHAREHOLDER the election of receiving in-kind property distributions.
 - c. The Trustees distribute in-kind property only to those SHAREHOLDERS who accept the TRUSTEES'S offer.

VI. DISCLOSURE AND MARKETING

A. Sales Material

Sales material, including without limitation, books, pamphlets, movies, slides, article reprints, television and radio commercials, materials prepared for broker/dealer use only, sales presentations (including prepared presentations to prospective SHAREHOLDERS at group meetings) and all other advertising used in the offer or sale of units shall conform to filing, disclosure, and adequacy requirements under any applicable state regulations. Statements made in sales material communicated directly or indirectly to the public may not conflict with, or modify risk factors or other statements made in the PROSPECTUS.

B. PROSPECTUS and its Contents

1. PROSPECTUS

A PROSPECTUS which is not part of a Registration Statement declared effective by the Securities and Exchange Commission pursuant to the Securities Act of 1933 shall generally conform to the disclosure requirements

which would apply if the offering were so registered. The format and information requirements of applicable Guide(s) promulgated by the Securities and Exchange Commission shall be followed, with appropriate adjustments made for the different business of the REIT.

2. Prohibited Representations

a. In connection with the offering and sale of SHARES in a REIT, neither the SPONSOR(S) nor the underwriter(s) may, in writing or otherwise, directly or indirectly, represent or imply that an Administrator has approved the merits of the investment or any aspects thereof.

b. Any reference to the REIT'S compliance with these Guidelines or any provisions herein which connotes or implies compliance shall not be allowed.

3. Forecasts and Projections

a. Neither the PROSPECTUS nor any sales material communicated directly or indirectly to the public shall contain a quantitative estimate of a REIT'S anticipated economic performance or anticipated return to participants, in the form of investment objectives, cash distributions, tax benefits or otherwise, except as permitted by this Section of these Guidelines.

b. The presentation of predicted future results of operations of programs shall be permitted but not required for SPECIFIED ASSETS REITS and shall be prohibited for all other REITS. The cover of the PROSPECTUS must contain in bold face language one of the following statements:

i. for SPECIFIED ASSET REITS with forecasts: "Forecasts are contained in this prospectus. Any representation to the contrary and any predictions, written or oral, which do not conform to that contained in the prospectus shall not be permitted"; or

ii. for all other REITS: "The use of forecasts in this offering is prohibited. Any representation to the contrary and any predictions, written or oral, as to the amount or certainty of any present or future cash benefit or tax consequence which may flow from an investment in this program is not permitted."

c. Content of Forecasts

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Forecasts for SPECIFIED ASSET REITS may be included in the PROSPECTUS and sales material of the REIT only if they comply with all of the following requirements:

i. Generally, forecasts shall be realistic in their predictions and shall clearly identify the assumptions made with respect to all material features of presentation. Forecasts should be examined by an independent certified public accountant in accordance with the Guide for Prospective Financial Statements and the Statement on Standards for Accountant's Services on Prospective Financial Information as promulgated by the American Institute of Certified Public Accountants. The report of the independent certified public accountant must be included in the PROSPECTUS.

ii. if any part of the forecast appears in the sales material, the entire forecast must be presented.

iii. Forecasts shall generally be for a period equivalent to the anticipated holding period for REIT assets. Forecasts which do not extend through the expected term of the REIT'S life must show the effects of a hypothetical liquidation of program assets under good and bad conditions. Yield information may not be presented for Forecasts which do not extend through the expected term of the REIT'S life.

iv. Forecasts shall disclose possible undesirable tax consequences of an early sale of program assets, such as depreciation recapture, the loss of prior year tax credits or the possible failure to generate sufficient cash from the disposition to pay the associated tax liabilities.

v. In computing any rate of return or yield to investors, no unrealized gains or value shall be included.

C. The ADMINISTRATOR may require that the DECLARATION OF TRUST be given to prospective SHAREHOLDERS.

VIII. MISCELLANEOUS

A. Provisions of the DECLARATION OF TRUST

The requirements and/or provisions of appropriate portions of the following Sections shall be included in the DECLARATION OF TRUST:

I.B.; II.A.; II.B.; II.C.; II.D.; II.E.; II.F.; II.G.; II.H.; III.B.; III.C.; III.F.; IV.A.2; IV.C.; IV.D.; IV.E.; IV.F.; IV.G.; V.A.; V.B.; V.C.; V.D.; V.E.2; V.G.; V.H.; V.I.; V.J.; V.K.; VI.A.; VI.B.; VI.C.; VI.D.; VI.B.; VI.F.; VI.G.; VI.H.; VI.I.

B. Amendments and Supplements

A marked copy of all amendments and supplements to an application shall be filed with the ADMINISTRATOR as soon as the amendment or supplement is available.

C. Cross Reference Sheet Requirement

The CROSS REFERENCE SHEET shall be included with the application for registration.

REIT GUIDELINES CROSS REFERENCE SHEET General Instructions

1. This CROSS REFERENCE SHEET should be completed and submitted with the Application for Registration.

2. Sections which are not applicable should be noted as such.

3. Provisions of the REIT which vary from the Guidelines must be explained by endnote; for example, if the REIT uses a defined term which is different from the Guidelines' definition, the variance must be explained. Endnotes should be numbered sequentially in the column designated "Endnotes" and should be presented on a rider identified as "Endnotes" with each endnote on the rider numerically corresponding to the endnote identified on the CROSS REFERENCE SHEET.

REIT GUIDELINES CROSS REFERENCE SHEET

Name of Applicant: _____

Section Number	Page Number	Endnote See	Guideline Section
Declaration of Trust	Prospectus	Instruction 3	

_____	_____	_____	I.B. Definitions
_____	_____	_____	2. Acquisition Expenses
_____	_____	_____	3. Acquisition Fee
_____	_____	_____	4. Advisor
_____	_____	_____	5. Affiliate
_____	_____	_____	6. Average Invested Assets
_____	_____	_____	

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			7.	Competitive Real Estate Com-
				mission
			8.	Contract Price for the Property
			9.	Construction Fee
			12.	Development Fee
			13.	Independent Expert
			14.	Independent Trustee
			17.	Net Assets
			18.	Net Income
			19.	Organization & Offering Ex-
				penses
			23.	Roll-up
			24.	Roll-up Entity
			25.	Shares
			26.	Shareholders
			27.	Specified Asset REITS
			28.	Sponsor
			29.	Total Operating Expenses
			30.	Trustees
			31.	Unimproved Real Property
			III.	Requirements of Sponsor, Ad-
				visor, Trustees & Affiliates
			A.	Minimum Capital
			B.	Number & Election of Trustees
			C.	Duties of Trustees

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			D. Experience of Trustees
			E. Fiduciary Duty
			F. Advisory Contract
			G. Liability and Indemnification
			H. Arbitration Provisions
			III. Suitability of Shareholders
			B. Income & Net Worth Standards
			D. Subscription Agreements
			E. Completion of Sale
			F. Minimum Investment
			IV. Fees, Compensation & Expenses
			A. Introduction
			B. Organization & Offering Expenses
			C. Acquisition Fees & Acquisition Expenses
			D. Total Operating Expenses
			E. Real Estate Commissions on Re-sale of Property
			F. Incentive Fees
			G. Advisor Compensation
			V. Conflicts of Interest & Investment Restrictions
			A. Sales & Leases to REIT
			B. Sales & Leases to Sponsor, Advisor, Trustees or Affiliates
			C. Loans

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_____	_____	_____	D.	Investment
_____	_____	_____		
_____	_____	_____	E.	Statement of Objectives
_____	_____	_____		
_____	_____	_____	F.	Multiple Programs
_____	_____	_____		
_____	_____	_____	G.	Other Transactions
_____	_____	_____		
_____	_____	_____	H.	Appraisal of Real Property
_____	_____	_____		
_____	_____	_____	I.	Roll-up Transaction
_____	_____	_____		
_____	_____	_____	J.	Leverage
_____	_____	_____		
_____	_____	_____	K.	Other Limitations
_____	_____	_____		
			VI.	Rights & Obligations of Share- holders
_____	_____	_____	A.	Meetings
_____	_____	_____		
_____	_____	_____	B.	Voting Rights of Shareholders
_____	_____	_____		
_____	_____	_____	C.	Liability of Shareholders
_____	_____	_____		
_____	_____	_____	D.	Reports
_____	_____	_____		
_____	_____	_____	1.	Annual Report
_____	_____	_____		
_____	_____	_____	E.	Access to Records
_____	_____	_____		
_____	_____	_____	F.	Repurchase of Shares
_____	_____	_____		
_____	_____	_____	G.	Distribution Reinvestment Plan
_____	_____	_____		
_____	_____	_____	H.	Distribution
_____	_____	_____		
_____	_____	_____	I.	Distributions in Kind
_____	_____	_____		
			VII.	Disclosure & Marketing
_____	_____	_____	B.	Prospectus and its Contents
_____	_____	_____		
_____	_____	_____	3.	Forecasts and Projections
_____	_____	_____		

[illegible]

I. Background

STATEMENTS OF POLICY_and_@_NASAA SOP)_and_footnotes(n5);vk n1 The 2007 Franchise Rule represents the first time the FTC has amended its Franchise Rule (the "Original Franchise Rule") since 1978, when it was

originally promulgated.STATEMENTS OF POLICY_and_@_NASAA SOP)_and_footnotes(n6);vk n2

Among other things, the 2007 Franchise Rule adopts new requirements for franchisors preparing franchise disclosure documents, also called "offering circulars." Since December 30, 1993, the FTC has allowed franchisors to prepare and distribute disclosure documents under one of two disclosure formats: (1) the FTC's Original Franchise Rule; or (2) the Uniform Franchise Offering Circular ("UFOC") Guidelines, adopted on April 23, 1993 by the North American Administrators Association, Inc. ("NASAA").STATEMENTS OF POLICY_and_@_NASAA SOP)_and_footnotes(n7);vk n3 After NASAA adopted the UFOC Guidelines, fifteen states ("Registration States") required franchisors to follow that disclosure format to comply with state franchise laws. As a practical matter, most franchisors have chosen to prepare their disclosure documents under the UFOC Guidelines, even in states where that format is not specifically required.

The FTC's 2007 Franchise Rule adopts disclosure requirements that closely track the UFOC Guidelines.STATEMENTS OF POLICY_and_@_NASAA SOP)_and_footnotes(n8);vk n4 In some instances, however, the 2007 Franchise Rule omits or streamlines UFOC Guideline disclosure requirements, such as broker disclosures, cover page risk factors, and detailed computer requirements. In addition, the 2007 Franchise Rule incorporates new disclosure requirements not found in the UFOC Guidelines, including disclosures related to a franchisor's parent, franchisor initiated litigation, confidentiality clauses and the existence of trademark-specific franchisee associations. The 2007 Franchise Rule also substantially revised the UFOC Guideline disclosure of statistical information on franchisees and outlets (Item 20), adopting the approach suggested by NASAA in its comment to the FTC's Notice of Proposed Rulemaking.STATEMENTS OF POLICY_and_@_NASAA SOP)_and_footnotes(n9);vk n5

In light of the similarities between the 2007 Franchise Rule and the UFOC Guidelines, and the FTC's lengthy and comprehensive regulatory review that preceded its adoption of the 2007 Franchise Rule, NASAA intends at this time to adopt the disclosure requirements under the 2007 Franchise Rule as a successor to the UFOC Guidelines, with minimal additional requirements, the most significant being a state risk factor cover page.

The FTC's 2007 Franchise Rule allows franchisors to choose to follow the new disclosure format on July 1, 2007, and some franchisors may seek to utilize that disclosure format in the Registration States as soon as possible. Consequently, until NASAA adopts a replacement for the UFOC Guidelines, NASAA recommends that, as of July 1, 2007, Registration States permit franchisors to file in those states franchise disclosure documents prepared under the 2007 Franchise Rule, in accordance with the Instructions set forth below. Franchisors may continue to file and use in the Registration States franchise disclosure documents prepared under the UFOC Guidelines until July 1, 2008.

II. Uniform Franchise Registration Application

In order to register a franchise in the Registration States, franchisors must continue to follow the Instructions provided under the UFOC Guidelines for filing franchise registration applications, and must continue to file the following application documents, other than the disclosure document, in the format required under the UFOC Guidelines:

A. Uniform Franchise Registration Application Page;

B. Supplemental Information page(s);

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C. Certification page;

D. Uniform Consent to Service of Process;

E. Sales Agent Disclosure Form;

F. If the applicant is a corporation or partnership or limited liability company, an authorizing resolution if the application is verified by a person other than applicant's officer or general partner;

G. Uniform Franchise Offering Circular, or

Uniform Franchise Disclosure Document (see Part III below);

H. Application Fee (varies by state);

I. Auditor's consent (or a photocopy of the consent) to the use of the latest audited financial statements in the offering circular; and J. Advertising or promotional materials, if required.

III. The Uniform Franchise Disclosure Document

A. Format.

The Uniform Franchise Disclosure Document shall be prepared in the format required under the 2007 Franchise Rule, *16 CFR 436.3-5*, as amended, (Subparts C and D), with the additions listed at Section III B and C below. A copy of the contents and instructions for preparing a Uniform Franchise Disclosure Document under the 2007 Franchise Rule, along with accompanying definitions applicable for preparing that form of disclosure document, is attached to these Instructions at Exhibit 1.

B. State Cover Page.

The Uniform Franchise Disclosure Document shall include the following State Cover Page prepared in accordance with these Instructions and shall immediately follow the Cover Page described at *16 CFR 436.3* of the 2007 Franchise Rule:

1. State the following legend:

STATE COVER PAGE

Your state may have a franchise law that requires a franchisor to register or file with a state franchise administrator before offering or selling in your state. REGISTRATION OF A FRANCHISE BY A STATE DOES NOT MEAN THAT THE STATE RECOMMENDS THE FRANCHISE OR HAS VERIFIED THE INFORMATION IN THIS DISCLOSURE DOCUMENT.

Call the state franchise administrator listed in Exhibit _____ for information about the franchisor, or about franchising in your state.

2. State the following:

MANY FRANCHISE AGREEMENTS DO NOT ALLOW YOU TO RENEW UNCONDITIONALLY AFTER THE INITIAL TERM EXPIRES. YOU MAY HAVE TO SIGN A NEW AGREEMENT WITH DIFFERENT TERMS AND CONDITIONS IN ORDER TO CONTINUE TO OPERATE YOUR BUSINESS. BEFORE YOU BUY, CONSIDER WHAT RIGHTS YOU HAVE TO RENEW YOUR FRANCHISE, IF ANY, AND WHAT TERMS YOU MIGHT HAVE TO ACCEPT IN ORDER TO RENEW.

3. If any of the following apply, state the following, using capital letters as shown:

Please consider the following RISK FACTORS before you buy this franchise:

THE FRANCHISE AGREEMENT REQUIRES YOU TO RESOLVE DISPUTES WITH US BY [LITIGATION/ARBITRATION/MEDIATION] ONLY IN [STATE]. OUT-OF-STATE [LITIGATION/ARBITRATION/MEDIATION] MAY FORCE YOU TO ACCEPT A LESS FAVORABLE SETTLEMENT FOR DISPUTES. IT MAY ALSO COST YOU MORE TO [SUE/ARBITRATE/MEDIATE] WITH US IN [STATE] THAN IN YOUR OWN STATE.

THE FRANCHISE AGREEMENT STATES THAT [STATE] LAW GOVERNS THE AGREEMENT, AND THIS LAW MAY NOT PROVIDE THE SAME PROTECTIONS AND BENEFITS AS LOCAL LAW. YOU MAY WANT TO COMPARE THESE LAWS.

4. In addition to the above, disclose other risk factors required by a state administrator.

5. If one or more risk factor applies, also state:

THERE MAY BE OTHER RISKS CONCERNING THIS FRANCHISE.

6. If applicable, state the following:

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We use the services of one or more FRANCHISE BROKERS or referral sources to assist us in selling our franchise. A franchise broker or referral source represents us, not you. We pay this person a fee for selling our franchise or referring you to us. You should be sure to do your own investigation of the franchise.

7.

(a) State the following: Effective Date: _____

(b) Leave the effective date blank until notified of effectiveness by the state administrator.

(c) If an applicant is using a multi state disclosure document, the applicant may list multiple state effective dates together on a separate page following the Supplement State Cover page.

A sample State Cover Page is attached following these Instructions at Exhibit 2.

C. Receipt.

If applicable state law requires a franchisor to provide the disclosure document earlier than the 14 days provided in the 2007 Franchise Rule, the franchisor shall add a statement to the receipt page to the uniform franchise disclosure document to accurately reflect state law requirements to deliver the disclosure document.

Exhibit 1: Uniform Franchise Disclosure Document

Definitions:

Unless stated otherwise, the following definitions apply throughout these Instructions to the extent they do not conflict with applicable state law.

(a) Action includes complaints, cross claims, counterclaims, and third-party complaints in a judicial action or proceeding, and their equivalents in an administrative action or arbitration.

(b) Affiliate means an entity controlled by, controlling, or under common control with, another entity.

(c) Confidentiality clause means any contract, order, or settlement provision that directly or indirectly restricts a current or former franchisee from discussing his or her personal experience as a franchisee in the franchisor's system with any prospective franchisee. It does not include clauses that protect franchisor's trademarks or other proprietary

information.

(d) Disclose, state, describe, and list each mean to present all material facts accurately, clearly, concisely, and legibly in plain English.

(e) Financial performance representation means any representation, including any oral, written, or visual representation, to a prospective franchisee, including a representation in the general media, that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits, or net profits. The term includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables.

(f) Fiscal year refers to the franchisor's fiscal year.

(g) Franchisee means any person who is granted a franchise.

(h) Franchise seller means a person that offers for sale, sells, or arranges for the sale of a franchise. It includes the franchisor and the franchisor's employees, representatives, agents, subfranchisors, and third-party brokers who are involved in franchise sales activities. It does not include existing franchisees who sell only their own outlet and who are otherwise not engaged in franchise sales on behalf of the franchisor.

(i) Franchisor means any person who grants a franchise and participates in the franchise relationship. Unless otherwise stated, it includes subfranchisors. For purposes of this definition, a "subfranchisor" means a person who functions as a franchisor by engaging in both pre-sale activities and post-sale performance.

(j) Parent means an entity that controls another entity directly, or indirectly through one or more subsidiaries.

(k) Person means any individual, group, association, limited or general partnership, corporation, or any other entity.

(l) Plain English means the organization of information and language usage understandable by a person unfamiliar with the franchise business. It incorporates short sentences; definite, concrete, everyday language; active voice; and tabular presentation of information, where possible. It avoids legal jargon, highly technical business terms, and multiple negatives.

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(m) Predecessor means a person from whom the franchisor acquired, directly or indirectly, the major portion of the franchisor's assets.

(n) Principal business address means the street address of a person's home office in the United States. A principal business address cannot be a post office box or private mail drop.

(o) Prospective franchisee means any person (including any agent, representative, or employee) who approaches or is approached by a franchise seller to discuss the possible establishment of a franchise relationship.

(p) Required payment means all consideration that the franchisee must pay to the franchisor or an affiliate, either by contract or by practical necessity, as a condition of obtaining or commencing operation of the franchise. A required payment does not include payments for the purchase of reasonable amounts of inventory at bona fide wholesale prices for resale or lease.

(q) Trademark includes trademarks, service marks, names, logos, and other commercial symbols.

Contents of the Uniform Franchise Disclosure Document

Part 1: Cover page.

Begin the disclosure document with a cover page, in the order and form as follows:

(a) The title "FRANCHISE DISCLOSURE DOCUMENT" in capital letters and bold type.

(b) The franchisor's name, type of business organization, principal business address, telephone number, and, if applicable, email address and primary home page address.

(c) A sample of the primary business trademark that the franchisee will use in its business.

(d) A brief description of the franchised business.

(e) The following statements:

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(1) The total investment necessary to begin operation of a [franchise system name] franchise is [the total amount of Item 7]. This includes [the total amount in Item 5] that must be paid to the franchisor or affiliate.

(2) This disclosure document summarizes certain provisions of your franchise agreement and other information in plain English. Read this disclosure document and all accompanying agreements carefully. You must receive this disclosure document at least 14 calendar-days before you sign a binding agreement with, or make any payment to, the franchisor or an affiliate in connection with the proposed franchise sale. [The following sentence in bold type] Note, however, that no governmental agency has verified the information contained in this document.

(3) The terms of your contract will govern your franchise relationship. Don't rely on the disclosure document alone to understand your contract. Read all of your contract carefully. Show your contract and this disclosure document to an advisor, like a lawyer or an accountant.

(4) Buying a franchise is a complex investment. The information in this disclosure document can help you make up your mind. More information on franchising, such as "A Consumer's Guide to Buying a Franchise," which can help you understand how to use this disclosure document, is available from the Federal Trade Commission. You can contact the FTC at 1-877-FTC-HELP or by writing to the FTC at 600 Pennsylvania Avenue, NW, Washington, D.C. 20580. You can also visit the FTC's home page at www.ftc.gov for additional information. Call your state agency or visit your public library for other sources of information on franchising.

(5) There may also be laws on franchising in your state. Ask your state agencies about them.

(6) [The issuance date].

(f) A franchisor may include the following statement between the statements set out at paragraphs (2) and (3) of this Part: "You may wish to receive your disclosure document in another format that is more convenient for you. To discuss the availability of disclosures in different formats, contact [name or office] at [address] and [telephone number]."

(g) Franchisors may include additional disclosures on the cover page, on a separate cover page, or addendum to comply with state pre-sale disclosure laws.

Part 2: Table of contents.

Include the following table of contents. State the page where each disclosure Item begins. List all exhibits by

letter, as shown in the following example.

Table of Contents

1. The Franchisor and any Parents, Predecessors, and Affiliates
2. Business Experience
3. Litigation
4. Bankruptcy
5. Initial Fees
6. Other Fees
7. Estimated Initial Investment
8. Restrictions on Sources of Products and Services
9. Franchisee's Obligations
10. Financing
11. Franchisor's Assistance, Advertising, Computer Systems, and Training
12. Territory

13. Trademarks

14. Patents, Copyrights, and Proprietary Information

15. Obligation to Participate in the Actual Operation of the Franchise Business

16. Restrictions on What the Franchisee May Sell

17. Renewal, Termination, Transfer, and Dispute Resolution

18. Public Figures

19. Financial Performance Representations

20. Outlets and Franchisee Information

21. Financial Statements

22. Contracts

23. Receipts

Exhibits

A. Franchise Agreement

Part 3: The Franchise Disclosure Document

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Item 1: The Franchisor, and any Parents, Predecessors, and Affiliates.

Disclose:

(1) The name and principal business address of the franchisor; any parents; and any affiliates that offer franchises in any line of business or provide products or services to the franchisees of the franchisor.

(2) The name and principal business address of any predecessors during the 10-year period immediately before the close of the franchisor's most recent fiscal year.

(3) The name that the franchisor uses and any names it intends to use to conduct business.

(4) The identity and principal business address of the franchisor's agent for service of process.

(5) The type of business organization used by the franchisor (for example, corporation, partnership) and the state in which it was organized.

(6) The following information about the franchisor's business and the franchises offered:

(i) Whether the franchisor operates businesses of the type being franchised.

(ii) The franchisor's other business activities.

(iii) The business the franchisee will conduct.

(iv) The general market for the product or service the franchisee will offer. In describing the general market, consider factors such as whether the market is developed or developing, whether the goods will be sold primarily to a certain group, and whether sales are seasonal.

(v) In general terms, any laws or regulations specific to the industry in which the franchise business operates.

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(vi) A general description of the competition.

(7) The prior business experience of the franchisor; any predecessors listed in Item 1(a)(2) of this part; and any affiliates that offer franchises in any line of business or provide products or services to the franchisees of the franchisor, including:

(i) The length of time each has conducted the type of business the franchisee will operate.

(ii) The length of time each has offered franchises providing the type of business the franchisee will operate.

(iii) Whether each has offered franchises in other lines of business. If so, include:

(A) A description of each other line of business.

(B) The number of franchises sold in each other line of business.

(C) The length of time each has offered franchises in each other line of business.

Item 2: Business Experience.

Disclose by name and position the franchisor's directors, trustees, general partners, principal officers, and any other individuals who will have management responsibility relating to the sale or operation of franchises offered by this document. For each person listed in this section, state his or her principal positions and employers during the past five years, including each position's starting date, ending date, and location.

Item 3: Litigation.

(1) Disclose whether the franchisor; a predecessor; a parent or affiliate who induces franchise sales by promising to back the franchisor financially or otherwise guarantees the franchisor's performance; an affiliate who offers franchises under the franchisor's principal trademark; and any person identified in Item 2 of this part:

(i) Has pending against that person:

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(A) An administrative, criminal, or material civil action alleging a violation of a franchise, antitrust, or securities law, or alleging fraud, unfair or deceptive practices, or comparable allegations.

(B) Civil actions, other than ordinary routine litigation incidental to the business, which are material in the context of the number of franchisees and the size, nature, or financial condition of the franchise system or its business operations.

(ii) Was a party to any material civil action involving the franchise relationship in the last fiscal year. For purposes of this section, "franchise relationship" means contractual obligations between the franchisor and franchisee directly relating to the operation of the franchised business (such as royalty payment and training obligations). It does not include actions involving suppliers or other third parties, or indemnification for tort liability.

(iii) Has in the 10-year period immediately before the disclosure document's issuance date:

(A) Been convicted of or pleaded nolo contendere to a felony charge.

(B) Been held liable in a civil action involving an alleged violation of a franchise, antitrust, or securities law, or involving allegations of fraud, unfair or deceptive practices, or comparable allegations. "Held liable" means that, as a result of claims or counterclaims, the person must pay money or other consideration, must reduce an indebtedness by the amount of an award, cannot enforce its rights, or must take action adverse to its interests.

(2) Disclose whether the franchisor; a predecessor; a parent or affiliate who guarantees the franchisor's performance; an affiliate who has offered or sold franchises in any line of business within the last 10 years; or any other person identified in Item 2 of this part is subject to a currently effective injunctive or restrictive order or decree resulting from a pending or concluded action brought by a public agency and relating to the franchise or to a Federal, State, or Canadian franchise, securities, antitrust, trade regulation, or trade practice law.

(3) For each action identified in paragraphs (1) and (2) of this Item 3, state the title, case number or citation, the initial filing date, the names of the parties, the forum, and the relationship of the opposing party to the franchisor (for example, competitor, supplier, lessor, franchisee, former franchisee, or class of franchisees). Except as provided in paragraph (4) of this Item 3, summarize the legal and factual nature of each claim in the action, the relief sought or obtained, and any conclusions of law or fact. STATEMENTS OF POLICY_and_@_NASAA SOP)_and_footnotes(n10);vk n6 In addition, state:

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(i) For pending actions, the status of the action.

(ii) For prior actions, the date when the judgment was entered and any damages or settlement terms. STATEMENTS OF POLICY_and_@_NASAA SOP)_and_footnotes(n11);.vk n7

(iii) For injunctive or restrictive orders, the nature, terms, and conditions of the order or decree.

(iv) For convictions or pleas, the crime or violation, the date of conviction, and the sentence or penalty imposed.

(4) For any other franchisor-initiated suit identified in paragraph (1)(ii) of this Item 3, the franchisor may comply with the requirements of paragraphs (3)(i)-(iv) of this Item 3 by listing individual suits under one common heading that will serve as the case summary (for example, "royalty collection suits").

Item 4: Bankruptcy.

(1) Disclose whether the franchisor; any parent; predecessor; affiliate; officer, or general partner of the franchisor, or any other individual who will have management responsibility relating to the sale or operation of franchises offered by this document, has, during the 10-year period immediately before the date of this disclosure document:

(i) Filed as debtor (or had filed against it) a petition under the United States Bankruptcy Code ("Bankruptcy Code").

(ii) Obtained a discharge of its debts under the Bankruptcy Code.

(iii) Been a principal officer of a company or a general partner in a partnership that either filed as a debtor (or had filed against it) a petition under the Bankruptcy Code, or that obtained a discharge of its debts under the Bankruptcy Code while, or within one year after, the officer or general partner held the position in the company.

(2) For each bankruptcy, state:

(i) The current name, address, and principal place of business of the debtor.

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(ii) Whether the debtor is the franchisor. If not, state the relationship of the debtor to the franchisor (for example, affiliate, officer).

(iii) The date of the original filing and the material facts, including the bankruptcy court, and the case name and number. If applicable, state the debtor's discharge date, including discharges under Chapter 7 and confirmation of any plans of reorganization under Chapters 11 and 13 of the Bankruptcy Code.

(3) Disclose cases, actions, and other proceedings under the laws of foreign nations relating to bankruptcy.

Item 5: Initial Fees.

Disclose the initial fees and any conditions under which these fees are refundable. If the initial fees are not uniform, disclose the range or formula used to calculate the initial fees paid in the fiscal year before the issuance date and the factors that determined the amount. For this section, "initial fees" means all fees and payments, or commitments to pay, for services or goods received from the franchisor or any affiliate before the franchisee's business opens, whether payable in lump sum or installments. Disclose installment payment terms in this section or in Item 10 of this part.

Item 6: Other Fees.

Disclose, in the following tabular form, all other fees that the franchisee must pay to the franchisor or its affiliates, or that the franchisor or its affiliates impose or collect in whole or in part for a third party. State the title "OTHER FEES" in capital letters using bold type. Include any formula used to compute the fees. STATEMENTS OF POLICY_and_@_NASAA SOP)_and_footnotes(n12);.vk n8

Item 6 Table OTHER FEES

Column 1	Column 2	Column 3	Column 4
Type of fee	Amount	Due Date	Remarks
.....			

(1) In column (1), list the type of fee (for example, royalties, and fees for lease negotiations, construction, remodeling, additional training or assistance, advertising, advertising cooperatives, purchasing cooperatives, audits, accounting, inventory, transfers, and renewals).

(2) In column (2), state the amount of the fee.

(3) In column (3), state the due date for each fee.

(4) In column (4), include remarks, definitions, or caveats that elaborate on the information in the table. If remarks

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are long, franchisors may use footnotes instead of the remarks column. If applicable, include the following information in the remarks column or in a footnote:

(i) Whether the fees are payable only to the franchisor.

(ii) Whether the fees are imposed and collected by the franchisor.

(iii) Whether the fees are non-refundable or describe the circumstances when the fees are refundable.

(iv) Whether the fees are uniformly imposed.

(v) The voting power of franchisor-owned outlets on any fees imposed by cooperatives. If franchisor-owned outlets have controlling voting power, disclose the maximum and minimum fees that may be imposed.

Item 7: Estimated Initial Investment.

Disclose, in the following tabular form, the franchisee's estimated initial investment. State the title "YOUR ESTIMATED INITIAL INVESTMENT" in capital letters using bold type. Franchisors may include additional expenditure tables to show expenditure variations caused by differences such as in site location and premises size.

Item 7 Table: YOUR ESTIMATED INITIAL INVESTMENT

Column 1 Type of ex- penditure	Column 2 Amount	Column 3 Method of pay- ment	Column 4 When due	Column 5 To whom pay- ment is to be made
.....				
Total.				

(1) In column (1):

(i) List each type of expense, beginning with pre-opening expenses. Include the following expenses, if applicable. Use footnotes to include remarks, definitions, or caveats that elaborate on the information in the Table.

(A) The initial franchise fee.

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(B) Training expenses.

(C) Real property, whether purchased or leased.

(D) Equipment, fixtures, other fixed assets, construction, remodeling, leasehold improvements, and decorating costs, whether purchased or leased.

(E) Inventory to begin operating.

(F) Security deposits, utility deposits, business licenses, and other prepaid expenses.

(ii) List separately and by name any other specific required payments (for example, additional training, travel, or advertising expenses) that the franchisee must make to begin operations.

(iii) Include a category titled "Additional funds--[initial period]" for any other required expenses the franchisee will incur before operations begin and during the initial period of operations. State the initial period. A reasonable initial period is at least three months or a reasonable period for the industry. Describe in general terms the factors, basis, and experience that the franchisor considered or relied upon in formulating the amount required for additional funds.

(2) In column (2), state the amount of the payment. If the amount is unknown, use a low-high range based on the franchisor's current experience. If real property costs cannot be estimated in a low-high range, describe the approximate size of the property and building and the probable location of the building (for example, strip shopping center, mall, downtown, rural, or highway).

(3) In column (3), state the method of payment.

(4) In column (4), state the due date.

(5) In column (5), state to whom payment will be made.

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(6) Total the initial investment, incorporating ranges of fees, if used.

(7) In a footnote, state:

(i) Whether each payment is non-refundable, or describe the circumstances when each payment is refundable.

(ii) If the franchisor or an affiliate finances part of the initial investment, the amount that it will finance, the required down payment, the annual interest rate, rate factors, and the estimated loan repayments. Franchisors may refer to Item 10 of this part for additional details.

Item 8: Restrictions on Sources of Products and Services.

Disclose the franchisee's obligations to purchase or lease goods, services, supplies, fixtures, equipment, inventory, computer hardware and software, real estate, or comparable items related to establishing or operating the franchised business either from the franchisor, its designee, or suppliers approved by the franchisor, or under the franchisor's specifications. Include obligations to purchase imposed by the franchisor's written agreement or by the franchisor's practice. STATEMENTS OF POLICY_and_@_NASAA SOP)_and_footnotes(n13);vk n9 For each applicable obligation, state:

(1) The good or service required to be purchased or leased.

(2) Whether the franchisor or its affiliates are approved suppliers or the only approved suppliers of that good or service.

(3) Any supplier in which an officer of the franchisor owns an interest.

(4) How the franchisor grants and revokes approval of alternative suppliers, including:

(i) Whether the franchisor's criteria for approving suppliers are available to franchisees.

(ii) Whether the franchisor permits franchisees to contract with alternative suppliers who meet the franchisor's criteria.

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(iii) Any fees and procedures to secure approval to purchase from alternative suppliers.

(iv) The time period in which the franchisee will be notified of approval or disapproval.

(v) How approvals are revoked.

(5) Whether the franchisor issues specifications and standards to franchisees, subfranchisees, or approved suppliers. If so, describe how the franchisor issues and modifies specifications.

(6) Whether the franchisor or its affiliates will or may derive revenue or other material consideration from required purchases or leases by franchisees. If so, describe the precise basis by which the franchisor or its affiliates will or may derive that consideration by stating:

(i) The franchisor's total revenue. STATEMENTS OF POLICY_and_@_NASAA SOP)_and_footnotes(n14);.vk
n10

(ii) The franchisor's revenues from all required purchases and leases of products and services.

(iii) The percentage of the franchisor's total revenues that are from required purchases or leases.

(iv) If the franchisor's affiliates also sell or lease products or services to franchisees, the affiliates' revenues from those sales or leases.

(7) The estimated proportion of these required purchases and leases by the franchisee to all purchases and leases by the franchisee of goods and services in establishing and operating the franchised businesses.

(8) If a designated supplier will make payments to the franchisor from franchisee purchases, disclose the basis for the payment (for example, specify a percentage or a flat amount). For purposes of this disclosure, a "payment" includes the sale of similar goods or services to the franchisor at a lower price than to franchisees.

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(9) The existence of purchasing or distribution cooperatives.

(10) Whether the franchisor negotiates purchase arrangements with suppliers, including price terms, for the benefit of franchisees.

(11) Whether the franchisor provides material benefits (for example, renewal or granting additional franchises) to a franchisee based on a franchisee's purchase of particular products or services or use of particular suppliers.

Item 9: Franchisee's Obligations.

Disclose, in the following tabular form, a list of the franchisee's principal obligations. State the title "FRANCHISEE'S OBLIGATIONS" in capital letters using bold type. Cross-reference each listed obligation with any applicable section of the franchise or other agreement and with the relevant disclosure document provision. If a particular obligation is not applicable, state "Not Applicable." Include additional obligations, as warranted.

Item 9 Table: FRANCHISEE'S OBLIGATIONS [In bold] This table lists your principal obligations under the franchise and other agreements. It will help you find more detailed information about your obligations in these agreements and in other items of this disclosure document.

Obligation	Section in agreement	Disclosure document item
a. Site selection and acquisition/lease		
b. Pre-opening purchase/leases		
c. Site development and other pre-opening requirements		
d. Initial and ongoing training		
e. Opening		
f. Fees		
g. Compliance with standards and policies/ operating manual		
h. Trademarks and proprietary information		
i. Restrictions on products/services offered		
j. Warranty and customer service requirements		
k. Territorial development and sales quotas		
l. Ongoing product/service purchases		
m. Maintenance, appearance, and remodeling requirements		
n. Insurance		
o. Advertising		

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p. Indemnification		
q. Owner's participation/management/staffing		
r. Records and reports		
s. Inspections and audits	.....	.....
t. Transfer	.....	.....
u. Renewal	.....	.....
v. Post-termination obligations	.....	.....
w. Non-competition covenants	.....	.....
x. Dispute resolution	.....	.....
y. Other (describe)	.....	.....

Item 10: Financing.

(1) Disclose the terms of each financing arrangement, including leases and installment contracts, that the franchisor, its agent, or affiliates offer directly or indirectly to the franchisee. STATEMENTS OF POLICY_and_@_NASAA SOP)_and_footnotes(n15);vk n11 The franchisor may summarize the terms of each financing arrangement in tabular form, using footnotes to provide additional information. For a sample Item 10 table, see Appendix A of this part. For each financing arrangement, state:

(i) What the financing covers (for example, the initial franchise fee, site acquisition, construction or remodeling, initial or replacement equipment or fixtures, opening or ongoing inventory or supplies, or other continuing expenses). STATEMENTS OF POLICY_and_@_NASAA SOP)_and_footnotes(n16);vk n12

(ii) The identity of each lender providing financing and their relationship to the franchisor (for example, affiliate).

(iii) The amount of financing offered or, if the amount depends on an actual cost that may vary, the percentage of the cost that will be financed.

(iv) The rate of interest, plus finance charges, expressed on an annual basis. If the rate of interest, plus finance charges, expressed on an annual basis, may differ depending on when the financing is issued, state what that rate was on a specified recent date.

(v) The number of payments or the period of repayment.

(vi) The nature of any security interest required by the lender.

(vii) Whether a person other than the franchisee must personally guarantee the debt.

(viii) Whether the debt can be prepaid and the nature of any prepayment penalty.

(ix) The franchisee's potential liabilities upon default, including any:

(A) Accelerated obligation to pay the entire amount due;

(B) Obligations to pay court costs and attorney's fees incurred in collecting the debt;

(C) Termination of the franchise; and

(D) Liabilities from cross defaults such as those resulting directly from non-payment, or indirectly from the loss of business property.

(x) Other material financing terms.

(2) Disclose whether the loan agreement requires franchisees to waive defenses or other legal rights (for example, confession of judgment), or bars franchisees from asserting a defense against the lender, the lender's assignee or the franchisor. If so, describe the relevant provisions.

(3) Disclose whether the franchisor's practice or intent is to sell, assign, or discount to a third party all or part of the financing arrangement. If so, state:

(i) The assignment terms, including whether the franchisor will remain primarily obligated to provide the financed goods or services; and

(ii) That the franchisee may lose all its defenses against the lender as a result of the sale or assignment.

(4) Disclose whether the franchisor or an affiliate receives any consideration for placing financing with the lender. If such payments exist:

(i) Disclose the amount or the method of determining the payment; and

(ii) Identify the source of the payment and the relationship of the source to the franchisor or its affiliates.

Item 11: Franchisor's Assistance, Advertising, Computer Systems, and Training.

Disclose the franchisor's principal assistance and related obligations of both the franchisor and franchisee as follows. For each obligation, cite the section number of the franchise agreement imposing the obligation. Begin by stating the following sentence in bold type: "Except as listed below, [the franchisor] is not required to provide you with any assistance."

(1) Disclose the franchisor's pre-opening obligations to the franchisee, including any assistance in:

(i) Locating a site and negotiating the purchase or lease of the site. If such assistance is provided, state:

(A) Whether the franchisor generally owns the premises and leases it to the franchisee.

(B) Whether the franchisor selects the site or approves an area in which the franchisee selects a site. If so, state further whether and how the franchisor must approve a franchisee-selected site.

(C) The factors that the franchisor considers in selecting or approving sites (for example, general location and neighborhood, traffic patterns, parking, size, physical characteristics of existing buildings, and lease terms).

(D) The time limit for the franchisor to locate or approve or disapprove the site and the consequences if the franchisor and franchisee cannot agree on a site.

(ii) Conforming the premises to local ordinances and building codes and obtaining any required permits.

(iii) Constructing, remodeling, or decorating the premises.

(iv) Hiring and training employees.

(v) Providing for necessary equipment, signs, fixtures, opening inventory, and supplies. If any such assistance is provided, state:

(A) Whether the franchisor provides these items directly or only provides the names of approved suppliers.

(B) Whether the franchisor provides written specifications for these items.

(C) Whether the franchisor delivers or installs these items.

(2) Disclose the typical length of time between the earlier of the signing of the franchise agreement or the first payment of consideration for the franchise and the opening of the franchisee's business. Describe the factors that may affect the time period, such as ability to obtain a lease, financing or building permits, zoning and local ordinances, weather conditions, shortages, or delayed installation of equipment, fixtures, and signs.

(3) Disclose the franchisor's obligations to the franchisee during the operation of the franchise, including any assistance in:

(i) Developing products or services the franchisee will offer to its customers.

(ii) Hiring and training employees.

(iii) Improving and developing the franchised business.

(iv) Establishing prices.

(v) Establishing and using administrative, bookkeeping, accounting, and inventory control procedures.

(vi) Resolving operating problems encountered by the franchisee.

(4) Describe the advertising program for the franchise system, including the following:

(i) The franchisor's obligation to conduct advertising, including:

(A) The media the franchisor may use.

(B) Whether media coverage is local, regional, or national.

(C) The source of the advertising (for example, an in-house advertising department or a national or regional advertising agency).

(D) Whether the franchisor must spend any amount on advertising in the area or territory where the franchisee is located.

(ii) The circumstances when the franchisor will permit franchisees to use their own advertising material.

(iii) Whether there is an advertising council composed of franchisees that advises the franchisor on advertising policies. If so, disclose:

(A) How members of the council are selected.

(B) Whether the council serves in an advisory capacity only or has operational or decision-making power.

(C) Whether the franchisor has the power to form, change, or dissolve the advertising council.

(iv) Whether the franchisee must participate in a local or regional advertising cooperative. If so, state:

(A) How the area or membership of the cooperative is defined.

(B) How much the franchisee must contribute to the fund and whether other franchisees must contribute a different amount or at a different rate.

(C) Whether the franchisor-owned outlets must contribute to the fund and, if so, whether those contributions are on the same basis as those for franchisees.

(D) Who is responsible for administering the cooperative (for example, franchisor, franchisees, or advertising agency).

(E) Whether cooperatives must operate from written governing documents and whether the documents are available for the franchisee to review.

(F) Whether cooperatives must prepare annual or periodic financial statements and whether the statements are available for review by the franchisee.

(G) Whether the franchisor has the power to require cooperatives to be formed, changed, dissolved, or merged.

(v) Whether the franchisee must participate in any other advertising fund. If so, state:

(A) Who contributes to the fund.

(B) How much the franchisee must contribute to the fund and whether other franchisees must contribute a different amount or at a different rate.

(C) Whether the franchisor-owned outlets must contribute to the fund and, if so, whether it is on the same basis as franchisees.

(D) Who administers the fund.

(E) Whether the fund is audited and when it is audited.

(F) Whether financial statements of the fund are available for review by the franchisee.

(G) How the funds were used in the most recently concluded fiscal year, including the percentages spent on production, media placement, administrative expenses, and a description of any other use.

(vi) If not all advertising funds are spent in the fiscal year in which they accrue, how the franchisor uses the remaining amount, including whether franchisees receive a periodic accounting of how advertising fees are spent.

(vii) The percentage of advertising funds, if any, that the franchisor uses principally to solicit new franchise sales.

(5) Disclose whether the franchisor requires the franchisee to buy or use electronic cash registers or computer systems. If so, describe the systems generally in non-technical language, including the types of data to be generated or stored in these systems, and state the following:

(i) The cost of purchasing or leasing the systems.

(ii) Any obligation of the franchisor, any affiliate, or third party to provide ongoing maintenance, repairs, upgrades, or updates.

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(iii) Any obligations of the franchisee to upgrade or update any system during the term of the franchise, and, if so, any contractual limitations on the frequency and cost of the obligation.

(iv) The annual cost of any optional or required maintenance, updating, upgrading, or support contracts.

(v) Whether the franchisor will have independent access to the information that will be generated or stored in any electronic cash register or computer system. If so, describe the information that the franchisor may access and whether there are any contractual limitations on the franchisor's right to access the information.

(6) Disclose the table of contents of the franchisor's operating manual provided to franchisees as of the franchisor's last fiscal year-end or a more recent date. State the number of pages devoted to each subject and the total number of pages in the manual as of this date. This disclosure may be omitted if the franchisor offers the prospective franchisee the opportunity to view the manual before buying the franchise.

(7) Disclose the franchisor's training program as of the franchisor's last fiscal year-end or a more recent date.

(i) Describe the training program in the following tabular form. Title the table "TRAINING PROGRAM" in capital letters and bold type.

Item 11 Table TRAINING PROGRAM

Column 1 Subject	Column 2 Hours of Classroom Training	Column 3 Hours of On- The-Job Training	Column 4 Location
.....			

(A) In column (1), state the subjects taught.

(B) In column (2), state the hours of classroom training for each subject.

(C) In column (3), state the hours of on-the-job training for each subject.

(D) In column (4), state the location of the training for each subject.

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(ii) State further:

(A) How often training classes are held and the nature of the location or facility where training is held (for example, company, home, office, franchisor-owned store).

(B) The nature of instructional materials and the instructor's experience, including the instructor's length of experience in the field and with the franchisor. State only experience relevant to the subject taught and the franchisor's operations.

(C) Any charges franchisees must pay for training and who must pay travel and living expenses of the training program enrollees.

(D) Who may and who must attend training. State whether the franchisee or other persons must complete the program to the franchisor's satisfaction. If successful completion is required, state how long after signing the agreement or before opening the business the training must be completed. If training is not mandatory, state the percentage of new franchisees that enrolled in the training program during the preceding 12 months.

(E) Whether additional training programs or refresher courses are required.

Item 12: Territory.

Disclose:

(1) Whether the franchise is for a specific location or a location to be approved by the franchisor.

(2) Any minimum territory granted to the franchisee (for example, a specific radius, a distance sufficient to encompass a specified population, or another specific designation).

(3) The conditions under which the franchisor will approve the relocation of the franchised business or the franchisee's establishment of additional franchised outlets.

(4) Franchisee options, rights of first refusal, or similar rights to acquire additional franchises.

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(5) Whether the franchisor grants an exclusive territory.

(i) If the franchisor does not grant an exclusive territory, state: "You will not receive an exclusive territory. You may face competition from other franchisees, from outlets that we own, or from other channels of distribution or competitive brands that we control."

(ii) If the franchisor grants an exclusive territory, disclose:

(A) Whether continuation of territorial exclusivity depends on achieving a certain sales volume, market penetration, or other contingency, and the circumstances when the franchisee's territory may be altered. Describe any sales or other conditions. State the franchisor's rights if the franchisee fails to meet the requirements.

(B) Any other circumstances that permit the franchisor to modify the franchisee's territorial rights (for example, a population increase in the territory giving the franchisor the right to grant an additional franchise in the area) and the effect of such modifications on the franchisee's rights.

(6) For all territories (exclusive and non-exclusive):

(i) Any restrictions on the franchisor from soliciting or accepting orders from consumers inside the franchisee's territory, including:

(A) Whether the franchisor or an affiliate has used or reserves the right to use other channels of distribution, such as the Internet, catalog sales, telemarketing, or other direct marketing sales, to make sales within the franchisee's territory using the franchisor's principal trademarks.

(B) Whether the franchisor or an affiliate has used or reserves the right to use other channels of distribution, such as the Internet, catalog sales, telemarketing, or other direct marketing, to make sales within the franchisee's territory of products or services under trademarks different from the ones the franchisee will use under the franchise agreement.

(C) Any compensation that the franchisor must pay for soliciting or accepting orders from inside the franchisee's territory.

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(ii) Any restrictions on the franchisee from soliciting or accepting orders from consumers outside of his or her territory, including whether the franchisee has the right to use other channels of distribution, such as the Internet, catalog sales, telemarketing, or other direct marketing, to make sales outside of his or her territory.

(iii) If the franchisor or an affiliate operates, franchises, or has plans to operate or franchise a business under a different trademark and that business sells or will sell goods or services similar to those the franchisee will offer, describe:

(A) The similar goods and services.

(B) The different trademark.

(C) Whether outlets will be franchisor owned or operated.

(D) Whether the franchisor or its franchisees who use the different trademark will solicit or accept orders within the franchisee's territory.

(E) The timetable for the plan.

(F) How the franchisor will resolve conflicts between the franchisor and franchisees and between the franchisees of each system regarding territory, customers, and franchisor support.

(G) The principal business address of the franchisor's similar operating business. If it is the same as the franchisor's principal business address stated in Item 1 of this part, disclose whether the franchisor maintains (or plans to maintain) physically separate offices and training facilities for the similar competing business.

Item 13: Trademarks.

(1) Disclose each principal trademark to be licensed to the franchisee. For this Item, "principal trademark" means the primary trademarks, service marks, names, logos, and commercial symbols the franchisee will use to identify the franchised business. It may not include every trademark the franchisor owns.

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(2) Disclose whether each principal trademark is registered with the United States Patent and Trademark Office. If so, state:

(i) The date and identification number of each trademark registration.

(ii) Whether the franchisor has filed all required affidavits.

(iii) Whether any registration has been renewed.

(iv) Whether the principal trademarks are registered on the Principal or Supplemental Register of the United States Patent and Trademark Office.

(3) If the principal trademark is not registered with the United States Patent and Trademark Office, state whether the franchisor has filed any trademark application, including any "intent to use" application or an application based on actual use. If so, state the date and identification number of the application.

(4) If the trademark is not registered on the Principal Register of the United States Patent and Trademark Office, state: "We do not have a federal registration for our principal trademark. Therefore, our trademark does not have many legal benefits and rights as a federally registered trademark. If our right to use the trademark is challenged, you may have to change to an alternative trademark, which may increase your expenses."

(5) Disclose any currently effective material determinations of the United States Patent and Trademark Office, the Trademark Trial and Appeal Board, or any state trademark administrator or court; and any pending infringement, opposition, or cancellation proceeding. Include infringement, opposition, or cancellation proceedings in which the franchisor unsuccessfully sought to prevent registration of a trademark in order to protect a trademark licensed by the franchisor. Describe how the determination affects the ownership, use, or licensing of the trademark.

(6) Disclose any pending material federal or state court litigation regarding the franchisor's use or ownership rights in a trademark. For each pending action, disclose: STATEMENTS OF POLICY_and_@_NASAA SOP)_and_footnotes(n17);.vk n13

(i) The forum and case number.

(ii) The nature of claims made opposing the franchisor's use of the trademark or by the franchisor opposing another person's use of the trademark.

(iii) Any effective court or administrative agency ruling in the matter.

(7) Disclose any currently effective agreements that significantly limit the franchisor's rights to use or license the use of trademarks listed in this section in a manner material to the franchise. For each agreement, disclose:

(i) The manner and extent of the limitation or grant.

(ii) The extent to which the agreement may affect the franchisee.

(iii) The agreement's duration.

(iv) The parties to the agreement.

(v) The circumstances when the agreement may be canceled or modified.

(vi) All other material terms.

(8) Disclose:

(i) Whether the franchisor must protect the franchisee's right to use the principal trademarks listed in this section, and must protect the franchisee against claims of infringement or unfair competition arising out of the franchisee's use of the trademarks.

(ii) The franchisee's obligation to notify the franchisor of the use of, or claims of rights to, a trademark identical to or confusingly similar to a trademark licensed to the franchisee.

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(iii) Whether the franchise agreement requires the franchisor to take affirmative action when notified of these uses or claims.

(iv) Whether the franchisor or franchisee has the right to control any administrative proceedings or litigation involving a trademark licensed by the franchisor to the franchisee.

(v) Whether the franchise agreement requires the franchisor to participate in the franchisee's defense and/or indemnify the franchisee for expenses or damages if the franchisee is a party to an administrative or judicial proceeding involving a trademark licensed by the franchisor to the franchisee, or if the proceeding is resolved unfavorably to the franchisee.

(vi) The franchisee's rights under the franchise agreement if the franchisor requires the franchisee to modify or discontinue using a trademark.

(9) Disclose whether the franchisor knows of either superior prior rights or infringing uses that could materially affect the franchisee's use of the principal trademarks in the state where the franchised business will be located. For each use of a principal trademark that the franchisor believes is an infringement that could materially affect the franchisee's use of a trademark, disclose:

(i) The nature of the infringement.

(ii) The locations where the infringement is occurring.

(iii) The length of time of the infringement (to the extent known).

(iv) Any action taken or anticipated by the franchisor.

Item 14: Patents, Copyrights, and Proprietary Information.

(1) Disclose whether the franchisor owns rights in, or licenses to, patents or copyrights that are material to the franchise. Also, disclose whether the franchisor has any pending patent applications that are material to the franchise. If so, state:

(i) The nature of the patent, patent application, or copyright and its relationship to the franchise.

(ii) For each patent:

(A) The duration of the patent.

(B) The type of patent (for example, mechanical, process, or design).

(C) The patent number, issuance date, and title.

(iii) For each patent application:

(A) The type of patent application (for example, mechanical, process, or design).

(B) The serial number, filing date, and title.

(iv) For each copyright:

(A) The duration of the copyright.

(B) The registration number and date.

(C) Whether the franchisor can and intends to renew the copyright.

(2) Describe any current material determination of the United States Patent and Trademark Office, the United States Copyright Office, or a court regarding the patent or copyright. Include the forum and matter number. Describe how the

determination affects the franchised business.

(3) State the forum, case number, claims asserted, issues involved, and effective determinations for any material proceeding pending in the United States Patent and Trademark Office or any court. STATEMENTS OF POLICY_and_@_NASAA SOP)_and_footnotes(n18);.vk n14

(4) If an agreement limits the use of the patent, patent application, or copyright, state the parties to and duration of the agreement, the extent to which the agreement may affect the franchisee, and other material terms of the agreement.

(5) Disclose the franchisor's obligation to protect the patent, patent application, or copyright; and to defend the franchisee against claims arising from the franchisee's use of patented or copyrighted items, including:

(i) Whether the franchisor's obligation is contingent upon the franchisee notifying the franchisor of any infringement claims or whether the franchisee's notification is discretionary.

(ii) Whether the franchise agreement requires the franchisor to take affirmative action when notified of infringement.

(iii) Who has the right to control any litigation.

(iv) Whether the franchisor must participate in the defense of a franchisee or indemnify the franchisee for expenses or damages in a proceeding involving a patent, patent application, or copyright licensed to the franchisee.

(v) Whether the franchisor's obligation is contingent upon the franchisee modifying or discontinuing the use of the subject matter covered by the patent or copyright.

(vi) The franchisee's rights under the franchise agreement if the franchisor requires the franchisee to modify or discontinue using the subject matter covered by the patent or copyright.

(6) If the franchisor knows of any patent or copyright infringement that could materially affect the franchisee, disclose:

(i) The nature of the infringement.

(ii) The locations where the infringement is occurring.

(iii) The length of time of the infringement (to the extent known).

(iv) Any action taken or anticipated by the franchisor.

(7) If the franchisor claims proprietary rights in other confidential information or trade secrets, describe in general terms the proprietary information communicated to the franchisee and the terms for use by the franchisee. The franchisor need only describe the general nature of the proprietary information, such as whether a formula or recipe is considered to be a trade secret.

Item 15: Obligation to Participate in the Actual Operation of the Franchise Business.

(1) Disclose the franchisee's obligation to participate personally in the direct operation of the franchisee's business and whether the franchisor recommends participation. Include obligations arising from any written agreement or from the franchisor's practice.

(2) If personal "on-premises" supervision is not required, disclose the following:

(i) If the franchisee is an individual, whether the franchisor recommends on-premises supervision by the franchisee.

(ii) Limits on whom the franchisee can hire as an on-premises supervisor.

(iii) Whether an on-premises supervisor must successfully complete the franchisor's training program.

(iv) If the franchisee is a business entity, the amount of equity interest, if any, that the on-premises supervisor must have in the franchisee's business.

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(3) Disclose any restrictions that the franchisee must place on its manager (for example, maintain trade secrets, covenants not to compete).

Item 16: Restrictions on What the Franchisee May Sell.

Disclose any franchisor-imposed restrictions or conditions on the goods or services that the franchisee may sell or that limit access to customers, including:

(1) Any obligation on the franchisee to sell only goods or services approved by the franchisor.

(2) Any obligation on the franchisee to sell all goods or services authorized by the franchisor.

(3) Whether the franchisor has the right to change the types of authorized goods or services and whether there are limits on the franchisor's right to make changes.

Item 17: Renewal, Termination, Transfer, and Dispute Resolution.

Disclose, in the following tabular form, a table that cross-references each enumerated franchise relationship item with the applicable provision in the franchise or related agreement. Title the table "THE FRANCHISE RELATIONSHIP" in capital letters and bold type.

(1) Describe briefly each contractual provision. If a particular item is not applicable, state "Not Applicable."

(2) If the agreement is silent about one of the listed provisions, but the franchisor unilaterally offers to provide certain benefits or protections to franchisees as a matter of policy, use a footnote to describe the policy and state whether the policy is subject to change.

(3) In the summary column for Item 17(c), state what the term "renewal" means for your franchise system, including, if applicable, a statement that franchisees may be asked to sign a contract with materially different terms and conditions than their original contract.

Item 17 Table: THE FRANCHISE RELATIONSHIP [In bold] This table lists certain important provisions of the franchise and related agreements. You should read these provisions in the agreements attached to this disclosure document.

Provision	Section in franchise or other agreement	Summary
a. Length of the franchise term		

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b. Renewal or extension of the term		
c. Requirements for franchisee to renew or extend		
d. Termination by franchisee	.....	.....
e. Termination by franchisor without cause	.....	.....
f. Termination by franchisor with cause	.....	.....
g. "Cause" defined -- curable defaults	.....	.....
h. "Cause" defined -- non-curable defaults	.....	.....
i. Franchisee's obligations on termination/non-renewal	.....	.....
j. Assignment of contract by franchisor	.....	.....
k. "Transfer" by franchisee -- defined	.....	.....
l. Franchisor approval of transfer by franchisee	.....	.....
m. Conditions for franchisor approval of transfer	.....	.....
n. Franchisor's right of first refusal to acquire franchisee's business	.....	.....
o. Franchisor's option to purchase franchisee's business	.....	.....
p. Death or disability of franchisee	.....	.....
q. Non-competition covenants during the term of the franchise	.....	.....
r. Non-competition covenants after the franchise is terminated or expires	.....	.....
s. Modification of the agreement	.....	.....
t. Integration/merger clause	.....	.....
u. Dispute resolution by arbitration or mediation	.....	.....
v. Choice of forum	.....	.....
w. Choice of law	.....	.....

Item 18: Public Figures.

Disclose:

(1) Any compensation or other benefit given or promised to a public figure arising from either the use of the public figure in the franchise name or symbol, or the public figure's endorsement or recommendation of the franchise to prospective franchisees.

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(2) The extent to which the public figure is involved in the management or control of the franchisor. Describe the public figure's position and duties in the franchisor's business structure.

(3) The public figure's total investment in the franchisor, including the amount the public figure contributed in services performed or to be performed. State the type of investment (for example, common stock, promissory note).

(4) For purposes of this section, a public figure means a person whose name or physical appearance is generally known to the public in the geographic area where the franchise will be located.

Item 19: Financial Performance Representations.

(1) Begin by stating the following:

The FTC's Franchise Rule permits a franchisor to provide information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets, if there is a reasonable basis for the information, and if the information is included in the disclosure document. Financial performance information that differs from that included in Item 19 may be given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information about possible performance at a particular location or under particular circumstances.

(2) If a franchisor does not provide any financial performance representation in Item 19, also state:

We do not make any representations about a franchisee's future financial performance or the past financial performance of company-owned or franchised outlets. We also do not authorize our employees or representatives to make any such representations either orally or in writing. If you are purchasing an existing outlet, however, we may provide you with the actual records of that outlet. If you receive any other financial performance information or projections of your future income, you should report it to the franchisor's management by contacting [name, address, and telephone number], the Federal Trade Commission, and the appropriate state regulatory agencies.

(3) If the franchisor makes any financial performance representation to prospective franchisees, the franchisor must have a reasonable basis and written substantiation for the representation at the time the representation is made and must state the representation in the Item 19 disclosure. The franchisor must also disclose the following:

(i) Whether the representation is an historic financial performance representation about the franchise system's existing outlets, or a subset of those outlets, or is a forecast of the prospective franchisee's future financial performance.

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(ii) If the representation relates to past performance of the franchise system's existing outlets, the material bases for the representation, including:

(A) Whether the representation relates to the performance of all of the franchise system's existing outlets or only to a subset of outlets that share a particular set of characteristics (for example, geographic location, type of location (such as free standing vs. shopping center), degree of competition, length of time the outlets have operated, services or goods sold, services supplied by the franchisor, and whether the outlets are franchised or franchisor-owned or operated).

(B) The dates when the reported level of financial performance was achieved.

(C) The total number of outlets that existed in the relevant period and, if different, the number of outlets that had the described characteristics.

(D) The number of outlets with the described characteristics whose actual financial performance data were used in arriving at the representation.

(E) Of those outlets whose data were used in arriving at the representation, the number and percent that actually attained or surpassed the stated results.

(F) Characteristics of the included outlets, such as those characteristics noted in paragraph (3)(ii)(A) of this Item 19, that may differ materially from those of the outlet that may be offered to a prospective franchisee.

(iii) If the representation is a forecast of future financial performance, state the material bases and assumptions on which the projection is based. The material assumptions underlying a forecast include significant factors upon which a franchisee's future results are expected to depend. These factors include, for example, economic or market conditions that are basic to a franchisee's operation, and encompass matters affecting, among other things, a franchisee's sales, the cost of goods or services sold, and operating expenses.

(iv) A clear and conspicuous admonition that a new franchisee's individual financial results may differ from the result stated in the financial performance representation.

(v) A statement that written substantiation for the financial performance representation will be made available to the prospective franchisee upon reasonable request.

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(4) If a franchisor wishes to disclose only the actual operating results for a specific outlet being offered for sale, it need not comply with this section, provided the information is given only to potential purchasers of that outlet.

(5) If a franchisor furnishes financial performance information according to this section, the franchisor may deliver to a prospective franchisee a supplemental financial performance representation about a particular location or variation, apart from the disclosure document. The supplemental representation must:

(i) Be in writing.

(ii) Explain the departure from the financial performance representation in the disclosure document.

(iii) Be prepared in accordance with the requirements of paragraph (3)(i)-(iv) of this Item 19.

(iv) Be furnished to the prospective franchisee.

Item 20: Outlets and Franchisee Information.

(1) Disclose, in the following tabular form, the total number of franchised and company-owned outlets for each of the franchisor's last three fiscal years. For purposes of this section, "outlet" includes outlets of a type substantially similar to that offered to the prospective franchisee. A sample Item 20(1) Table is attached as Appendix B to this part.

Table No. 1 Systemwide Outlet Summary For years [] to []

Column 1 Outlet Type	Column 2 Year	Column 3 Outlets at the Start of the Year	Column 4 Outlets at the End of the Year	Column 5 Net Change
Franchised	2004			
	2005			
	2006			
Company- Owned	2004			
	2005			
	2006			
Total Outlets	2004			
	2005			
	2006			

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(i) In column (1), include three outlet categories titled "franchised," "company-owned, and "total outlets."

(ii) In column (2), state the last three fiscal years.

(iii) In column (3), state the total number of each type of outlet operating at the beginning of each fiscal year.

(iv) In column (4), state the total number of each type of outlet operating at the end of each fiscal year.

(v) In column (5), state the net change, and indicate whether the change is positive or negative, for each type of outlet during each fiscal year.

(2) Disclose, in the following tabular form, the number of franchised and company-owned outlets and changes in the number and ownership of outlets located in each state during each of the last three fiscal years. Except as noted, each change in ownership shall be reported only once in the following tables. If multiple events occurred in the process of transferring ownership of an outlet, report the event that occurred last in time. If a single outlet changed ownership two or more times during the same fiscal year, use footnotes to describe the types of changes involved and the order in which the changes occurred.

(i) Disclose, in the following tabular form, the total number of franchised outlets transferred in each state during each of the franchisor's last three fiscal years. For purposes of this section, "transfer" means the acquisition of a controlling interest in a franchised outlet, during its term, by a person other than the franchisor or an affiliate. A sample Item 20(2) Table is attached as Appendix C to this part.

Table No. 2 Transfers of Outlets from Franchisees to New Owners (other than the Franchisor) For years [] to []

Column 1 State	Column 2 Year	Column 3 Number of Transfers
.....	2004	
	2005	
	2006	
.....	2004	
	2005	
	2006	
Total	2004	
	2005	
	2006	

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(A) In column (1), list each state with one or more franchised outlets.

(B) In column (2), state the last three fiscal years.

(C) In column (3), state the total number of completed transfers in each state during each fiscal year.

(ii) Disclose, in the following tabular form, the status of franchisee-owned outlets located in each state for each of the franchisor's last three fiscal years. A sample Item 20(3) Table is attached as Appendix D to this part.

Table No. 3 Status of Franchised Outlets For years [] to []

Col. 1 State	Col. 2 Year	Col. 3 Outlets at Start of Year	Col. 4 Outlets Opened	Col. 5 Termina- tions	Col. 6 Non- Renewals	Col. 7 Reac- quired by Franchisor	Col. 8 Ceased Opera- tions-- Other Reasons	Col. 9 Outlets at End of the Year
_____	2004	.....	.....	.....	.....	.....	.....	.....
_____	2005	.....	.....	.....	.	....	.....	.
_____	2006	.....	.....	.....	.....	.....	.....	.....
_____					.			.
								
					.			.
_____	2004	.....	.....	.....	.....	.....	.....	.....
_____	2005	.....	.....	.....	.	....	.....	.
_____	2006	.....	.....	.....	.....	.....	.....	.....
_____					.			.
								
					.			.
Totals		.....	.....	.....	.....	.....	.....	.....
					.			.

(A) In column (1), list each state with one or more franchised outlets.

(B) In column (2), state the last three fiscal years.

(C) In column (3), state the total number of franchised outlets in each state at the start of each fiscal year.

(D) In column (4), state the total number of franchised outlets opened in each state during each fiscal year. Include

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both new outlets and existing company-owned outlets that a franchisee purchased from the franchisor. (Also report the number of existing company-owned outlets that are sold to a franchisee in Column 7 of Table 4).

(E) In column (5), state the total number of franchised outlets that were terminated in each state during each fiscal year. For purposes of this section, "termination" means the franchisor's termination of a franchise agreement prior to the end of its term and without providing any consideration to the franchisee (whether by payment or forgiveness or assumption of debt).

(F) In column (6), state the total number of non-renewals in each state during each fiscal year. For purposes of this section, "non-renewal" occurs when the franchise agreement for a franchised outlet is not renewed at the end of its term.

(G) In column (7), state the total number of franchised outlets reacquired by the franchisor in each state during each fiscal year. For purposes of this section, a "reacquisition" means the franchisor's acquisition for consideration (whether by payment or forgiveness or assumption of debt) of a franchised outlet during its term. (Also report franchised outlets reacquired by the franchisor in column 5 of Table 4).

(H) In column (8), state the total number of outlets in each state not operating as one of the franchisor's outlets at the end of each fiscal year for reasons other than termination, non-renewal, or reacquisition by the franchisor.

(I) In column (9), state the total number of franchised outlets in each state at the end of the fiscal year.

(iii) Disclose, in the following tabular form, the status of company-owned outlets located in each state for each of the franchisor's last three fiscal years. A sample Item 20(4)

Table is attached as Appendix E to this part.

Table No. 4 Status of Company-Owned Outlets For years [] to []

Col. 1 State	Col. 2 Year	Col. 3 Outlets at Start of the Year	Col. 4 Outlets Opened	Col. 5 Outlets Reacquired From Fran- chisee	Col. 6 Outlets Closed	Col. 7 Outlets Sold to Fran- chisee	Col. 8 Outlets at End of the Year
.....	2004						
.....	2005			.		.	.
	2006						
				.		.	.
							
				.		.	.
.....	2004						

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.....	2005			.		.	.
	2006						
				.		.	.
							
				.		.	.
Totals	2004						
	2005			.		.	.
	2006						
				.		.	.
							
				.		.	.

(A) In column (1), list each state with one or more company-owned outlets.

(B) In column (2), state the last three fiscal years.

(C) In column (3), state the total number of company-owned outlets in each state at the start of the fiscal year.

(D) In column (4), state the total number of company-owned outlets opened in each state during each fiscal year.

(E) In column (5), state the total number of franchised outlets reacquired from franchisees in each state during each fiscal year.

(F) In column (6), state the total number of company-owned outlets closed in each state during each fiscal year. Include both actual closures and instances when an outlet ceases to operate under the franchisor's trademark.

(G) In column (7), state the total number of company-owned outlets sold to franchisees in each state during each fiscal year.

(H) In column (8), state the total number of company-owned outlets operating in each state at the end of each fiscal year.

(3) Disclose, in the following tabular form, projected new franchised and company-owned outlets. A sample Item

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20(5) Table is attached as Appendix F to this part.

Table No. 5 Projected Openings As Of [Last Day of Last Fiscal Year]

Column 1 State	Column 2 Franchise Agree- ments Signed But Outlet Not Opened	Column 3 Projected New Fran- chised Outlet In The Next Fiscal Year	Column 4 Projected New Company- Owned Outlet In the Next Fiscal Year
.....			
.....			
Total			

(i) In column (1), list each state where one or more franchised or company-owned outlets are located or are projected to be located.

(ii) In column (2), state the total number franchise agreements that had been signed for new outlets to be located in each state as of the end of the previous fiscal year where the outlet had not yet opened.

(iii) In column (3), state the total number of new franchised outlets in each state projected to be opened during the next fiscal year.

(iv) In column (4), state the total number of new company-owned outlets in each state that are projected to be opened during the next fiscal year.

(4) Disclose the names of all current franchisees and the address and telephone number of each of their outlets. Alternatively, disclose this information for all franchised outlets in the state, but if these franchised outlets total fewer than 100, disclose this information for franchised outlets from contiguous states and then the next closest states until at least 100 franchised outlets are listed.

(5) Disclose the name, city and state, and current business telephone number, or if unknown, the last known home telephone number of every franchisee who had an outlet terminated, canceled, not renewed, or otherwise voluntarily or involuntarily ceased to do business under the franchise agreement during the most recently completed fiscal year or who has not communicated with the franchisor within 10 weeks of the disclosure document issuance date. STATEMENTS OF POLICY_and_@_NASAA SOP)_and_footnotes(n19);vk n15 State in immediate conjunction with this information: "If you buy this franchise, your contact information may be disclosed to other buyers when you leave the franchise system."

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(6) If a franchisor is selling a previously-owned franchised outlet now under its control, disclose the following additional information for that outlet for the last five fiscal years. This information may be attached as an addendum to a disclosure document, or, if disclosure has already been made, then in a supplement to the previously furnished disclosure document.

(i) The name, city and state, current business telephone number, or if unknown, last known home telephone number of each previous owner of the outlet;

(ii) The time period when each previous owner controlled the outlet;

(iii) The reason for each previous change in ownership (for example, termination, non-renewal, voluntary transfer, ceased operations); and

(iv) The time period(s) when the franchisor retained control of the outlet (for example, after termination, non-renewal, or reacquisition).

(7) Disclose whether franchisees signed confidentiality clauses during the last three fiscal years. If so, state the following: "In some instances, current and former franchisees sign provisions restricting their ability to speak openly about their experience with [name of franchise system]. You may wish to speak with current and former franchisees, but be aware that not all such franchisees will be able to communicate with you." Franchisors may also disclose the number and percentage of current and former franchisees who during each of the last three fiscal years signed agreements that include confidentiality clauses and may disclose the circumstances under which such clauses were signed.

(8) Disclose, to the extent known, the name, address, telephone number, email address, and Web address (to the extent known) of each trademark-specific franchisee organization associated with the franchise system being offered, if such organization:

(i) Has been created, sponsored, or endorsed by the franchisor. If so, state the relationship between the organization and the franchisor (for example, the organization was created by the franchisor, sponsored by the franchisor, or endorsed by the franchisor).

(ii) Is incorporated or otherwise organized under state law and asks the franchisor to be included in the franchisor's disclosure document during the next fiscal year. Such organizations must renew their request on an annual basis by submitting a request no later than 60 days after the close the franchisor's fiscal year. The franchisor has no obligation to verify the organization's continued existence at the end of each fiscal year. Franchisors may also include the following

statement: "The following independent franchisee organizations have asked to be included in this disclosure document."

Item 21: Financial Statements.

(1) Include the following financial statements prepared according to United States generally accepted accounting principles, as revised by any future United States government mandated accounting principles, or as permitted by the Securities and Exchange Commission. Except as provided in paragraph (2) of this Item, these financial statements must be audited by an independent certified public accountant using generally accepted United States auditing standards. Present the required financial statements in a tabular form that compares at least two fiscal years.

(i) The franchisor's balance sheet for the previous two fiscal year-ends before the disclosure document issuance date.

(ii) Statements of operations, stockholders equity, and cash flows for each of the franchisor's previous three fiscal years.

(iii) Instead of the financial disclosures required by paragraphs (1)(i) and (ii) of this Item 21, the franchisor may include financial statements of any of its affiliates if the affiliate's financial statements satisfy paragraphs (1)(i) and (ii) of this Item 21 and the affiliate absolutely and unconditionally guarantees to assume the duties and obligations of the franchisor under the franchise agreement. The affiliate's guarantee must cover all of the franchisor's obligations to the franchisee, but need not extend to third parties. If this alternative is used, attach a copy of the guarantee to the disclosure document.

(iv) When a franchisor owns a direct or beneficial controlling financial interest in a subsidiary, its financial statements should reflect the financial condition of the franchisor and its subsidiary.

(v) Include separate financial statements for the franchisor and any subfranchisor, as well as for any parent that commits to perform post-sale obligations for the franchisor or guarantees the franchisor's obligations. Attach a copy of any guarantee to the disclosure document.

(2) A start-up franchise system that does not yet have audited financial statements may phase-in the use of audited financial statements by providing, at a minimum, the following statements at the indicated times:

(i) The franchisor's first partial or full fiscal year selling franchises. An unaudited opening balance sheet.

(ii) The franchisor's second fiscal year selling franchises. Audited balance sheet opinion as of the end of the first partial or full fiscal year selling franchises.

(iii) The franchisor's third and subsequent fiscal years. All required financial statements for the previ-

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al years selling franchises.

ous fiscal year, plus any previously disclosed audited statements that still must be disclosed according to paragraphs (1)(i) and (ii) of this Item 21.

(iv) Start-up franchisors may phase-in the disclosure of audited financial statements, provided the franchisor:

(A) Prepares audited financial statements as soon as practicable.

(B) Prepares unaudited statements in a format that conforms as closely as possible to audited statements.

(C) Includes one or more years of unaudited financial statements or clearly and conspicuously discloses in this section that the franchisor has not been in business for three years or more, and cannot include all financial statements required in paragraphs (1)(i) and (ii) of this Item 21.

Item 22: Contracts.

Attach a copy of all proposed agreements regarding the franchise offering, including the franchise agreement and any lease, options, and purchase agreements.

Item 23: Receipts.

Include two copies of the following detachable acknowledgment of receipt in the following form as the last pages of the disclosure document:

(1) State the following:

Receipt

This disclosure document summarizes certain provisions of the franchise agreement and other information in plain language. Read this disclosure document and all agreements carefully.

If [name of franchisor] offers you a franchise, it must provide this disclosure document to you 14 calendar-days before you sign a binding agreement with, or make a payment to, the franchisor or an affiliate in connection with the proposed franchise sale.**[or sooner if required by applicable state law]**

If [name of franchisor] does not deliver this disclosure document on time or if it contains a false or misleading statement, or a material omission, a violation of federal law and state law may have occurred and should be reported to the Federal Trade Commission, Washington, D.C. 20580 and [state agency].

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(2) Disclose the name, principal business address, and telephone number of each franchise seller offering the franchise.

(3) State the issuance date.

(4) If not disclosed in Item 1, state the name and address of the franchisor's registered agent authorized to receive service of process.

(5) State the following:

I received a disclosure document dated _____ that included the following Exhibits:

(6) List the title(s) of all attached Exhibits.

(7) Provide space for the prospective franchisee's signature and date.

(8) Franchisors may include any specific instructions for returning the receipt (for example, street address, email address, facsimile telephone number).

Appendix A: Sample Item 10 Table SUMMARY OF FINANCING OFFERED

Item Financed	Source of Financing	Down Pay- ment	Amount Financed	Term (Yrs)	Interest Rate	Monthly Payment	Prepay Penalty	Security Required	Liability Upon Default	Loss of Legal Right on De- fault
Initial Fee										
										
Land/ Constr										
										
Leased Space										
										
Equip. Lease										
										
Equip. Purchase										
										
Opening Inventory										
										

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Other Fin-
 ancing

Appendix B: Sample Item 20(1) Table -- Systemwide Outlet Summary System-
 wide Outlet Summary For years 2004 to 2006

Column 1 Outlet Type	Column 2 Year	Column 3 Outlets at the Start of the Year	Column 4 Outlets at the End of the Year	Column 5 Net Change
Franchised	2004	859	1,062	+203
	2005	1,062	1,296	+234
	2006	1,296	2,720	+1,424
Company Owned	2004	125	145	+20
	2005	145	76	-69
	2006	76	141	+65
Total Outlets	2004	984	1,207	+223
	2005	1,207	1,372	+165
	2006	1,372	2,861	+1,489

Appendix C: Sample Item 20(2) Table -- Transfers of Franchised Outlets Transfers of Out-
 lets from Franchisees to New Owners (other than the Franchisor) For years 2004 to 2006

Column 1 State	Column 2 Year	Column 3 Number of Transfers
NC	2004	1
	2005	0
	2006	2
SC	2004	0
	2005	0
	2006	2
Total	2004	1
	2005	0
	2006	4

Appendix D: Sample Item 20(3) Table -- Status of Franchise Outlets Status of Franchise Outlets
 For years 2004 to 2006

Col. 1 State	Col. 2 Year	Col. 3 Outlets at Start of Year	Col. 4 Outlets Opened	Col. 5 Termi- nations	Col. 6 Non- Renew- als	Col. 7 Reac- quired by Franchisor	Col. 8 Ceased Opera- tions-- Other Reasons	Col. 9 Outlets at End of the Year
AL	2004	10	2	1	0	0	1	10
	2005	11	5	0	1	0	0	15
	2006	15	4	1	0	1	2	15
AZ	2004	20	5	0	0	0	0	25
	2005	25	4	1	0	0	2	26
	2006	26	4	0	0	0	0	30

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Totals	2004	30	7	1	0	0	1	35
	2005	36	9	1	1	0	2	41
	2006	41	8	1	0	1	2	45

Appendix E: Sample Item 20(4) Table -- Status of Company-Owned Outlets Status of Company-Owned Outlets For years 2004 to 2006

Col. 1 State	Col. 2 Year	Col. 3 Outlets at Start of the Year	Col. 4 Outlets Opened	Col. 5 Outlets Reacquired From Fran- chisee	Col. 6 Outlets Closed	Col. 7 Outlets Sold to Fran- chisee	Col. 8 Outlets at End of the Year
NY	2004	1	0	1	0	0	2
	2005	2	2	0	1	0	3
	2006	3	0	0	3	0	0
OR	2004	4	0	1	0	0	5
	2005	5	0	0	2	0	3
	2006	3	0	0	0	1	2
Totals	2004	5	0	2	0	0	7
	2005	7	2	0	3	0	6
	2006	6	0	0	3	1	2

Appendix F: Sample Item 20(5) Table -- Projected New Franchised Outlets Projected New Franchised Outlets As of December 31, 2006

Column 1 State	Column 2 Franchise Agree- ments Signed But Outlet Not Opened	Column 3 Projected New Franchised Outlet In The Next Fisc- al Year	Column 4 Projected New Company- Owned Outlet In the Next Fiscal Year
CO	2	3	1
NM	0	4	2
Total	2	7	3

* * *

[ATTACHED SEPARATELY]

* * *

Exhibit 2: Sample State Cover Page

STATE COVER PAGE

Your state may have a franchise law that requires a franchisor to register or file with a state franchise administrator before offering or selling in your state. REGISTRATION OF A FRANCHISE BY A STATE DOES NOT MEAN

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THAT THE STATE RECOMMENDS THE FRANCHISE OR HAS VERIFIED THE INFORMATION IN THIS DISCLOSURE DOCUMENT.

Call the state franchise administrator listed in Exhibit _____ for information about the franchisor, or about franchising in your state.

MANY FRANCHISE AGREEMENTS DO NOT ALLOW YOU TO RENEW UNCONDITIONALLY AFTER THE INITIAL TERM EXPIRES. YOU MAY HAVE TO SIGN A NEW AGREEMENT WITH DIFFERENT TERMS AND CONDITIONS IN ORDER TO CONTINUE TO OPERATE YOUR BUSINESS. BEFORE YOU BUY, CONSIDER WHAT RIGHTS YOU HAVE TO RENEW YOUR FRANCHISE, IF ANY, AND WHAT TERMS YOU MIGHT HAVE TO ACCEPT IN ORDER TO RENEW.

Please consider the following RISK FACTORS before you buy this franchise:

1. THE FRANCHISE AGREEMENT REQUIRES YOU TO RESOLVE DISPUTES WITH US BY ARBITRATION ONLY IN MINNESOTA. OUT-OF-STATE ARBITRATION MAY FORCE YOU TO ACCEPT A LESS FAVORABLE SETTLEMENT FOR DISPUTES. IT MAY ALSO COST YOU MORE TO ARBITRATE WITH US IN MINNESOTA THAN IN YOUR OWN STATE.
2. THE FRANCHISE AGREEMENT STATES THAT MINNESOTA LAW GOVERNS THE AGREEMENT, AND THIS LAW MAY NOT PROVIDE THE SAME PROTECTIONS AND BENEFITS AS LOCAL LAW. YOU MAY WANT TO COMPARE THESE LAWS
3. THERE MAY BE OTHER RISKS CONCERNING THIS FRANCHISE.

We use the services of one or more FRANCHISE BROKERS or referral sources to assist us in selling our franchise. A franchise broker or referral source represents us, not you. We pay this person a fee for selling our franchise or referring you to us. You should be sure to do your own investigation of the franchise.

Effective Date: _____

FOOTNOTES:

(n1)Footnote 1. NASAA is an organization representing the 50 state securities administrators. In the United States, there is a dual state/federal approach to the regulation. State securities statutes provide for registration of purchase or sale of securities. Compliance with securities both federal and state law is mandatory. effecting transactions in securities or advising on the offer and sale of securities within each state and for licensing of persons

(n2)Footnote 2. In the U. S., the regulatory philosophies underlying federal and state securities laws are similar, but not identical. The federal approach, described issuance of non-voting stock to the public or escrowing of deeply-discounted promotional shares as "full disclosure," requires disclosure of all material facts about the security, the issuer and the held by insiders generally are applied in only a offering. State law requires compliance with full small number of offerings. disclosure but issuers also may have to meet additional investor protection standards imposed under state law. Such standards as prohibition on

(n3)Footnote 3. The states have initiated various steps to reduce unnecessary regulatory burdens. For example, filing identical documentation with each state in the majority of states currently provide a process which the securities are to be offered. Coordination provides for a simpler and faster review by called "coordination". When an issuer files a securities offering with the SEC, it may "coordinate" by

(n4)Footnote 4. state authorities and effectiveness generally is concurrent with the SEC. NASAA also provides a

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forum for discussion of regulatory issues among the states and with the SEC to facilitate standardization of regulation to the greatest extent possible.

(n5)Footnote 1. 16 CFR 436, as amended, 72 FR 15444 (Mar. 30, 2007).

(n6)Footnote 2. 43 FR 59614 (Dec. 21, 1978).

(n7)Footnote 3. 16 CFR 436.1 (a)-(e), 58 FR 69224 (Dec. 30, 1993).

(n8)Footnote 4. 2007 Franchise Rule, 72 FR 15448.

(n9)Footnote 5. 2007 Franchise Rule, 72 FR at 15502.

(n10)Footnote 6. Franchisors may include a summary opinion of counsel concerning any action if counsel consent to use the summary opinion and the full opinion is attached to the disclosure document.

(n11)Footnote 7. If a settlement agreement must be disclosed in this Item, all material settlement terms must be disclosed, whether or not the agreement is confidential. However, franchisors need not disclose the terms of confidential settlements entered into before commencing franchise sales. Further, any franchisor who has historically used only the Franchise Rule format, or who is new to franchising, need not disclose confidential settlements entered prior to the effective date of this Rule.

(n12)Footnote 8. If fees may increase, disclose the formula that determines the increase or the maximum amount of the increase. For example, a percentage of gross sales is acceptable if the franchisor defines the term "gross sales."

(n13)Footnote 9. Franchisors may include the reason for the requirement. Franchisors need not disclose in this Item the purchase or lease of goods or services provided as part of the franchise without a separate charge (such as initial training, if the cost is included in the franchise fee). Describe such fees in Item 5 of this section. Do not disclose fees already described in Item 6 of this part.

(n14)Footnote 10. Take figures from the franchisor's most recent annual audited financial statement required in Item 21 of this part. If audited statements are not yet required, or if the entity deriving the income is an affiliate, disclose the sources of information used in computing revenues.

(n15)Footnote 11. Indirect offers of financing include a written arrangement between a franchisor or its affiliate and a lender, for the lender to offer financing to a franchisee; an arrangement in which a franchisor or its affiliate receives a benefit from a lender in exchange for financing a franchise purchase; and a franchisor's guarantee of a note, lease, or other obligation of the franchisee.

(n16)Footnote 12. Include sample copies of the financing documents as an exhibit to Item 22 of this part. Cite the section and name of the document containing the financing terms and conditions.

(n17)Footnote 13. The franchisor may include an attorney's opinion relative to the merits of litigation or of an action if the attorney issuing the opinion consents to its use. The text of the disclosure may include a summary of the opinion if the full opinion is attached and the attorney issuing the opinion consents to the use of the summary.

(n18)Footnote 14. If counsel consents, the franchisor may include a counsel's opinion or a summary of the opinion if the full opinion is attached.

(n19)Footnote 15. Franchisors may substitute alternative contact information at the request of the former franchisee, such as a home address, post office address, or a personal or business email address.