IN THE TENTH DISTRICT COURT OF APPEALS
FRANKLIN COUNTY, OHIO

IN THE MATTER OF BLUE FLAME ENERGY CORP., et al.,	:	
Appellees,	:	
v.	:	Case No. 05AP-1053
OHIO DEPARTMENT OF COMMERCE	:	
Appellant	:	

BRIEF OF *AMICUS CURIAE* NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., IN SUPPORT OF THE OHIO DEPARTMENT OF COMMERCE

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INTRODUCTION

The North American Securities Administrators Association, Inc. ("NASAA") submits this Brief in Support of Appellant Ohio Department of Commerce, Division of Securities ("Appellant" or "Division") and offers the perspective of all state securities regulators on the important issues presented. The lower court's ruling should be reversed for the following reasons. First, Appellees engaged in a prohibited general solicitation and general advertisement of its offering. As a result of this activity, Appellees are not entitled to claim an exemption from the registration requirements under the Ohio Securities Laws. Second, Appellees purposefully conducted business in the State of Ohio through their websites and through transactions with Ohio residents. Therefore, Appellees are subject to personal jurisdiction in Ohio.

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.

Members of NASAA include the state securities agencies, such as the Ohio Division of Securities, 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. The information in those records helps ensure that investors receive disclosures about investments before they part with their money and that the brokers offering those investments are properly qualified and licensed.

NASAA supports the work of its members in many ways: coordinating multi-state enforcement actions, offering 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 primarily for two reasons. First, the Court's disposition of the issues will significantly affect the ability of the Ohio Division of Securities to protect Ohio

residents under the Ohio Securities Act. The lower court's decision gives unscrupulous issuers and promoters a safe haven under Regulation D, Rule 506: they are shielded from state regulation simply by invoking the rule, whether or not they have satisfied its conditions or are entitled to its preemptive effect. The lower court's ruling also deprives the Division of jurisdiction over those who use the internet to promote securities offerings to Ohio residents. Because these issues represent emerging areas of state securities law, the Court's ruling in this appeal can be expected to influence other courts in similar cases. As evidenced by the lower court's reliance on judicial decisions issued by noon-Ohio courts, the impact of this case thus will extend beyond Ohio's borders to states across the country.

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 in light of the important benefits that state regulators offer to the investing public. In this case, for example, 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 lower court's

ruling to the contrary cannot be reconciled with statutory analysis, Congressional intent, or the most recent and better-reasoned court decisions addressing the issue. The Appellees' 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.

Unless this Court overturns the ruling of the lower court on the issues presented, the Ohio Division of Securities and state securities regulators across the country will be hampered in their regulatory efforts, and unscrupulous promoters will be given an advantage that Congress never intended.

ARGUMENT

I. The National Securities Markets Improvement Act of 1996 ("NSMIA") Does Not Preempt the Authority of State Securities Regulators to Regulate Securities Offerings That Do Not Qualify for the Exemption From Registration Pursuant to Regulation D, Rule 506.

The historical role of state securities regulators, the language that Congress adopted to limit that role under certain circumstances, and the case law interpreting that 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.

A. There Is a Long History of Dual Regulation Under State and Federal Law for the Protection of Investors

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. Hazen, The Law of Securities Regulation (2nd Ed. 1990) 367. Other state legislatures began enacting laws regulating securities transactions early this century, and today every state has enacted a securities statute. Palmiter, Securities Regulation (2nd Ed. 2002) Section 1.4. The federal securities laws were passed in the 1930s in the wake of the market crash of 1929. 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. Walker, 60-SUM Law & Contemp. Probs. (Summer 1997) 237. 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, Section 77p, Title 15, U.S. Code Securities Exchange Act of 1934 § 28, Section 78bb, Title 15, U.S. Code.

The parallel system of securities regulation remained virtually unchanged in the United States for over six decades until 1996 when Congress passed the National Securities Markets Improvement Act ("NSMIA"). Congress's goal in enacting NSMIA was to promote efficiency and capital formation in the financial markets, while maintaining a high level of investor protection. To achieve this

specific goal, NSMIA allocated to the federal government primary regulatory responsibility for specifically enumerated securities offerings, chiefly those that are national in character. The purpose of NSMIA was clearly stated in the legislative history as follows:

> The legislation seeks to further 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.

H.R. Rep. No. 104-622, at 3878 (1996), reprinted in 1996 U.S.C.C.A.N. 3877, 3878.

B. NSMIA and the Applicable Regulations Carefully Limit Preemption to "Covered Securities"

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 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;

Section 77r(a), Title 15, U.S. Code.

Therefore, *provided* that a security falls into the category of a "covered security," it is exempt from registration at the state level and states are preempted from requiring the filing of any documents beyond what is filed with the Securities and Exchange Commission ("SEC").

Covered securities are defined in Section 18 of the Securities Act, and they include, in addition to securities listed on national stock exchanges, certain "exempt offerings:"

> (4) Exemption in connection with certain exempt offerings--A security is a covered security with respect to a transaction that is exempt from registration under this subchapter pursuant to--
>
> (A) paragraph (1) or (3) of section 77d of this title, and the issuer of such security files reports with the Commission pursuant to section 78m or 78o(d) of this title;
>
> (B) section 77d(4) of this title;
>
> (C) section 77c(a) of this title, other 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 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 or such security is located; or
> (D) Commission rules or regulations issued under section 77d(2) of this title, except that this subparagraph does not prohibit a State from imposing notice filing requirements that are substantially similar to those required by rule or regulation under section 77d(2) of this title that are in effect on September 1, 1996.

Section ____, Title 15, U.S. Code.

The reference to rules or regulations "under section 4(2) of this title" encompasses Regulation D, Rule 506, concerning the private offering of securities. _Section 230.501 et seq., Title 17, C.F.R. defines those offerings that do not involve "public offerings" within the meaning of Section 4(2). Section 230.506, Title 17, C.F.R.. All offers and sales made under Rule 506 must satisfy the terms and conditions of Rules 501, 502, and 503 of Regulation D. See Hazen, Law of Securities Regulation (5th Ed. 2005) Section 4.25. 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.

Section 230.506, Title 17, C. F. R.

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." Section 230.502, Title 17, C.F.R. Thus, an offering pursuant to Rule 506 is a private offering within the scope of Section 4(2), *if* it satisfies all of the conditions of the rule, including the restrictions on general solicitation and advertising.

In this case, the Appellees violated the prohibition on general solicitation or general advertising. The Hearing Officer found in favor of the Appellant and ruled that the materials placed on the Appellees' website were general solicitations. Report and Recommendation, Administrative Hearing Officer D. Michael Quinn, at 22 (Dec. 9, 2003). The Magistrate expressly declined to overturn this finding: "Upon review of the arguments of counsel and the reproduced web pages, this writer cannot determine that the Division was in error as to the content of the webpages." Magistrate's Decision and Recommendation, at 10 (Mar. 1, 2005). The Court of Common Pleas also sided with the Appellant on this issue, noting that the evidence was sufficient to support the finding that the Appellees had engaged in prohibited general solicitations. Decision, at 12 (Aug.

27, 2005). Perhaps most significantly, the Appellees have not challenged this finding on appeal to this Court. [1]

C. By Virtue of the Fact that Appellees Engaged in General Solicitation and General Advertising, Their Offering Is Not a "Covered Security" and it Is Fully Subject to State Regulation

Because the Appellees engaged in general solicitation, the Appellees' offering did not satisfy Rule 506, it did not constitute a "covered security," and the preemptive effect of NSMIA does not apply. The starting point in the analysis is the language of the applicable statute, in this case subsection 4(D) of Section 18

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[1] These findings are amply supported by the record. As discussed in detail by the Administrative Hearing Officer, the website touted the benefits of investing in Direct Participation Programs and specifically the potential rewards of investing in Appellees' business operations. In addition to the website(s) maintained by the Appellees, the Hearing Officer also noted an article that appeared on "The Bull & Bear Financial Report" website with the heading "Blue Flame Energy Corporation" and the subheading, "Gas Well Partnerships = Tax Breaks and 20+ Year Cash Flow Portfolio Diversification for Aggressive High Net Worth Investors." See generally Report and Recommendation, Administrative Hearing Officer Michael D. Quinn, at 7 (Oct. 9, 2003).

These findings are in accordance with the SEC's view. "Broad use of the Internet for exempt securities offerings under Regulation D is problematic because of the requirement that these offerings not involve a general solicitation or advertising." Use of Electronic Media, SEC Release Nos. 7856, 33-7856, 34-42728, at12 (Apr. 28, 2000). The SEC has suggested that determining whether or not a communication is in fact a general solicitation or general advertisement prohibited by Rule 502(c) is a two step analysis. First, is the communication in question a general solicitation or general advertisement? Second, if it is, is it being used by the issuer or by someone on the issuer's behalf to offer or sell the securities? Interpretive Release on Regulation D, SEC Release No. 6455, 17 C.F.R. 6455. The Hearing Officer below reviewed all of the internet sites maintained by the Appellees, as well the article that appeared on the website of a third party, and answered both of these questions in the affirmative.

of NSMIA, quoted above, *supra* 7-8. This language on its face refutes the Appellees' principal contention that states may not regulate Regulation D, Rule 506 offerings 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 "with respect to a transaction that **is exempt** from registration . . . pursuant to . . . Commission rules or regulations . . . ." Section ____, Title 15, U.S. Code (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 Commission's rules and regulations.

The wording and the structure of Regulation D, Rule 506 provides additional and ample 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 Section 230.506(a), Title 17, C.F.R. (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 Section 230.56(b), Title, C.F.R. (emphasis added).

In both the commentary to the rule and in the wording of Rule 508 of Regulation D, the SEC expressly addressed the distinction between complete and only partial compliance with the rule. In the commentary, the SEC 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. See Section 230.501, Title 17, C.F.R. *preliminary notes*, Note 6. Conversely, in Rule 508, the SEC took pains to specify the very limited circumstances under which the exemption might still be available in the absence of total compliance with the rule. 17 C.F.R. § 230.508. Those conditions do not apply here because, as a threshold matter, the Appellees 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. Section 230.508 (a) (2), Title 17, C.F.R.[2]

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. Section 77r (c) (3) Title 15, U.S. Code. In the case of Regulation D, Rule 506 offerings, the required 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 claim the exemption.

D. The Better-Reasoned Decisions from Both Federal and State Courts Support Appellant's Interpretation and Application of NSMIA

Although the case law is not uniform, several recent and well-reasoned decisions lend direct support to Ohio's interpretation and application of the provisions of NSMIA at issue in this case. In *Buist v. Time Domain Corp.*, (Ala. 2005) Fed. Sec. L. Rep. P93, 308, 2005 WL 1793342, the plaintiff sued the defendant alleging violations of the Alabama Securities Act. The defendant moved for partial summary judgment arguing that the subject securities were "covered securities" issued pursuant to Regulation D, Rule 506 and as such the plaintiff's state law claims were preempted. The plaintiffs argued that the defendants had not proved that the securities were in fact covered securities. *Buist* at *3. The trial court granted the motion and the plaintiff appealed.

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[2] Appellees furthermore could not avail themselves of the good faith provisions of Regulation D, Rule 508. Their violations of Rule 502(c) were not "insignificant"

In reversing the trial court, 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* at *4. Likewise, "the burden of establishing an exemption is on the party who claims it." *Buist* at *4 (citing *SEC v. Ralston Purina Co.*, (1953) 346 U.S. 119, 126). 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). *Buist* at *4. 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.

In *Myers v. OTR Media, Inc.*, (W.D.K.Y, 2005), Case No. 05 CV101M, 2005 WL 2100996, the court also dealt with 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

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and were carried out with the full intent and knowledge of the Appellees.

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* 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." *Myers* at *5.

In *AFA Private Equity Fund 1 v. Miresco Investment Services et al.*, (E.D. Mich. 2005), Fed. Sec. L. Rep. P93, 541, 2005 WL 2417116, 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* 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, it is the issuer's burden to establish that the exemption applies and that all conditions for the exemption have been satisfied. *AFA* at *9 (citing *S.E.C. v. Raulston Purina Co.*, (1953) 346 U.S. 119, 126-27).

Appellees rely principally on *Temple v. Gorman*, (S.D. Fla. 2002), 201 F. Supp.2d 1238 to support their position that the Division's action in this matter is

preempted regardless of whether or not the requirements of Regulation D, Rules 501, 502, 503, and 506 were satisfied. In *Temple,* a private plaintiff attempted to recover investments in a purported Regulation D, Rule 506 offering pursuant to remedies available under Florida state securities law. The plaintiff argued that the issuer failed to comply with the requirements of Regulation D and Rule 506. As the offering was not registered with the state and failed to satisfy the standards of Regulation D and Rule 506, the plaintiff argued that the securities were illegally sold and he was entitled to a rescission of the transaction. The *Temple* court ruled against the plaintiff and held that regardless of whether or not an issuer actually complies with the substantive requirements of Regulation D or Rule 506, the securities sold to the plaintiff were in fact covered securities. As a result, plaintiff's claim under Florida securities law was preempted. The *Temple* decision was followed in *Lillard v. Stockton*, (N.D. Okla. 2003) , 267 F. Supp.2d 1081. 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.[3]

[3] 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.

Temple and *Lillard* are not persuasive and should not control the outcome of this appeal. In the *Buist* opinion, the court expressly rejected the holdings of *Temple* and *Lillard.* In short, the court noted an "absence of any citation to caselaw or other supporting authority" for the holding in *Temple*. *Buist* at *5. As *Lillard* simply relied on *Temple*, the Alabama Supreme Court declined to follow it as well.

In reaching the conclusion that state law is preempted regardless of whether or not the issuer satisfies the requirements of Regulation D and Rule 506, the courts in *Temple* and *Lillard* disregarded the express language of the statute and the regulations, as discussed above. NSMIA clearly restricts the category of federal covered securities under section 4(2) as those made pursuant to a Commission rule or regulation. 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 with the meaning of section 4(2).

The decisions in *Temple* and *Lillard* have drawn criticism from a number of commentators. One treatise writer has described the *Temple* holding as "highly suspect." Hazen, Law of Securities Regulation (5th Ed. 2005) Section 4.24. Another commentator noted that the *Temple* decision was "incorrectly decided." Long, A Hedge Fund Primer, (Aug. 2005) 1503 PLI/Corp. 233. Accordingly, the

better-reasoned cases support the Appellant's position that the Appellees' offering was not a "covered security" because it did not satisfy the elements of Rule 506.

E. 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. 73d Cong., 1st Sess.1 (1933)

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." 1996 U.S.S.C.A.N. 3877, 3895. Applying the

provisions of NSMIA in a manner consistent with this purpose requires the Appellees interpretation to be rejected. 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. As stated in Appellant's brief, the Division receives approximately 1800 Regulation D filings a year and the SEC receives approximately 16,000 filings a year. Appellant's Brief at page 24. Appellees are arguing that this Court grant promoters who use the Regulation D, Rule 506 label – whether legitimately or not – unfettered access to Ohio investors, thus broadening a preemption scheme that already restricts state states regulatory authority with respect to an enormous volume of privately offered securities. See Manning, *Reflections of a Dual Regulation of Securities: A Case for Reallocation of Regulatory Responsibility*, (2000) 78 Was. U.L.Q. 497, 504. 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 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. Hazen, Law of Securities Regulation (5th Ed. 2005) Section 4.25 This means that when the transaction qualifies for Rule 506's safe harbor, there is an exemption from state registration requirements. However, if the safe harbor or Rule 506 is unavailable or lost, then the state registration requirements are not preempted and the issuer must either register under state law or find an applicable state law exemption. See Hazen at Section 4.25. The Hearing Officer correctly concluded that by virtue of its use of general solicitation, Appellees violated Rule 502(c) thereby forfeiting the exemption provided in Rule 506.

II. As a Result of Appellees Conduct Within the State of Ohio, the Ohio Division of Securities had Personal Jurisdiction to Investigate Appellees Activities and Ultimately to Pursue an Administrative Claim Against Appellees.

The Hearing Officer found that the Ohio Division of Securities had both subject matter and personal jurisdiction in this matter and could pursue an administrative enforcement case against Appellees. Subsequently, both the Magistrate and Common Pleas Judge overruled the Hearing Officer, finding that the websites were not "interactive to a degree that reveals specifically intended interaction with residents" of Ohio. Decision, at 10. This ruling is not consistent with the record in this case or with the leading cases addressing the types of internet activity that give rise to personal jurisdiction. Because the internet has become such a popular tool among those who promote investment offerings, it is

exceptionally important for this aspect of the lower court's decision to be corrected on appeal.

A. The Appellant Has Jurisdiction to Pursue Its Enforcement Action the Appellees

Appellant has personal jurisdiction to pursue its administrative claim against Appellees under the leading decision on internet solicitations, *Zippo Manufacturing Company v. Zippo Dot Com, Inc.* (W.D. PA. 1997), 952 F. Supp. 119. This case established a sliding scale approach for analyzing cases involving internet activities and under what circumstances such activities warranted a finding of personal jurisdiction. The *Zippo* case has been cited favorably by an Ohio Court and its analysis used to find personal jurisdiction.[4]

As explained in *Zippo*, personal jurisdiction can be constitutionally exercised depending on the nature and quality of commercial activity that an entity conducts over the internet. *Zippo* at 1124. The likelihood of jurisdiction is proportional to the type and amount of activity. The *Zippo* court further posited that whether or not personal jurisdiction could be exercised depended on where the activity fell on a spectrum or sliding scale. On one end of the spectrum, "are situations where a defendant clearly does business over the Internet. If the

[4] *Edwards v. Erdley, et al.*, (2001), 118 Ohio Misc. 2d 232, 770 N.E. 2d 672. The Court of Common Pleas of Ohio, Franklin County, used the *Zippo* analysis in determining that the court had personal jurisdiction to hear a medical malpractice claim involving a non-resident defendant that used the internet to advertise certain medical services.

defendant enters into contracts with residents of a foreign jurisdiction that involve the knowing and repeated transmission of computer files over the Internet, personal jurisdiction is proper." *Zippo* at 1124 (citing *CompuServe, Inc. v. Patterson* (C.A. 6 1996), 89 F.3d 1257). At the opposite end of the spectrum are cases where a defendant has simply posted a website that can be viewed by internet users across the globe. "A passive Web site that does little more than make information available to those who are interested in it is not grounds [for a Court] to exercise personal jurisdiction." *Zippo* at 1124 (citing *Bensusan Restaurant Corp. v. King*, (S.D.N.Y. 1996), 937 F. Supp. 295). Those cases that occupy the middle ground of this spectrum are those involving sites where a user can exchange information with the host computer. "In these cases the exercise of jurisdiction is determined by examining the level of interactivity and commercial nature of the exchange of information occurs on the Web site." *Zippo* at 1124 (citing *Maritz, Inc.v. Cybergold, Inc.* (E.D.Mo. 1996), 947 F. Supp. 1328).

The Appellees' websites were more than mere passive sites maintained for the purpose of making available generic information about the Appellees. In fact, a careful review of the facts as detailed in the Hearing Officer's Report and Recommendation confirms the existence of that interactivity, in the form of persistent and knowing solicitations of Ohio residents to purchase securities, necessary to support a finding of personal jurisdiction under *Zippo*.

First, Appellees are interrelated companies sharing identities both in management and mission. Essentially, therefore, the Court has before it two websites – one maintained by Blue Flame and one maintained by Energy Group.

Second, the websites maintained by Blue Flame and Energy Group did not simply contain information about the companies. Rather, these websites, as noted by the Hearing Officer, touted the operations of the companies by claiming that an investor would experience significant tax advantages; that the business operations of these companies was time tested, thereby limiting liability and maximizing benefits; and that an investment in these companies was less then most public offerings. Critically, each website also displayed questionnaires intended to allow potential investors to request contact from a representative from the company.

Third, these entities were touted in an article written by a third party under the close supervision of management at Blue Flame and the Energy Group. Excerpts from the article as pointed out by the Hearing Officer include the following.

- Investors in Blue Flame DPPs benefit directly from undiluted cash flow and tax benefits;
- "We anticipate that investors will receive checks from these partnerships for 20 years or more," says Larry Buettner, Blue Flame's President;
- Blue Flame DPPs are a clear alternative to investing in real estate, stocks, bonds, and mutual funds offering both ongoing cash flows and tax benefits"; and,

- Blue Flame Energy Corp is an intriguing and potentially lucrative investment.

Report and Recommendation, Administrative Hearing Officer D. Michael Quinn, at 7 – 8 (Dec. 9, 2003).

At the conclusion of the article, potential investors were encouraged to perform their own due diligence as to Blue Flame. In order to assist potential investors in this undertaking the article listed contact information for Blue Flame including the name of the director of Investor Relations, toll free telephone numbers, addresses, fax numbers, website information, and an email address.

It is clear from the facts cited by the Hearing Officer throughout his Report and Recommendation that the Appellees intended this website to serve as a vehicle for the offer of their securities to the general public. These sites were not simply passive sites from which a person could read about the operations of the company and no more. The sites were designed to attract potential investors and to provide a means by which such investors could contact the Appellees in order to engage in transactions in securities.[5]

When a defendant makes a conscious choice to conduct business with the residents of a forum state, "it has clear notice that it is subject to suit there."

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[5]At least two Ohio residents have invested in the Appellees' offerings. Although the record does not indicate whether these transactions arose as a direct consequence of the internet solicitations, these business dealings with Ohio residents provide an additional and independent basis, apart from the Appellees' internet activities, for a finding that the Appellees are conducting business in Ohio and are subject to the Division's jurisdiction.

Zippo at 1126 (citing *World-Wide Volkswagen v. Woodson* (1980), 444 U.S. 286). Pursuant to the joint stipulations filed with the Hearing Officer, Appellees filed reports with the Division reflecting two transactions with Ohio residents. Report and Recommendation, Administrative Hearing Officer D. Michael Quinn, at 3 (Dec. 9, 2003). By generating interest in its securities through its website and by executing transactions with two Ohio residents, Appellees have clearly and unequivocally subjected themselves to suit in Ohio. If Appellees had not wanted to be amendable to jurisdiction in Ohio, they could have chosen not to sell their securities to Ohio residents.

While the contacts between Appellees and Ohio in the form of executed transactions is not extensive,[6] the United States Supreme Court has held that even a single contact can be sufficient. *McGee v. International Life Insurance Co.* (1957), 355 U.S. 220, 223. The test has always focused on the nature and quality of the contacts, not the number. *International Shoe Company v. Washington* (1945), 326 U.S. 310, 320.

Personal jurisdiction in this matter is not lacking under any theory the Appellees might put forward. Appellees operated websites that not only contained information about their companies, but also promoted the operations of the various ventures. The websites were designed to entice potential investors

[6] The record does not reflect how many Ohio residents actually contacted Appellees as opposed to how many transactions were actually consummated.

and provided a means by which those potential investors could contact the company in furtherance of the purchase of the securities of Appellees' companies. Appellees participated in the writing of an article further touting the Appellees' operations and, in such article, included extensive contact information for Appellees including a website and email address. This article appeared on the website of a third party and was available for viewing by anyone Finally, Appellees executed transactions in securities with two Ohio residents who purchased interests in the Appellees' businesses. For these reasons, the Hearing Officer correctly found that the Appellant had jurisdiction and the Court should reverse the ruling to the contrary by the Magistrate and Court of Common Pleas Judge.

B. State Securities Regulators Must Have Jurisdiction Over the Type of Internet Solicitations at Issue in this Case In Order to Protect the Investing Public From Fraud and Abuse

In the interest of investor protection, it is vitally important that state securities regulators in Ohio and elsewhere have jurisdiction over the Appellees and other promoters who solicit the public to invest in securities. The internet is now widely used as a medium for promoting and selling investments. Many of those offerings and solicitations are fraudulent, as evidenced by the investor education materials disseminated by NASAA as well as the SEC. For example, internet offerings have consistently appeared on NASAA's annual list of the

nation's "Top Ten" investment scams. See "NASAA's 2005 Top 10 Threats to Investors" (Mar. 24, 2005).[7] NASAA has described the problem in these terms:

> **INTERNET FRAUD.** The Internet is here to stay, and so is Internet investment fraud. Many of the online scams regulators see today are merely new versions of schemes that have been fleecing offline investors for years. For example, regulators have noted an increase on "online boiler room" activity promoting penny or microcap stocks on the Internet. Con artists also are using the Internet to issue and widely distribute bogus news releases to falsely inflate the value of these stocks before cashing out at the expense of unsuspecting investors. For more information see NASAA's Investor Alert.

In order to address the problem of internet fraud, securities regulators must be able to bring their enforcement resources to bear – to identify the perpetrators, to enjoin unregistered or fraudulent offerings, and to punish those who seek easy access to their victims via the internet. The ruling in the court below should be reversed because it establishes an unwarranted jurisdictional hurdle that obviously will interfere with these enforcement efforts, to the detriment of the investing public.

CONCLUSION

For the reasons stated herein, *Amicus* urges the Court to reverse the Court of Common Pleas in this matter and reinstate the Cease and Desist Order issued by the Commissioner of Securities.

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[7] Available at: http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/2719.cfm#.

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CERTIFICATE OF SERVICE

The undersigned certifies that a true and correct copy of the foregoing *Brief of Amicus Curiae North American Securities Administrators Association, Inc. in Support of the Ohio Department of Commerce* was served via U.S. Mail, postage prepaid, on January 4, 2006 upon the following:

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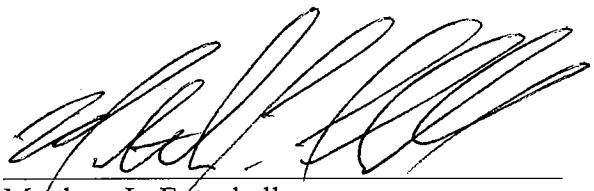

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