Appeal No. 06-17011

IN THE UNITED STATES
COURT OF APPEALS FOR THE NINTH CIRCUIT

CONSOLIDATED MANAGEMENT GROUP, LLC,
CONSOLIDATED LEASING ANADARKO JOINT VENTURE,
AND CONSOLIDATED LEASING HUGOTON JOINT VENTURE #2,

Plaintiffs/Appellants,

v.

PRESTON DUFAUCHARD,
CALIFORNIA CORPORATIONS COMMISSIONER, AND
CALIFORNIA DEPARTMENT OF CORPORATIONS,

Defendants/Appellees.

On Appeal From The September 20, 2006, Decision Of The Honorable Jeffrey S. White Of The U.S. District Court For The Northern District Of California, San Francisco Division D.C. No. CV-06-04203-JSW

BRIEF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., AS *AMICUS CURIAE* IN SUPPORT OF DEFENDANTS/APPELLEES FOR AFFIRMANCE

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rule of Appellate Procedure 26.1, *Amicus Curiae* North American Securities Administrators Association, Inc., ("NASAA") states that it has no parent corporation and that there is no publicly held corporation that owns 10% or more of NASAA's stock.

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INTRODUCTION

The North American Securities Administrators Association, Inc. ("NASAA") submits this Brief in Support of Defendants/Appellees Preston DuFauchard, California Corporations Commissioner and the California Department of Corporations (collectively, "Commissioner") and offers the perspective of state securities regulators on the important issues presented. The district court correctly applied *Younger* abstention principles in declining to grant injunctive relief and its decision should be affirmed. Plaintiffs/Appellees Consolidated Management Group, LLC, Consolidated Leasing Anadarko Joint Venture, and Consolidated Leasing Hugoton Joint Venture #2 (collectively, the "Consolidated Parties") engaged in prohibited general solicitations of their offerings. As a result of this activity, the Consolidated Parties are not entitled to claim a federal exemption from the registration requirements under the California Securities Laws. Accordingly, under the facts of this case, the state's authority has not been preempted, the state's interest is intact, and abstention is appropriate.

IDENTITY AND INTEREST OF THE *AMICUS CURIAE*

NASAA is the nonprofit association of state, provincial, and territorial securities regulators in the United States, Canada, and Mexico. It has 67 members, including the securities regulators in all 50 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. Formed in 1919, it is the oldest international

organization devoted to protecting investors from fraud and abuse in the offer and sale of securities.

The members of NASAA are the state securities agencies, including the California Department of Corporations, that are responsible for regulating securities transactions under state law. Their fundamental mission is protecting investors, and their jurisdiction extends to a wide variety of investment products and financial services. Their principal activities include registering certain types of securities; licensing the firms and agents who offer and sell securities or provide investment advice; investigating violations of state law; and initiating enforcement actions where appropriate. Through the various records maintained by state securities regulators, including information related to securities offerings and the individuals who promote the offerings, state securities regulators help protect investors.

NASAA supports the work of its members in many ways: coordinating multi-state enforcement actions, conducting training programs, publishing investor education materials, and offering its views on proposed legislation governing financial services. Another core function of NASAA is to represent the membership's position, as *amicus curiae,* in significant cases involving financial services regulation.

NASAA and its members have a stake in the outcome of this case as the Court's disposition of the issues will significantly affect the ability of the Commissioner and other state securities regulators to protect investors by requiring certain types of securities to be registered. The registration of securities provides important safeguards to the public. It makes information about securities offerings available to potential investors; it enables regulators to review investment offerings, before they are circulated, for evidence of fraud and other possible violations; and it allows regulators to issue stop orders when an offering poses a threat to potential investors. *See generally* LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 388 (3d ed. 1989) (fundamental goals of the securities acts were achieved through two mechanisms: antifraud provisions and registration requirements); *id.* at 527 (remedies for registrations that are incomplete or misleading include orders refusing registration to be effective and stop orders); UNIF. SEC. ACT §§ 301-306 (1956) (registration requirements under state law and remedies for violation thereof); *see also Capital General Corp. v. Dept. of Business Regulation,* 837 P.2d 568, 571 (Utah Ct. App. 1992) (cease and desist order was in the public interest because sale of unregistered securities deprives investors of the statutory protections afforded under the Utah Uniform Securities Act).

Through this registration mechanism, regulators can often prevent or minimize injury to the investing public. Affirmance of the lower court's ruling will help ensure that state securities regulators can exercise this authority unless an offering is truly entitled to an exemption from registration. This Court's ruling can be expected to influence other courts in similar cases as evidenced by the lower court's reliance on judicial decisions issued by other courts on this very issue.[1]

NASAA and its members also have a more general interest in helping to limit the erosion of state regulatory authority through a misinterpretation of Congress's preemption provisions. State regulators in the areas of securities, banking, and insurance all play a vital role in protecting the public. Although Congress can and does set limits on the scope of state regulation, those limits must be fairly interpreted and applied, in light of Congressional intent and the important benefits that state regulators offer to the investing public. In this case, for example,

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[1]NASAA's interest in this appeal is reflected in other *amicus* briefs that it has filed. *See, e.g.,* Brief filed by NASAA in *Blue Flame Energy Corp. v. Ohio Dept. of Commerce, Division of Securities, available at www.nasaa.org/content.pdf. Blue Flame* was an appeal brought by the Ohio Department of Commerce, Division of Securities, in the Ohio Court of Appeals for the Tenth Appellate District seeking to overturn a trial court ruling that the state was preempted by NSMIA from pursuing registration violations by an issuer claiming a Regulation D, Rule 506 exemption. The appellate court reversed the lower court and ruled that the state was not preempted. *See Blue Flame Energy Corp. v. Ohio Department of Commerce, Division of Securities*, No. 05AP-1053, 2006 WL 3775856 (Ohio Ct. App. 2006).

Congress has exempted bona fide private offerings under Regulation D, Rule 506 from state registration, but it plainly did not intend that exemption to apply where the offering is not in fact private. The Consolidated Parties' attempt to stretch federal preemption beyond legitimate boundaries, in order to insulate its activities from state regulation, should be rejected. By siding against these claims, NASAA seeks to uphold respect for the congressionally recognized authority of state regulators over public securities offerings being sold in their respective jurisdictions.

Finally, NASAA is compelled to submit this brief in part to correct a mischaracterization by the Consolidated Parties regarding NASAA's stance on state regulatory authority over Regulation D, Rule 506 offerings. In their Opening Brief, the Consolidated Parties inaccurately represented that NASAA believes state authority to regulate offerings which purport to be exempt as federal covered securities under Regulation D, Rule 506 is preempted by NSMIA. Appellant's Opening Brief at 10 n.4. This simply is not an accurate characterization of NASAA's position and NASAA should be afforded the opportunity to correct the record.

ARGUMENT

I. The District Court's Decision To Abstain Was Correct Because The National Securities Markets Improvement Act Of 1996 ("NSMIA") Does Not Preempt The Authority Of State Securities Regulators To Regulate Securities That Do Not Qualify For An Exemption From Registration

The historical and important role of state securities regulators, the language that Congress adopted to limit that role under certain circumstances, and the case law interpreting the statutory language all support the axiomatic proposition that offerings under Regulation D, Rule 506 are not exempt from state regulation unless they actually comply with the provisions of Regulation D, Rule 506. Consequently, where issuers and promoters have failed to comply with those requirements, state regulators have a continued regulatory role over these offerings and a continued "state interest" within the meaning of the abstention doctrine.

A. The regulation of non-exempt securities is an important state interest and there is a long history of dual regulation of securities under state and federal law for the protection of investors

The lower court correctly ruled that this case involves an important state interest for purposes of the abstention doctrine, because the Commissioner's underlying enforcement action, based on state law, is *not* preempted. The idea that a federal court should abstain from interfering with ongoing state judicial proceedings is based on a recognition that the United States is "made up of a Union of separate state governments, and a continuance of the belief that the National

Government will fare best if the States and their institutions are left free to perform their separate functions in their separate ways." *Younger v. Harris*, 401 U.S. 37, 44 (1971). In finding that abstention was appropriate, the lower court conducted an analysis of the three requirements that must be present before a court will abstain from exercising jurisdiction, as set forth in *Middlesex County Ethics Committee v. Garden State Bar Ass'n.*, 453 U.S. 423 (1982). Specifically, the court inquired as to whether there was an ongoing state judicial proceeding; whether the proceedings involved an important state interest; and whether the state forum offered an adequate opportunity to raise constitutional challenges. *Middlesex,* 453 U.S. at 432. Finding that all three prongs were satisfied, the lower court properly invoked abstention and dismissed the Consolidated Parties' complaint.[2]

As a threshold challenge to the lower court's ruling, the Consolidated Parties contend that any interference with an alleged state interest would not be substantial since this controversy only involves one administrative order. However, the fact that the underlying controversy only involves one order is of no significance. The inquiry is not narrowly confined to the number of proceedings. Rather, it is the

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[2] For purposes of its *Younger* analysis the lower court determined that preemption was not "readily apparent." However, regardless of the precise meaning of "readily apparent," NSMIA does not preempt the state registration requirements for securities that are not covered by the statute. Because preemption does not

importance "of the generic proceedings to the state." *New Orleans Public Service, Inc. v. Council of the City of New Orleans et al.* 491 U.S. 350, 366 (1989). In this matter the "generic interest" is the protection of investors through the regulation of the offer and sale of securities (and in this case specifically the registration of securities which are not exempt). Hence, even if the impact of this case was confined to a single administrative order involving a lone issuer affecting only one investor, the state's interest would be quite sufficient for purposes of the abstention doctrine. As stated by the lower court, the principle at issue is the state's authority to investigate and possibly regulate those who are in violation of federal and state registration laws. This qualifies as an important state interest.

Of course, the state interest in this case extends far beyond the state's right to protect investors in a single enforcement action. At stake is the right of states to regulate an entire class of offerings – those made under Rule 506 – where promoters have failed to abide by the terms of the Rule. These investments are more and more prevalent and state regulators are increasingly concerned that they are often being used as vehicles for improper purposes.[3] As evidence of this

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apply at all in this case, it is logically impossible for preemption to be "readily apparent."

[3] The number of Regulation D, Rule 506 offerings "notice filed" with the states is significant. For example, in California, 8,215 Regulation D, Rule 506 filings were submitted to the Department of Corporations in 2006. In Georgia, the number of Rule 506 offerings filed was 1788; in Tennessee the number filed was 1,288; and, in Maryland the number was 2,134.

concern, on January 25, 2007, NASAA set forth its regulatory priorities in its Legislative Agenda for the 110th Congress ("Legislative Agenda").[4] NASAA called on Congress to reinstate state regulatory oversight of Regulation D offerings. NASAA is particularly concerned that the provisions of Regulation D and Rule 506 are insufficient for investor protection, even when an issuer fully complies with the terms. At a minimum, then, where offerings do not comply with the requirements of Regulation D, Rule 506, state regulatory authority should apply.

Despite the attempt by the Consolidated Parties to muddy the water, NASAA has not taken the position that states are preempted from regulating non-exempt securities. In fact, NASAA has consistently argued in its briefs and elsewhere that strict compliance with Rule 506 is necessary before such offerings can be deemed "covered securities" exempt from registration. *See* Legislative Agenda, *supra* (NASAA noted its concern that some courts have found offerings made under the guise of Regulation D, Rule 506 to be immune from state law regardless of compliance with the Rule); *see also.* NASAA's *amicus* brief filed in *Blue Flame* (offerings under Regulation D, Rule 506 are not exempt from state regulation unless they actually comply with the provisions of Regulation D, Rule

[4]NASAA's "Pro-Investor Agenda for the 110th Congress," *available at* http://www.nasaa.org/content/Files/agenda.pdf.

506). The representation made by the Consolidated Parties as to NASAA's position on NSMIA preemption is wrong as evidenced by the language in NASAA's Legislative Agenda and its *Blue Flame* amicus brief.

Finally, of course, is the state's general interest in preventing preemption of state regulation through a misinterpretation of federal law. The regulation of securities by the states preceded federal regulation by more than twenty years with the passage of a state securities statute in Kansas in 1911. THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 367 (2d ed. 1990). Other state legislatures began enacting laws regulating securities transactions in the early twentieth century, and today every state has enacted a securities act. ALAN R. PALMITER, SECURITIES REGULATION § 1.4 (2d ed. 2002). The federal securities laws were passed in the 1930s in the wake of the market crash of 1929 and they were viewed as a supplement to, rather than a substitute for, state blue sky laws, in order to help address the widespread abuses that led to the crash. RICHARD H. WALKER, *Evaluating the Preemption Evidence: Have the Respondents Met Their Burden?,* 60 LAW & CONTEMP. PROBS. 237 (Summer 1997). Both the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act") contain express savings clauses preserving state law rights and remedies. *See* Securities Act of 1933 § 16, 15 U.S.C. § 77p; Securities Exchange Act of 1934 § 28, 15 U.S.C. § 78bb.

Clearly, the "generic interest" of the state in regulating securities for the promotion of fair and open markets as well as protection of its citizens from dishonest conduct is unquestionably important and has been acknowledged by courts and federal lawmakers alike . The lower court properly found that interference by the federal courts with the Commissioner's ability to carry out this important state interest, regardless of the number of orders at issue, would be substantial.

B. The plain language of NSMIA and the applicable regulations carefully limit preemption to "Covered Securities"

With respect to the core issue in this case, the states continue to have an interest in the regulation of Regulation D, Rule 506 offerings where, as here, promoters have failed to comply with all the applicable requirements under Rule 506. Under these circumstances, NSMIA simply does not preempt state authority.

The plain, unambiguous language of NSMIA calls for preemption of state authority only where the purported exempt security actually complies with the statute and regulations. The starting point in this analysis is the language of the statute itself. *American Bar Assoc. v. Fed. Trade Comm'n*, 430 F.3d 457, 467 (D.C. Cir. 2005), citing *Group Life and Health Ins. Co. v. Royal Drug Co.*, 440 U.S. (1979). "It is a universally recognized rule of statutory construction that a court should look first to the language of the statute to determine the legislative purpose." *SEC v. Ambassador Church*, 679 F.2d 608, 611 (6th Cir. 1982). "Where

the statutory language provides a clear answer, the analysis ends there." *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 438 (1999).[5]

A basic element of securities regulation is the registration requirement. Both state and federal laws require that before a security can be offered and sold, the security must either be registered with the appropriate regulatory body or exempt from registration as provided by statute. The Capital Markets Improvement Act of 1996, a part of NSMIA, amended Section 18 of the Securities Act to eliminate the necessity of registering certain securities with state regulators. It provides that under specified conditions, state laws requiring registration are preempted. The scope of that preemption is delineated in terms of "covered securities." The language used by Congress in fashioning these exemptions is as follows.

> (a) Scope of Exemption -Except as otherwise provided in this section, no law, rule, regulation, or order, or other

[5] In addition to the plain language of the statute, the legislative history also supports the Commissioner's interpretation and application of NSMIA. Specifically, the legislative history clearly states that those securities sold "pursuant to" a SEC rule or regulation adopted under Section 4(2) would be considered "covered securities" entitled to preemption. H.R. REP. NO.104-622, at 32 (1996), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3895. The term "pursuant to" means "in accordance with." Webster's New World Dictionary (3rd College ed. 1988). Clearly the legislative history indicates Congress's intent that to be entitled to preemption the securities must be offered in accordance with all of the rule requirements. Because the Consolidated Parties used general solicitation in violation of the Rule, the securities are not exempt and state law applies. Furthermore, as pointed out later in the brief, to argue that an issuer may avoid state regulation simply by labeling the offering as a "covered security" trenches the investor protection policies that spurred Congress to enact the federal laws in the first instance and which remain unchanged even after the passage of NSMIA.

> administrative action of any State or Territory of the United States, or the District of Columbia, or any political subdivision thereof
> (1) requiring, or with respect to, registration or qualification of securities, or registration or qualification of securities transactions, shall directly or indirectly apply to a security that--
> (A) is a covered security; or
> (B) will be a covered security upon completion of the transaction

15 U.S.C. § 77r(a)(1)(A)-(B).

Therefore, the plain language of the statute clearly indicates that if, and only if, a security falls into the category of a "covered security," it is exempt from registration at the state level and states are preempted from reviewing such offerings or requiring the filing of any documents beyond what is filed with the Securities and Exchange Commission ("SEC" or "Commission").

C. Purported Regulation D, Rule 506 offerings cannot be deemed "Covered Securities" unless they actually comply with all of the requirements under Regulation D, Rule 506

Covered securities are defined in Section 18 of the Securities Act, and they include, in addition to securities listed on national stock exchanges, certain securities issued in transactions provided for in SEC regulations. The reference to rules or regulations in Section 18 encompasses Regulation D, Rule 506, concerning the private offering of securities. 17 C.F.R. §§ 230.501 - 230.508. Regulation D was intended to be a basic element in a uniform system of state-federal exemptions. 17 C.F.R. § 230.501, *preliminary notes*. It is composed of eight

rules, 501-508, and the first three rules set forth general terms and conditions that apply in whole or in part to the exemptions. Rules 504, 505, and 506 are the exemptive provisions. Rule 506 defines those offerings that do not involve "public offerings" within the meaning of Section 4(2). 17 C.F.R. § 230.506. All offers and sales made under Rule 506 must satisfy the terms and conditions of Rules 501, 502, and 503 of Regulation D. *See* THOMAS LEE HAZEN, LAW OF SECURITIES REGULATION § 4.25 (5th ed. 2005). Rule 506 states in part as follows:

> (a) Exemption. Offers and sales of securities by an issuer that satisfy the conditions of paragraph (b) of [506] shall be deemed to be transactions not involving any public offering within the meaning of section 4(2) of the [Securities] Act [of 1933].
> (b) Conditions to be met.
> (1) General Conditions. To qualify for exemption under this section, offers and sales must satisfy all the terms and conditions of [Rules] 501 and 502.

17 C.F.R. § 230.506.

Among the requirements that must be satisfied before the exemption can be claimed is a limitation on the manner in which the securities can be offered to the public, found in Rule 502(c). Specifically, "[n]either the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising." 17 C.F.R. § 230.502. Thus, an offering pursuant to Rule 506 must be a private offering as required by Section 4(2).

Subsection (D) of Section 18 of NSMIA, which defines a category of "covered security" in terms of the offerings that are exempt pursuant to regulations

adopted by the SEC, clearly refutes the Consolidated Parties' principal contention that Regulation D, Rule 506 offerings are "covered securities" regardless of whether those offerings actually comply with the requirements of the regulation. Subsection (D) plainly states that an offering is a covered security only if "the offer or sale of such security **is exempt** from registration . . . pursuant to Commission rule or regulation . . . ." 15 U.S.C. § 77r(b)(4)(D) (emphasis added). It does not say that such offerings are exempt from state registration if the security "purports to be exempt," or "is claimed by the issuer to be exempt," or "is labeled as exempt." Thus, Congress's language makes it abundantly clear that to be considered a covered security the offering must actually be exempt pursuant to the SEC's rules and regulations.

The wording and the structure of Regulation D, Rule 506 provides additional proof that an offering must actually satisfy all of the relevant requirements in order to benefit from the exemption. Part (a) confers the exemption only on "offers and sales of securities by an issuer **that satisfy the conditions**" set forth in the rule. *See* 17 C.F.R. § 230.506 (a) (emphasis added). With respect to the general conditions, the rule declares that "[t]o qualify for exemption under this section, offers and sales **must satisfy all the terms and conditions of §§ 230.501 and 230.502,"** which include the prohibition on general solicitation or general advertising. *See* 17 C.F.R. § 230.506(b) (emphasis added).

In both the commentary to the rule and in the wording of Rule 508 of Regulation D, the SEC displayed a sensitivity to the distinction between actual and purported compliance with the rule. In the commentary, the Commission went so far as to state that even technical compliance with all of the terms and condition of the rule would not be sufficient to exempt the issuer from the registration obligation if the transaction was part of a plan or scheme to evade the requirements of the Act. Conversely, in Rule 508, the SEC took pains to specify the exacting conditions under which loss of the exemption might be avoided in the absence of complete compliance with the rule. Those conditions do not apply here because, as a threshold matter, the Consolidated Parties never invoked them. More importantly, they could not possibly apply in this case because those conditions cannot be met where the restrictions on the manner of solicitation have been violated. 17 C.F.R. § 230.508(a)(2).[6]

Removing all doubt on this issue is the preservation of state authority set forth in NSMIA. Congress not only preserved the states' antifraud power over otherwise exempt offerings, it also stipulated that states retain the authority to suspend any offering where a required "filing or fee" has not been submitted. 15 U.S.C. § 77r(c)(3). In the case of Regulation D, Rule 506 offerings, the required

[6] The Consolidated Parties furthermore could not avail themselves of the good faith provisions of Regulation D, Rule 508. Their violations of Rule 502(c) were not

filing is the Form D. It is untenable to suggest that Congress would permit states to enjoin an offering where the issuer fails to file the Form D, but would tie the states' hands completely where the issuer files a false Form D or fails to meet the very conditions that are necessary to qualify for the exemption.

D. By virtue of the fact that the consolidated parties engaged in general solicitation, preemption does not apply and the securities offered are fully subject to state regulation

The basis for the action taken by the Commissioner in this matter was the result of prohibited general solicitation of investors by agents of the Consolidated Parties. As discussed above, Regulation D, Rule 502(c), prohibits the use of general solicitation by the issuer or any person acting on behalf of the issuer for all offers and sales made under Regulation D. 17 C.F.R. § 230.502(c). In short, the Commissioner alleged that an agent for the Consolidated Parties engaged in general solicitation for unregistered securities. The Commissioner issued an administrative order which was sustained by an administrative law judge and subsequently affirmed by a California state court judge. Because an agent for the Consolidated Parties engaged in general solicitation, the securities are not "covered securities" and the preemptive effect of NSMIA does not apply.

"insignificant" and were carried out with the full intent and knowledge of the Consolidated Parties.

E. The better-reasoned decisions from both federal and state courts support the Commissioner's interpretation and application of NSMIA

A survey of the case law in this area reveals that while state and federal courts are not uniform, an overwhelming number of well-reasoned decisions directly support the Commissioner's interpretation and application of the provisions of NSMIA at issue in this case. Most recently the Sixth Circuit Court of Appeals, the first federal appeals court to consider this issue, rebuffed the idea that securities sold pursuant to Regulation D, Rule 506 are "covered securities" entitled to preemption regardless of whether or not the issuer actually complies with the applicable regulations. *Brown v. Earthboard Sports USA, Inc.*, No. 05-637, 2007 WL 777491, *5 (6th Cir. 2007). Like the Consolidated Parties, the securities issuer in *Brown* claimed that the subject securities were offered "pursuant to" an exemption and state laws governing the registration of securities were thereby preempted. In rejecting this argument, the *Brown* court observed that such a reading would eviscerate all state securities registration requirements and this is a result Congress did not intend when it adopted NSMIA. *Brown*, 2007 WL 777491 at *7. The plain and restrictive language of the statue makes it clear that it was not Congress's goal to broadly preempt state securities law such that "state registration requirements could be avoided merely by adding spurious boilerplate

language to subscription agreements suggesting that the offerings were 'covered,' or by filing bogus documents with the SEC." *Id.*

In addition to the Sixth Circuit case discussed above, other courts have refused to read NSMIA in the broad preemptive manner advocated by the Consolidated Parties. In *Buist v. Time Domain Corp.*, 926 So.2d 290 (Ala. 2005), the Alabama Supreme Court closely examined Regulation D, Rule 506 and the various burdens the parties must carry relative to those exemptions. The court pointed out that the defendants bear the burden of proof on the affirmative defense of preemption. *Buist,* 926 So.2d at 293. Likewise, "the burden of establishing an exemption is on the party who claims it." *Id.* (citing *SEC v. Ralston Purina Co.*, 346 U.S. 119, 126 (1953)). The court went on to say that under Rule 506 exemption and preemption are functionally equivalent. In other words, if an issuer can satisfy the requirements of Rule 506 then it is entitled to claim the exemption and by virtue of the exemption all relevant state securities laws are preempted save for those expressly reserved in NSMIA (i.e. state filing requirements, fees, and anti-fraud authority). *Id.* However, the court made clear that before a party can invoke preemption, it must prove that its offering has complied with all of the requirements of Regulation D. The court ruled that the defendants had not sustained their burden of showing compliance with the conditions set out in

Regulation D, Rule 506 and therefore reversed the trial court's grant of partial summary judgment. *Buist,* 926 So.2d at 298.

In *Myers v. OTR Media, Inc.*, No. 1:05 CV 101 M, 2005 WL 2100996 (W.D. KY 2005), the court also addressed the issue of the preemptive effect of Regulation D, Rule 506. The plaintiff in *Myers* moved for summary judgment arguing that the defendants had failed to comply with the requirements of Regulation D, Rule 506. The defendants argued that there was sufficient evidence to create a question of fact as to compliance with the Rule. The court in analyzing the issues cited Regulation D, Rule 506(b), which states that in order "to qualify for an exemption under this section, offers and sales must satisfy all the terms and conditions of [sections] 230.501 and 230.502". *Myers,* 2005 WL 2100996 at *5. The court denied the plaintiff's motion and held that the defendants had proffered sufficient evidence to raise a question of fact "as to whether they are exempt under Rule 506." *Id.*.

In *AFA Private Equity Fund 1 v. Miresco Investment Services*, No. 02-7460, 2005 WL 2417116 (E.D. Mich. 2005), the defendant argued that the plaintiff had failed to state a claim based on an unregistered sale of securities because the securities at issue were federally covered and thus exempt from registration. *AFA*, 2005 WL 2417116 at *9. After reviewing the applicable provisions of NSMIA and the regulations, the court agreed with the plaintiff's argument that the issuer must

present evidence showing that the securities at issue are exempt from registration under the rules adopted by the SEC pursuant to section 4(2). Moreover, the court held that it is the issuer's burden to establish that the exemption applies and that all conditions for the exemption have been satisfied. *Id.* (citing *S.E.C. v. Raulston Purina Co.*, 346 U.S. 119, 126-27 (1953)).

Still other courts have rejected the principle of broad NSMIA preemption holding that "the only way to assert federal preemption is to first show that an exemption from federal registration actually applies." *Hamby v. Clearwater Consulting Concepts, LLP*, 428 F. Supp. 2d 915, 921 (E.D. Ark. 2006); *Grubka v. Webaccess International, Inc.*, 445 F. Supp. 2d 1259, 1270 (D. Colo. 2006) ("Nowhere [does NSMIA] indicate that that a security may satisfy the definition [of a covered security] if it is *sold pursuant to* a putative exemption") (emphasis in original); *Blue Flame Energy Corp. v. Ohio Department of Commerce, Division of Securities,* No. 05AP-1053, 2006 WL 3775856, *11 (Ohio App. 10 Dist. 2006) (a security is covered if it is exempt from registration not if it is sold pursuant to a putative exemption.).

The Consolidated Parties rely on a decision rendered by a district court in Florida for the proposition that an issuer need only invoke the moniker of Regulation D, Rule 506 in order to enjoy preemption. *See Temple v. Gorman*, 201 F. Supp. 2d 1238 (S.D. Fla. 2002). Essentially, the *Temple* court held that state

laws were preempted regardless of whether or not the requirements of Regulation D, Rules 501, 502, 503, and 506 were satisfied. Reading the words "pursuant to" into the text of NSMIA, the *Temple* court ruled that for purposes of preemption, it makes no difference if an issuer actually complies with the law, rather what is important is that the issuer invoked the exemption provided in NSMIA. The *Temple* decision was followed in *Lillard v. Stockton*, 267 F. Supp. 2d 1081 (N.D. OK. 2003) and *Pinnacle Commc'ns. Int'l, Inc. v. Am. Family Mortgage Corp.*, 417 F. Supp. 2d. 1073, 1087 (D. Minn. 2006) ("When an offering purports to be exempt under federal Regulation D, any allegation of improper registration is covered exclusively by federal law.") Without extensive analysis, the *Lillard* court cited *Temple* in finding that regardless of whether the issuer actually complied with the requirements of Regulation D and Rule 506, the plaintiff's private civil action under the state's securities laws was preempted pursuant to the provisions of NSMIA.[7]

In reaching the conclusion that state law is preempted regardless of whether or not the security is actually an exempt security, the courts in *Temple* and *Lillard* disregarded the express language of the statute and the regulations. As discussed

[7] The court in *Lillard* noted in its opinion that the plaintiffs failed to respond to the preemption argument when it was raised by the defendants in various briefs and pleadings, and further that the plaintiffs failed to respond to the argument when it was raised by the defendants at a hearing. *Lillard*, at 1116. This history casts additional doubt on the precedential effect of the *Lillard* case.

above, NSMIA clearly restricts the category of federal covered securities. Rule 506 in turn clearly states that only those offers and sales of securities that satisfy the conditions in the rule shall be deemed to be transactions not involving any public offering. In short, the offering must actually be a "covered security," that is, one that complies with the applicable law, before it is entitled to preemption. To read the statute otherwise would allow a defendant to escape liability under state law "simply by declaiming its alleged compliance with Regulation D" and such a reading of the law is "an unsavory proposition" that would "eviscerate the statute." *Grubka*, 445 F. Supp. 2d at 1270; *See also. Brown v. Earthboard Sports USA, Inc.*, No. 05-637, 2007 WL 777491, *7 (6th Cir. 2007).

In addition to the numerous courts that have rejected *Temple* and its progeny, commentators in the field of securities law have also found fault with these opinions by noting the obvious: the security has to actually comply with the rules in order to be considered a "covered security" entitled to federal preemption. Hugh H. Makens, *Blue Sky Practice – Part I: Doing it Right*, SL075 ALI-ABA 549, 554 (Mar. 16, 2006). One treatise writer has described the *Temple* holding as "highly suspect." THOMAS LEE HAZEN, LAW OF SECURITIES REGULATION § 4.24 (5th ed. 2005). Another commentator noted that the *Temple* decision was "incorrectly decided." Joseph C. Long, *A Hedge Fund Primer*, 1503 PLI/Corp. 233 (Aug. 2005); *see also* 12 JOSEPH C. LONG, BLUE SKY LAW § 3:81 (2005) ("If

all that was required for preemption was a bald-face statement that the offering was made under Rule 506, then any con artist could avoid state regulation by telling the investor that the offering was a private placement under Rule 506").

F. The Appellees' interpretation of NSMIA is inconsistent with the policy of investor protection that underlies federal securities law, even as amended by NSMIA

When the federal securities statutes were debated and adopted, Congress was very much concerned with investor protection. This concern is evident in the legislative history of the Securities Act, excerpted below, which places investor protection first in a long list of objectives.

> The purpose of this bill is to protect the investing public and honest business. The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; to restore the confidence of the prospective investor in his ability to select sound securities; to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power.

S. REP. NO. 73-47, at 1 (1933); *see also Piper v. Chris-Craft Indus.*, 430 U.S. 1 (1977) (recognizing Congress's intent in passing the federal securities laws as the protection and benefit of individual investors).

And, in NSMIA, Congress did not abandon the goal of protecting investors. As Congress drafted the language for the section 4(2) exemption, it was careful to point out that the purpose of the exemption was to "facilitate private placement of securities consistent with the public interest and the protection of investors." H.R. REP. NO. 104-622 (1996), *Reprinted in* U.S.S.C.A.N. 3877, 3895. However, applying the provisions of NSMIA in a manner consistent with this purpose requires the rejection of the arguments raised by the Consolidated Parties. Specifically, if an issuer complies with the rules governing private offerings, then it is entitled to avoid state registration requirements. If, on the other hand, the issuer disregards the rules it should not escape the scrutiny of the state regulators simply by invoking Regulation D, Rule 506.

This argument takes on especially great weight in light of the volume of Regulation D, Rule 506 offerings that are filed every year. The Consolidated Parties are arguing that this Court grant promoters who use the Regulation D, Rule 506 label – whether legitimately or not – unfettered access to California investors, thus broadening a preemption scheme that already restricts state regulatory authority with respect to an enormous volume of privately offered securities. *See* Gilbert Warren Manning, *Reflections of a Dual Regulation of Securities: A Case for Reallocation of Regulatory Responsibility*, 78 Was. U.L.Q. 497, 504 (2000).

Clearly such an argument does not comport with the federal or state securities laws as originally enacted or as amended by NSMIA.

In short, in order to qualify for the exemption provided in Rule 506 and obtain relief from state registration requirements, all offers and sales made under Rule 506 must satisfy the terms and conditions of Rules 501, 502, and 503 of Regulation D. THOMAS LEE HAZEN, LAW OF SECURITIES REGULATION § 4.25 (5th ed 2005). The Consolidated Parties failed to do so in this case because they engaged in general solicitation. Accordingly, their offerings were not exempt from state registration requirements.

CONCLUSION

For the reasons stated herein, *Amicus* urges the Court to affirm the lower court in this matter.

Dated this the 2nd day of April 2007.

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AND CIRCUIT RULE 32-1 FOR CASE NUMBER 06-17011

I hereby certify that pursuant to Red. R. App. P. 29(d) and Ninth Circuit Rule 32-1, the attached *amicus* brief is proportionately spaced, has a typeface of 14 points or more, and contains 6,219 words.

Dated April 2, 2007.

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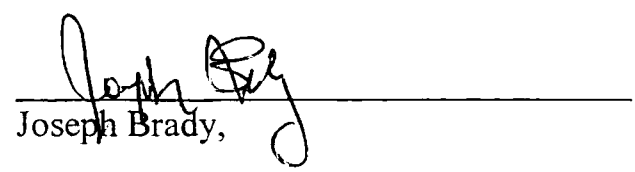

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