THE COLORADO DIVISION OF SECURITIES

SUBMITTED BY
THE COLORADO DEPARTMENT OF REGULATORY AGENCIES
OFFICE OF POLICY & RESEARCH
JUNE 1993

June 22, 1993

The Honorable Vickie Agler, Chairperson
Joint Sunrise/Sunset Review Committee
State Capitol
Denver, CO 80203

Dear Representative Agler:

The Colorado Department of Regulatory Agencies has completed the evaluation of the Colorado Division of Securities. We are pleased to submit this written report, which will be the basis for my office's oral testimony before the Joint Legislative Sunrise/Sunset Review Committee. This report is submitted pursuant to section 24-34-104(8)(a) of the Colorado Revised Statutes, which states in part:

> The Department of Regulatory Agencies shall conduct an analysis of the performance of each division, board or agency or each function scheduled for termination under this section....
>
> The Department of Regulatory Agencies shall submit a report and such supporting materials as may be requested, to the Sunrise and Sunset Review Committee created by joint rule of the Senate and House of Representatives, no later than July 1 of the year preceding the date established for termination....

This report discusses the question of whether there is a need for the regulation provided under the Colorado Securities Act, the Colorado Commodity Code, the Municipal Bond Supervision Act, and the Local Government Investment Pool Trust Fund Administration and Enforcement Act. The report also discusses the effectiveness of the Colorado Division of Securities and its staff in carrying out the intention of the statutes and makes recommendations for statutory and administrative changes in the event this regulatory program is continued by the General Assembly.

Sincerely,

Joseph A. Garcia
Executive Director

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EXECUTIVE SUMMARY

Colorado has regulated the offer and sale of securities to investors since 1923. The purpose of the modern Colorado Division of Securities is to protect those who would invest in securities from fraud and illegal dealings by the sellers of securities and those who represent them. The Division is also charged with maintaining "...public confidence in securities markets while avoiding unreasonable burdens on participants in capital markets." The Legislature's intent to provide protection to securities investors while at the same time allowing the reasonably free operation of capital markets in Colorado results in the unique regulatory structure of the Colorado Securities Act, which is administered by the Colorado Division of Securities.

The Colorado Securities Act was passed by the Legislature in 1990 in response to serious abuses that were occurring in Colorado capital markets. Although the Act has been in place for only three years, it has provided important new regulatory tools to the Colorado Division of Securities. The result has been a dramatic decrease in illegal securities activity in Colorado. Armed with an effective law, the Colorado Division of Securities has been able effectively to carry out the Legislature's directive to protect the investing public while not unduly burdening the securities industry.

This Sunset Review discusses the impact of the Colorado Securities Act and the effectiveness of the Colorado Division of Securities in carrying out the Act. This report also discusses the work of the Division in administering the Colorado Commodity Code and the Colorado Municipal Bond Supervision Act (the Local Government Investment Pool Trust Fund Administration and Enforcement Act was only just enacted and will take effect July 1, 1993). This report finds that these acts, in general, are being administered efficiently by the Colorado Division of Securities. Experience with the operation of these laws since their adoption has pointed out the need for some "fine tuning" amendments in order to allow them to operate as effectively as intended by the Legislature.

This report makes the following key findings and recommendations:

1. The regulation of securities by the Colorado Division of Securities has been effective and should be continued.

2. The existing system of securities regulation in Colorado consists of a complex partnership of state, federal and private self-regulatory organizations. The enormous changes that are occurring in financial markets in Colorado and throughout the world require a high order of coordination and cooperation among these regulatory agencies. No single regulator is equal to the task of adequate securities regulation alone.

3. Although securities regulation by the Colorado Division of Securities under the Colorado Securities Act has been increasingly effective, the scope of regulation continues to be incomplete because Colorado lacks a law that would allow it to regulate the operations of financial planners and investment advisers in the state. This report recommends the adoption of such a law.

4. The Colorado Securities Act should be amended so that banks, their agents and

employees engaging in the securities brokerage business are regulated as broker-dealers and sales representatives under the Colorado Securities Act.

5. The Colorado Securities Act should be amended to include administrative authority that would allow the Securities Commissioner summarily to issue administrative orders to halt the offering of unregistered securities and the activities of unlicensed securities salespersons and broker-dealers.

6. The Colorado Securities Act should include specific authority for the Securities Commissioner to issue consent orders on the basis of stipulations between staff and respondents to carry out more efficiently the provisions of the Act without resort to extensive and costly litigation.

7. The Colorado Securities Act should provide that willful violations of duly issued orders of the Securities Commissioner would be punishable as class 6 felonies under the criminal code.

8. The Colorado Securities Act should provide that, in connection with the commencement of administrative proceedings against broker-dealers and sales representatives, the Securities Commissioner has the explicit authority summarily to suspend such licenses in appropriate circumstances, consistent with the due process provisions of the Colorado Administrative Procedures Act.

9. The Colorado Commodity Code should be amended to give the Securities Commissioner explicit authority to issue interpretive opinions upon request by persons seeking clarification of the law.

10. The Colorado Securities Act should be amended to provide that investment companies doing business in Colorado should be required to register annually with the Division of Securities.

11. The securities laws administered by the Division of Securities should be amended to provide that judicial review of final agency actions taken by the Division of Securities should be under the jurisdiction of the Colorado Court of Appeals.

12. The Colorado securities laws should be amended to empower the Colorado Division of Securities to obtain access to information routinely kept by other agencies of state government, such as the Corporations Division of the Office of the Secretary of State and the Motor Vehicle Division of the Department of Revenue, when such information is necessary as part of an investigation of possible securities law violations being conducted by the Division.

CHAPTER 1 - INTRODUCTION AND HISTORICAL PERSPECTIVE

THE SUNSET PROCESS

The Colorado Division of Securities and its regulatory functions under the Colorado Securities Act, Title 11, Article 51, C.R.S., will terminate on July 1, 1994, unless continued by the General Assembly pursuant to the Sunset Act, section 24-34-104(23), C.R.S. The purpose of this Sunset Report is to evaluate the performance of the Colorado Division of Securities based on the statutory evaluation criteria which are attached as Appendix A of this report. The central question this report seeks to answer is whether the continuation of this regulatory program is necessary and beneficial to the public health, safety and welfare of the people of Colorado, and whether, if the program is continued, significant changes are necessary to improve agency operations and thereby enhance the public interest.

Research for this report began in August, 1992. Each member of the staff of the Colorado Division of Securities was interviewed, as were members of the securities industry, current and former Colorado legislators, consumer activists, members of the Office of the Colorado Attorney General and officers of the federal government. Literature pertaining to current issues in the securities industry was consulted in order to compile a list of issues. Numerous articles in newspapers and periodicals appeared during the course of this review and lent immediacy and substance to the theoretical literature. Finally, numerous pieces of legislation relating to securities regulation were either considered or passed by the Colorado Legislature and the United States Congress during the course of this review. The author appreciates the time and information which was made available by all those who were contacted in the course of writing this report.

DEVELOPMENT OF "BLUE SKY LAWS" AND OTHER U.S. SECURITIES REGULATION

In the United States, the issuance of securities by organizations needing to raise significant sums of money and the purchase of those securities by persons willing to put up that money can trace one of their primary roots back to the American Revolution. Faced with financing the cost of the war against the British, the Continental Congress, the Continental Army and a number of the colonies issued varying forms of financial notes and scrip. The soldiers in the Continental Army and the merchants who provided supplies to the army were often "paid" in these "evidences of indebtedness" by the cash-poor colonies and their fledgling federal government. After the war ended, much of this scrip was redeemed by the United States Government, initially to the tune of about $80 million, and the debt refinanced in the form of bonds. As early as May, 1792, 24 New York City brokers met to implement an agreement setting out the terms and conditions for trading these bonds and the commissions that they would charge the public for investing in them. The brokers were careful to provide in their agreements that for the bonds that they themselves purchased for their own accounts and for trading among themselves, more favorable terms, conditions and interest rates would apply. By 1817, these brokers and their trading activities had developed to the point that they decided to adopt a formal constitution and designate themselves as the "New York Stock and Exchange Board." Sometime during the middle of the Civil War, this name was shortened to become simply the "New York Stock Exchange."

As the United States grew, kinds of securities other than bonds and debt instruments issued by the federal government began to be offered to the investing public. A growing economy meant new and expanding companies that required cash to finance their operations. At first, the transportation industry became a leader as American railroads expanded to the West. Later, "equity investments" in the stocks of companies such as banks and insurance companies also became popular.

As investing in securities became more widespread in the new nation, the number of markets where the public could learn about and purchase the stocks and bonds grew rapidly. At one point around the middle of the 19th century, there were more than 100 "stock markets" or "stock exchanges" spread throughout the United States, mostly in major cities. Although few of these stock exchanges survived over the years, their emergence was a clear sign that a sophisticated financial economy was beginning to develop in the United States. The discovery of gold in California during that period fired the imagination of thousands of new investors who thought they saw an opportunity to put their money into companies that were exploiting the new mineral finds. Although many of these stock offerings were fraudulent and were based on non-existent or unproductive mines, investments in securities continued to grow.

It was also around this time that individual states began to require companies doing business within their borders to submit financial information regarding the sale of their stock and other "investment instruments." The combination of the lack of federal regulation and the fact that most of America's securities markets and exchanges operated as "private business clubs" (Report of the Hughes Commission, New York, 1909) led some states to take the precaution of asking for basic financial information from companies offering securities for sale to the public. Later, as the Industrial Revolution got underway in the United States, many private citizens and government officials, particularly in the more rural parts of the country, began to suspect that "eastern robber barons" were taking advantage of unsophisticated investors by offering them the "opportunity" to put their money into worthless investments and schemes that had no chance of ever returning a profit, if they existed at all. The abuses of the "trusts," including those of the industrial empires which were developing in oil, manufacturing, steel and railroads, gave rise in part to the Progressive Movement of the early 1900's that was aimed, in part, at putting a stop to the worst of these abuses.

It is not surprising, therefore, that the State of Kansas, one of the homes of the Progressive Movement, should become the first in the country to enact a law regulating the sale of securities in the year 1911. North Carolina followed suit the same year and in 1912, Arizona and Louisiana enacted securities regulatory laws. Within two years, fully 23 states had adopted these laws, with 17 of them identical to or modeled after the Kansas Act. By 1933, the year in which federal securities regulation was first enacted, fully 48 states and Hawaii had enacted some form of what had come to be known as "Blue Sky Regulation."

Where did the term "Blue Sky Law" come from to refer to state securities regulation? According to Harvard Law Professor Louis Loss:

> *The precise date and place when this term was first coined is unknown, but by 1911 the term was in general usage. "The State of Kansas, most wonderfully prolific and rich in farming products, has a large proportion of agriculturists not versed in ordinary business methods. The State was the hunting ground of promoters of fraudulent enterprises; in fact their frauds became so barefaced that it was stated that they would sell building lots in the blue sky in fee simple. They became known as blue sky merchants, and the legislation intended to prevent their frauds was called Blue Sky Law."* Mulvey, Blue Sky Law, 36 Kan L.T. 37, (1916).

Even the United States Supreme Court began referring to state securities laws as "Blue Sky Laws," as the justices proceeded to hear the first challenges to them. In 1917, the Court erased any doubt as to the validity of state securities regulation by upholding Ohio's securities regulatory law in the case of Hall v. Geiger-Jones Company, 242 U.S. 539 (1917). The court held that state securities laws were fully supported by the police power retained by the states under the United States Constitution and the prevention of fraud and the protection of the public were appropriate goals for these laws. The Justices pointed out that state "Blue Sky Laws" were important and necessary because of their purpose of preventing "speculative schemes which have no more basis than so many feet of blue sky." Hall, *supra*.

Colorado passed its first Securities Act in 1923. Patterned generally after the Kansas Act, Colorado's law essentially required the reporting of financial data by corporations offering securities in this state. During its first ten years, this Act was administered by a clerk in the Office of Secretary of State who received and filed documents and collected filing fees. By 1931, it became apparent that securities dealers and salespersons needed to be licensed in order to control better the offering of securities in the state. The result was the Colorado Fraudulent Practices Act of 1931, which granted state officials this power.

In the wake of the 1929 stock market crash, and as part of the first hundred days of the administration of President Franklin Delano Roosevelt, the federal government was finally moved to enact its first securities regulatory law, 22 years after the enactment of the first state securities law. The Securities Act of 1933 (the "33 Act") and its companion, the Securities Exchange Act of 1934 (the "34 Act"), became the cornerstones of federal securities regulation. To this day, state securities laws continue to provide protection to state residents from fraudulent securities offerings, along with federal securities laws, which developed in response to the national collapse of the stock markets and certain practices in the securities industry in the wake of the stock market crash of 1929. In fact, as Congress followed the lead of the states by enacting securities regulation, the chairman of the Senate Committee on Banking and Currency concluded in 1934 that due to "...evils and abuses which flourished on the exchanges and their disastrous effects upon the entire nation... federal regulation is necessary and desirable." Senate Report No. 1455, 73rd Congress, 2nd Session, 81 (1934).

Federal securities acts are generally designed to deal with national securities issues, such as the offer and sale of securities across state lines. The 34 Act was designed to regulate national securities markets, stock exchanges, brokers and the secondary markets that were trading in securities. The 34 Act also created the Securities and Exchange Commission, which is the key federal agency involved in national securities regulation in the United States. Both the 33 and 34 Acts "...contemplated overlap and coexistence" with state securities laws, providing specifically for concurrent regulation of securities with the states. In fact, the 1933 Act "...specifically recognizes this dual regulatory system and the role of the states' blue sky provisions in the regulation of securities offerings." Ad Hoc Subcommittee on Merit Regulation, American Bar Association Report on State Merit Regulation of Securities Offerings, 41 Business Law 785, (1986).

BALANCE AND INTERDEPENDENCY ARE KEY

The parallel development of state and federal securities laws is characterized by (1) the balance they seek to achieve between appropriate regulation and an open securities market; and (2) their interdependency. While the first characteristic of these laws is readily understandable, since it is often found in state and federal laws that regulate businesses and occupations in the United States, the latter characteristic is not. Many commentators over the years have suggested that there should be a uniform system of securities regulation on either the state or the federal level, but not on both levels. State Blue Sky Laws: A Stronger Case for Federal Preemption Due to Increasing Internationalization of Securities Markets, Brian J. Fahrney, Northwestern University Law Review (1992). However, most of these commentators ignore the scope and complexity of modern securities regulation. Placing all the responsibilities of the existing and interdependent federal, state and industry securities regulators at only one level would require an enormous increase in regulators and their resources.

Just as the state securities laws have cooperated with the self-regulatory efforts of the securities industry and securities markets and exchanges, the federal laws have also been designed to coexist and overlap with the system of state and industry regulation. Although this regulatory system is confusing, it reflects the complexity of today's United States and international securities industry. It also reflects the desires of federal and state regulators as well as members of the securities industry and operators of securities exchanges and markets. If anything, this complicated system is working better today than it has at anytime in its history, as will be discussed in later chapters of this report.

Summing up the interplay between government securities regulators and the self-regulatory efforts of the securities industry, in its 1986 Report on Securities and Futures, How the Markets Developed and How They are Regulated, the United States General Accounting Office said,

> *Today, the concept of securities industry self-regulation remains much as intended by the framers of the original Securities Exchange Act. They realized the inherent dangers of giving the industry free reign, but they sought to balance industry initiative with government controls. The regulatory system has not always been a cooperative relationship between industry and government, but compromises have usually been reached in order to resolve the practical problems of administering a very complex and rapidly changing market.* USGAO Report No. GGD-86-26, May 15, 1986.

CHAPTER 2 - MODERN COLORADO SECURITIES LAWS

INTRODUCTION: THE HEART OF A SECURITIES LAW

The heart of any securities law, including Colorado's, is the explanation of what is meant by the term "security." Although the eyes of the average person begin to glaze over as soon as the word is mentioned, a simple working definition would provide that "...[a] security is any investment of money in a common enterprise made for the purpose of making a profit primarily through the efforts of a third party." Testimony of Wellington E. Webb, Executive Director, Department of Regulatory Agencies for the Executive Committee of the Legislative Council, October 26, 1983. An obvious example of a security would be the stock of a corporation. A more "exotic" example would be an investment scheme that was offered in Colorado about ten years ago, dealing with investments in rabbit. In return for an investment of $20,000, which included the purchase of one buck (male) and four doe (female) rabbits, the creative party offering this opportunity promised to purchase every pelt produced from the investor's breeding stock after one year. As will be discussed in this report, examples of securities offerings that have attracted the attention of state and federal regulators in Colorado continue to be many and varied.

Thirty-seven states have adopted all or substantially all of the Uniform Securities Act of 1956 (the "Uniform Act") prepared by the National Conference of Commissioners on Uniform State Laws. The Uniform Act was completely revised by the Commissioners in 1985 ("RUSA"). The Colorado Securities Act is patterned after RUSA. A few other states have adopted laws similar to RUSA, while others have amended their Uniform Act-model laws by adopting parts of RUSA.

In the Uniform Act, the term "security" is defined as follows:

> *"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 any insurance company promises to pay a fixed number of dollars either in a lump sum or periodically for life or some other specified period.*

From the foregoing list, it is clear that there are many kinds of securities. It is also important to note that the standard state definition of a security seeks to maintain the bright line dividing the securities industry from the insurance industry. This is the case even though an insurance company endowment policy or annuity may look very much like a security. (It should be noted that variable rate annuities are construed to be securities under federal securities law even though they are, by definition, not securities under state securities law.) Finally, although a number of the instruments recited in the definition above are obscure, many of them are familiar, such as stocks, notes and bonds. Case law over eight decades of securities regulation in the United States has helped to define the meaning of these terms, in particular, the meaning of the most controversial of the terms listed, which is the term "investment contract."

Investment contracts are so interesting in modern securities law because they are so often the form taken by:

> *...a dazzling array of bizarre and usually fraudulent investment schemes. Such investments are often referred to as "exotic" securities. Investment contract theory has been applied to sales of investment interests in orange groves, chinchilla ranches, rabbit farms, barrels of whiskey, pyramid schemes and most recently, ostrich farms!* <u>Fraud in the International Securities Markets</u>, a case study by Philip A. Feigin, 1992 Oxford Conference, September 23, 1992.

Often, it is the state securities regulator who is the front line of defense and public protection against the offering of these exotic investment schemes.

The U.S. Supreme Court provided state and federal securities regulators with a clear definition of what constitutes an investment contract in the famous case of <u>SEC v. W.J. Howey Co.</u>, 328 U.S. 293 (1946). In this case, the Supreme Court interpreted the meaning of investment contract as used in the definition of a "security" in the 33 and 34 Acts. The ruling was adopted subsequently by most state courts and regulators.

> *The so-called "Howey test" provides that an investment contract will be found in an arrangement wherein there is (1) an investment of money (2) in a common enterprise (3) with the expectation of profit (4) based on the essential managerial efforts of the promoter or third party. In sum, the securities laws will protect the passive investor who invests with the expectation that the profit to be derived from the venture will be the result of the efforts of some person other than the investor.* <u>Fraud in the International Securities Markets</u>, *supra*.

HOW STATE SECURITIES LAWS PROTECT THE PUBLIC

Armed with adequate definitions of the kinds of instruments that might be "securities" and the well established principle of securities law that the law is to be broadly construed to effectuate its public protection purposes, securities regulation can begin to operate. State and federal securities regulators actually begin their work when an "offer" or "sale" of a security is made. In Colorado, as in most states, this means that any offer or sale of the security in question is either made to a person in this state or from a person in this state. However, the simplicity in the administration of the state securities laws ends there. This is because even after determining that a security has been offered for sale, and that the regulator therefore has jurisdiction, the next step is to determine if the security is registered for sale in the state, and if not, whether the security is being issued by one of a number of specific organizations and institutions whose securities are exempt from the securities registration requirements of state law, or whether the proposed transaction is among the list of securities transactions exempted from those same registration requirements.

The following securities are generally exempt from state securities law registration requirements:

Securities issued by:

- Banks
- Canada and other foreign governments
- Cooperative associations
- Corporations organized under acts of Congress
- Credit unions
- Employee stock plans
- Holding companies holding utility securities
- Insurance companies
- Certain non-profit organizations
- Public utilities and railroads
- Savings and loan associations
- States and political subdivisions
- Trust companies
- The United States and its territories

Other exempt securities:

- Securities designated for listing on the NASDAQ/NMS (over the counter markets)
- Securities listed on stock exchanges registered with the SEC
- Certain commercial paper

The following transactions in securities are generally exempted from state securities law registration requirements:

Isolated, non-issuer transactions
Limited or private offerings
Receiver's or trustee's sales
Sales of corporate preorganization certificates
Sales of notes secured by mortgages or deeds of trust
Sales to banks, insurance companies, trust companies and similar institutions
Sales to existing security holders
Transactions between issuers and underwriters

It is easy to see from the foregoing list why securities attorneys and experts are able to make a living giving advice to their clients on whether their securities offering qualifies for an exemption in a given jurisdiction. Ironically, the purpose of these exemptions is not to add to the complexity of securities law, but to try to apply regulation only where it is necessary. Where other institutional or regulatory bodies have jurisdiction, or where investors are generally thought not to be at great risk, the securities laws of Colorado and other states provide these exemptions.

In Colorado, as in most states, the two key screening devices used by regulators are: (1) the requirement that, in order to be lawfully offered or sold, a security must first be registered in the state or exempt from the requirement; and (2) the requirement that those engaging in the business of selling securities must first be licensed in the state to do so. By examining the securities and those selling them, the state securities regulator is able to track the activity of the industry and to identify fraudulent or other illegal activity. In applying these registration and licensing requirements, securities regulators must become expert at determining whether their state's law confers jurisdiction on them to take action in any given case.

The general rule of securities registration on the state level is that it is unlawful to offer or sell any security in a state unless it is first registered in that state or it is exempt from the registration requirement. Registration is mostly a matter of meeting statutory requirements and disclosing basic information regarding the securities to be sold. A willful violation of the registration requirement is a felony offense. State securities law, including that in Colorado, works in coordination with federal law. Most SEC registered offerings are exempt from state registration requirements altogether (because they are listed for sale on exchanges or the NASDAQ NMS) or may be registered with the state by "coordination."

The purpose here, of course, is to promote coordination between government entities in order to maximize limited resources and provide the greatest degree of investor protection possible in the circumstances. In addition, a continuing theme in securities law is the attempt to balance the need for regulation with the need to allow capital formation to occur in the securities markets without undue burden.

FULL DISCLOSURE OR MERIT REVIEW? -- *A Fundamental Controversy*

The essential element of all securities laws is the requirement that the issuer must provide to prospective purchasers full and fair disclosure of all material facts about the offering. Under no circumstances does the securities regulator make qualitative judgments about an offering for public consumption, like "approving an offering" as a "good deal," or "recommending" or "discouraging" the purchase of a particular security. On the contrary, under the "full and fair disclosure" requirement, as long as all material facts are disclosed, even the worst of investments may be lawfully offered and sold.

Under this disclosure system, it is only when the issuer has failed to make full and fair disclosure, or when fraud is later detected in connection with a registered securities offering, that the securities regulator is authorized to intercede and stop the deal. For government officials and members of the public who are used to more direct assurances of the quality of the goods and services being offered, securities regulation based on disclosure can be hard to understand. Perhaps its basic purpose can be traced to the free enterprise system in America which encourages the formation of "risk capital" in order to achieve business growth. Another factor may be the public policy option that government should mandate full disclosure but the substantive investment decision should be left to the individual.

The Colorado Securities Act imposes these standard "full and fair disclosure" requirements, as does the 33 Act. If a security is registered with the Colorado Division of Securities by "coordination," a cursory review is performed to verify that the offering qualifies for such registration, but such an offering is not reviewed at all for full and fair disclosure. That is left to the SEC. However, if the security is registered by "qualification," the Division of Securities will carefully review it to see that it qualifies under Colorado law by meeting the full and fair disclosure requirements. In this way, regulatory oversight by and among state, federal and industry securities regulators is coordinated rather than duplicated.

Some states, however, provide a much more stringent level of review, known as "merit review." This concept is controversial in the securities industry because it tends to empower securities regulators to review securities offerings on a substantive basis. For example, the first state securities law, that of Kansas dating from 1911, allowed the Kansas Bank Commissioner to make substantive evaluations of offerings, and provided him with some very broad authority.

> *[If the Commissioner finds that a proposed offering contains] any provision that is unfair, unjust, inequitable or oppressive to any class of contributors, or if he decides from his examination of its affairs that said investment company is not solvent and does not intend to do a fair and honest business, and in his judgment does not promise a fair return on the stocks, bonds or other securities by it offered, then he shall notify such investment company in writing of his findings and it shall be unlawful for such company to do any further business in this state.* Kansas Laws, 1911 as quoted in Reed, "Blue Sky" Laws, 88 Annals, 177 (1920).

Modern "merit review" state securities statutes are not intended to guarantee the success of any venture but more to balance the risks of the venture between the promoter of the securities and the investors. Most merit review determinations concern the amount of compensation to be paid to the promoters and underwriters out of the proceeds of the offering, and how much "cheap stock" the promoters will be allowed. Since merit review differs widely in both concept and practice from the federal securities laws, it has generated much controversy. In theory, an offering could meet all federal standards but nonetheless be disallowed in one state or another. Some states with merit review statutes have even disagreed among themselves about whether to allow the offering of the same security!

Colorado had a modified merit review system in its 1961 Securities Act for all registered securities. A few years later, however, this authority was limited to apply to only those offerings registered here that were not registered with the Securities and Exchange Commission. In 1981, the General Assembly virtually eliminated all registration requirements in Colorado with the adoption of extremely broad exemptions from the requirement. In 1990, when the General Assembly adopted the current Colorado Securities Act, merit review authority was not included. Rather, the familiar "full and fair disclosure of all material facts" standard of review for registration was adopted.

PREVENTING SECURITIES FRAUD

While most securities may be offered legally on the state and national level regardless of whether they are likely to return a profit to the investor, they still must meet the disclosure provisions that are central to securities law. If this disclosure is inadequate, the powerful anti-fraud provisions generally found in all securities laws are brought to bear. Thus, although the law does not assure investors of making quality securities investments, it mandates that security sellers must make full and fair disclosure of all material facts to the investor before the purchase. The traditional concept of *caveat emptor*, i.e., "buyer beware," is replaced with *caveat venditor*, i.e., "seller beware."

The most famous anti-fraud statute in the U.S. is actually not a statute at all but an SEC rule, Rule 10b-5. The drafters of the Uniform Securities Act adopted the language of Rule 10b-5 as the state anti-fraud statute. It provides that:

> *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 an untrue statement of material fact or to omit to state a material fact necessary 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 that operates or would operate as a fraud or deceit on any person. Section 409 Uniform Securities Act (1966); Section 11-51-603(1), C.R.S.*

In Colorado, violation of the anti-fraud provisions of the Colorado Securities Act is a criminal offense punishable as a class 3 felony.

HOW THE COLORADO SECURITIES ACT WORKS

It is generally acknowledged in the securities industry in Colorado that the Colorado Securities Act is an example of a good modern state securities law. Colorado has had considerable experience in regulating securities, not always successfully, since it first adopted the great majority of the provisions of the Uniform Securities Act in 1961. As indicated earlier, the Colorado Securities Act is based on RUSA.

Generally speaking, there are six principal aspects to the typical law: (1) definitions, jurisdiction and administration, (2) securities registration, (3) broker-dealer and investment advisers licensing/registration, (4) anti-fraud provisions, (5) enforcement and (6) private civil liability. In the Uniform Act and RUSA, the essential concepts of three different federal laws -- the 33 Act, the 34 Act and the Investment Advisers Act of 1940 ("the 40 Act") [not to be confused with the Investment Company Act of 1940] -- were thrust together into one model state securities law.

The Colorado Securities Act has all of the principal features described above save one -- investment adviser regulation. Colorado remains one of the seven U.S. jurisdictions without investment adviser regulation, (they are Arizona, Colorado, the District of Columbia, Iowa, Massachusetts, Ohio, Vermont and Wyoming).

When a security is registered for sale with the Colorado Securities Commissioner, the process of screening the offering to make sure that it complies with Colorado law begins. The fact that a securities offering is registered with the SEC under federal law in no way obviates the necessity of dealing with the laws of the states in which the offering will be made.

As indicated previously, and as required by Colorado law, securities laws have evolved so that most federally registered offerings may either be registered at the state level with little or no substantive review (registration by coordination) or are exempt from state registration requirements (for example, if they are listed for sale by recognized exchanges). Section 402(a)(8) Uniform Securities Act (1956); section 11-51-307(1)(f), C.R.S.

The Colorado Division of Securities is also careful to be on the lookout for securities that are being offered to Colorado investors that have not been registered with anyone. Periodically, information regarding these offerings will appear in newspapers, on bulletin boards or by word of mouth. The Colorado Division of Securities is then careful to investigate these matters to ascertain whether fraud is being committed, whether the person or firm offering the security simply did not realize that it was, in fact, a security and therefore falls within the gamut of state securities laws, or that there was a securities registration requirement.

Most of the problems and inconsistencies imposed by disparate levels of review of offerings have been eliminated in recent years with the development of state law exemptions from registration requirements and changes in the marketplace. Most national and regional offerings occur today on either recognized securities exchanges or on the highest tier of the over-the-counter auction market maintained by the National Association of Securities Dealers ("NASD") called the "NASDAQ" (NASD Automated Quotation System) "National Market System" ("NMS"). Almost all states have adopted a NASDAQ/NMS Exemption or added the NMS to the "exchange listed" exemption already contained in their laws. Section 11-51-307(1)(f), C.R.S. Companies qualifying for such listing are generally regarded as having sufficient qualities to obviate the necessity of the public protections afforded by state registration requirements. Those that do not meet exchange or NMS listing standards remain subject to state registration review, and, most state regulators would argue, rightly so.

The Colorado securities registration scheme is comprised of two methods of registration. Offerings registered with the SEC and listed on recognized exchanges or the NMS are exempt from registration. Offerings registered with the SEC but not exchange-listed may utilize the very streamlined "registration by filing" method. Section 11-51-303, C.R.S. All that is required is that the issuer submit a simple notification form to the Securities Commissioner along with a copy of the approved prospectus and a fee. With one exception to be discussed later, the Securities Division has no review authority over such offerings. They are registered automatically.

Offerings that are not registered with the SEC (and therefore, by definition, not exchange-listed) and that do not qualify for some exemption, must register with the Securities Commissioner under the "registration by qualification" process. Such offerings are reviewed by the Securities Division examiners for compliance with the "full and fair disclosure" provisions of the Colorado Securities Act. The Act also provides for a simplified qualification process, called "limited offering registration," for certain Colorado issuers raising no more than $1 million. Section 11-51-304(6), C.R.S.

A general precept of state securities law is that the government only intervenes to require registration when an offering is to be made to the general public. Consequently, there is an array of exemptions from registration provided in the typical state securities law. For example, private offerings made to sophisticated investors are generally exempt from registration requirements, but they must remain private and the investors must be "accredited" or "sophisticated," i.e., they must be in a position to bear the risk of loss of their entire investment. A full listing of registration exemptions would be inappropriate here. Suffice it to say that most securities offerings and transactions are exempt from the registration requirement. The requirement for registration is the exception, not the rule.

As stated previously, the Colorado Securities Act includes a very streamlined "registration by coordination" system regarding offerings registered with the SEC. In Colorado, it is called "registration by filing." The Securities Division does not perform any review of such offerings, with one exception. A major focus of the 1990 securities law reform effort was the imposition of restrictions on "blank check" offerings. These offerings, also (mistakenly) called "blind pools," are characterized by the fact that they involve an entity that has no business. Its only reason for being is to look for another business or businesses to acquire. Purportedly, the promoters use the funds raised to conduct this search.

These offerings became the vehicle of choice for penny stock fraud in the mid to late 1980's. With virtually no information regarding the company or what it was doing, the securities of "blank check" companies were easily manipulated by unscrupulous promoters and broker-dealers.

The Colorado Securities Act "blank check" provisions required such companies to place most of the proceeds raised in any public offering -- regardless of whether registered with the SEC or in Colorado only -- in escrow until such time as a business was acquired. At that point, the Securities Commissioner would be notified, and the release of the escrowed funds to the promoters was authorized.

The "blank check" provisions operated directly to prevent the abuse of proceeds raised in public offerings. Indirectly, they imposed inhibitions on filing such offerings in Colorado. Along with similar provisions in other states' securities laws, the Colorado law served as a model for federal "blank check" legislation in 1992. The impact of the Colorado "blank check" provisions is described later in this report.

LICENSING REQUIREMENTS PROTECT THE PUBLIC

As indicated above, Colorado does not currently license investment advisers, their representatives or financial planners, in spite of numerous abuses which have occurred in relation to the business activities of these persons. However, Colorado law does provide effective consumer protection in the area of regulation of securities broker-dealers and securities sales representatives.

The Uniform Act provides that "broker-dealers" are persons who engage in the business of effecting or attempting to effect transactions in securities for their own account or the account of others. This is the Colorado Securities Act definition as well. Section 11-51-201(2), C.R.S. The Uniform Act defines an "agent" as an individual who represents a broker-dealer or an issuer in effecting or attempting to effect transactions in securities. Although they are called "sales representatives" in the Colorado Securities Act, the definition is essentially the same. Section 11-51-201(17), C.R.S. The Uniform Act defines an "investment adviser" as a person who for compensation, engages in the business of advising clients as to the value of securities, and the individuals who work for them in advising clients are called "investment adviser representatives." As noted, Colorado does not currently regulate investment advisers or investment adviser representatives.

Under general state securities law, it is illegal to transact business in a state as a broker-dealer, agent, investment adviser or investment adviser representative unless first licensed or registered (the terms are used interchangeably) in those capacities by the administrator. Colorado law prohibits unlicensed broker-dealer and sales representative activity at section 11-51-401(1), C.R.S.

State securities laws generally provide statutory grounds for denial of a license and the sanctioning of licensees. The most important of these is generally referred to as "dishonest and unethical business practices." The administrator is generally provided with the authority to adopt rules defining such practices. In Colorado, the Securities Commissioner is empowered to adopt similar rules, although this authority is somewhat more restricted than in the Uniform Act. Section 11-51-410(1)(g), C.R.S.

Colorado has tried for several years to pass legislation regulating investment advisers and financial planners, thus far without success. The lack of regulation for investment advisers has become a serious problem over the course of the last decade. On the federal level, investment advisers must register with the SEC under the Investment Advisers Act of 1940. However, little regulatory oversight is exercised in this area by the SEC. For their part, broker-dealers must register with the SEC under the 34 Act.

Broker-dealers must also become members of organizations such as the NASD or the New York Stock Exchange, so called "self-regulatory organizations" or "SRO's." Broker-dealer agents must become registered with the NASD, but there is no SEC agent licensing. There is no SRO for investment advisers. There are, however, several private associations which represent the interests of many investment advisers and financial planners.

In addition to working with the SEC and other state securities regulators, the Colorado Division of Securities works closely with the self-regulatory organizations as well. For example, the states and the NASD have established a centralized licensing system for broker-dealers and agents. The SEC utilizes this system as well. It is called the Central Registration Depository ("CRD"). It is a tremendous database that provides not only licensing, but also enforcement and communication functions for the states, the NASD and the SEC. The general public can also call the NASD or their state's securities agency to check up on a broker-dealer or agent before they do business with them to determine if they have any disciplinary record.

Colorado law specifically empowers the Colorado Division of Securities to use and participate in the CRD system in order to track the licensing histories of securities broker-dealers and sales representatives.

ENFORCEMENT

Although the registration and licensing provisions of the Colorado Securities Act are the regulatory "tripwire" defenses in protecting the public, vigorous law enforcement work by state regulators is crucial in curbing the worst abuses.

The Uniform Securities Act provides a state securities regulator with a variety of enforcement tools. There are three general levels of enforcement remedies: administrative sanctions, civil injunctive actions, and referrals for criminal prosecution. The administrator is given extremely broad authority to investigate "...to determine whether any person has violated or is about to violate any provision..." of the [Uniform] Act. Section 11-51-601(1), C.R.S. Among the most powerful investigative tools is the administrator's authority to issue subpoenas. Section 11-51-601(2), C.R.S. Subpoenas may be enforced in a court of law, and refusals to comply may be punishable as contempt. Sections 11-51-601(3) and (4), C.R.S.

The states expend a large percentage of their resources on enforcement. Colorado is no exception to this rule. In 1989, there were a total of 1,258 state personnel involved in securities regulation. In that year, states initiated a total of 3,678 enforcement actions, including the initiation of 355 criminal proceedings, obtaining 253 criminal convictions, 45 temporary injunctive orders and 158 permanent injunctions in court, issuing 756 consent administrative orders and 1,515 "cease and desists" orders (administrative versions of injunctive actions), as well as taking 869 denial, suspension and revocation actions against licensees. This compares to a total of 310 enforcement actions taken by the SEC in the same approximate period, including the initiation of fewer than a dozen criminal prosecutions as a result of SEC referral. In general, the state laws are far more flexible, allowing the states to respond more quickly to discovery of violative conduct than federal authorities. These comparisons are not meant in any way to denigrate the enforcement efforts of the SEC. They are presented instead to make the point that the primarily local focus of state securities regulators is analogous to that of neighborhood police, dealing in large part with day to day financial "street crimes." The SEC generally limits its efforts to large scale problems. Fraud in the International Securities Markets, *supra*.

In the administrative law realm, the Colorado Securities Act empowers the Securities Commissioner to issue administrative stop orders to deny or suspend certain securities registrations (section 11-51-306, C.R.S.), and to deny applications for licenses and to impose sanctions against licensed broker-dealers and sales representatives for statutorily proscribed conduct (section 11-51-410, C.R.S.). Civilly, the [Colorado Securities] Act empowers the Commissioner to seek injunctive relief in Denver District Court against persons who are violating or who are about to violate the securities law. Section 11-51-602, C.R.S. Finally, the Commissioner is authorized by the Act to refer evidence of criminal wrongdoing to the State Attorney General, a local district attorney or the United States Attorney. Section 11-51-603(3), C.R.S.

The typical state securities law also provides private rights of action for aggrieved investors. Section 11-51-604, C.R.S. Investors can seek damages in court from persons who sell them unregistered, non-exempt securities, from those who act as broker-dealers or investment advisers for them when not licensed to do so, and from people who defraud them.

There are also specialized provisions of other laws, such as the Colorado Consumer

Protection Act, which may empower private investors, under certain circumstances, to seek damages and to recover their costs of suit and attorneys fees as well. Section 6-1-105(z), C.R.S.

JUDICIAL INTERPRETATION OF STATE SECURITIES LAWS

In general, state courts have been willing to uphold the actions of state securities regulators in pursuing violations of state securities laws. Many state courts have construed their state's securities law as remedial in nature, as laws that should be liberally construed to protect the public. For example, the Minnesota Supreme Court upheld that state's blue sky law shortly after its passage with the opinion that "...it is a proper and needful exercise of the police power of the state and should not be given a narrow construction." State v. Gopher Tire and Rubber Company, 146 Minn. 52, 177 N.W. 937 (1920).

Colorado's appellate courts have been active in considering the scope of the "investment contract" definition under Colorado state law. Lowery v. Ford Hill Investment Company, 192 Colo. 125, 556 P.2d 1201, (1976); Raymond Lee Organization v. Division of Securities, 196 Colo. 112, 556 P.2d 1209 (1976); and Griffin v. Jackson, 759 P.2d 839 (Colo. App. 1988). In 1990, Colorado fell into line with the mainstream of the country with regard to its interpretation of the term "investment contract" with the addition at the end of the "securities" definition of the following sentence:

> *For purposes of [the Colorado Securities Act], an "investment contract" need not involve more than one investor nor be limited to those circumstances wherein there are multiple investors who are joint participants in the same enterprise.* Section 11-51-207(14), C.R.S.

Regardless of whether the courts construe state securities statutes strictly or liberally, they have generally held that

> *...the inconvenience to the honest and conscientious engaged in the legitimate securities business in complying with the rules, regulations and licensing provisions of the blue sky laws must be weighed with the immeasurable benefits to and the savings of untold amounts of money by the general public, as a result of the suppression of fraudulent practices in the securities field.* Blue Sky Law Reports, Section 520, Volume 880, 1990.

OTHER COLORADO SECURITIES RELATED LAWS

The Colorado Division of Securities is also required to administer the Colorado Municipal Bond Supervision Act and the Colorado Commodity Code. The Colorado Municipal Bond Supervision Act, Title 11, Article 59, C.R.S., was passed by the Colorado Legislature in 1991, but was vetoed by the Governor. The Colorado Supreme Court subsequently upheld a lower court decision that the Governor's veto was ineffective and that this Act is part of state law. Since the Court's ruling at the end of 1992, the Colorado Division of Securities has begun to hire the staff necessary to implement the Act, the purpose of which is to "...empower the Securities Commissioner to regulate and monitor the issuance of municipal bonds of political subdivisions and to develop information and recommendations for appropriate action for the General Assembly in connection therewith." Section 11-59-102(2), C.R.S.

In responding to the collapse of a number of special districts as part of a general slump in Colorado real estate at the end of the 1980's, the General Assembly declared that:

> *...it is in the best interests of this state and its citizens that safeguards and full disclosure be made in connection with the issuance of bonds of special districts and municipal and county improvement districts and that this article is necessary to protect the continued provision of public services and the credit of political subdivisions.* Section 11-59-102(4), C.R.S.

As with the Colorado Securities Act, the Legislature provided that the Colorado Municipal Bond Supervision Act is to be broadly construed to effectuate its public protection purposes. As this report is published, the Colorado Division of Securities is about to take up its supervisory responsibilities in this area for the first time.

Under the Colorado Commodity Code, the Division of Securities is given regulatory authority similar to that provided under the Colorado Securities Act. The Commodity Code is intended to protect the public from investing in illegal or fraudulent commodity contracts, options or other buy-sell arrangements. Commodities are defined under the Act as any agricultural product, grain, livestock, metals and minerals, gems, foreign currencies, coins, and "...all other goods, articles, products or items of any kind." Section 11-53-102(4), C.R.S.

As in the Securities Act, the administration of the Colorado Commodity Code is closely linked with the regulatory efforts of the federal government, in this case, both the Securities and Exchange Commission and the Commodity Futures Trading Commission. This law also parallels the securities laws in that it contains numerous definitions of commodities that are included and excluded under the law as well as numerous provisions concerning persons and transactions that are exempt from regulatory oversight by the State Securities Commissioner. The law specifically prohibits fraudulent conduct and misleading filings. It also provides for liability for violations of the law by principals, or other persons who control parties selling illegal commodity contracts.

As with the Securities Act, the general purpose of the Commodity Code is to protect investors, "...to prevent and prosecute illegal and fraudulent schemes involving commodity contracts and commodity options, and to maximize coordination with federal law and other states' laws and the administration and enforcement thereof." Section 11-53-111, C.R.S.

The Securities Commissioner is granted wide powers to enforce the Colorado Commodity Code, including investigatory powers both inside and outside of Colorado, injunctive powers and the ability to refer violations for criminal prosecution. A violation of the Colorado Commodity Code is a class 3 felony and may be prosecuted by the Attorney General or any district attorney having jurisdiction. It is interesting to note that Colorado concern with this type of investor abuse dates from 1931, and was initially known as the "Anti-Bucketing Law" L.31, p. 175, Section 10; CSA, C.148, Section 52. Under the old law, "bucket shops" were places where salespersons would talk unsuspecting investors into purchasing commodities, usually as part of fraudulent schemes meant only to relieve the investor of his or her money. This Act was repealed and reenacted in 1989 as the Colorado Commodity Code, including substantial updates in terminology and provisions regarding cooperation with federal government authorities. This Act provides additional authority to the Securities Commissioner, not in conflict with the Securities Act, to address fraudulent schemes in this area.

CHAPTER 3 - THE COLORADO DIVISION OF SECURITIES REGULATORY RECORD

The Colorado Division of Securities is a medium sized regulatory program, authorized to employ about twenty-two people at any given time, with a budget of about $1.6 million. Department of Regulatory Agencies Budget, Fiscal Year 1993-1994.

> *The central goal of the Division of Securities program is the protection of the investing public from those who would defraud them, who would sell unregistered, non-exempt securities or unlawful commodity contracts to them, or who would sell securities to them without being licensed as broker-dealers or sales representatives unless such licensing is not required.* Department of Regulatory Agencies Budget, *supra.*

The Division is divided into three sections. The largest section is the Enforcement Section, which includes nine full-time employees (FTEs). Since enforcement of the securities laws is arguably the most time- and resource-intensive of any of the functions performed by the Division, it is understandable that the majority of the Division's employees would be devoted to this section. The Examination Section of the Division consists of about five FTE. These persons are tasked with reviewing the business practices of Colorado securities broker-dealers and sales representatives to determine their compliance with state law. They form the first line of public protection on the theory that field examinations will disclose potential problems and minor violations that can be remedied administratively. Examinations also uncover major violations, and the examiners work closely with the Enforcement Section when this occurs. Finally, the administration of the entire Division is the responsibility of six employees, headed by the Securities Commissioner and the Deputy Commissioner. This staff is responsible for seeing that the daily operations of the Division are carried out and that the examination and enforcement staff receive the support and direction necessary.

SECURITIES REGULATORY ACTIVITIES

The Colorado Division of Securities enforcement activities include:

> *...investigation and support of litigation involving violations of the Colorado Securities Act and the Colorado Commodity Code. The investigators conduct interviews and take statements of witnesses, review and analyze corporate, business, financial and bank records, prepare memoranda and evidence for use in litigation, support the Attorney General and other law enforcement authorities in the preparation and conduct of administrative, civil and criminal cases, and provide testimony as to their investigations and findings. The Division's investigations may lead to criminal prosecutions, civil actions, or administrative hearings and sanctions.* Department of Regulatory Agencies Budget, *supra*.

The Division's enforcement activities often receive considerable media attention. Frequently, the kinds of cases that the Division pursues, such as the "exotic" securities fraud cases, attract the attention of the press due to the large amounts of money stolen and the creative nature of the scam. The Division often works closely with the Colorado Attorney General's Office, the United States Attorney's Office and with local district attorneys in putting these cases together. This cooperative effort between government agencies with overlapping and complimentary enforcement responsibilities for securities law violations generally works well. It allows the investigative team in the Colorado Division of Securities to prepare a case using their securities law expertise, while making efficient use of government attorneys prosecuting these violations in various Colorado jurisdictions. It is important to note in this context that the availability of resources to pursue significant violations of the securities laws is always a crucial issue in determining whether and how to go forward with any given case.

Although the Division's activities are divided for administrative purposes, all of the Division's activities are directed toward enforcement of the securities laws.

> *The Division's activities also include: (1) reviewing securities registration applications and exemption filings; (2) processing broker-dealer and sales representative license applications and amendments; (3) inspecting broker-dealers and sales representatives licensed to do business in Colorado; (4) maintaining computerized licensing information for all broker-dealers and sales representatives doing business in Colorado; and (5) responding to inquiries from the public and the securities industry and the Bar regarding compliance with Colorado law.* Department of Regulatory Agencies Budget, *supra*.

SECURITIES DIVISION ACCOMPLISHMENTS

The greatest single accomplishment of the Securities Division over the last six years came in 1990 winning the repeal by the Colorado Legislature of the Securities Act of 1981 and its replacement by the Colorado Securities Act. The lack of regulatory authority in the 1981 Act was a major contributing factor in the rise and persistence of the fraud and investor abuses that came to dominate the Denver and Colorado "penny stock" over-the-counter market.

It is hard to emphasize enough in any discussion of Colorado securities regulation the importance of the adoption in 1990 of the Colorado Securities Act. Colorado had followed a national trend toward deregulation in the financial services and securities industries when it adopted the Securities Act of 1981. It appeared to members of Congress and members of many state legislatures at the beginning of the decade of the 80's that deregulation would allow financial markets to compete more aggressively, thereby creating a healthier market and larger profits. In the savings and loan industry, Congress passed the Garn-St. Germain Act, which allowed savings and loan associations to move quickly into lending large amounts of money in areas outside their traditional markets. In the securities field, the Securities and Exchange Commission and state securities regulators were pressed to adopt a "hands off" approach in order to allow the securities industry to compete vigorously in the open markets of the 80's.

In Colorado, the securities industry strongly supported the adoption of the 1981 Securities Act, which removed the Division's authority to review securities offerings registered with the SEC and discontinued the licensing of brokers, dealers and sales representatives. Report of the State Auditor, Division of Securities Performance Audit, July 1990. A number of firms that became household names in Colorado and around the country during the decade of the 80's, such as Blinder, Robinson & Company, Inc., and others, strongly supported the new, weaker regulatory scheme adopted by the Legislature in 1981.

The disastrous result of these deregulatory moves was well documented. Crawford and Sihler, The Troubled Money Business, The Death of an Old Order and the Rise of a New Order, Second Edition, 1992. Congress is still trying to unravel and pay off the tangled web of debts accumulated by the nation's savings and loan industry, and securities regulators are continuing to see the fallout from the wide-open securities markets and elaborate securities scams conducted around the country during the 1980's. In particular, Denver and Colorado became well-known as the home of an enormous "penny stock market" characterized by high pressure, telemarketing sales tactics, market manipulations, sales practice abuses and criminal fraud. It has been estimated that American investors lost $2 billion dollars a year to penny stock swindles. It was in part due to these disastrous losses and the astonishingly cavalier fashion in which some securities broker-dealers operated their businesses that the Colorado Legislature moved to clean up the industry by adopting the Colorado Securities Act.

In the wake of the adoption of the Colorado Securities Act, the Securities Commissioner and the Division of Securities have adopted comprehensive rules to aid in the interpretation and administration of the Act. They have also modernized the Division with computerization and automation of functions.

CASES IN SECURITIES LAW ENFORCEMENT

One is astonished at the incredible blatancy and creativity with which certain fraudulent securities dealers operate. It is these operators who become the target of state and federal regulators seeking to protect the public from fraudulent investment schemes. The North American Securities Administrators Association ("NASAA") and the Council of Better Business Bureaus ("CBBB") periodically publish "Investor Alerts" designed to warn and inform the investing and consumer public about the latest investment scam, things to watch out for, how to protect yourself from being taken, and what to do if you have been. In discussing the widespread securities fraud incident to penny stock abuses in the late 70's and early 80's, NASAA and the CBBB reported that:

> *...in Colorado, when the Denver penny stock market collapsed in 1982, largely as a result of fraudulently inflated prices, hundreds of millions of dollars were lost by thousands of unfortunate investors. Following the collapse, new waves of buying and selling simply set the stage all over again for another generation of fraud. One study revealed that 45% of the penny stocks surveyed were being sold by promoters who were convicted felons, securities violators, reputed crime figures, or who were under investigation for financial misdealing.*
>
> *...The situation became so uncontrollable in Utah that the Governor formed a Securities Fraud Task Force, which spent about ten months investigating the nature and extent of the problem in that state. In recent years, said the resulting report, Utah has gained a reputation as the site of an inordinate amount of securities fraud and other investment frauds. Ten of these frauds have involved over 9,000 Utahns who have experienced a loss of approximately $200 million. In addition to direct investment losses, these frauds have caused a loss of confidence in Utah's lawful securities market, made it more difficult for legitimate businesses to raise capital, and fostered a negative image of Utah's people and institutions. The indirect financial losses to Utahns may thus be significantly greater than the direct losses.*
>
> *The persistence and brazenness of the penny stock manipulators is such, however, that statewide counterattacks often do no more than cause temporary setbacks and force the perpetrators to move their operations to another locale. Within a year or so of the Utah Task Force Report, penny stocks were right back in circulation.* Investor Alert!, Universal Press Syndicate, New York, 1988, at Page 100.

In Colorado, a joint state and federal penny stock task force led by the Unites States Attorney continues to operate in order to pursue what is left of the now essentially defunct operations of the Colorado penny stock market.

Before the passage of the Colorado Securities Act, the Securities Division had virtually no authority over what securities could be sold in Colorado or who could sell them. The only real authority provided in the Securities Act of 1981 was to investigate and pursue frauds, all too often, long after investors had been fleeced. With the passage of the 90 Act, however, it became much more difficult for scam artists to sell their worthless investments. Almost all non-exchange listed public offerings must be registered with the Securities Commissioner, providing authority for early intervention when unregistered offerings are detected. The Commissioner was also empowered to require promoters of the infamous penny stock market "blind pools" or "blank checks" to escrow investor money until a real use for the funds is found. New licensing requirements provide the Commissioner the authority to deny the worst applicants a license at all, and to discipline licensees who violate the law. In addition, the huge investor losses of the 80's in the securities markets across the country motivated state legislatures and the Congress to begin a general strengthening of the securities laws, which put many of the most outrageous schemers out of business.

While the decade of the 80's perhaps represented the worst in securities abuses since the stock market crash of 1929, the staying power of the fraudulent securities operants over time is truly impressive. During the course of the research for this report, hardly a week passed without a new story or series of articles on the latest legal actions pertaining to an entrepreneur or a corporation that had induced the public to invest its money in yet another fraudulent securities scheme. As will be seen, the public is often shocked not only to discover that the persons they trusted with their money are no more than modern versions of nineteenth century snake oil salesmen, but also that it is nearly impossible to get their money back. In some cases, the courts have gone so far as to hold that investors are "participants" in the fraudulent schemes, since they should have known that the outrageous profits being promised as a part of the scheme most likely had their basis in illegal conduct.

As NASAA points out,

> *...sometimes it seems the more esoteric the scheme, the easier it is to dupe the public. This is true of many pyramid swindles. In Kansas in the spring of 1985, the state's Securities Commissioner issued a restraining order against a syndicate it accused of operating an illegal scheme that had already taken in $10 million from investors in more than thirty states. The product that was so effectively promoted to eager investors: "Activator Kits," which were used to grow fungus cultures that would be sold to an affiliated cosmetics manufacturer at a heady profit. What the 12,000 people who rushed to plunk down their money had failed to find out was that there was no known market for the fungus cultures and that they had not been cleared by the federal government as safe for marketing. Furthermore, the*

much publicized cosmetics manufacturing plant was never in commercial operation and there were no product sales of any kind in progress. The Kansas Securities Commission indicted the promoters when it discovered evidence of the classic pyramid swindle: the syndicate was simply paying off the initial participants, including its own members, by recruiting an ever-increasing number of investors. Investor Alert!, *supra*, at Page 115.

NASAA goes on to point out some reasons for the staying power of the traditional Ponzi schemes.

The driving force behind this renaissance of the Ponzi Swindle is the recent explosion of financial services and often bewildering new investments available to the public. In this crowded and fast changing marketplace, Ponzi promoters have an increasing number of "costumes" at their disposal with which to dress up their schemes and shield them from ready detection. So it is that the path to spotting the Ponzi scheme is more difficult than ever. Investor Alert!, *supra*, at Page 110.

The technical differences between various types of securities fraud are generally unimportant to investors who have been swindled. While many Colorado residents were among those who invested in the "Activator Kits" and were subsequently given the "opportunity" to become managers in the company and in turn to sell the kits to other novice investors, they did not recognize the hallmarks of the traditional pyramid scheme until it was too late. The classic Ponzi scheme is even more blatant than the pyramid scheme and can be distinguished by the payments made to initial investors by large numbers of later investors, all of whom are seeking to make extreme profits from a dubious investment plan.

The classic Ponzi scheme amounts to little more than robbing an army of Peters to pay a handful of Pauls. As the number of initial investors (the Pauls) grows and the new supply of investors (the Peters) dwindles, the Ponzi bubble bursts under the pressure of meeting the promised interest payments. While some initial payments are actually made in order to drum up new recruits, the vast majority of investors in a Ponzi scheme end up losing all or most of their money. Investor Alert!, *supra*, at Page 114.

RECENT MAJOR COLORADO SECURITIES FRAUD CASES

M&L BUSINESS MACHINES -- *A Study in Cooperation*

M&L Business Machines first came to the attention of the Colorado Division of Securities in the late 1980's (before the enactment of the Colorado Securities Act) on suspicion of securities fraud. M&L was offering investors up to 10% per week return on their investments. One of the earliest letters to the Division questioning this activity came from the parents of a young investment adviser. They had been persuaded by their son to invest $5,000 in M&L. These Colorado investors wanted to know from the Securities Division whether the investment was legal.

According to documents filed with the Federal Bankruptcy Court in Denver, M&L Business Machines used to be one of the major suppliers of business machines in Colorado. It even had the largest third party service contract for IBM typewriters in all of the western United States during the late 1980's. However, M&L's business was not confined simply to selling and servicing business machines.

> *By 1984 M&L began soliciting money from "private investors" across the United States and abroad who were told their money was needed to buy large quantities of equipment. The investors, numbering over 1,000 by the end, were promised high rates of return on the theory that when the equipment was resold, the investors would share in the profits.*
>
> *In a typical transaction, an investor would write M&L a check for $10,000 on the promise that in a month he would get back his money plus, say, 20%. The investor would receive postdated checks from M&L in exchange for his initial contribution. For that thirty day, $10,000 investment, the investor would take back two checks dated the end of the month: a $2,000 check for interest and a $10,000 check for principal. But by 1985, M&L stopped using investors' money to buy equipment, instead just stacking in its warehouse cartons filled with bricks and foam. The investors continued to be paid off only as long as M&L was able to find new investors.* Westword, "Burning in Ponzi Hell", March 2, 1993, at Page 14.

After repeated requests for information from M&L by the Colorado Division of Securities investigatory staff were ignored, the Securities Division subpoenaed M&L's records. Those subpoenas were contested, but finally enforced by a Denver District Court. Even at that point, M&L's attorneys failed to provide all of the information requested and offered numerous explanations and excuses as to why certain records were not available. Securities Division investigators even made site visits to M&L, but the extreme intransigence of M&L's officers and their lawyers continued to impede the investigation. Many M&L investors, in spite of fearing the loss of their money, refused to speak with investigators at all. M&L's officers finally recognized the fact that they had been caught, and put the company into bankruptcy on

October 1, 1990, in the apparent belief that seeking refuge in bankruptcy would somehow thwart the Division's investigation. At that time, M&L's "private investor program" was represented as being insolvent. Instead of being thwarted, the Division actually pursued M&L in bankruptcy court, and succeeded in obtaining the order of the court to appoint a trustee over the affairs of the company. The trustee appointed later reported that the company had about $35,000 in the bank but had $83 million outstanding in uncashed M&L checks held by investors. Westword, *supra*.

The Colorado Division of Securities continued to work on the case, in cooperation with the trustee. Evidence of substantial criminal securities, bankruptcy and mail fraud was uncovered. In taking the lead in the prosecution of this case, U.S. Attorney Mike Norton cited the extensive investigation and assistance of the Colorado Division of Securities as being a key factor in his ability to prosecute successfully.

<u>MICROTECHNICS AEROSPACE SYSTEMS, INC.</u> -- *Another Fraudulent Offering*

Sometimes, fraudulent securities offerings sound so good that even relatively sophisticated investors and units of government are taken in by them. Such was the case with the investments offered by a company called Microtechnics Aerospace Systems and its principals, Marvin V. Selph and Joseph N. Sandoval. In 1988, workers at Rocky Flats contacted the Securities and Exchange Commission with complaints about stock being offered by Microtechnics. The SEC contacted the Colorado Division of Securities and referred the matter to them for investigation.

The story that emerged after investigation by the staff at the Securities Division wrote another chapter in the creativity of fraudulent securities scam artists. According to Division records,

> *...the defendants offered and sold approximately 18,988,296 shares of stock in Microtechnics to approximately 504 investors in Colorado and ten other states for approximately $585,949. Before coming to Colorado, the defendants pulled off an almost identical operation in New Mexico. They left after the New Mexico Securities Bureau issued a cease and desist order against them for sale of unregistered securities and fraud, and after Selph was investigated, arrested and convicted of criminal securities violations in Albuquerque. In Colorado, the defendants failed to inform investors about the New Mexico problems, and made the untrue statements of material facts that Microtechnics had developed an airplane collision avoidance device which was ready for testing and marketing and that Microtechnics was arranging an initial public offering.*

In fact, there never was a working prototype of the device nor had an IPO been negotiated with any underwriter. Report to the Securities Law Review Committee of the Colorado Bar Association, Colorado Division of Securities, June 6, 1989.

Apparently, Selph was a master at selling his non-existent "airplane collision avoidance system." He claimed that the securities offering was a "Rule 504" private placement that was being handled by a well-known national brokerage house in compliance with federal securities laws. He often sold the product face to face with individual investors, and particularly targeted employees at the Rocky Flats Nuclear Weapons Plant and Hispanic businessmen's associations in Colorado and other states. Although most investors only invested about $500 in Microtechnics stock, a number of investors gave Selph between $10,000 and $15,000. His pitch was so good that economic development officials from the City of Pueblo offered him enticements to settle in their city, including free office space. Selph would often show potential investors his offices and a mock-up of the collision avoidance device which was intended to be installed in aircraft, "...as soon as the National Transportation Safety Board approves." The investors did not realize, apparently, that the mock-up was merely a metal shell with various gauges, lights and dials glued on its face, and that it did not contain any internal components, much less a sophisticated aircraft collision avoidance system.

The Division filed a civil injunctive action against Selph, Sandoval and Microtechnics. Selph and Microtechnics failed to file an answer and a default judgment was entered for $585,000. The matter was referred by the Division to the Attorney General's Office. The Attorney General and the Pueblo District Attorney filed criminal securities fraud, unregistered broker-dealer, principal and representative and COCCA charges against Selph; and criminal securities fraud and unregistered broker-dealer, principal and representative charges were filed against Sandoval. In all, ten counts of criminal securities fraud, one count of failure to register as a securities dealer and three counts of racketeering under Colorado's Organized Crime Control Act ("COCCA") were filed. Selph was eventually convicted on March 16, 1991, and was sentenced to sixteen years in prison. Report to the Securities Law Review Committee of the Colorado Bar Association, Colorado Division of Securities, *supra*.

COLORADO OSTRICH FARMS -- *An "Exotics" Scam*

As stated earlier, the more esoteric the scheme, the easier it is to dupe the public. Investor Alert! *supra*, at page 115. Indeed, this was the case when Colorado investors were defrauded of over $400,000 in a securities fraud scheme involving investments in ostriches. In this case, five individuals were charged with a total of 36 felony counts and one misdemeanor count. The indictment was returned by the State Grand Jury based on work of investigators from the Colorado Division of Securities working in cooperation with the Attorney General's office.

According to the indictment, during the period of January 1991 through June 1992, the

> *defendants sold so-called "Joint Venture Agreements" to approximately 100 investors in Denver, Adams, Boulder, Douglas, Jefferson, El Paso and other Colorado counties. The State alleged that these Agreements constituted "investment contract" securities. The Agreements called for investors to purchase ostriches through Colorado Ostrich Farms. After receipt of an investors funds, the defendants were supposed to select the particular breeding pairs to buy from suppliers, raise, insure and care for the birds, hatch the eggs and sell the chicks. The investors did not have any responsibilities other than to come up with the money. The investors and the company were to split the proceeds of the sales of the new birds.*
>
> *The indictment goes on to charge that in selling these "Joint Venture Agreement" securities to investors, the defendants represented that they had expertise in the selection, purchasing and care of ostriches, but in fact they did not. Likewise, contrary to their representation to investors that they had the facilities to hatch ostrich eggs, the defendants either did not have such facilities at all or the facilities they had were substandard. The defendants allegedly misrepresented to investors the quality, breed, health, method of identification and age of the birds to be purchased. In addition, the defendants were charged with representing to investors that the money collected from them would be used for down payments on ostriches and that it would be sent to ostrich suppliers to guarantee delivery, when instead investor funds were rarely sent on to suppliers, and over half of the money raised was used to pay commissions, salaries, and the personal expenses of the defendants and others.* Joint Press Release of Colorado Attorney General Gale Norton and Securities Commissioner Philip Feigin, August 20, 1992.

All five defendants have pled guilty to one or more of the charges. Sentencing is scheduled for July 16, 1993 in El Paso County District Court.

It is sometimes hard not to laugh at schemes like this in retrospect, but it must be remembered that hard-earned savings that might otherwise have been put to good purposes were lost. It is the people who think they are too smart to be conned who are often the most likely to be the next victims.

Under the Securities Act of 1981, it would have been much more difficult to pursue this matter. First, the "investment contract" test in effect at the time would have required the Division to establish that the investors were joint participants in the enterprise, i.e., that they would share and share alike in the profits or losses of the enterprise. Second, the initial action taken in this was the execution of a search warrant by law enforcement authorities on the basis of an affidavit submitted by a Securities Division investigator that the defendants were offering and selling unregistered, non-exempt securities in violation of the Colorado Securities Act. Under the 1981 Act, an exemption would have been available. Formal enforcement action would have had to wait until further evidence of fraud was established. Many more persons could have been victimized while that evidence was being gathered.

FIRST CHOICE SECURITIES CORPORATION -- *The Penny Stock Market Is Still Alive In Colorado*

The first major case brought by the Securities Commissioner and the Securities Division under the new broker-dealer regulatory authority provided in the Colorado Securities Act was against the penny stock firm First Choice Securities Corporation. In a civil injunctive complaint filed in Denver District Court and in an administrative action filed with the Division of Administrative Hearings, the Commissioner and the Division charged that First Choice and its agents duped investors through high-pressure telephone sales of two stocks in 1990 and 1991. After a full hearing on the matter before an Administrative Law Judge, and that Judge's Initial Decision finding that the firm and its agents had violated the securities law and rules, the Commissioner issued his Final Order, revoking the license of the firm as well as imposing other sanctions on the individuals involved.

> *The state charged First Choice used high-pressure sales tactics to pitch the stocks of Parkway Capital, a "blind pool" shell company with no assets or stated business plan, and Rephex Inc., an Irish electronics firm. In both cases, First Choice salespeople made false statements about the companies' business prospects and omitted other material facts in their sales pitches. State officials estimate as many as 600 investors may have been bilked of some $500,000.* "State Revokes First Choice Broker' Licenses", The Denver Post, October 21, 1992.
>
> ***
>
> *State Securities Commissioner Philip Feigin Tuesday pulled the securities licenses of five former principals of the Englewood penny stock firm First Choice Corporation.*
>
> *The action by Feigin overruled licenses suspensions imposed by an administrative law judge. Feigin's ruling was the first major test of the state securities act of 1991, which gave the securities commissioner the power to grant or take away securities licenses.*
>
> *Feigin said his overruling of the weaker penalties by the administrative law judge shows*

he intends to be tough on stock fraud. "State Securities Chief Yanks 5 Licenses", Rocky Mountain News, October 21, 1992.

On February 22, 1993, the Securities Commissioner announced that an Order of Permanent Injunction and Final Judgment had been entered against First Choice Securities Corporation and three other defendants. The Order was entered by Denver District Court Judge Robert S. Hyatt.

> *Judge Hyatt permanently enjoined First Choice Securities Corporation, Gregory F. Walsh, Derek H. Yamada and Richard Herzog from violating the Colorado Securities Act of 1990, and entered judgments against them totaling $7,375,000 for state securities law violations involving the marketing of the securities of Parkway Capital Corporation and RePhex, Inc. during the period 1989 through 1991.* Press Release of Securities Commissioner Philip Feigin, February 22, 1993.

LA JOLLA CAPITAL

A case currently being pursued by the Colorado Division of Securities highlights the fact that the Division of Securities under the Colorado Securities Act is now empowered to pursue unlicensed activity.

The May 29, 1993 issue of The Denver Post reported that the Securities Division had filed administrative charges against "La Jolla Capital Corp.," a San Diego-based brokerage house, charging, among other things, that the firm had employed unlicensed salesmen in its Englewood, Colorado franchise office.

> *The Division of Securities has also claimed that La Jolla Capital knew that five of its salesmen in this office did not have the necessary licenses, let them operate anyway, and then tried to hide the fact from customers.* "Colorado Files Charges Against California Broker", The Denver Post, May 29, 1993.

The alleged securities violations occurred from

> *...September 1992 through January 1993. Those charged tried to conduct at least 90 securities transactions involving a total of $370,000, from people in Colorado, Texas, Illinois, Michigan, Nevada and New York.* The Denver Post, *supra*.

The salesmen were not licensed in any of the states mentioned at the time of this activity. In addition, some of those charged appear to have lengthy disciplinary histories with the securities regulators of other states.

> *The charges were filed May 21 and were the result of a routine examination of La Jolla*

that was conducted last October. The Division also says that the company used an internal recordkeeping system designed to hide the fact that their sales representatives were unlicensed. The Denver Post, *supra*.

FINANCIAL PLANNERS\INVESTMENT ADVISERS -- *Problems Continue*

RANDY ROMERO

Colorado continues to be one of the few jurisdictions that has not extended to its Division of Securities the authority to regulate the activities of financial planners and investment advisers. The operations of fraudulent financial planners and investment advisers are constantly in the news in articles detailing the small, large, and sometimes spectacular losses suffered by unsuspecting investors in this state. For example, the front page of the July 12, 1992, edition of The Sunday Denver Post featured the story of Randy Romero, a local financial planner from Lakewood who even (allegedly) defrauded his pastor of his entire retirement savings of $92,000. In addition, in unconfirmed reports, Romero is alleged to have defrauded up to $12 million from 300 Denver area investors. Many, like the pastor in the story, said they lost their life savings and face retirement nearly penniless. The Sunday Denver Post, "Scam Victims Seek Missing Millions", July 12, 1992.

JAMES DONAHUE

Romero's allegedly fraudulent dealings were small in comparison with those of Englewood-based "investment adviser" James Donahue, whose huge national scheme collapsed in 1991, and may have cost investors $300 million. Donahue took money from investors large and small, saying that he had found a way to reap huge earnings without risk by employing a "hedging strategy" in the otherwise volatile and risky options market. In fact, Donahue had lost millions employing the strategy, and was using what was left of the investors' money for his own purposes, including investments in electricity-generating windmill farms in California, in a desperate attempt to recoup the losses. After an investigation by the U.S. Attorney in which the Securities Division provided significant cooperation, Donahue was charged, pled guilty, and was sentenced to five years in prison in 1992, but regulators point out that this sentence was insignificant in comparison with the damage Donahue caused.

According to NASAA, the lack of regulation in the financial planner field has become acute in the last few years as the number of financial planners has grown enormously.

> *The number of financial planners in the two most widely recognized trade associations in the U.S. swelled from 15,000 in the early 1980's to about 40,000 by the middle of the decade and is still growing. The sad fact of the matter is that there are some 200 thousand people who have hung up their shingles as "financial planners," many of whom are fortune hunters whose only objective is to use their clients as stepping stones to self-enrichment. Despite the booming activity in this field and an estimate that 35 million American households could be customers for financial plans, the business is very loosely regulated and only a small percentage of the so-called experts are registered with the SEC. One survey of consumer complaints and enforcement actions in twenty states revealed that fraud and abuse in the financial planning field was totaling more than $30 million a year in those areas alone.* Investor Alert!, *supra*, at Page 43.

The United States General Accounting Office has also targeted problems in the financial planner industry as a priority issue in the new Congress.

> *Legislation is needed to strengthen the SEC's oversight of the investment advisers industry. This industry, consisting of about 17,500 registered advisers who manage a total of more than five trillion dollars in assets, affects the lives of millions of Americans who set up a plan for retirement, for their children's education, or for their survivors. It is also an industry that has significantly damaged the lives of many individuals through fraud, embezzlement, or the provision of misleading or inappropriate advice.*
>
> *SEC's current oversight program may be doing more harm than good by giving investors a false sense of confidence that SEC-approved advisers are both well qualified and well regulated. In 1992, SEC had only 46 inspectors for all registered advisers. In 1990, almost 60% of advisers registered for more than one year had never been inspected. SEC needs additional resources and enhanced registration and inspection programs. Enhanced programs would (1) verify adviser-supplied education and experience information and check all available federal criminal history sources; (2) identify advisers who should be registered that are not; (3) register all individuals and advisory firms who give advice; and (4) inspect adviser business operations within a reasonable time, such as within one year of registration and periodically thereafter according to risk.* USGAO, "Financial Services Industry Issues" GAO Report No. 0CG-93-10TR, December, 1992.

THE COLORADO LEGISLATURE'S RESPONSE TO FINANCIAL PLANNER\INVESTMENT ADVISER ABUSES

In 1991, it was discovered that Steven Wymer, an investment adviser and money manager from Irvine, California, had engaged in a broad campaign of fraud. His victims included local government entities, banks and trust funds across the country. In Colorado, Wymer swindled more than $57 million from Lakewood-based Jefferson Bank and Trust and two other Colorado entities. The Denver Post, "Wymer: Closer Inspections Would Have Prevented Scam". Wymer told SEC investigators that their brief inspections of his records failed to uncover his fraudulent activities.

> *Wymer managed $1.2 billion through his Institutional Treasury Management company and had clients including Weld County and the Investment Trust of Colorado, a pool of about $107 million invested on behalf of thirty government agencies in the state. Most of the small cities and counties that joined with Wymer were looking for a safe harbor for their surplus cash. But Wymer actually was running a sophisticated Ponzi scheme that stole money from some investors to pay off others. The scam collapsed in 1991 after several cities in Iowa unexpectedly tried to cash in. Wymer told lawmakers that he was aided by stock brokers who agreed to help shift funds without sending confirmation statements to his clients, "Some of my clients never learned the real status of their accounts," he testified.* The Denver Post, *supra*.

In addition to underlining the continuing need for stronger regulation of financial planners and investment advisers, the Wymer case also prompted the Colorado General Assembly to enact changes to the statutes governing the establishment and operation of local governments' surplus trust funds. It is often the case that units of local government have surplus cash on hand that is not needed for current operations. These funds can be placed in banks, but the return is not always optimized. Colorado law authorized local governments to create what were called "local government surplus funds trust funds" (section 24-75-701, C.R.S.) so that their pooled surplus funds could be utilized to maximize return while maintaining safety at the same time. In essence, these trust funds were money market funds. They were not required to be registered with the SEC under the Investment Company Act of 1940 because they were composed of local government funds. It was these funds that were the target of Steven Wymer's fraudulent activities.

In 1993, the Colorado General Assembly created the Local Government Investment Pool Trust Fund Administration and Enforcement Act (House Bill 93-1159, repealing and re-enacting sections 24-75-701 and 702, adding new provisions to these sections, and adding section 11-51-901, *et seq.*, C.R.S.). This Act gives responsibility to the Division of Securities to monitor the operations of the trust funds and adds anti-fraud provisions to the Colorado Securities Act for illegal activities pertaining to these trust funds. The new law takes effect July 1, 1993.

However, in the 1993 Session, the General Assembly failed to pass amendments to the

Colorado Securities Act that would have strengthened it by providing the Colorado Division of Securities with the authority to regulate the activities of Colorado financial planners and investment advisers. Indeed, this is the second year in a row in which the Legislature has come close to, but has failed, to pass such legislation. The proposed law was the result of a 1991 Sunrise study of the financial planner\investment adviser industry. Finding widespread evidence of abuse in this field, the Colorado Division of Securities, NASAA, various private associations of financial planners and numerous others have urged the Legislature to strengthen the law in this area. In spite of wide agreement as to the need for this law, wide agreement as to its specific terms and in spite of the fact that industry fees would pay for the additional costs of this regulation, the Legislature has failed to act. As will be noted later, this report does not include a specific recommendation to adopt financial planner\investment adviser regulation in Colorado because it is the expressed intention of the Securities Commissioner to continue efforts in the 1994 session of the General Assembly to fulfill the 1991 recommendation of the Sunrise/Sunset Committee that such regulation be implemented.

CONCLUSION

The variety and complexity of securities fraud and other securities laws violations in the United States today explains the need for the complex system of state, federal and industry regulation discussed in this report. "Securities regulation is a full-time job for experts." Blue Sky Law Reports, *supra.* The Colorado Division of Securities and the Colorado Securities Act have been created by Legislature with this fact in mind. The need to keep track of securities offerings and securities salespeople, the need to investigate alleged securities law violations and the need to move swiftly and effectively against the violators are the requirements that drive the operations of the Division. These imperatives have caused the Legislature to empower the Commissioner of Securities, rather than a board or commission, with the responsibility to carry out these laws. While a few states have securities commissions, Colorado is among the vast majority of states acknowledging the greater efficiency of the Securities Commissioner model.

Recent audits of the Securities Division have discussed the huge volume of information which must be processed on a regular basis simply to track securities offerings and securities broker-dealers and sales representatives. For example, the Division receives between 80 and 120 calls per day as well as a minimum of 70 pieces of mail. In spite of successful prosecution of securities violators, information regarding potential securities violations continues to pour into the Division. For example, in 1991 and 1992, the Division closed 359 active cases, but opened almost exactly as many cases, based on complaints and information it had received from various sources.

The State Auditor found that the Division is generally doing a good job of handling its regulatory responsibilities. The handling of information, case management and resource distribution were three areas which were recommended for improvement, and the Division has moved aggressively to meet those recommendations. In addition to devoting more employee time to examining the books and records of Colorado broker-dealers, the Division has improved its complaint handling techniques and has instituted a computerized case tracking system called LawBase, which will allow the Division's management team constantly to keep track of all the cases currently under investigation.

Broker-dealers in the state believe the Division is doing a good job. In response to questions posed to them, several Colorado broker-dealers indicated that Colorado's securities laws had been much improved as a result of the Colorado Securities Act. Information requested of the Securities Division the information has been timely provided, accurate and freely available. In the area of securities regulation, it was noted that the Colorado Division of Securities has been very active and effective. Particular note was made of the fact that the Division of Securities has been highly efficient in cooperating with the U.S. Attorney, the Attorney General's Office and with district attorneys around the state in pursuing securities law violations.

Clearly, Colorado's Division of Securities is an example of an effective regulatory program. This effectiveness is best demonstrated by the fact that, over the last three years alone, the Colorado Legislature has chosen to enlarge the responsibilities of the Division by adding two new laws for it to administer. While there is always room for improvements in the administration of these laws (for example, it is clear that not enough consumers know the existence of the Securities Division and its regulatory functions), the conclusion that the Colorado Division of Securities is one of the best state securities regulatory agencies of its kind in North America today is well supported by the evidence. Further amendments to the Colorado Securities Act, additional experience in administering these laws and increased cooperation with federal and industry regulators having jurisdiction in this area are key elements in improving this regulatory record. The recommendations contained in the following chapter of this report are aimed at making specific improvements in the administration by the Colorado Division of Securities of the laws for which it is responsible and to better protect the citizens of the state.

STATISTICAL CHARTS

The statistical charts that follow provide an overview of the Colorado Division of Securities' securities registration, broker-dealer licensing, and enforcement activities over the last three years.

SECURITIES REGISTRATION

FISCAL YEAR	REGISTER BY FILING	REGISTER BY QUALIF.	LIMITED OFFERING	FEDERAL EXEMPTION	INVESTMENT COMPANIES
1990-1991	596	0	2	597	1930
1991-1992	457	17	9	612	1834
1992-1993	442*	38*	5*	615*	1894*

* = projections based on actual figures as of the end of May 1993.

Blank checks:

FISCAL YEAR	BLANK CHECK FILINGS
1990-1991	29
1991-1992	8
1992-1993	1

Of the 38 blank check companies that filed with the Division since July 1, 1990, eight withdrew and five were abandoned. The proceeds raised by 15 remain in escrow. Six actually broke escrow (one of them was owned by the FBI!) Four offerings remain pending with the Division.

BROKER-DEALER LICENSING

FISCAL YEAR	BROKER-DEALER APPLICATION	BROKER-DEALER RENEWALS	AGENT APPLICATIONS	AGENT RENEWALS
1990-1991	197	1463	18,528	43,291
1991-1992	233	1469	20,250	44,811
1992-1993	228*	1547*	23,387*	48,226*

* = Projections based on actual figures as of the end of May 1993.

As of May 1993, 1,641 broker-dealers and 54,904 sales representatives were licensed to do business in Colorado.

ENFORCEMENT

FISCAL YEAR	NEW FILES	ADMIN. REFERS.	ORDERS	CIVIL REFERS.	INJS.	CRIM. REFERS.	PROSE-CUTION	CONVS.
89-90	191	-	2	18	15	6	8	5
90-91	130	2	6	23	9	2	0	6
91-92	169	5	4	17	13	6	9	10
92-93	106*	5*	7*	15*	20*	7*	11*	9*

* = projections based on actual figures as of June 18, 1993.

CHAPTER 4 - RECOMMENDATIONS

INTRODUCTION

National and local financial markets are changing at a very dynamic and rapid pace. All of the financial regulatory programs in Colorado will have to adapt to these changes, especially those relating to securities regulation. Colorado will be called upon to develop and implement a coordinated approach to financial regulation in order to ensure that the public is protected and well served, and that the regulatory goals of adequate and balanced financial regulation in Colorado are achieved.

In order to meet this goal, government will need to do a better job of responding to industry changes than it has in the past. During the decade of the 80's, when the securities, banking and financial service industries complained that regulation was stifling competition, government responded quickly on the state and national levels with a significant wave of deregulation. The disastrous results of that wave of deregulation are the subjects of many entertaining best sellers, movies and other media. Ironically, the task faced by government regulators in the 1990's is very similar to the one faced in the 1980's: how can government adequately balance the need for free and open markets with the need for consumer protection?

This report has found that Colorado is substantially recovering from its mistakes in the securities regulation field in the 1980's. This recovery is due to the vigorous regulatory efforts of the Colorado Division of Securities, the Colorado Attorney General's Office, the U.S. Attorney's Office and the offices of district attorneys around the state. The securities industry, through the NASD and through committees of practitioners who provide advice to the securities regulators on the state and national levels, has also assisted in improving regulation in the wake of the abuses of the 80's.

Government, however, is often the last to respond to changes in the industry. In fact, government is often the tool that is used to defend the status quo. Most commentators agree that the theme of the 1990's in the securities, banking, financial services and insurance industries will be increasingly fierce competition with a corresponding blurring of the lines between industries which have historically been separate. Since government regulation has also historically been based on the clear separation of these industries, governments will be hard pressed to respond to industry changes while keeping the balance between open markets and consumer protection. The Troubled Money Business, *supra*, at Page 238.

In Colorado, as in most states, regulatory responsibilities for the securities, banking, financial services and insurance industries are split between four different divisions within the Department of Regulatory Agencies: the Division of Securities, the Division of Banking, the Division of Financial Services, and the Division of Insurance. As the products that are sold within each of these industries cross the traditional lines that until recently separated them, regulators in each area will need to cooperate intensively. For example, as banks seek to sell securities, either in-house or through subsidiaries, securities regulators will be required to determine whether the offerings made and the persons selling the securities are complying with state and federal laws. Similarly, as insurance companies seek to sell annuity contracts, which carry many of the hallmarks of a securities investment contract, regulators will be faced with the same basic issue: achieving adequate and balanced regulation.

Colorado's Division of Securities has made significant progress in helping to put the Colorado Securities Act in place in this state and in finding effective ways of implementing the law. In addition, the securities regulators have had to stretch their resources and time commitments in order to cover their responsibilities under new laws recently passed by the Legislature, including the Colorado Commodity Code, the Municipal Bond Supervision Act and the Local Government Investment Pool Trust Fund Administration and Enforcement Act. While experience with the latter Acts is still limited, experience with the Colorado Securities Act has shown that the Colorado Division of Securities has been effectively empowered by the Legislature to regulate the securities industry. In particular, the coordinated system of securities regulation established as part of the 33 and 34 Acts has been continued in Colorado's Act. A key element of the success of implementing the Colorado Securities Act has been the ability of the Colorado Division of Securities to work closely and cooperatively with other law enforcement agencies and the industry.

However, problems in the industry remain. Unregistered securities continue to be offered and unlicensed securities broker-dealers and salespersons continue to operate in Colorado. Resource constraints continue to be a problem and the law itself is not always adequate to meet the challenges posed by an evolutionary securities industry. Worst of all, securities fraud continues to crop up, often in new and creative formats. Colorado's experience in the 1980's with a weakened regulatory system clearly shows that deregulation in this area is a poor public policy choice. Rather, the continued struggle to find the appropriate balance between effective regulation and the free function of an open market is the appropriate direction for public policy to take in this area. Therefore, the Department of Regulatory Agencies recommends that the Legislature continue the regulation of securities in Colorado under the Colorado Securities Act and related laws through the Colorado Division of Securities.

RECOMMENDATION 1: CONTINUE THE COLORADO DIVISION OF SECURITIES -- THE COLORADO GENERAL ASSEMBLY SHOULD CONTINUE THE REGULATION OF SECURITIES IN COLORADO THROUGH THE DIVISION OF SECURITIES PURSUANT TO TITLE 11, ARTICLE 51, C.R.S.

RECOMMENDATION 2: THE GENERAL ASSEMBLY SHOULD CONTINUE THE COLORADO DIVISION OF SECURITIES UNTIL JULY 1, 2002.

DISCUSSION

The Colorado Division of Securities has been studied several times during and in the wake of the passage of the Colorado Securities Act. The State Auditor conducted a performance audit of the Division in July 1990 and a follow-up audit of the Division in the Fall of 1992. Amendments to the Colorado Securities Act proposed in this report and improvements in the operation of the Division of Securities pursuant to the Auditor's Reports should significantly improve the record of the Division in carrying out its regulatory activities. However, the remarkable pace of evolution that is occurring in the securities, banking, financial services and insurance industries in the United States and internationally argues for a sunset date eight, rather than ten years, in the future, which will require that the next Sunset study of the Securities Division begin in the year 2000. This should allow adequate time for the Division to function freely and to begin to establish a reviewable regulatory record.

RECOMMENDATION 3: THE EXCLUSION OF BANKS FROM THE DEFINITION OF "BROKER-DEALER" SHOULD BE LIMITED, APPLYING ONLY TO ACTIVITIES OF BANKS INVOLVING THEIR OWN ACCOUNT OR THE EXERCISE OF THEIR FIDUCIARY AND TRUST POWERS.

The General Assembly should amend section 11-51-201(1)(c), the section of the Colorado Securities Act that provides a broad exclusion from broker-dealer licensing for "banks," to provide that a bank is excluded from the definition only when acting for its own account or when exercising its trust or fiduciary powers.

> **11-51-201(2).** "Broker-dealer" means a person engaged in the business of effecting purchases or sales of securities for the accounts of others or in the business of purchasing and selling securities for the person's own account. The term does not include the following:

(c) A bank, WHEN ACTING FOR ITS OWN ACCOUNT OR WHEN EXERCISING TRUST OR FIDUCIARY POWERS PERMITTED FOR BANKS UNDER APPLICABLE STATE OR FEDERAL LAWS AND REGULATIONS PROVIDING FOR THE ORGANIZATION, OPERATION, SUPERVISION AND EXAMINATION OF SUCH BANKS;

DISCUSSION

Under current Colorado law, all banks are excluded from the definition of the term "broker-dealer." Colorado law defines a "broker-dealer" as "...a person engaged in the business of effecting purchases or sales of securities for the accounts of others or in the business of purchasing and selling securities for the person's own account." There are several other exclusions from the definition. This definition and the exclusions have their roots in the securities laws of the United States and the several states as those laws have developed over the past 80-odd years.

One of the key reasons for the exclusion of banks from the term "broker-dealer" in the securities laws is related to the existence of the Banking Act of 1936, also known as the Glass-Steagall Act. One of the key provisions of the Glass-Steagall Act, as it was construed for many years, is that it prevented banks from engaging in general securities business activities. Although the Glass-Steagall Act is still in effect, recent liberalizing interpretations by federal banking authorities have significantly broadened the scope of activities in which federally chartered banks may engage. The result is that many national banks are now engaged in a wide variety of securities-related activities, even though the "broker-dealer" definitional exclusion for banks remains in place. Consumers may be led to believe that investments offered to them at their bank are insured against loss by the federal government; the persons engaged in the business of selling securities on bank premises (perhaps without a securities license due to the exclusion) may not have the background and be subject to the same laws and rules as the brokerage employee down the street.

The amendment proposed above would maintain the exclusion of banks from the definition of broker-dealer when those banks are engaged in traditional bank activities, i.e., buying or selling securities for their own accounts or when they are exercising trust or fiduciary powers. In the former case, the consumer is not implicated; in the latter case, the consumer is protected since the bank is acting as a fiduciary. In other cases, when a bank is acting as, with, or through a broker-dealer, or engaging in some fashion in the business of effecting purchases or sales of securities for the accounts of others, the amendment recommended above would require them and their securities sales employees to obtain licenses. Licensure would require observance of Colorado securities laws and would provide basic protection to Colorado securities investors. In this way, the securities market would be allowed to continue to operate without undue burden and Colorado investors would receive the protection of Colorado securities law.

RECOMMENDATION 4: REQUIRE REGISTERING INVESTMENT COMPANIES TO RENEW REGISTRATION ANNUALLY

The General Assembly should amend section 11-51-302(7) to require investment companies registering in Colorado that are also registered with the SEC under the Investment Company Act of 1940 to renew their Colorado registration each twelve months, and should amend section 11-51-707(3)(a) to accommodate such a renewal.

> **11-51-(302)(7).** A registration statement under section 11-51-303, EXCEPT THE REGISTRATION STATEMENT OF AN INVESTMENT COMPANY REGISTERED UNDER THE FEDERAL "INVESTMENT COMPANY ACT OF 1940", is effective for one year after its effective date and thereafter is effective during the period or periods, but only those periods, when the prospectus contained in the registration statement filed under the federal "Securities Act of 1933" meets the requirements of subsection (a) of section 10 of such federal "Securities Act of 1933". A REGISTRATION STATEMENT UNDER SECTION 11-51-303 OR 11-51-304 OF AN INVESTMENT COMPANY REGISTERED UNDER THE FEDERAL "INVESTMENT COMPANY ACT OF 1940" IS EFFECTIVE FOR ONE YEAR AFTER ITS EFFECTIVE DATE, AND MAY BE RENEWED BY THE FILING WITH THE SECURITIES COMMISSIONER OF A RENEWAL NOTICE. EVERY PERSON FILING SUCH A RENEWAL NOTICE SHALL PAY A RENEWAL FEE, WHICH SHALL BE DETERMINED AND COLLECTED PURSUANT TO SECTION 11-51-707. Any registration statement under section 11-51-304 is effective for one year after its effective date unless the securities commissioner by rule or order extends the period of effectiveness. A registration statement under section 11-51-303 or 11-51-304 may be terminated or withdrawn upon the request of the issuer or the person who filed the registration statement and with the consent of the securities commissioner. All outstanding securities of the same class as a registered security are considered to be registered for the purpose of a nonissuer transaction or series of transactions while the registration statement is effective.

> **11-51-707(3)(a).** The division shall set the amount of each fee which it is authorized by law to collect under this article. The budget request and the fees for the division shall reflect direct and indirect costs. The division, in the discretion of the securities commissioner, may set registration fees payable under section 11-51-302 according to a scale of rates applied to the dollar amount of the securities to be registered, with a maximum fee specified. The division, in the discretion of the securities commissioner, may set AN INVESTMENT COMPANY RENEWAL FEE PAYABLE UNDER SECTION 11-51-302 (7) AND an exemption fee payable under section 11-51-307 (1) (k) for each series, portfolio, separate account, or fund of an open-end management company or unit investment trust.

DISCUSSION

Most state securities laws require investment companies registered with the SEC under the Investment Company Act of 1940 nonetheless to register as well with the state securities administrator. The Colorado Securities Act provides that these companies may register with the Securities Commissioner, but also provides the so-called "blue chip" investment company exemption, championed by the investment company industry, which must be claimed once every twelve months. A vast majority of investment companies do business in Colorado by claiming this exemption each year. Even so, a loophole exists in current law that allows these companies to avoid annual exemption filings by registering once, because no follow-up filing is required if they keep their SEC registration up to date (which they all do anyway). These amendments provide that all investment companies must file annually, whether they register or claim the exemption. The Investment Company Institute is in support of this change.

RECOMMENDATION 5: AMEND STATUTORY LICENSING DISQUALIFICATION FOR PERSONS SUBJECT TO COURT INJUNCTIONS ISSUED BY CONSENT, AND IN RECOGNITION OF THE NORTH AMERICAN FREE TRADE AGREEMENT

The General Assembly should amend the statutory licensing disqualification for persons who have been enjoined by courts to include orders issued by consent without findings of fact, and in recognition of the North American Free Trade Agreement. The amendments should read as follows:

Amend section 11-51-410(1)(d) as follows:

11-51-410(1)(d). ~~Has been found in a final decree~~ IS CURRENTLY THE SUBJECT OF A TEMPORARY OR PERMANENT INJUNCTION issued by a court of competent jurisdiction ~~within the past five years~~, in an action instituted by the securities commissioner, the securities agency or administrator of another state or a Canadian province or territory, OR A MEXICAN PROVINCE OR TERRITORY the securities and exchange commission, or the commodity futures trading commission, to have violated any securities registration or broker-dealer or similar license requirement in any federal, state, or provincial law or to have engaged in fraudulent conduct;

Amend section 11-51-410(1)(f)(I) to read as follows:

11-51-410(1)(f)(I). An order by the securities agency or administrator of another state or Canadian province or territory, OR MEXICAN PROVINCE OR TERRITORY, entered after notice and opportunity for hearing and based upon fraudulent conduct, denying or revoking a person's license as a broker-dealer, sales representative, or investment advisor, or the substantial equivalent of those terms, or suspending of barring the right of the person to be associated with a broker dealer;

DISCUSSION

Adoption of Recommendation 5 will provide uniform language with respect to persons who are subject to denial, suspension or revocation of their securities licenses as a result of currently being the subject of a temporary or permanent injunction issued by a court. Current language provides for disqualification only in the case where a court has issued findings that the defendant violated the law. A large number of these civil injunctive enforcement cases are resolved by stipulation, i.e., they are settled without the court issuing findings at all. The amendment would allow the Securities Commissioner to consider licensing disqualification on the basis of any injunction, not only those issued after a trial. In addition, the time limit in current law should be eliminated to better protect the public from persons who have violated the law. The length of time that has passed since the issuance of an injunctive order may still be argued, but an arbitrary five year cutoff in not in the public interest.

In the Colorado Securities Act, the General Assembly has already recognized the international nature of the securities industry by including provisions that mention actions taken by governmental units in Canada. Many of the key provisions of the North American Free Trade Agreement as adopted by Canada, the United States and Mexico pertain to the ability among the nationals of each country freely to practice their professions in North America. While the treaty emphasizes this ability, it also provides that the laws of each of state or province must be complied with by the practitioners in question. Reference to the nation of Mexico in the same context as the current reference to the nation of Canada in the Colorado Securities Act will help functionally to integrate the provisions of the North American Free Trade Agreement into the standard operations of the Colorado Division of Securities.

RECOMMENDATION 6: PROVIDE SPECIFIC AUTHORITY FOR SUMMARY SUSPENSION OF LICENSES

The General Assembly should amend section 11-51-410 by adding a new subsection (4) to read as follows:

> **11-51-410(4).** THE SECURITIES COMMISSIONER MAY, BY SUMMARY ORDER UNDER SECTION 11-51-606(3)(a)(IV), SUMMARILY SUSPEND A LICENSE UNDER THIS PART 4 PENDING ANY FURTHER PROCEEDING UNDER SECTION 11-51-606(3)(c) AND FINAL DETERMINATION OF ANY PROCEEDING UNDER THIS SECTION.

<u>DISCUSSION</u>

Under current law, the Securities Commissioner must proceed under the general provisions of the Administrative Procedures Act in the event of the need to summarily suspend a securities license or registration. Specific authority to proceed according to the Colorado Securities Act, as amended by the new section proposed in Recommendation 9 of this report, will provide the Securities Commissioner with legal recourse that is specifically tailored to a violation of the securities laws. The same due process protections as found in the Administrative Procedures Act are found in the Colorado Securities Act.

RECOMMENDATION 7: FACILITATE SHARING OF CONFIDENTIAL INFORMATION -- ELIMINATE THE UNNECESSARY REQUIREMENT THAT STAFF OBTAIN COMMISSIONER'S PERMISSION BEFORE DISCUSSING ENFORCEMENT MATTERS WITH LAW ENFORCEMENT PERSONNEL AND FURTHER PROVIDE THE SECURITIES DIVISION WITH ACCESS TO CRIMINAL RECORDS AND FOR THE CONFIDENTIALITY OF INVESTIGATIVE INFORMATION

The General Assembly should amend section 11-51-601(5), to do away with the requirement that the Division staff first obtain the written authorization of the Securities Commissioner before they may discuss an enforcement matter with other law enforcement personnel, and to provide the Division of Securities with greater access to confidential information and for the confidentiality of investigative information.

> **11-51-601(5).** Information in the possession of, filed with, or obtained by the securities commissioner in connection with a private investigation under this section shall be confidential. No such information may be disclosed by the securities commissioner of any of the officers or employees of the division of securities except ~~after authorization in~~

~~writing by the securities commissioner or any designee of such commissioner that disclosure of information in the case is~~ WHEN necessary ~~and~~ OR appropriate in connection with a particular investigation or proceeding under this article or for any law enforcement purpose. ~~The absence of written authorization pursuant to this subsection (5) shall not be proof of the lack of authorization in fact and shall not constitute grounds for the exclusion of any such information as evidence in any proceeding.~~ FOR PURPOSES OF THIS SUBSECTION (5) AND ARTICLE 75 OF TITLE 24, C.R.S., THE DIVISION OF SECURITIES SHALL BE CONSTRUED AS A "CRIMINAL JUSTICE AGENCY" AS DEFINED IN SECTION 24-72-302 (3), C.R.S., AND CONFIDENTIAL DOCUMENTS AND OTHER INFORMATION OBTAINED BY THE SECURITIES COMMISSIONER OR ANY OF THE OFFICERS OR EMPLOYEES OF THE DIVISION OF SECURITIES UNDER THIS SECTION SHALL BE CONSTRUED AS "CRIMINAL JUSTICE RECORDS" AS DEFINED BY SECTION 24-72-302 (4), C.R.S. No OTHER provision of this article 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 securities commissioner or any of the officers or employees of the division of securities.

DISCUSSION

It is made clear in the Colorado Securities Act that the information obtained by the Division of Securities in its exercise of its investigative authority is confidential, and that information so obtained may only be disclosed when necessary in furtherance of an investigation, in an official proceeding like a hearing or trial, or in discussions with law enforcement personnel. It is expressly made unlawful for the employees of the Division to use such information otherwise. The Act goes on to require that Division employees first obtain the Commissioner's written permission to disclose confidential information, although there is little consequence if they do not. Practice has shown that such authorization is obtained by Division investigators in every instance prior to disclosing confidential investigative information, and that in virtually every such instance, this shuffle of paperwork has preceded discussions with other state or federal securities regulators, self-regulatory organizations, or other state or federal law enforcement authorities. It has proven to be a cumbersome and entirely superfluous requirement, and should be deleted.

Many of the Division's investigations carry with them the potential for criminal prosecution. The Division's investigations also often require and benefit from access to other confidential records, records that are often restricted as to who may view them. By declaring that the Division shall be construed as a criminal justice agency for purposes of the Public Records Act, the Division may gain access to similar confidential records maintained by other agencies in the state. Also, by construing the Division's investigative records as criminal justice records for purposes of that Act, the Division will be in a better position to preserve the confidentiality of those records.

RECOMMENDATION 8: WILLFUL VIOLATION OF SECURITIES COMMISSIONER'S ORDER SHOULD BE A FELONY OFFENSE

The General Assembly should amend section 11-51-603(2) as follows:

> **11-51-603(2).** Any person who willfully violates any of the provisions of this article, except section 11-51-501, OR ANY ORDER ISSUED BY THE SECURITIES COMMISSIONER UNDER THIS ARTICLE commits a class 6 felony and shall be punished as provided in section 18-1-105, C.R.S.

<u>DISCUSSION</u>

Violation of the anti-fraud provisions of the Colorado Securities Act is a class 3 felony. Violation of any other provision of the Securities Act or any rule duly promulgated by the Securities Commissioner is a class 6 felony. However, violations of administrative orders issued by the Securities Commissioner, such as stop trading orders or orders barring individuals from association with a broker-dealer, to prevent or to stop further violations of the Securities Act are not punishable as felonies. Since these orders are only issued after evidence is amassed in a thorough investigation, and since the Commissioner is required to state his findings and conclusions of law publicly, with full provisions for notice and hearing pursuant to the APA, the rights of the accused are fully protected. However, those who intentionally violate the securities laws are also likely to scoff at an administrative order that is not backed up by the potential of more serious enforcement sanctions. By making the Securities Commissioner's duly issued orders enforceable as class 6 felonies, even intentional violators of the law will be much more likely to cease their illegal activities when so ordered.

RECOMMENDATION 9: EMPOWER THE COMMISSIONER TO ISSUE ADMINISTRATIVE ENFORCEMENT ORDERS

The General Assembly should amend section 11-51-606, to empower the Commissioner of Securities to enforce Colorado securities laws through the use of administrative orders pursuant to the Administrative Procedures Act. The restated section should read as follows:

> **11-51-606. Enforcement by administrative order and conduct of proceedings.** (1) Any administrative proceeding under this article shall be conducted pursuant to the provisions of sectionS <u>24-4-104</u> AND 24-4-105, C.R.S., EXCEPT THAT SECTION 24-4-104(3), C.R.S., SHALL NOT APPLY TO PROCEEDINGS UNDER THIS ARTICLE. The securities commissioner shall refer the conduct of all hearings to an administrative law judge appointed pursuant to part 10 of article 30 of title 24, C.R.S. Every hearing in an administrative proceeding shall be public unless the securities commissioner, in the securities commissioner's discretion, grants a request joined in by all the respondents that the hearing be conducted privately.
>
> (2) WHENEVER IT APPEARS TO THE SECURITIES COMMISSIONER UPON

SUFFICIENT GROUNDS SATISFACTORY TO THE SECURITIES COMMISSIONER AS PRESENTED TO THE SECURITIES COMMISSIONER IN A STIPULATION BETWEEN THE OFFICERS OR EMPLOYEES OF THE DIVISION OF SECURITIES AND ANY PERSON THAT SUCH PERSON HAS ENGAGED IN OR IS ABOUT TO ENGAGE IN ANY ACT OR PRACTICE CONSTITUTING A VIOLATION OF SECTIONS 11-51-301, 11-51-401(1), OR IN CONNECTION WITH SUCH VIOLATION, SECTION 11-51-501, THE SECURITIES COMMISSIONER MAY ISSUE A CONSENT ORDER AGAINST SUCH PERSON PROHIBITING FURTHER VIOLATION OF SUCH PROVISIONS AND, IF APPROPRIATE FOR THE PROTECTION OF INVESTORS AND PROVIDED FOR IN THE STIPULATED SETTLEMENT, IMPOSING OTHER CONDITIONS, LIMITATIONS AND SANCTIONS, AS MAY BE.

(3)(a)(I) WHENEVER IT APPEARS TO THE SECURITIES COMMISSIONER UPON SUFFICIENT EVIDENCE SATISFACTORY TO THE SECURITIES COMMISSIONER AS PRESENTED TO THE SECURITIES COMMISSIONER IN A PETITION FOR SUMMARY ORDER OF PROHIBITION BY THE OFFICERS AND EMPLOYEES OF THE DIVISION OF SECURITIES TO THE SECURITIES COMMISSIONER THAT ANY PERSON HAS ENGAGED IN OR IS ABOUT TO ENGAGE IN ANY ACT OR PRACTICE CONSTITUTING A VIOLATION OF SECTIONS 11-51-301 OR 11-51-401(1), OR IN CONNECTION WITH SUCH VIOLATION, SECTION 11-51-501, AND THAT THERE ARE GROUNDS TO ISSUE SUCH ORDER SUMMARILY UNDER SUBSECTION (b) OF THIS SECTION, THE SECURITIES COMMISSIONER MAY ISSUE A SUMMARY ORDER OF PROHIBITION AGAINST SUCH PERSON PROHIBITING FURTHER VIOLATION OF SUCH PROVISIONS.

(II) WHENEVER IT APPEARS TO THE SECURITIES COMMISSIONER UPON SUFFICIENT EVIDENCE SATISFACTORY TO THE SECURITIES COMMISSIONER AS PRESENTED TO THE SECURITIES COMMISSIONER IN A PETITION FOR SUMMARY STOP ORDER UNDER SECTION 11-51-306(2) BY THE OFFICERS AND EMPLOYEES OF THE DIVISION OF SECURITIES TO THE SECURITIES COMMISSIONER THAT THERE ARE GROUNDS TO ISSUE A STOP ORDER UNDER SECTION 11-51-306(1) AND THAT THERE ARE GROUNDS TO ISSUE SUCH ORDER SUMMARILY PURSUANT TO SUBSECTION (b) OF THIS SECTION, THE SECURITIES COMMISSIONER MAY ISSUE A SUMMARY STOP ORDER REGARDING SUCH REGISTRATION STATEMENT.

(III) WHENEVER IT APPEARS TO THE SECURITIES COMMISSIONER UPON SUFFICIENT EVIDENCE SATISFACTORY TO THE SECURITIES COMMISSIONER AS PRESENTED TO THE SECURITIES COMMISSIONER IN A PETITION FOR SUMMARY ORDER SUSPENDING EXEMPTION UNDER SECTION 11-51-310(1)(b) BY THE OFFICERS AND EMPLOYEES OF THE DIVISION OF SECURITIES TO THE SECURITIES COMMISSIONER THAT THERE ARE GROUNDS TO ISSUE AN ORDER SUSPENDING EXEMPTION UNDER SECTION 11-51-310(1)(b) AND THAT THERE ARE GROUNDS TO ISSUE SUCH ORDER SUMMARILY PURSUANT TO SUBSECTION (b) OF THIS SECTION, THE SECURITIES COMMISSIONER MAY ISSUE A SUMMARY ORDER SUSPENDING EXEMPTION.

(IV) WHENEVER IT APPEARS TO THE SECURITIES COMMISSIONER UPON SUFFICIENT EVIDENCE SATISFACTORY TO THE SECURITIES COMMISSIONER AS PRESENTED TO THE SECURITIES COMMISSIONER IN A PETITION FOR SUMMARY ORDER OF SUSPENSION BY THE OFFICERS AND EMPLOYEES OF THE DIVISION OF SECURITIES TO THE SECURITIES COMMISSIONER THAT THERE ARE GROUNDS TO ISSUE AN ORDER OF SUSPENSION UNDER SECTION 11-51-410(1) AND THAT THERE ARE GROUNDS TO ISSUE SUCH ORDER SUMMARILY PURSUANT TO SUBSECTION (b) OF THIS SECTION, THE SECURITIES COMMISSIONER MAY ISSUE A SUMMARY ORDER OF SUSPENSION SUSPENDING THE LICENSE OF THE LICENSEE OR THE REGISTRATION OF THE REGISTRANT, AS MAY BE.

(b)(I) NO SUMMARY ORDER MAY BE ENTERED UNDER THIS SECTION UNLESS THE SECURITIES COMMISSIONER FINDS, IN ADDITION TO THE FINDINGS REQUIRED UNDER SECTION 11-51-704(2), THAT IMMEDIATE ISSUANCE OF THE ORDER IS IMPERATIVELY NECESSARY FOR THE PROTECTION OF INVESTORS. AN ORDER ISSUED UNDER THIS SECTION IS EFFECTIVE WHEN ENTERED AND SHALL BE ACCOMPANIED BY A BRIEF STATEMENT OF FINDINGS OF FACT AND CONCLUSIONS OF LAW.

(II) NO ORDER MAY BE ENTERED UNDER THIS SECTION AND SECTION 11-51-410(4) UNLESS PROMPTLY FOLLOWING ITS ISSUANCE, AN ADMINISTRATIVE PROCEEDING UNDER SECTION 24-4-104 AND 24-4-105, C.R.S., IS COMMENCED.

(c)(I) UPON ENTRY OF ANY ORDER UNDER THIS SECTION, THE SECURITIES COMMISSIONER SHALL PROMPTLY NOTIFY EACH PERSON AGAINST WHOM IT HAS BEEN ENTERED OF ITS ENTRY AND THE REASONS THEREFOR BY PROVIDING TO EACH PERSON AT THEIR LAST KNOWN MAILING ADDRESS A COPY OF THE ORDER AND THE ACCOMPANYING FINDINGS OF FACT AND CONCLUSIONS OF LAW.

(II) IN THE CASE OF A SUMMARY ORDER OF PROHIBITION, A SUMMARY STOP ORDER, OR A SUMMARY ORDER SUSPENDING EXEMPTION, WITHIN TWENTY-ONE CALENDAR DAYS FROM THE ENTRY OF THE ORDER, ANY PERSON AGAINST WHOM THE ORDER WAS ENTERED MAY MAKE A WRITTEN REQUEST OF THE SECURITIES COMMISSIONER THAT THE MATTER OF THE CONTINUANCE OF THE EFFECTIVENESS OF THE SUMMARY ORDER BE SET FOR HEARING. WITHIN TWO BUSINESS DAYS OF THE RECEIPT OF THE WRITTEN REQUEST, THE SECURITIES COMMISSIONER SHALL REFER THE MATTER OF THE CONTINUANCE OF THE EFFECTIVENESS OF THE SUMMARY ORDER AS AN ADMINISTRATIVE PROCEEDING TO AN ADMINISTRATIVE LAW JUDGE FOR EXPEDITED HEARING. IN THE CASE OF A SUMMARY ORDER OF SUSPENSION, THE CONTINUANCE OF THE EFFECTIVENESS OF SUCH ORDER SHALL BE A MATTER BEFORE THE ADMINISTRATIVE LAW JUDGE, BUT SUCH ORDER SHALL REMAIN IN EFFECT DURING THE PENDENCY OF THE PROCEEDING UNLESS VACATED OR MODIFIED BY THE ADMINISTRATIVE LAW JUDGE AFTER NOTICE AND OPPORTUNITY FOR HEARING ON THE CONTINUANCE OF THE EFFECTIVENESS OF SUCH ORDER TO THE OFFICERS OR EMPLOYEES OF THE DIVISION OF SECURITIES AND THE RESPONDENTS.

(III) IN THE CASE OF A SUMMARY ORDER OF PROHIBITION, A SUMMARY STOP ORDER, OR A SUMMARY ORDER SUSPENDING EXEMPTION, IF NO REQUEST FOR HEARING IS RECEIVED BY THE SECURITIES COMMISSIONER WITHIN TWENTY-ONE CALENDAR DAYS FROM THE ENTRY OF SUCH ORDER, THE ORDER SHALL BE FINAL.

<u>To conform with the above, amend section 11-51-306(2) as follows:</u>

11-51-306(2). The securities commissioner may, by summary order under section 11-51-606~~(2)~~<u>(3)(a)(II)</u>, summarily postpone or suspend the effectiveness of a registration statement pending final determination of any proceeding under this section.

<u>DISCUSSION</u>

The enforcement of the Colorado securities laws by the Colorado Division of Securities is hampered currently because the Securities Commissioner lacks the authority to issue administrative orders against violators in appropriate circumstances. Currently, when violations such as selling unregistered securities, selling securities without a license, and fraud committed in connection with such unregistered, unlicensed activity are detected, the Securities Commissioner is forced to choose between referring the matter for criminal prosecution or to the Regulatory Law Section of the Attorney General's Office for commencement of a civil injunctive action in court, even in less important cases -- very costly and time consuming undertakings -- or taking no formal action whatsoever. There is currently no enforcement authority short of full court action in the case of many violations. Therefore, some violations proven by the Division may go unredressed because of prioritization of limited resources.

Most of the regulatory entities within the Colorado Department of Regulatory Agencies already have authority granted by the Legislature to issue administrative orders to prevent violations of the law. During the 1993 Session of the Legislature, the General Assembly extended this power to the Colorado Commissioner of Insurance. The proposed amendment to the Colorado Securities Act as stated above would limit the summary order administrative authority of the Securities Commissioner to matters involving the sale of unregistered securities, selling securities without a license, and fraud committed in connection with such unregistered, unlicensed activity, and would require the Securities Commissioner to: (1) act only on sufficient evidence; (2) state his findings of fact and conclusions of law; and (3) provide the full text of the order to the violator. In addition, the respondent would be provided 21 days to request a hearing on the matter, and a timely hearing, if one is requested, would be held before an impartial administrative law judge.

Although court actions will remain the mainstay of the Securities Division's enforcement arsenal, administrative authority would be an important addition. Not all violations are worthy of formal court action. In other cases, it is the nature of securities law violations that the law is broken and investors are harmed often before a body of evidence is amassed sufficient to proceed to court for a temporary or permanent injunction. In fact, administrative law itself arose because traditional court procedures were too cumbersome to accommodate the emergency circumstances that could better be handled by administrative agencies, given their subject matter expertise. The use of administrative orders by the Securities Commissioner will give Colorado securities regulators a much better chance to catch securities law violators on a timely basis and to protect the public more efficiently.

RECOMMENDATION 10: JUDICIAL REVIEW OF FINAL ORDERS SHOULD BE CONDUCTED BY THE COLORADO COURT OF APPEALS

The General Assembly should amend section 11-51-607(1) as follows:

> **11-51-607(1)**. Any person aggrieved by a final order of the securities commissioner may obtain a review of the order in the ~~district court of the city and county of Denver~~ COURT OF APPEALS pursuant to the provisions of section 24-4-106, C.R.S.

DISCUSSION

Final orders of many, if not most, of the regulatory agencies within the Department of Regulatory Agencies are subject to judicial review by the Colorado Court of Appeals rather than the District Court. The change is proposed here as well, not only for the sake of conformity, but because the Court of Appeals is a more appropriate forum for the ponderous and time consuming consideration of the appeal of the typically complex securities issues of fact and law that emerge from a full hearing before an administrative law judge and then a final order issued by the Securities Commissioner.

RECOMMENDATION 11: ALLOW INTERPRETIVE OPINIONS UNDER THE COLORADO COMMODITY CODE

The General Assembly should amend the Colorado Commodity Code by adding a new section 11-53-211 to read as follows:

> **11-53-211. Interpretive opinions.** THE SECURITIES COMMISSIONER MAY HONOR REQUESTS FROM INTERESTED PERSONS FOR CONFIRMATION OF THE APPLICABILITY OF PARTICULAR EXCLUSIONS FROM THE DEFINITIONS SET FORTH AT SECTION 11-53-102 OR THE EXEMPTIONS SET FORTH AT SECTIONS 11-53-104 AND 11-53-105 OR FOR OTHER INTERPRETIVE OPINIONS REGARDING ANY PROVISION OF THIS ARTICLE. ANY PERSON MAKING SUCH REQUEST SHALL PAY AN OPINION FEE, WHICH SHALL BE DETERMINED AND COLLECTED PURSUANT TO SECTION 11-51-707, C.R.S., AND WHICH SHALL NOT BE REFUNDABLE. IN RESPONSE TO ANY REQUEST FOR A CONFIRMATION OR OTHER INTERPRETIVE OPINION RECEIVED UNDER THIS SECTION, THE SECURITIES COMMISSIONER MAY WAIVE ANY CONDITION IMPOSED UNDER THIS ARTICLE AS IT APPLIES TO THE PERSON MAKING THE REQUEST.

DISCUSSION

Under current law, the Securities Commissioner is empowered to issue interpretive opinions under the Colorado Securities Act, but he does not have specific power to do so under the Colorado Commodity Code. Because the securities laws are complex, persons working in the securities industry often contact the Colorado Division of Securities in order to obtain information and clarification on the applicability of the law to their businesses. Providing the Securities Commissioner with the authority to issue interpretive opinions should aid the industry in properly understanding and applying the Colorado Commodity Code.

INVESTMENT ADVISER\FINANCIAL PLANNER REGULATION

As discussed in this report and the 1991 Sunrise Report, the regulation of the securities industry in Colorado is incomplete, since there is no provision to regulate investment advisers and financial planners. Over and over again, members of the Legislature have been angered by the abuses that are occurring across the United States and in Colorado by some persons engaging in this business. Since everyone with assets to invest is potentially a customer of a financial planner, and since the life savings of the vast majority of these people may be at stake, it is imperative that Colorado move to adopt regulation in this area.

We have not included financial planner/investment adviser regulation as a formal recommendation in this report because it is already the intention of the Securities Commissioner, pursuant to the Sunrise Committee recommendation of 1991, once again to seek adoption of such regulation in the upcoming session of the Colorado General Assembly. Twice before, the proposal has met with favor from a substantive perspective. The principal sticking point has been its fiscal impact. Although the regulatory program proposed in this legislation is entirely self-funding, based as it is upon fees charged to the members of the industry, it would still require enlarging the staff of the Colorado Division of Securities by at least three full time employee positions. As it grappled with the budget in the wake of Amendment 1, the 1993 Legislature was ultimately unwilling to add this new program to Colorado government. However, in this case, the urgency of the need for financial planner regulation is a priority that must be factored into Colorado's budgetary calculus. Several years of work now have gone into drafting this legislation and the need for this consumer protection bill is evident and growing. Since the 1993-1994 Colorado Budget did not approach the expenditure limits set under Amendment 1, and since this program is cash-funded, there is no compelling reason why the protection offered Colorado consumers by this legislation need be further delayed.

APPENDIX A

SUNSET STATUTORY EVALUATION CRITERIA

(I) Whether regulation by the agency is necessary to protect the public health, safety and welfare; whether the conditions which led to the initial regulation have changed; and whether other conditions have arisen which would warrant more, less or the same degree of regulations;

(II) If regulation is necessary, whether the existing statutes and regulations establish the least restrictive form of regulation consistent with the public interest, considering other available regulatory mechanisms and whether agency rules enhance the public interest and are within the scope of legislative intent;

(III) Whether the agency operates in the public interest and whether its operation is impeded or enhanced by existing statutes, rules, procedures and practices of the Department of Regulatory Agencies and any other circumstances, including budgetary, resource and personnel matters;

(IV) Whether an analysis of agency operations indicates that the agency performs its statutory duties efficiently and effectively;

(V) Whether the composition of the agency's board or commission adequately represents the public interest and whether the agency encourages public participation in its decisions rather than participation only by the people it regulates;

(VI) The economic impact of regulation and, if national economic information is available, whether the agency stimulates or restricts competition;

(VII) Whether complaint, investigation and disciplinary procedures adequately protect the public and whether final dispositions of complaints are in the public interest or self-serving to the profession;

(VIII) Whether the scope of practice of the regulated occupation contributes to the optimum utilization of personnel and whether entry requirements encourage affirmative action;

(IX) Whether administrative and statutory changes are necessary to improve agency operations to enhance public interest.

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The following employees of the Division of Securities were also interviewed at length. Without their assistance, this report would not have been possible.

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