2003 SUNSET REVIEW

Colorado Department of Regulatory Agencies
Office of Policy and Research

Colorado Division of Securities
Colorado Securities Board

October 15, 2003

STATE OF COLORADO

DEPARTMENT OF REGULATORY AGENCIES
Office of the Executive Director
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Bill Owens
Governor

October 15, 2003

Members of the Colorado General Assembly
c/o the Office of Legislative Legal Services
State Capitol Building
Denver, Colorado 80203

Dear Members of the General Assembly:

The Colorado Department of Regulatory Agencies has completed its evaluation of the Colorado Division of Securities and the Colorado Securities Board. I am pleased to submit this written report, which will be the basis for my office's oral testimony before the 2004 legislative committee of reference. The report is submitted pursuant to section 24-34-104(9)(b), of the Colorado Revised Statutes (C.R.S.), 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 supporting materials to the office of legislative legal services no later than October 15 of the year preceding the date established for termination….*

The report discusses the question of whether there is a need for the regulation provided under Article 51 of Title 11, C.R.S. The report also discusses the effectiveness of the Division and staff in carrying out the intent of the statutes and makes recommendations for statutory changes in the event this regulatory program is continued by the General Assembly.

Sincerely,

Richard F. O'Donnell
Executive Director

2003 Sunset Review
Colorado Division of Securities and the Colorado Securities Board
EXECUTIVE SUMMARY

Department of Regulatory Agencies

Bill Owens
Governor

Richard F. O'Donnell
Executive Director

Quick Facts

What is Regulated? The Colorado Division of Securities (Division) regulates Colorado's securities, municipal bond and commodities industries, and it supervises local government investment pools.

Between fiscal years 97-98 and 01-02, 770 securities offerings were registered with the Division, with an approximate value of $10 billion, and 516 municipal bond offerings were made, with an approximate value of $3.4 billion.

Who is Regulated?
- 2,578 broker-dealers
- 154,588 broker-dealer sales representatives
- 1,478 investment advisors
- 5,685 investment advisor representatives

How is it Regulated? Unless exempt, all securities, municipal bonds and commodities offered for sale in Colorado must be registered with the Division. Among the five-member Securities Board's duties is providing advice to the Securities Commissioner. The Board and Division are located in the Department of Regulatory Agencies.

What Does it Cost? The fiscal year 01-02 budget to oversee this program was $2,538,941. There are 20 full-time equivalent employees allocated to the program.

The following fees were imposed: $60 for broker-dealers and investment advisors; $13 for broker-dealer sales representatives and investment advisor representatives; $200 for registering a security by filing; $100 for registering a security by qualification; and $75 for filing a notice on an exempt security.

What Disciplinary Activity is There? During the five year period fiscal year period 1998-2002, the Division's disciplinary proceedings consisted of:

Opened Cases	633
Revocations	15
Warning Letters	26
Injunctions	35
Criminal Convictions	50
Restitution Orders	43
Other	316

Where Do I Get the Full Report? The full sunset review can be found on the internet at: http://www.dora.state.co.us/opr/2003Securities.pdf

Key Recommendations

Continue the Division and the Board until 2015
The U.S. Securities and Exchange Commission regulates securities at the national level and investigates potential violations of federal securities laws that have national and/or international implications. Securities regulation at the state level helps to ensure that investment schemes that more directly impact the citizens of Colorado are scrutinized. This review finds that the Division and the Board are both necessary to protect the safety and welfare of the people of Colorado.

Include variable rate annuities in the definition of "security"
Colorado's definition of "security" specifically excludes both fixed and variable rate annuities; rather they are regulated as insurance products. At the federal level, variable rate annuities are considered securities. Sellers of such products in Colorado are licensed insurance producers and are regulated by the Colorado Division of Insurance (DOI). The DOI, however, lacks the authority and expertise to investigate sales practices, which include the suitability of a particular product to a particular client. The Division, on the other hand, possesses such authority and expertise. This review recommends continuation of the exclusion from the definition of "security" for fixed rate annuities, but not for variable rate annuities.

When issuing a cease and desist order, permit the Division to issue the order first, and then hold a hearing
Cease and desist orders are issued in situations where certain conduct is so egregious that it must be stopped immediately. The Division's process for issuing cease and desist orders, however, runs contrary to this goal in that it requires a hearing to be held prior to issuance of the cease and desist order. This causes a delay in the issuance of the order and permits the allegedly egregious conduct to continue until such time as the cease and desist order is issued. This review recommends authorizing the Division to issue the cease and desist order, and then to permit the subject of the order to request a timely hearing on the matter.

…Key Recommendations Continued

Replace Colorado's registration of securities by filing with a system of registration by coordination

Registration by coordination is more issuer-friendly in that it permits the issuer to submit to the Division, in general, the same documents it filed with the SEC. Both systems of registering securities apply to securities that are also registered with the SEC. Both systems require the issuer of the securities to submit to the Division substantially the same information.

Clarify the manner in which rescission offers must be structured

Occasionally, it becomes necessary to rescind, or undo, a securities transaction due to, for example, a violation of the securities laws. The terms of a rescission offer typically allow the violator to avoid civil liability, so the form of such an offer is critical. However, the current statutory provision regarding rescission offers provides little guidance. This review recommends clarifying the manner in which such offers must be made in order to avoid civil liability.

Include in the grounds for which discipline may be imposed, or a license denied, violations of the securities laws of other nations

Like many industries, the securities industry has become increasingly internationalized. As a result, a broker-dealer may be found to have violated the securities laws of another nation by that nation's securities regulators. This review recommends that violation of the securities laws of another nation may serve as grounds for discipline or denial of a license in Colorado.

Major Contacts Made In Researching the 2002 Sunset Review of the Colorado Division of Securities and the Colorado Securities Board

Members of the Colorado Securities Board
Certified Financial Planner Board of Standards, Inc.
Colorado Attorney General's Office
Colorado Bar Association
Colorado Department of Regulatory Agencies, Division of Insurance
Colorado Department of Regulatory Agencies, Division of Securities
Financial Planning Association, Metro Denver Chapter
Investment Council Association of America
Member of Colorado Delegation to the National Conference of Commissioners on Uniform State Laws
National Association of Insurance Commissioners
National Association of Securities Dealers
North American Securities Administrators Association
Securities Industry Association
Securities Professionals
U.S. Attorney's Office
U.S. Securities and Exchange Commission

What is a Sunset Review?

A sunset review is a periodic assessment of state boards, programs, and functions to determine whether or not they should be continued by the legislature. Sunset reviews focus on creating the least restrictive form of regulation consistent with the public interest. In formulating recommendations, sunset reviews consider the public's right to consistent, high quality professional or occupational services and the rights of businesses to exist and thrive in a highly competitive market, free from unfair, costly or unnecessary regulation.

Sunset Reviews are Prepared By:
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Background

The Sunset Process

The regulatory functions of the Colorado Division of Securities (Division) and the Colorado Securities Board (Board) in accordance with Article 51 of Title 11, Colorado Revised Statutes (C.R.S.), shall terminate on July 1, 2004, unless continued by the General Assembly. During the year prior to this date, it is the duty of the Department of Regulatory Agencies (DORA) to conduct an analysis and evaluation of the Division and the Board pursuant to section 24-34-104(9)(b), C.R.S.

The purpose of this review is to determine whether the Division and the Board should be continued for the protection of the public and to evaluate the performance of the Board, Division and staff. During this review, the Division and the Board must demonstrate that there is still a need for the Division and the Board, and that current regulation is the least restrictive form of regulation that is consistent with the public interest. DORA's findings and recommendations are submitted via this report to the legislative committee of reference of the Colorado General Assembly. Statutory criteria used in sunset reviews may be found in Appendix A on page 42.

Methodology

As part of this review, DORA staff attended Board and Municipal Bond Advisory Committee meetings, interviewed Division staff, reviewed Board records and minutes, reviewed case files, accompanied Division staff on an examination of the books and records of a broker-dealer, interviewed members of the regulated community, interviewed officials with state and national professional associations, interviewed representatives from federal regulatory and law enforcement authorities, reviewed Colorado statutes and Board rules, and reviewed the laws of other states.

Profile of the Profession

The Division and the Board are charged with regulating the securities industry in Colorado. This entails regulation of securities issuers with respect to the actual issuance of securities, and also of many of the individuals and firms involved in the securities industry, including broker-dealers and their sales representatives, and investment advisers and their representatives.

Nomenclature in the securities industry, as in all industries, is important and can be somewhat confusing. For example, the terms “broker-dealer” and “investment adviser” are frequently used by lay people to refer to individuals. In the securities industry, however, these terms most frequently refer to firms or entities, although a broker-dealer or an investment adviser may be an individual. These firms, in turn, either employ, or independently contract with, individuals who are referred to as “sales representatives” and “investment adviser representatives,” respectively.

The types of transactions that may be executed by broker-dealers, investment advisers and their respective representatives is completely dependent upon the type of licenses held by the entity and the individual.

Put simply, broker-dealers and their sales representatives are what most people think of as stockbrokers. They assist investors, whether they are large institutional investors or individuals, in the buying or selling of stocks, bonds, shares in mutual funds or other securities. They are ethically bound to provide information about the advantages and disadvantages of an investment based on each investor's objectives. Broker-dealers and their sales representatives are heavily regulated at both the federal and state levels.

Investment advisers and their representatives primarily provide investors with advice as to the types of securities or other investment vehicles in which to invest, not necessarily particular securities to purchase or sell. Many financial planners are investment advisers or investment adviser representatives, but not all investment advisers or investment adviser representatives are financial planners.

Importantly, an investment adviser or investment adviser representative may not earn a commission in connection with the purchase or sale of any security unless that investment adviser or investment adviser representative is also licensed as a broker-dealer or a broker-dealer sales representative, or associates with a licensed broker-dealer that will execute the transaction. Depending on certain criteria, including the total value of assets under management, investment advisers and their representatives are either regulated by the federal government or the state government.

History of Regulation

Regulation of the securities industry first began in the United States in 1911, with the passage of the first state securities law in Kansas. By 1919, 32 states had passed their own securities laws, which are commonly referred to as "blue sky laws." Colorado passed its first securities statute in 1923, and has regulated the securities industry ever since. Today, all 50 states, Puerto Rico and the District of Columbia regulate some aspect of the securities industry.

The federal government, however, did not enter the realm of securities regulation until after the stock market crash of 1929. Acting under the presumption that the crash of 1929 occurred because of the abandonment of fair, honest and prudent dealings in the securities markets in the decades following World War I, and recognizing the need to fill the regulatory gaps created by the states' limited jurisdiction, Congress passed the Securities Act of 1933 ('33 Act). The '33 Act regulates primarily through requiring securities to be registered with the U.S. Securities and Exchange Commission (SEC), unless such securities are exempt.

The following year, Congress passed the Securities Exchange Act of 1934 ('34 Act), which requires companies that issue securities to periodically disclose material information about themselves, and for the first time, required broker-dealers and their sales representatives to register with the SEC. The subsequent passage of the Glass-Steagall Act erected barriers between the banking, insurance and securities industries.

In 1940, Congress passed two additional pieces of legislation: the Investment Advisers Act of 1940, which required investment advisers and their representatives to register with the SEC; and, the Investment Company Act of 1940, which introduced regulation of investment companies, such as mutual funds.

Throughout this period, Colorado continued to regulate the securities industry. However, by the 1980s, Colorado had developed a reputation for having relatively weak laws and correspondingly weak regulation, and thus became the center of the penny stock scandals that rocked the country during that decade. In response, the Colorado General Assembly adopted, in 1990, a modified version of the Revised Uniform Securities Act (RUSA), which was drafted by the National Conference of Commissioners on Uniform State Laws (NCCUSL).

Also in the early 1990's, the General Assembly placed within the jurisdiction of the Division, regulation of commodities, municipal bonds, and investment advisers, as well as supervision of local government investment pools.

Then, in 1996, Congress passed the National Securities Markets Improvement Act of 1996 (NSMIA), which, among other things, preempted state regulation of many issuances of securities. NSMIA also bifurcated the regulation of investment advisers and their representatives. NSMIA mandated that the SEC regulate those investment advisers with more than $25 million under management, leaving the states to regulate those with less than $25 million. Under NSMIA, the states also maintain licensing authority of investment adviser representatives, regardless of whether the investment adviser with which the investment adviser representative is associated is regulated by the state or by the SEC.

Congress subsequently passed the Gramm-Leach-Bliley Financial Modernization Act of 1999, which, among other things, began to break down the barriers between the banking, insurance and securities industries that had been in place since the passage of the Glass-Steagall Act.

In 2000, the Colorado General Assembly amended the Colorado Securities Act to grant to the Division the authority to issue cease and desist orders and empowered the Board to hold "show cause" hearings prior to the issuance of such orders.

In response to the securities markets crises following the scandals at companies such as Enron, WorldCom, and many others, Congress passed the Sarbanes-Oxley Act in 2002. Though often criticized as a knee-jerk reaction to the crises of the day, Sarbanes-Oxley requires, among other things, chief executive officers and chief financial officers of publicly traded companies to certify the accuracy of company filings and financial statements.

Finally, in late 2002, NCCUSL published the 2002 Uniform Securities Act (USA), which is intended to bring those jurisdictions that adopt it into compliance with recent federal legislation, including NSMIA, Gramm-Leach-Bliley and Sarbanes-Oxley. As of September 2003, only Missouri and Oklahoma had already adopted the USA.

Legal Framework

A comprehensive legal analysis of the securities laws is well beyond the scope of this report. However, this "Legal Framework" section is intended to provide a basic understanding of how state and federal securities laws work together to regulate the securities industry.

It is perhaps easiest to think of securities regulation and the roles of the Colorado Division of Securities (Division) and the Colorado Securities Board (Board) as consisting of two primary functions: 1) regulation of securities; and, 2) regulation of the firms and individuals involved in the trading of those securities.

The federal government regulates the securities industry through a myriad of acts, but the two most important are the Securities Act of 1933 ('33 Act), which primarily addresses the issuance of securities, and the Securities Exchange Act of 1934 ('34 Act), which primarily regulates transactions in securities and securities professionals. Colorado regulates the securities industry through the Colorado Securities Act (Colorado Act), which may be found at section 11-51-101, *et seq.*, of the Colorado Revised Statutes (C.R.S).

A general tenet of securities law is that, unless exempt, all securities must be registered. This tenet forces an issuer to ask and answer two questions prior to issuance: 1) is the instrument to be offered a security; and, 2) if it is a security, is there an applicable exemption from registration for the security itself or is there an applicable exemption for the transaction?

The Colorado Act, at section 11-51-201(17), C.R.S, the '33 Act, at section 2(a)(1), and the '34 Act, at section 3(a)(10), define the term "security" in a substantially similar manner as meaning:

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

Perhaps one of the most controversial and well-litigated provisions of this definition is the term "investment contract." In the landmark decision of *SEC v. W.J. Howey & Co.*, 328 U.S. 293 (1946), the U.S. Supreme Court held that an investment contract is a contract, transaction or scheme whereby a person invests his/her money in a common enterprise with the expectation of profits solely from the efforts of others.

With such a broad interpretation, the courts of many jurisdictions have held a wide variety of investment schemes to be investment contracts, and thus securities. Examples of some of these schemes include, but are by no means limited to:

- A scheme whereby a company sold plots in an orange grove, with a fixed number of trees per plot and the purchasers of the plots then signed service agreements whereby the seller of the plots would tend the trees, harvest and sell the fruit and provide the investor with the profits.
- Various iterations of pyramid and Ponzi schemes, where early participants are paid out of the investments provided by new participants. These schemes require the constant addition of new participants to pay earlier participants the promised returns.
- Viatical settlements, which involve purchasing, at a discount, the expected proceeds of life insurance policies from those who are often terminally ill. This allows the seller to derive some living benefit from the life insurance, and because the policies are purchased at a discount, investors realize a profit.
- Investments in gold and managed accounts.
- Interests in limited partnerships.

Once an issuer determines that the instrument to be offered is a security, the next step is to determine first, whether the security itself is exempt from registration requirements and second, whether the transaction is exempt from registration. Although the requisite analyses in the hunt for exemptions is similar at both the federal and state levels, it is necessary to conduct these analyses for both levels.

The number and nuances of exemptions available under the ’33 Act, the ’34 Act and the Colorado Act are vast. With regard to the security, most exemptions pertain to the nature of the issuer (i.e., banks, insurance companies, governmental entities) and whether the security is listed on a recognized stock exchange. With regard to the transaction, most exemptions depend upon whether the issuer is involved in the transaction, the dollar amount involved, the number and sophistication of the investors involved, and the method by which the securities are to be distributed. The ’34 Act also requires issuers to file periodic reports with the SEC.

Exemptions from all three acts can generally be found within the statutory confines of the acts themselves, or, as is more often the case, within the volumes of rules promulgated pursuant to the relevant acts.

The first step is to determine whether the security is subject to an available federal exemption under the ’33 Act. Even if a federal exemption is available, the issuer must also review the laws of every state in which the security will be offered, to determine the availability of exemptions is those jurisdictions.

The National Securities Markets Improvement Act of 1996 (NSMIA) went a long way in preempting the states' ability to require the registration of securities with state regulators. NSMIA amended the '33 Act to limit the states' ability to require the registration of "covered securities," which are defined to include:

- Nationally traded securities, such as those listed on the New York Stock Exchange, National Association of Securities Dealers Automated Quotation System and the American Stock Exchange;
- Securities issued by an investment company that is registered under the Investment Company Act of 1940;
- Securities sold to qualified purchasers; or,
- Securities issued under certain types of exempt offerings.

While the NSMIA amendments certainly curtail the states' ability to require that certain securities be registered, they by no means eliminate the role of state securities regulators in the system of securities registration. NSMIA has simply limited the universe of securities for which the state may require registration.

If no exemptions apply, the security and/or the transaction must be registered. Depending upon the complexity of the deal and the provisions under which registration is effected, registration may involve the filing of relatively simple forms or it may involve a great deal more.

The second primary component of securities regulation involves the licensing of broker-dealers, investment advisers and their respective representatives.

A broker-dealer can be either an individual or a firm, but a broker-dealer sales representative is an individual employed by, or who independently contracts with, a broker-dealer. Section 11-51-201(2), C.R.S., defines "broker-dealer" as any 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."

An investment adviser can be either an individual or a firm, but an investment adviser representative is an individual employed by, or who independently contracts with, an investment adviser. Section 11-51-201(9.5)(a)(I), C.R.S., defines an investment adviser as:

> any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.

This definition includes financial planners or others who provide investment advisory services. There are several notable exceptions to who is and who is not an investment adviser under the various laws. For example, investment advisers who have more than $25 million under management are considered federal covered advisers and are regulated by the U.S. Securities and Exchange Commission (SEC) pursuant to the Investment Advisers Act of 1940, while those with less than $25 million under management fall within the jurisdiction of the states. Another example of persons who are not investment advisers for purposes of Colorado law are publishers or authors of material in bona fide newspapers, magazines, or business or financial publications with regular paid circulations.

Subject to certain exceptions and exemptions, some of which are discussed above, no broker-dealer, investment adviser or representative of either may transact business in Colorado unless licensed by the Division. Importantly, this means that even a broker-dealer who is in New York, for example, but who transacts business in Colorado, must be licensed in Colorado.

In general, broker-dealers that engage in interstate commerce must register with the SEC. In the case of such broker-dealers, the applicant must have completed and maintain current registration information with the SEC to obtain a license in Colorado. Broker-dealers that are not SEC-registered must comply with Colorado licensing requirements, which are substantially similar to those imposed by the SEC.

Broker-dealer sales representatives that work for an SEC-registered broker-dealer, must complete and maintain current registration information with an SEC-approved, self-regulatory organization, such as the National Association of Securities Dealers (NASD), which maintains the Central Registration Depository system.

Broker-dealer sales representatives that work for broker-dealers that are not registered with the SEC, must satisfy Colorado's licensing requirements, which may entail the passage of a series of examinations. This requirement is substantially similar to the requirements imposed on sales representatives that work for SEC-registered broker-dealers.

Because licensees may be licensed to transact business in Colorado, but may not be located in the state, both types of licensees must provide the Division with a consent to service of process.

Notably, the '34 Act specifically recognizes and sanctions the role of self-regulatory organizations such as the NASD in the regulation of broker-dealers and their sales representatives.

Regulation of investment advisers is slightly different, however, in that it is bifurcated, depending on, for example, the value of the assets under management. Generally, investment advisers with over $25 million under management must register with the SEC. These firms are frequently referred to as "federal covered investment advisers," and they must notify the Division if they have a place of business in the state, but they need not obtain a license from the Division. Investment advisers with less than $25 million under management, however, must be licensed by the Division unless there is an applicable exemption. Generally, all investment adviser representatives that have a place of business in Colorado must be licensed by the Division.

Licenses of broker-dealer sales representatives and investment adviser representatives are tied to the broker-dealer or investment adviser, as the case may be, for whom that representative works. This means that a representative who switches firms must re-license under the name of the representative's new firm. This process ensures that representatives remain affiliated with a firm and that regulators are able to identify all of a firm's representatives.

The Colorado Act also addresses fraud in connection with the offer, sale or purchase of any security. Specifically, section 11-51-501(1), C.R.S., prohibits the employment of any device, scheme or artifice to defraud; the making of any untrue statement of material fact or omission of a material fact that is necessary to make the statements made, in the light of the circumstances under which they are made, not misleading; and, engaging in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

Any person who willfully violates Colorado's anti-fraud provisions is guilty of a Class 3 felony, which is punishable by 4 to 12 years' imprisonment and/or a fine of between $3,000 and $750,000.

Willful violation of any other provision of the Colorado Act constitutes a Class 6 felony, which is punishable by 12 to 18 months imprisonment and/or a fine of between $1,000 and $100,000.

Although the Securities Commissioner (Commissioner) has the authority to administer the Colorado Act, the Colorado Act provides for private rights of action, which allow private citizens to bring civil actions where appropriate. Generally, and depending upon the violations asserted, such actions must be brought within two years of the violation or three years after the discovery of the facts giving rise to the cause of action. The federal acts, too, provide for private rights of action, but they must generally be brought within one year of the discovery of the violation.

Furthermore, the Commissioner may issue a cease and desist order to any person who violates or is about to violate any provision of the Colorado Act. Appeals of any action taken by the Division or the Commissioner are to the Colorado Court of Appeals.

To assist the Division and the Commissioner in carrying out their duties, the General Assembly created the five-member, Governor-appointed Securities Board (Board), which must meet at least quarterly, and consists of two Colorado-licensed attorneys, one certified public accountant, and two members of the public at large. At least one member of the Board must reside west of the continental divide. Members of the Board are not compensated for their service.

The primary duties of the Board are to advise the Commissioner; to serve as hearing panels on the issuance of cease and desist orders, summary orders and registration suspensions; and, to provide to the Executive Director of the Department of Regulatory Agencies an annual evaluation of the performance of the Commissioner.

It is unlawful for the Commissioner, any Board member or any employee of the Division to use, for personal benefit, any information that is filed with or obtained by the Commissioner or the Division that is not made public.

In addition to the Colorado Act, the Commissioner and the Division are also charged with administering and enforcing the provisions of the following acts and statutory provisions:

- The Local Government Investment Pool Trust Fund Administration and Enforcement Act (Government Investment Pool Act), which may be found at section 11-51-901, *et seq.*, C.R.S., and the provisions of section 24-75-701, *et seq.*, C.R.S. The Government Investment Pool Act permits local governments to pool their financial resources, which are frequently taxpayer monies, so that they may enjoy greater diversity in their investments. The Commissioner is charged with overseeing the management of these pools, and each pool must have an investment adviser managing the funds in the pool.

- The Colorado Commodity Code, which may be found at section 11-53-101, *et seq.*, C.R.S. Commodities are defined as including any agricultural, grain or livestock product or by-product, any metal or mineral, any gem or gemstone, any foreign currency, and all other goods, articles, products or items of any kind. The Colorado Commodity Code sets forth transactional exemptions and exemptions for people who offer and sell commodity contracts.

- The Colorado Municipal Bond Supervision Act, which may be found at section 11-59-101, *et seq.*, C.R.S. This act was passed in 1991, following a decade of defaults on Colorado municipal bond offerings. Municipal bonds are typically issued to raise funds for municipalities, such as special districts, using various forms of taxing authority to cover repayment of the bonds. Municipal bonds are usually issued in larger denominations, which has a tendency to promote participation by mostly institutional investors. Such institutions are typically in a better position to assess the various risks involved with municipal bonds and to absorb whatever losses may result. The 17-member Municipal Bond Advisory Committee, which meets quarterly and except as noted, is appointed by the Governor, is composed of three members of the General Assembly (one each appointed by the Speaker of the House, President of the Senate and the Governor); one municipal securities broker-dealer; one representative of a county; one representative of a municipality; one representative of a special district; one representative of a bank; one bond counsel representative; one real estate developer representative; three members of the general public with experience in municipal financing; and, four owners of residential real estate in a special district. Like securities in general, municipal bonds must be registered with the Division, unless an enumerated exemption from such requirement applies.

Program Description and Administration

The Colorado Division of Securities (Division) and the Securities Commissioner (Commissioner) are charged with administering the Colorado Securities Act (Colorado Act), the Municipal Bond Supervision Act (Municipal Bond Act), the Colorado Commodity Code and the Local Government Investment Pool Trust Fund Administration and Enforcement Act.

Administration is effected primarily through a system of registering various instruments, licensing individuals and firms, and through inspections, or audits, of the records of relevant entities.

To assist the Division and the Commissioner in their assigned tasks, the General Assembly has created the five-member Colorado Securities Board (Board), to provide advice on certain securities issues, and the 17-member Municipal Bond Advisory Committee, to provide advice on certain municipal bond issues. Both bodies are composed of non-compensated volunteers and meet quarterly. The meetings of both bodies rarely last more than one or two hours.

Table 1 below illustrates Division expenditures and staffing levels for fiscal years 97-98 through 01-02.

Table 1
Program Expenditures

Fiscal Year	Total Program Expenditure	FTE
97-98	$2,145,749	22
98-99	$2,268,326	21
99-00	$2,363,398	20
00-01	$2,513,790	20
01-02	$2,538,941	20

The Division is staffed by 20 full-time equivalent (FTE) employees, who are divided into three primary sections: Administrative (2.0 FTE); Examinations (7.0 FTE) and Enforcement (9.0 FTE). Additionally, there are the Commissioner and the Deputy Commissioner.

The Examinations Section comprises a Chief Examiner, 2.0 FTE who process license applications, 2.0 FTE who process the registration of securities, and 2.0 FTE who conduct field examinations and audits.

The Enforcement Section comprises a Chief Investigator, 7.0 FTE who are investigators and 1.0 FTE who is a forensic accountant.

In addition to its statutorily defined functions, the Division also conducts community outreach and education activities. For example, in 2002, the Commissioner gave more than 40 presentations to community and other groups regarding the mission of the Division, how to identify and avoid securities fraud, and other important educative topics.

Licensing

The Examinations Section is charged with oversight of the Division's licensing functions for broker-dealers, investment advisers and their respective representatives.

The tables below illustrate the numbers of licensees and licensing applications processed by the Division for fiscal years 97-98 through 01-02.

Table 2
Securities and Exchange Commission (SEC)-Registered Broker-Dealer and Sales Representative Licensing

Fiscal Year	New Broker-Dealer Applicants	Broker-Dealer Renewals	New Sales Representative Applicants	Sales Representative Renewals
97-98	304	2,054	38,184	85,363
98-99	283	2,126	36,875	94,689
99-00	301	2,267	45,524	106,893
00-01	307	2,388	47,470	123,276
01-02	230	2,327	34,332	120,206

As Table 2 indicates, the number of broker-dealers has remained relatively constant over the five-year period under review. The number of broker-dealer sales representatives, however, has increased dramatically, from a total of 123,547 in fiscal year 97-98, to a total of 154,538 in fiscal year 01-02, an increase of almost 40,000, or approximately 25 percent.

This surge in numbers can be attributed to at least two factors. First, the period under review includes years during which the stock markets were soaring, so demand for broker-dealer services was at an all time high.

Second, the licensing fees assessed by the Division are relatively low. In fiscal year 02-03, for example, the licensing fee for a broker-dealer was only $60, and $13 for a sales representative. As will be discussed in greater detail below, when a sales representative applies for licensure, such application is made through the National Association of Securities Dealers' (NASD) Central Registration Depository (CRD). This enables a sales representative to literally check a box for each jurisdiction in which licensure is sought. With licensing fees as low as $13, Colorado is an attractive jurisdiction in which to seek licensure, even if the sales representative has no clients in this state.

It is also important to note that although the Division has licensed more than 150,000 broker-dealers and representatives, not all are physically located in Colorado. Recall that unless exempt, broker-dealers and representatives, as well as investment advisers and representatives, must be licensed in Colorado if they transact business in this state, regardless of where they are physically located. According to Division statistics, in fiscal year 01-02, only 6.9 percent of Colorado-licensed broker-dealers and sales representatives were actually domiciled in this state.

Table 3
Non-SEC-Registered Broker-Dealers and Sales Representatives

Fiscal Year	New Broker-Dealer Applicants	Broker-Dealer Renewals	New Sales Representative Applicants	Sales Representative Renewals
97-98	1	8	5	32
98-99	0	8	5	27
99-00	1	8	6	26
00-01	1	8	4	24
01-02	3	8	16	24

A broker-dealer need not be registered with the SEC in order to be licensed as such in Colorado. However, the licensing fees remain $60 for the broker-dealer, and $13 for a sales representative. As Table 3 indicates, these numbers remained relatively constant until fiscal year 01-02, and, notably, are significantly lower than those for SEC-registered broker-dealers and sales representatives. In fiscal year 01-02, a Colorado Springs insurance company that was in the formation stage, commissioned its sales representatives to sell securities in the insurance company, thus making them agents of the issuer and requiring licensure.

Table 4
Mortgage Brokers and Sales Representatives

Fiscal Year	New Mortgage Broker Applicants	Mortgage Broker Renewals	New Sales Representative Applicants	Sales Representative Renewals
97-98	0	13	0	15
98-99	0	13	0	14
99-00	0	13	0	14
00-01	0	10	0	10
01-02	0	10	0	10

Additionally, the Division licenses certain types of mortgage brokers and their representatives. The definition of “security” includes the term “notes.” Mortgages are notes, secured by real property; thus they are, technically, securities, meaning that mortgage brokers deal in securities. Table 4 contains licensing information for the five-year period indicated.

The Division's primary mission is to protect investors. Therefore, by rule, the Division has exempted from licensing requirements, those mortgage brokers who deal in mortgages with institutional investors. This exemption is logical when one considers that institutional investors are better able to assess risk and can more easily absorb losses. However, if the mortgage broker seeks out individual investors to back a mortgage, that broker must be licensed by the Division.

The best way to draw the distinction is to consider Mr. and Mrs. A, who approach Mortgage Broker to find them a mortgage for their new house. If Mortgage Broker solicits institutions, such as banks and other traditional mortgage lenders, Mortgage Broker need not be licensed by the Division. However, if Mortgage Broker solicits Mr. B or Ms. C to invest in a mortgage or note for the As, Mortgage Broker must be licensed by the Division.

These numbers, too, have remained relatively constant over the course of the five-year period under review. The licensing fee for mortgage brokers is also $60, and $13 for representatives.

Finally, the Division also licenses investment advisers and their representatives. Table 5 below illustrates that, like SEC-registered broker-dealers, the number of Colorado-licensed investment advisers has remained relatively constant, whereas the number of representatives has increased by more than 2,000 during the course of the five-year period under review.

Table 5
Investment Advisers and Representatives

Fiscal Year	New Investment Adviser Applicants	Investment Adviser Renewals	New Investment Adviser Representative Applicants	Investment Adviser Representative Renewals
97-98	N/A	N/A	N/A	N/A
98-99	995	0	4,237	0
99-00	191	950	1,175	3,596
00-01	244	1,050	1,397	3,922
01-02	299	1,179	1,192	4,493

Data is not available for fiscal year 97-98 because it was not until fiscal year 99-00 that the Division, as a result of the federal National Stock Markets Improvement Act of 1996 (NSMIA), began regulating investment advisers with less than $25 million under management, as well as their representatives. Prior to fiscal year 99-00, the SEC regulated all investment advisers in Colorado, regardless of the amount of money under management. The large number of new applicants in fiscal year 98-99 can be explained as preparation for the beginning of regulation in the latter half of that fiscal year.

The license fee for an investment adviser is $60, and it is $13 for an investment adviser representative.

In addition to licensing, the Division's Examination Section is also responsible for registering securities. Securities can be registered with the Division by filing, by qualification, or by limited offering registration.

A registration by filing indicates that the subject securities have also been registered with the SEC pursuant to the Securities Act of 1933 ('33 Act). An applicant for registration by filing must provide the Division with a copy of the prospectus, various standardized forms, and payment of a $200-fee.

Table 6 below provides considerable information regarding registrations by filings, including the total number of registrations and the total value of such registrations. Notably, over the course of the five-year period under review, nearly $110 billion in securities have been registered in Colorado.

Table 6
Registrations by Filing

	FY 97-98	FY 98-99	FY 99-00	FY 00-01	FY 01-02	Totals
Filed	216	135	129	114	95	689
Effective	162	103	92	87	76	520
Terminated	17	25	15	16	11	84
Withdrawn	34	14	18	10	2	78
Pending	20	18	19	17	17	91
Deficient	0	0	0	0	0	0
Amount	$27,562,402,720	$19,526,439,865	$19,743,401,863	$33,166,486,456	$9,945,237,395	**$109,943,968,299**

Terminated offerings are offerings that terminated, or were completed, by their own terms. This can be due to a number of factors, including time limitations or, as is more likely the case, the attainment of a pre-determined monetary goal.

Securities may also be registered by qualification. A registration by qualification indicates that the subject securities have not been registered with the SEC. Registration by qualification requires that the issuer file with the Division all offering materials constituting full and fair disclosure, and payment of a $100-fee.

Table 7 below provides a considerable amount of information regarding registrations by qualification. Notably, over the course of the five-year period under review, almost $500 million worth of securities have been registered by qualification in Colorado.

Table 7
Registrations by Qualification

	FY 97-98	FY 98-99	FY 99-00	FY 00-01	FY 01-02	Totals
Filed	15	15	21	10	8	**69**
Effective	12	11	5	5	6	**39**
Terminated	12	11	5	5	1	**34**
Withdrawn	3	4	16	5	2	**30**
Pending	0	0	0	0	0	**0**
Deficient	0	0	0	0	0	**0**
Amount	$150,100,000	$108,554,995	$11,541,000	$104,055,000	$115,400,000	**$489,650,995**

Finally, an issuer may file a limited offering registration, which generally indicates that the issuer's principal place of business is in Colorado, that it will not raise more than $1 million in the particular offering and that at least 80 percent of the proceeds from the offering will be used in Colorado. Table 8 below provides information on limited offering registrations.

Table 8
Limited Offering Registrations

	FY 97-98	FY 98-99	FY 99-00	FY 00-01	FY 01-02	Totals
Filed	1	3	1	7	0	**12**
Effective	0	3	0	3	0	**6**
Terminated	0	3	0	3	0	**6**
Withdrawn	1	0	1	4	0	**6**
Pending	0	0	0	0	0	**0**
Deficient	0	0	0	0	0	**0**
Amount	$500,000	$1,800,000	$20,000	$925,000	0	$3,245,000

Table 9 contains combined data from Tables 6 through 8. The most noteworthy items in this table are the five-year totals of 565 effective registrations worth over $110 billion.

Table 9
Combined Registration Totals

	FY 97-98	FY 98-99	FY 99-00	FY 00-01	FY 01-02	Totals
Filed	232	153	151	131	103	770
Effective	174	117	97	95	82	565
Terminated	29	39	20	24	12	124
Withdrawn	38	18	35	19	4	114
Pending	20	18	19	17	17	91
Deficient	0	0	0	0	0	0
Amount	$27,713,002,720	$19,636,794,860	$19,754,962,863	$33,271,466,456	$10,060,637,395	**$110,436,864,294**

The Division attributes the decrease in the total number of registrations, which occurred between fiscal years 99-00 and 01-02, on two factors. First, NSMIA, through preemption, has significantly narrowed the universe of securities that the several states may review or register. As a result, issuers have been claiming exemptions from registration, which has increased the number of exempt offerings, as illustrated in Table 10, below.

Table 10
Exempt Offerings

	FY 97-98	FY 98-99	FY 99-00	FY 00-01	FY 01-02
Exempt Offerings	1,005	1,013	1,685	1,482	1,235

Exempt filings reflect primarily Regulation A and Regulation D offerings made pursuant to the ’33 Act, for which notices are filed with the Division, along with the appropriate filing fee of $75. Since these offerings are filed under the federal securities laws, the Division does not have information relating to the amount of each offering, and thus could not provide totals for the fiscal years under review.

Second, market conditions since 2000 have affected the ability of issuers, especially those seeking smaller amounts of capital, to raise funds for business ventures. As seen from the above tables, there were no limited offerings in fiscal year 01-02, and only six registrations by qualification deemed effective for the same year. This reflects a significant decrease from the previous fiscal year’s number, and is consistent with the Division’s experience in light of overall market conditions during these time periods.

In addition to securities, the Division also has jurisdiction over local government investment pool trust funds. These funds are required to register with the Commissioner in order to accept investments from local governmental entities. Since fiscal year 98-99, there have been only four registered trust funds and the total value under management in fiscal year 01-02 was $3.5 billion.

Finally, the Division also has jurisdiction over municipal bond offerings, pursuant to the Municipal Bond Act. Like securities, municipal bond offerings must be registered, unless exempt. Since the Municipal Bond Act became effective in 1992, all such offerings have fallen within one of the available exemptions.

With this in mind, Table 11 illustrates the number and value of exempt municipal bond offerings made in Colorado since fiscal year 97-98.

Table 11
Municipal Bond Filings

	FY 97-98	FY 98-99	FY 99-00	FY 00-01	FY 01-02
Municipal Bond Offerings	77 @ $322.7 million	111 @ $574.4 million	98 @ $810 million	120 @ $900.4 million	110 @ $831 million

Since no municipal bonds have been registered under this act since it was enacted, an obvious question becomes whether the act remains necessary. However, the Division’s staff maintains that the exemptions provided for in the act are accomplishing their intended goals by assisting issuing districts in structuring their offerings to provide for appropriate market distribution. This, the Division asserts, results in offerings that are structured and placed in market-appropriate ownership, thus justifying continuance of the act.

As evidence of this assertion, only one municipal bond offering since 1992, the year in which the Municipal Bond Act became effective, has gone into default. That case, which occurred in the first half of 2003, was the result of the poor financial condition of the developer, a situation of which the bond holders, all of which were institutional investors, were well aware, prior to purchase of the bonds.

Examinations

While the Division does not generally administer any examinations, the most significant role of the licensing program is to evaluate applications against numerous statutory disqualifications. In other words, the Colorado Act enumerates certain conduct that precludes entities and/or individuals from obtaining or keeping a license.

The Division is expressly prohibited by statute from imposing an examination requirement on the sales representatives of SEC-registered broker-dealers. One explanation for this statutory prohibition may be that there are other licensing authorities, most significantly the NASD, that impose a wide range of examination requirements on the same universe of individuals.

The NASD, through a nation-wide network of testing centers, administers virtually all examinations related to the investment industry in the United States. Examinees and licensees then register with the NASD-maintained CRD, which is the computerized registration system for broker-dealer and sales representative license applications. Upon registering with the CRD, entities and individuals literally check a box for those jurisdictions in which they would like to be licensed.

If the candidate's information is complete and the candidate is not subject to disciplinary actions or other disclosure items, the CRD notifies Division staff via computer. Staff in the Division's Examinations Section then reviews the application and proceeds as warranted. This may involve something as simple as reviewing the application and approving it with no further action, or it may involve the Division contacting the candidate for an explanation or documentation, as the situation warrants.

All applications submitted for broker-dealer or investment adviser licensing are reviewed by Division staff and are subject to the same process as representative licensing reviews.

Therefore, although the Division licenses approximately 122,000 broker-dealers and sales representatives, Division staff reviews only a handful of applications each year.

The Colorado Act, however, does impose examination requirements, or acceptable substitutions, for investment adviser representatives. The required examinations are entitled Series 65 or Series 7/66 combination. These North American Securities Administrators' Association (NASAA) developed examinations are administered by the NASD through its national testing centers.

In addition to reviewing investment adviser and representative applications for statutory disqualifications, the Division seeks to ensure that the applicant has passed all necessary examinations or otherwise meets minimum qualifications to engage in investment adviser activity.

In 2001, the Division began using the Investment Adviser Registration Depository (IARD), which operates on a similar principal as the CRD for the broker-dealer side of the industry. The IARD is the result of a joint venture between the SEC and NASAA. The IARD is not yet fully implemented, but when it is, investment adviser licensing should be as computerized as it is for broker-dealers.

All licenses are valid for one year and must be renewed annually.

Inspections

The Examinations Section is also responsible for conducting periodic examinations, or audits, of licensees. Recall that approximately two staff members are dedicated to this function, which primarily entails reviewing the books and records of the subject entities to determine whether the examinee is in compliance with the Colorado Act.

Table 11 provides information on the number and duration of examinations.

Table 11
Examination Information

Fiscal Year	Number of Exams	Average Preparation Time (in hours)	Average On-site Time (in hours)	Average Follow-Up Time - Reports, etc. (in hours)
98-99	31	17	25	36
99-00	37	15	21	30
00-01	46	7	11	14
01-02	50	7	10	15

Notably, the amount of time devoted to examinations decreased substantially between fiscal year 99-00 and 00-01. The Division attributes this to its implementation of several recommendations made by the Office of the State Auditor in 2000. These changes, which include improved time-tracking, risk-based selection of examinees, and a more efficient use of staff time, resulted in a more efficient use of Division resources

The typical audit begins a day or two before the examiner goes to the office of the examinee. During this time, the examiner reviews whatever information the Division has on the examinee. This may include complaint/case files, if any; the names of licensed representatives and principals; locations of branch offices, if any; advertising; and, web sites. The examiner may also contact another agency, such as the NASD or the SEC, to determine whether that agency is looking at the examinee for any reason or if that agency has recently examined the examinee, and to determine whether there are any items to which particular attention should be paid.

On the day of the examination, the examiner goes to the office of the examinee unannounced. The examiner then delivers a list of documents to be provided and begins asking questions about the examinee's operations.

The document request seeks relatively basic information: policy and procedures manual; list of all current employees; list of all principals; list of all recent hires; list of all recently terminated employees; complaint and correspondence files; commission runs for the top three producers; list of all discretionary accounts; documents relating to any deals in which the examinee acted as underwriter or market maker; financial statements; copy of NASD membership agreement; form agreements for clients; and, copies of the most recent NASD or SEC investigations.

In addition to the document request, the examiner will also interview the examinee's manager or the manager's designee, as well as one or more representatives at that particular location. These interviews are designed to solicit more general information.

Depending on the size of the examinee and how well organized its records are, the examiner may be in the offices of the examinee anywhere from a single day up to a week. Once the examiner returns to the Division's offices, the examiner reviews the documents provided and any notes taken and drafts a report. If any deficiencies are discovered, the examinee may receive a letter informing the examinee of the deficiencies, or, in the case of more serious deficiencies, disciplinary action may be taken.

Throughout the examination process, the examiner asks questions of the examinee and may request documentation in addition to that contained on the initial document request.

The Office of the State Auditor's 2000 performance audit of the Division specifically cited the Examinations Section for limiting its examinations to the Denver-Metropolitan area, thus neglecting licensees in the remainder of the state. Due to a constrained budget, the Division continues to focus examinations primarily on the Denver-Metropolitan area. However, in fiscal year 02-03, 22 percent of the examinations conducted by the Division were outside of this geographical region. Examinations were conducted in Boulder, Avon, Greeley, and Grand Junction. Additionally, the Division conducted two examinations on out-of-state licensees via mail.

It is also important to recall the extent to which licensees are regulated by other entities. Both the SEC and the NASD conduct examinations of their registrants and members, as the case may be. Thus, although the Division does not necessarily audit a large number of licensees, between the Division, the SEC and the NASD, a larger number of licensees are being audited than the information in Table 11 indicates.

Complaints/Disciplinary Actions

The Division's other administrative unit, the Enforcement Section, is responsible for receiving and investigating complaints regarding potential violations. Information about potential violators can come from a variety of sources, such as:

- Examinations conducted by the Examinations Unit that discover misconduct;
- Consumers/Investors;
- Newspapers; and,
- Other governmental agencies, such as federal, state or municipal.

Similarly, the types of violations can range from minor licensing and/or registration violations, all the way up to violations of the Colorado Act's anti-fraud provisions.

Once the Division receives a complaint, the staff of the Enforcement Section first seeks to determine whether, if the allegations were proven true, a securities violation occurred. The staff then begins a preliminary investigation to determine whether the allegations are provable.

If there are provable allegations that constitute a violation of the Colorado Act, the staff will then open a case for the complaint. If multiple complaints pertain to the same investment scheme, broker-dealer, etc., they will generally be combined into the same case.

Table 12
Information Regarding Opened Cases

Nature of Cases	FY 97-98	FY 98-99	FY 99-00	FY 00-01	FY 01-02
Broker-Dealer/Representative Abuse (e.g., Rule violations, sales practices)	14	19	20	16	9
Investment Adviser/Representative Abuse	3	6	5	15	14
Fraud by Licensee	23	28	23	33	15
Unlicensed Broker-Dealer/Representative	80	89	72	88	67
Unlicensed Investment Advisor/Representative	N/A	N/A	N/A	8	6
Commodities Violations	9	11	8	2	4
Unregistered Securities	76	89	74	84	61
Securities Fraud by Unlicensed/Unregistered Person	74	83	68	83	56
Other	7	4	4	5	2
Total Cases Opened	**286**	**329**	**274**	**334**	**234**

As these numbers indicate, the number of cases opened by the Division has fluctuated over the course of the five-year period under review.

If the case appears to have criminal implications, the Enforcement Section contacts the appropriate district attorney so as to coordinate efforts and avoid duplication of efforts. Additionally, the Division may contact and/or work with or refer cases as appropriate to federal authorities, such as the SEC, the Federal Bureau of Investigation, the U.S. Postal Service or the Office of the U.S. Attorney, as well as regulators of other states. The Office of the Colorado Attorney General (AGO) is also authorized to bring criminal prosecutions involving securities fraud.

In making the determination as to which agency will take over an investigation, Division staff looks to the statutory mandates of each organization. For example, the SEC typically takes cases with national or international implications, corporate fraud or insider trading, whereas the Division typically retains those, and receives cases from other agencies, where a majority of the investors or investments are located in Colorado.

If the Enforcement Section takes the lead in an investigation, it can mean tracking down thousands of potential leads. For this reason, the investigator(s) assigned to the case must focus and narrow the scope of the investigation.

It is important to note that throughout this process, the Division prioritizes and re-prioritizes cases as circumstances change. For example, a case that starts out looking like something minor can be reprioritized if the investigation shows more serious infractions, and vice versa. Division resources are then appropriated as warranted.

Between June 2001 and June 2003, the Division opened the following number of cases regarding the following types of issues:

1 Accounting Fraud
14 Investment Adviser Fraud
6 Broker-Dealer Abuse
8 Broker-Dealer Fraud
5 Broker-Dealer Conversion
1 Bank Involvement
3 Bulletin Board/Internet
1 Churning
1 Certificate of Deposit
2 Commodities-Related Investments
2 Elder Fraud
1 Equipment Leasing
7 Exotic Investment
5 Factoring Accounts Receivable
2 Misleading Filing
1 Forgery
32 General Fraud
1 Gaming/Casinos
3 Hedge Fund
2 High Tech
1 Humanitarian
1 Insurance Related
2 Insider Trading
1 International Trading Program
1 Lease/Buy-Back System
1 Mining
5 Market Manipulation
3 Mortgage/Loan Broker
4 Oil and Gas
4 Prime Bank Notes
2 Precious Metals
4 Ponzi Scheme
1 Pennystock Fraud
2 Multi-Level Marketing/Pyramid
6 Unregistered Securities
10 Real Estate
7 Trust Deed Fractionalizing
4 Telemarketing
2 Theft
13 Unlicensed Broker-Dealer/Agent
1 Unlicensed Investment Adviser
2 Unauthorized Trading
6 Viatical Settlements

These numbers indicate that most violations of the Colorado Act involve nontraditional or exotic investment schemes and fraud. These types of cases are more difficult to investigate and even more difficult to successfully prosecute.

If the Enforcement Section determines that a violation has occurred and that disciplinary action is warranted, the case will be referred to the AGO, in the case of administrative or civil enforcement proceedings, or to the AGO, the appropriate district attorney, or even the U.S. Attorney, in the case of criminal proceedings.

The Division has a number of enforcement and disciplinary tools at its disposal. Table 13 below, indicates the types of actions taken and the frequency with which they have been employed.

Table 13
Final Dispositions

Type of Action	FY 97-98	FY 98-99	FY 99-00	FY 00-01	FY 01-02	Totals
Warning Letters	1	6	8	5	6	**26**
Broker-dealer/ Representative License Revocation or Denial	4	3	4	3	0	**14**
Investment Adviser/Representative License Revocation or Denial	N/A	N/A	N/A	1	0	**1**
Broker-dealer/Representative Sanctions (non-revocation)	4	4	5	2	3	**18**
Investment Adviser/Representative Sanctions (non-revocation)	N/A	N/A	N/A	0	3	**3**
Cease and Desist Orders	N/A	N/A	N/A	N/A	3	**3**
Civil Enforcement Complaint	3	5	6	5	4	**23**
Injunctions/Temporary Restraining Orders	4	11	7	5	8	**35**
Judgments	1	8	6	1	5	**21**
Bankruptcy Interventions	1	0	0	2	1	**4**
Contempt Order	2	1	1	1	2	**7**
Criminal Referral/Charges	12	7	12	5	3	**39**
Convictions	6	14	14	9	7	**50**
Restitution Order	6	12	10	8	7	**43**
Totals	**44**	**71**	**73**	**47**	**52**	**287**

Recall that it was not until 1999 that the Division obtained jurisdiction over investment advisers and their representatives, thus no enforcement actions were taken against such entities or individuals prior to this date.

Similarly, the Division first obtained the authority to issue Cease and Desist Orders on July 1, 2002, so there were no such orders prior to this date.

Table 14 illustrates the total value of restitution orders obtained by the Division in the indicated years. Restitution values indicate the dollar amounts which, if collected or recovered, would be returned to Colorado investors.

Table 14
Restitution Orders

	FY 97-98	FY 98-99	FY 99-00	FY 00-01	FY 01-02
Value of Restitution Orders	$3,055,323	$1,516,312	$2,646,707	$3,068,479	$2,547,891

Variations occur from year to year due, in part, to the value of the securities involved, the number of cases prosecuted, and other factors. It is noteworthy, however, that the Division averages approximately $2.5 million in restitution orders each year, and it has secured orders worth approximately $12.8 million over the course of the five years under review.

Analysis and Recommendations

During the course of this sunset review, the Department of Regulatory Agencies (DORA) solicited input from a variety of sources. A number of significant issues were presented and considered including:

- Continuation of the Division of Securities (Division) and the Securities Board (Board);
- Adoption of the Uniform Securities Act of 2002;
- Amendment of the definition of “security” to include variable rate annuities and Viatical settlements;
- Continuation of the annual evaluations of the Securities Commissioner (Commissioner) by the Board;
- Continuation of the current process for issuing cease and desist orders;
- Imposition of term limits on members of the Board; and,
- Continuation of quarterly meetings of the Municipal Bond Advisory Committee versus less frequent meetings.

Some of these issues are discussed in the recommendations that follow. Those that are not discussed were found to have fallen outside the scope of the statutory criteria of sunset reviews.

Recommendation 1 – Continue the Colorado Division of Securities and the Colorado Securities Board until 2015.

The driving question in any sunset review is whether the program under review is necessary to protect the health, safety or welfare of the public. DORA concludes that such regulation is necessary to protect the public.

The fundamental philosophy behind securities regulation is the goal of investor protection and establishing the “rules of the game” so as to maintain the integrity of the market. A securities market with integrity will, theoretically, induce people to invest in securities. When the rules are obeyed, the securities markets work and drive investment in the economy. When the rules are disobeyed, the markets lose credibility and people stop investing.

Thus, securities regulation is necessary so as to ensure that the underlying philosophy of the U.S. securities markets prevail. Securities regulation was born out of a need to level the playing field somewhat. Full and fair disclosure, which securities regulation mandates, helps to ensure that the investor has all of the information necessary to weigh the potential risks and rewards of investing in a given security. Securities regulation does not attempt to evaluate whether a given security is a good investment or a bad investment. The purpose of securities regulation in the U.S. is to ensure that the investor has access to the information that will assist that investor in making his or her own determination as to whether a given security is a good investment or a bad investment.

A secondary sunset question, however, is whether existing regulation is the least restrictive form of regulation that is consistent with the public interest. An obvious question when discussing securities regulation in the context of this sunset criterion is why is state regulation necessary, given the strength and pervasiveness of federal securities regulation?

First, the U.S. Securities and Exchange Commission (SEC), the federal agency charged with regulating the securities industry, has, primarily, a national focus, whereas the Division has more of a Colorado focus. For example, the SEC typically would not investigate the following types of cases:

- Cases where the majority of perpetrators, victims or witnesses are in Colorado;
- Broker-dealer violations that are discovered through the SEC examination process that do not have a nationwide issue involved;
- Cases involving the theft of money, such as pyramid and Ponzi schemes, affinity fraud, etc.; and,
- Insurance agents selling securities because such cases usually involve one-on-one types of issues.

Because these types of cases typically involve smaller sums of money and do not have a national impact, the SEC generally refers them to the Division, which is commonly referred to as "the cop on the street." If the Division did not exist and did not investigate these cases, these types of consumer harm may go unaddressed.

An individual who wants to complain about investment fraud could file a complaint with the SEC, where the complaint will, more than likely, sit until many more individuals complain about the same activity. That same, single complaint to the Division, however, is more likely to receive attention much sooner.

Additionally, the structure of the securities markets anticipates both federal and state regulation. Although federal regulation is quite comprehensive, there remain gaps, which the states must fill. Such issues typically involve the value of an offering, the types and number of individuals to whom such securities will be offered, etc. If such numbers are small enough, a federal exemption may apply. This does not, however, mean that regulation is unnecessary; it simply means that the federal government has deemed that federal regulation is not necessary.

The penny stock schemes of the 1970s and 1980s provide a case in point. Many of these schemes involved stocks of low cost in small companies, and were too small to receive the attention of federal regulators. Thousands of Coloradans lost millions of dollars in these schemes because, at the time, the Colorado Securities Act was too weak to adequately deal with them. As a result of this inaction, many people lost their life savings and were financially ruined.

Finally, when economic times are tough, and the stock markets are performing poorly, many people tend to look at "alternative investments." This opens the door for unscrupulous schemes that prey on the vulnerable. The vulnerable, many times, are senior citizens who cannot afford to lose what they put at risk.

For all of these reasons, the Division and securities regulation in Colorado should be continued. The Board, too, has an important part to play in the regulation of securities in Colorado. The Board fulfills two primary functions: 1) to serve as an advisory body to the Commissioner; and, 2) to act as a hearing panel on cease and desist and other orders. This second duty is important because such cases often involve technical issues of securities law and the expertise of the Board members is often helpful in resolving such issues.

Another issue that arose during the course of this sunset review was whether Colorado should repeal the current Colorado Securities Act (Colorado Act) and adopt the 2002 Uniform Securities Act (USA).

The USA was first published in October 2002 by the National Conference of Commissioners on Uniform State Laws (NCCUSL). During the five-year drafting process, NCCUSL worked with representatives from state and federal regulatory entities; the securities, insurance and banking industries; and, many others. A primary goal of the USA was to provide the states with a law that complies with recent federal legislation, such as the National Securities Markets Improvement Act of 1996 (NSMIA), the Gramm-Leach-Bliley Financial Modernization Act of 1999, the Sarbanes-Oxley Act of 2002, and several others.

However, a year has not yet passed since the publication of the USA and the consequences of it are still largely unknown. As part of this sunset review, DORA solicited input from a variety of sources as to whether Colorado should adopt the USA. By and large, most individuals had not yet read the USA or were not yet familiar enough with it to debate its merits.

Only two states, Missouri and Oklahoma, have adopted the USA as of September 2003. Both of those states' acts will not become effective until sometime in 2004, so the experiences of those states cannot yet be looked at for examples of what the unintended consequences of the USA might be. Furthermore, both states have determined that they will have to abandon most, if not all, of their current rules and regulations and promulgate new rules, thus incurring substantial administrative costs.

Finally, the consumer protection provisions of the USA, particularly with respect to private rights of action, are considerably weaker than those of the Colorado Act. Given the recent history of multitudes of companies restating entire years' worth of earnings due to accounting "errors," now is not the time to curtail the rights of private citizens to bring legal actions against those who have potentially defrauded them.

Because of the high potential for unintended consequences, because there is a disturbing lack of secondary analytical resources available regarding the USA, and because of the weaker consumer protection provisions in the USA, DORA cannot, at this time, recommend adoption of the USA.

Because the recommendations contained in this report do not represent major policy changes, DORA recommends that the Division and the Board be continued for eleven years, until 2015.

Recommendation 2 – Amend the definition of "security" to include variable rate annuities.

Section 11-51-201(17)(a), C.R.S., currently excludes from the definition of "security" an "annuity contract under which an insurance company promises to pay a sum of money either in a lump sum or periodically for life or some other specified period." This language expressly excludes from the definition of "security" both fixed and variable rate annuities.

Annuities are similar to mutual funds, but typically offer three basic features not found in mutual funds: 1) tax-deferred treatment of earnings; 2) a death benefit; and, 3) payout options that can provide guaranteed income for life. There are two basic phases involved in annuities: 1) the accumulation phase, when the investor makes contributions, or pays premiums; and, 2) the payout phase, when the investor receives payments from the annuity.

The exclusion of fixed rate annuities is not controversial – the consumer pays a certain amount of money each year for a certain number of years, and, upon maturation, the annuity pays the consumer a pre-determined amount.

Variable rate annuities, however, are more problematic because there is more risk involved. The higher the risk, the higher the potential payout upon maturation.

At the federal level, variable rate annuities are securities. Colorado, however, along with many other states, has excluded such products from state securities regulation. Rather, the sales of such products are regulated through the Division of Insurance (DOI). Because variable rate annuities are securities under federal law, the salesperson must be either a broker-dealer or a broker dealer sales representative. This also means that the salesperson has taken and passed the appropriate NASD examination.

Under Colorado law, the salesperson must also be licensed by the DOI as an insurance producer, and must be specifically licensed to sell this particular line of product.

The problem, thus, becomes one of jurisdiction and which agency, the DOI or the Division, is better able to protect the public from the unscrupulous sale of variable rate annuities. Both the DOI and the Division have anti-fraud provisions. However, if the DOI receives a complaint regarding the sale of a variable rate annuity, the DOI only has jurisdiction to determine whether the insurance producer provided the required information to the consumer and whether that information was accurate or fraudulent.

The Division, on the other hand, would have the ability to inquire as to the sales practices involved in the offer and sale, including the suitability of the sale. That is, did the sales representative determine whether a variable rate annuity was a suitable investment vehicle for a particular client?

For example, the Division provided DORA with copies of advertisements that have appeared in other parts of the country. These advertisements were targeted to recruiting individuals to sell variable rate annuities. Following are some of the claims used to recruit salespeople:

- Matt works with Seniors! Matt sees three seniors a day! Matt picks up an average of $70k per sale! Matt will provide you with his dynamite senior seminar program!
- Sell Annuities to Seniors Who Don't Have Money!
- Seniors have 77% of the nation's wealth – why prospect anyone else?
- There is NO OTHER MARKET MORE LUCRATIVE, MORE EFFICIENT than the SENIOR MARKET SELLING ANNUITIES!

Because the Division does not have jurisdiction over complaints involving such products because under Colorado law they are not securities, it does not expressly track the number of complaints it receives regarding them. However, the NASD reports that the number of complaints involving variable rate products is increasing nationwide. Between July 2001 and July 2003, the NASD received approximately 1,070 complaints involving variable rate annuities.

In 1999, the NASD received just five complaints regarding variable rate products in its Denver District Office, which covers five states (Arizona, Colorado, New Mexico, Utah and Wyoming). These five complaints represented just 1.75 percent of the complaints fielded by that office.

Between January 1 and July 11, 2003, however, the Denver District Office received 18 complaints involving variable rate products, representing 10.34 percent of its total complaints. Consumers filed 16 of these complaints.

While these numbers are still relatively small, the increase represented by them is somewhat alarming. In just five years, the NASD's Denver District Office saw an 8 percent increase in the number of complaints involving variable rate annuities.

Finally, in May 2003, the NASD issued an Investor Alert regarding variable rate annuities and the hard sell tactics that are often utilized. Because of the way commissions are typically paid on variable rate annuities, there is a large incentive for sales representatives to churn accounts. This can result in the sale of variable rate annuities to people who are ill suited to them.

The National Association of Insurance Commissioners (NAIC) also agrees that increased regulation of the sales practices utilized in variable rate annuities is justified. A draft position paper circulated by the NAIC states that it does not matter whether it is a state's securities or insurance regulator that takes on this additional burden, so long as the public is adequately protected.

Thus, the data support regulating the sales practices involved in selling variable rate annuities, but the question remains, should this responsibility be shouldered by the DOI or the Division?

In synthesizing current federal and state requirements, the salesperson would have to be a Colorado-licensed insurance producer that is affiliated with a broker-dealer. The chances are very high that such a person is already a Colorado-licensed broker-dealer or sales representative.

In 2001, the Kansas Securities Division explored this very issue. After spending months and thousands of hours comparing licensing lists of their Securities Division and their Insurance Division, they discovered that fully 93 percent of the insurance agents in Kansas authorized to sell variable rate products were already licensed by that state's Securities Division as broker-dealer sales representatives. The Division estimates that similar numbers would hold true in Colorado.

Thus, although joint jurisdiction and dual licensing may, at first, appear problematic, such is not necessarily the case. It is reasonable to conclude that most Colorado insurance producers that are authorized to sell variable rate annuities are also already licensed by the Division.

By adding variable rate annuities to the definition of "security," the Division would have jurisdiction to investigate questionable sales practices and investigate complaints regarding suitability.

In addition, at least 13 states currently regulate variable rate annuities as securities. A move in this direction by Colorado, therefore, would not be without precedent.

The General Assembly should amend section 11-51-201(17)(a), C.R.S., to read, in pertinent part:

> does not include any insurance or endowment policy or annuity contract under which an insurance company promises to pay a FIXED sum of money, either in a lump sum or periodically for life. . . .

Recommendation 3 – Revise the the process for issuing a cease and desist order so that a hearing is held after such an order is issued, rather than before, and so as to allow such hearings to be held before an administrative law judge.

In 2000, the General Assembly amended the Colorado Act to authorize the issuance of cease and desist orders by the Division. The process to issue a cease and desist order (C&D Process), as enumerated in section 11-51-606, C.R.S., is rather cumbersome and deserves additional attention.

The purpose of a cease and desist order is simple: the Division has identified conduct that is so bad that it must be stopped immediately in order to protect the public.

The C&D Process, however, does not accommodate this goal. The current C&D Process requires Division staff to avoid communications regarding a potential cease and desist case with the Commissioner, thus erecting a "wall of neutrality." The Division's staff initially files a petition with the Commissioner requesting that the Commissioner issue a "show cause order" to the alleged violator. The show cause order essentially informs the alleged violator that the position of the Division is that the conduct being engaged in is a violation of the Colorado Act, and it affords the alleged violator an opportunity to have a hearing to show cause as to why a cease and desist order should not be issued.

No sooner than 10 days, and no later than 21 days from service of the show cause order, a show cause hearing must be held. At this hearing, the Division is represented by an Assistant Attorney General, the alleged violator may be also be represented by counsel, and three members of the Board serve as the hearing panel. It is important to note that the requirement that a hearing be held within the noted time frame is loose. One side may request, and the other may consent to, extensions of time to better prepare for the hearing. This provides a built-in incentive for the alleged violator to delay the hearing because the cease and desist order has not yet been issued, so the conduct that is at the heart of the matter may continue.

After the show cause hearing has concluded, the hearing panel prepares its initial decision, which includes findings of fact, conclusions of law and a recommendation as to whether the cease and desist order should be issued. This initial decision is then forwarded to the Commissioner, who has, thus far, been removed from the proceedings.

The Commissioner then reviews all of the evidence and determines whether to issue the cease and desist order.

Under the current C&D Process, the final cease and desist order may not be issued for several months after the alleged violator was served with the show cause order. Thus, the purpose of the cease and desist order has been circumvented.

The C&D Process should be amended so as to allow the Division to issue the cease and desist order from the start. The alleged violator should then be allowed 15 days to request a hearing, and that hearing should be held within 20 days of the issuance of the cease and desist order. This process will help to ensure that a hearing is held as quickly as possible, which is essential given the fact that the cease and desist order will take immediate effect and, thus, the alleged violator will be prevented from conducting business. The initial decision should be required to be issued within 10 days of the conclusion of the hearing. The initial decision should become final unless either side files exceptions with the Commissioner within five days of the issuance of the initial decision. If no exceptions are filed, the initial decision would become the final order, which would represent a condensed timeline of 35 days from the date on which the cease and desist order was first issued.

If exceptions are filed, the Commissioner should be required to issue a final order within 10 days of the filing of the exceptions. This would represent a timeline of 45 days from the date on which the cease and desist order was first issued.

These time saving measures are of paramount importance should the complained of conduct be found not to have violated the Colorado Act and the cease and desist order ultimately be vacated. It would be poor public policy for the state to unduly prevent the conduct of legitimate business.

Additionally, the Colorado Act should be amended to permit, at the discretion of the Division, a hearing panel composed of members of the Board, or an administrative law judge from the Division of Administrative Hearings, to conduct the hearing.

Since first being granted the authority to issue cease and desist orders in 2000, the Division has sought only four such orders. This has required volunteer Board members to rearrange their schedules at the last minute, and then sit through hearings that can last up to a week or more. Additionally, the hearing panels have had to rule on discovery and evidentiary motions.

Although no cease and desist hearings were conducted during the course of this sunset review, thus preventing DORA from observing such a hearing first hand, several Board members and Division staff expressed concern regarding the process. Although two of the Board members are attorneys, they are not litigators, so their familiarity with the rules of evidence and the more relaxed nature of administrative proceedings is minimal.

Additionally, these hearing panel members expressed concern over pleadings practice and what is and what is not appropriate in an administrative hearing. In short, these panel members complained of many of the same issues that initially gave rise to the creation of administrative law judges – lay people do not understand, nor should the state expect them to understand, how to conduct a hearing.

For the foregoing reasons, the C&D Process should be amended to permit a post-issuance hearing on cease and desist orders, and allow for the hearing to be conducted by either a hearing panel of Board members, or an administrative law judge.

Recommendation 4 – For those securities that have been registered under the Securities Act of 1933, require state registration by coordination, rather than registration by filing.

Section 11-51-303, C.R.S., currently requires issuers of securities that have already registered such securities with the SEC, or that are in the process of doing so, to register such securities with the Division by a process known as “filing.” This process generally entails the filing with the Division of basic information about the issuer and about the security being offered. Registration by coordination essentially requires the submission of the same information, but requires the issuer to file with Colorado the same documentation that was filed with the SEC for the initial federal registration, thus reducing the overall workload of the issuer.

Registration by coordination, therefore, is more issuer-friendly and is more streamlined, because it is “coordinated” with the issuer’s federal registration of the subject securities.

Additionally, as part of this sunset review, DORA surveyed the securities laws of eight other western states (Wyoming, Utah, Arizona, New Mexico, Texas, Oklahoma, Kansas and Nebraska). Seven of these states allow registration by coordination. Only Arizona does not permit this type of registration, and this is partially explainable by the fact that Arizona is a "merit review" state, which means that Arizona's securities regulators review applications for registration not merely for adequacy of disclosure, but also for substantive issues.

For these reasons, the General Assembly should require that such securities be registered by coordination, and amend section 11-51-303, C.R.S., as follows:

> **11-51-303. Registration by ~~filing~~ COORDINATION.** (1) Securities for which a registration statement has been filed under the federal "Securities Act of 1933" in connection with the offering of the securities may be registered by ~~filing~~ COORDINATION. A registration statement ~~for a registration by filing~~ AND ACCOMPANYING RECORDS under this section must contain the following information and be accompanied by the consent to service of process required by section 11-51-706:
>
> (a) ~~A statement of eligibility for registration by filing~~ A COPY OF THE LATEST FORM OF PROSPECTUS FILED UNDER THE SECURITIES ACT OF 1933;
>
> (b) ~~The name, address, form of organization, and jurisdiction of organization of the issuer~~ A COPY OF THE ARTICLES OF INCORPORATION AND BYLAWS OR THEIR SUBSTANTIAL EQUIVALENTS CURRENTLY IN EFFECT; A COPY OF ANY AGREEMENT WITH OR AMONG UNDERWRITERS; A COPY OF ANY INDENTURE OR OTHER INSTRUMENT GOVERNING THE ISSUANCE OF THE SECURITY TO BE REGISTERED; AND A SPECIMEN, COPY OR DESCRIPTION OF THE SECURITY THAT IS REQUIRED BY RULE ADOPTED OR ORDER ISSUED UNDER THIS ARTICLE;
>
> (c) ~~The title of the security being registered under this article, and the number or amount being registered under this article~~ COPIES OF ANY OTHER INFORMATION OR ANY OTHER RECORDS FILED BY THE ISSUER UNDER THE SECURITIES ACT OF 1933 REQUESTED BY THE SECURITIES COMMISSIONER; and
>
> (d) ~~With respect to a person on whose behalf a part of the offering is to be made in a nonissuer distribution, the name, address, and amount of securities of the issuer held by the person as of the date of the filing of the registration statement~~ AN UNDERTAKING TO FORWARD EACH AMENDMENT TO THE FEDERAL PROSPECTUS, OTHER THAN AN AMENDMENT THAT DELAYS THE EFFECTIVE DATE OF THE REGISTRATION STATEMENT, PROMPTLY AFTER IT IS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION.

(2) ~~If the information and documents required to be filed by subsection (1) of this section have been on file with the securities commissioner for at least five business days or any shorter period that the securities commissioner by rule or order allows and if the applicable registration fee has been paid before the effectiveness of the federal registration statement, a registration statement under this section automatically becomes effective concurrently with the effectiveness of the federal registration statement. If the federal registration statement becomes effective before all the conditions in this subsection (2) are satisfied or waived, the registration statement becomes effective when all the conditions are satisfied or waived. The person filing the registration statement under this article shall promptly notify the securities commissioner of the date and time when the federal registration statement became effective and shall promptly file with the securities commissioner the final prospectus relating to the federal registration statement. A final prospectus shall be deemed promptly filed if it is filed with the securities commissioner within five business days after the first distribution of the final prospectus to investors.~~ A REGISTRATION STATEMENT UNDER THIS SECTION BECOMES EFFECTIVE SIMULTANEOUSLY WITH OR SUBSEQUENT TO THE FEDERAL REGISTRATION STATEMENT WHEN ALL OF THE FOLLOWING CONDITIONS ARE SATISFIED:

(a) A STOP ORDER UNDER SUBSECTION (3) OF THIS SECTION OR SECTION 11-51-306, OR ISSUED BY THE SECURITIES AND EXCHANGE COMMISSION IS NOT IN EFFECT AND A PROCEEDING IS NOT PENDING AGAINST THE ISSUER UNDER SECTION 11-51-410; AND

(b) THE REGISTRATION STATEMENT HAS BEEN ON FILE FOR AT LEAST TWENTY DAYS OR A SHORTER PERIOD PROVIDED BY RULE ADOPTED OR ORDER ISSUED BY THE SECURITIES COMMISSIONER.

(3) THE REGISTRANT SHALL PROMPTLY NOTIFY THE SECURITIES COMMISSIONER OF THE DATE WHEN THE FEDERAL REGISTRATION STATEMENT BECOMES EFFECTIVE AND THE CONTENT OF ANY PRICE AMENDMENT AND SHALL PROMPTLY FILE A NOTICE CONTAINING THE PRICE AMENDMENT. IF THE NOTICE IS NOT TIMELY RECEIVED, THE SECURITIES COMMISSIONER MAY ISSUE A STOP ORDER, WITHOUT PRIOR NOTICE OR HEARING, RETROACTIVELY DENYING EFFECTIVENESS TO THE REGISTRATION STATEMENT OR SUSPENDING ITS EFFECTIVENESS UNTIL COMPLIANCE WITH THIS SECTION. THE SECURITIES COMMISSIONER SHALL PROMPTLY NOTIFY THE REGISTRANT OF AN ORDER BY TELEGRAM, TELEPHONE, OR ELECTRONIC MEANS AND PROMPTLY CONFIRM THIS NOTICE. IF THE REGISTRANT SUBSEQUENTLY COMPLIES WITH THE NOTICE REQUIREMENTS OF THIS SECTION, THE STOP ORDER IS VOID AS OF THE DATE OF ITS ISSUANCE.

> (4) IF THE FEDERAL REGISTRATION STATEMENT BECOMES EFFECTIVE BEFORE EACH OF THE CONDITIONS IN THIS SECTION IS SATISFIED OR IS WAIVED BY THE SECURITIES COMMISSIONER, THE REGISTRATION STATEMENT IS AUTOMATICALLY EFFECTIVE UNDER THIS ARTICLE WHEN ALL THE CONDITIONS ARE SATISFIED OR WAIVED. IF THE REGISTRANT NOTIFIES THE SECURITIES COMMISSIONER OF THE DATE WHEN THE FEDERAL REGISTRATION STATEMENT IS EXPECTED TO BECOME EFFECTIVE, THE SECURITIES COMMISSIONER SHALL PROMPTLY NOTIFY THE REGISTRANT BY TELEGRAM, TELEPHONE, OR ELECTRONIC MEANS AND PROMTLY COFIRM THIS NOTICE, INDICATING WHETHER ALL THE CONDITIONS ARE SATISFIED OR WAIVED AND WHETHER THE SECURITIES COMMISSIONER INTENDS THE INSTITUTION OF A PROCEEDING UNDER SECTION 11-51-306. THE NOTICE BY THE SECURITIES COMMISSIONER DOES NOT PRECLUDE THE INSTITUTION OF SUCH A PROCEEDING.

Furthermore, section 11-51-306, C.R.S., should be amended as follows in order to make the proposed language for section 11-51-303(1)(d), C.R.S., enforceable:

> (1) The securities commissioner may issue a stop order denying effectiveness to, or suspending or revoking the effectiveness of, any registration statement, if the securities commissioner finds violations of the escrow provisions in section 11-51-302(5) or (6), or, in the case of any registration statement under section 11-51-304, if the securities commissioner finds that the order is in the public interest and that any one of the following grounds exists:
>
> (e) WITH RESPECT TO A SECURITY SOUGHT TO BE REGISTERED UNDER SECTION 11-51-303, THERE HAS BEEN A FAILURE TO COMPLY WITH THE UNDERTAKING REQUIRED BY SECTION 11-51-303(1)(d).

Recommendation 5 – Include in the grounds for which discipline may be imposed, or a license denied, violation of the securities laws of other nations.

Like much of the U.S. economy, the financial services industry, which includes the securities industry, is becoming increasingly internationalized. Individuals from other nations transact business in this country and in this state on a daily basis. If such individuals transact business in securities in this state, unless they are exempt, they are subject to the licensing provisions of the Colorado Act.

However, the Colorado Act does not include in the grounds for discipline or denial of a license, regardless of whether such license is as a broker-dealer, investment adviser, or a representative of either, a violation of the securities laws of a foreign nation.

Therefore, section 11-51-410(1), C.R.S., should be amended to specifically enumerate when the Commissioner may deny or condition such a license, or discipline a licensee, by adding a new paragraph and a new subsection that read as follows:

> (m) AFTER NOTICE AND OPPORTUNITY FOR A HEARING, HAS BEEN FOUND WITHIN THE PREVIOUS TEN YEARS:
>
> (I) BY A COURT OF COMPETENT JURISDICTION TO HAVE WILLFULLY VIOLATED THE LAWS OF A FOREIGN JURISDICTION UNDER WHICH THE BUSINESS OF SECURITIES, COMMODITIES, INVESTMENT, FRANCHISES, INSURANCE, BANKING OR FINANCE IS REGULATED;
>
> (II) TO HAVE BEEN THE SUBJECT OF AN ORDER OF A SECURITIES REGULATOR OF A FOREIGN JURISDICTION DENYING, REVOKING, OR SUSPENDING THE RIGHT TO ENGAGE IN THE BUSINESS OF SECURITIES AS A BROKER-DEALER, AGENT, SALES REPRESENTATIVE, INVESTMENT ADVISER, INVESTMENT ADVISER REPRESENTATIVE, OR SIMILAR PERSON; OR
>
> (III) TO HAVE BEEN SUSPENDED OR EXPELLED FROM MEMBERSHIP BY OR PARTICIPATION IN A SECURITIES EXCHANGE OR SECURITIES ASSOCIATION OPERATING UNDER THE SECURITIES LAWS OF A FOREIGN JURISDICTION.

The “notice and opportunity for a hearing” language will help to ensure that such person’s due process rights were observed during any such foreign proceeding.

It is also important to note that all of the grounds for discipline in section 11-51-410, C.R.S., are permissive. That is, in taking action on any such grounds, the Commissioner has a certain degree of discretion, such that a violation of this new subsection would not act as an automatic bar to licensure or result in automatic discipline. It would simply provide the Commissioner with the necessary tools to deny licensure or to discipline a licensee, should these conditions exist without satisfactory explanation.

Recommendation 6 – Include in the grounds for which discipline may be imposed, or a license denied, failure to demonstrate the necessary qualifications for the license sought.

Typically, when the Division receives an application for licensure, the applicant has already taken and passed the required NASD examinations, thus providing *de facto* evidence that such applicant is qualified to engage in the activities authorized by the examination taken.

Occasionally, however, the Division will receive an application from an individual that was previously licensed and that desires to re-enter the field, but has been out of the business long enough that the NASD examination that person took for original licensure is no longer valid. This person must either retake the appropriate NASD examination, or request an examination waiver by the Commissioner.

Unfortunately, if the Commissioner denies the waiver request and the person does not take the required examination or withdraw the application, the application remains technically open because the Division lacks the statutory authority to deny it for lack of qualification.

Therefore, section 11-51-410, C.R.S., should be amended as follows, to allow the Division to deny such applications and to reach administrative closure:

> (n) IS NOT QUALIFIED ON THE BASIS OF FACTORS SUCH AS TRAINING, EXPERIENCE, AND KNOWLEDGE OF THE SECURITIES BUSINESS. HOWEVER, IN THE CASE OF AN APPLICATION BY A SALES REPRESENTATIVE FOR A BROKER-DEALER THAT IS A MEMBER OF A SELF-REGULATORY ORGANIZATION OR BY AN INDIVIDUAL FOR LICENSURE AS AN INVESTMENT ADVISER REPRESENTATIVE, A DENIAL ORDER MAY NOT BE BASED ON THIS PARAGRAPH (n) IF THE INDIVIDUAL HAS SUCCESSFULLY COMPLETED ALL EXAMINATIONS REQUIRED BY THIS ARTICLE. THE SECURITIES COMMISSIONER MAY REQUIRE AN APPLICANT FOR A LICENSE UNDER SECTION 11-51-403 WHO HAS NOT BEEN LICENSED IN A STATE WITHIN THE TWO YEARS PRECEDING THE FILING OF AN APPLICATION IN THIS STATE TO SUCCESSFULLY COMPLETE AN EXAMINATION.

Recommendation 7 – Clarify the manner in which rescission offers must be structured in order to avoid civil liability under the Colorado Act.

From time to time, one or more of the parties to a securities transaction discovers, after the conclusion of the transaction, that a provision of the Colorado Act was violated. In such cases, the violator is obligated to rescind, or undo, the transaction. Because the civil liability provisions of the Colorado Act provide protection to a party that attempts to rescind a deal, the manner in which the offer to rescind is made is of paramount importance. Unfortunately, the Colorado Act provides little guidance in this area.

In its most simplistic form, a rescission offer might involve the seller/issuer presenting the purchaser with two alternatives: 1) surrender the securities back to the seller/issuer at the purchase price, plus interest; or, 2) retain the securities, but relinquish the right to bring an action against the issuer/seller based on the grounds leading to the rescission offer.

The reasons leading up to a rescission offer are many. A few examples include the offer or sale of securities that were not properly registered or that were offered under a defective registration statement. A rescission offer might also be made in a case where the sale was effected by a broker-dealer that was not licensed in Colorado. These scenarios could all provide grounds for a purchaser to bring a legal action.

Thus, rescission offers typically involve the private parties to a transaction. They do not usually involve the Division, so this recommendation does not involve a matter of enforcement. Rather, the Division reports that it frequently receives phone calls from attorneys and others who need to conduct a rescission offer and are in search of guidance. This is because the Colorado Act currently provides little direction as to how to conduct a rescission offer.

Section 11-51-604(9), C.R.S., is the only provision in the Colorado Act that addresses rescission offers, and it merely states that a person that receives a rescission offer may sue under the Colorado Act. Section 11-51-604(9), C.R.S., reads:

> (9) (a) No buyer may sue under this section:
>
> (I) If the buyer received a written rescission offer, before suit and at a time when the buyer owned the security, to refund the consideration paid together with interest at the statutory rate from the date of payment, less the amount of any income received on the security, and the buyer failed to accept the offer within thirty days of its receipt; or
>
> (II) If the buyer received such an offer before suit and at a time when the buyer did not own the security, unless the buyer rejects the offer in writing within thirty days of its receipt.
>
> (b) If, after acceptance, a rescission offer is not performed in accordance with its terms, the buyer may obtain relief under this section without regard to the rescission offer.

As discussed above, this provision provides no guidance as to how to structure a rescission offer. This can result in unnecessary costs being incurred by the seller/issuer, as well as purchasers being presented with potentially flawed rescission offers that do not adequately inform them of their rights.

For the foregoing reasons, the General Assembly should amend section 11-51-604(9), C.R.S., as follows:

> (9) ~~(a)~~ No ~~buyer,~~ PURCHASER, SELLER OR RECIPIENT OF INVESTMENT ADVICE may sue under this section IF:
>
> ~~(I) If the buyer received a written rescission offer, before suit and at a time when the buyer owned the security, to refund the consideration paid together with interest at the statutory rate from the date of payment, less the amount of any income received on the security, and the buyer failed to accept the offer within thirty days of its receipt; or~~
>
> ~~(II) If the buyer received such an offer before suit and at a time when the buyer did not own the security, unless the buyer rejects the offer in writing within thirty days of its receipt.~~
>
> (a) THE PURCHASER, SELLER OR RECIPIENT OF INVESTMENT ADVICE RECEIVES IN A RECORD, BEFORE THE ACTION IS INSTITUTED:

(I) AN OFFER STATING THE RESPECT IN WHICH LIABILITY UNDER THIS SECTION MAY HAVE ARISEN AND FAIRLY ADVISING THE PURCHASER, SELLER OR RECIPIENT OF INVESTMENT ADVICE OF THAT PERSON'S RIGHTS IN CONNECTION WITH THE OFFER, AND ANY FINANCIAL OR OTHER INFORMATION NECESSARY TO CORRECT ALL MATERIAL MISREPRESENTATIONS OR OMISSIONS IN THE INFORMATION THAT WAS REQURIED BY THIS ARTICLE TO BE FURNISHED TO THAT PERSON AT THE TIME OF THE PURCHASE, SALE, OR INVESTMENT ADVICE;

(II) IF THE BASIS FOR RELIEF UNDER THIS SECTION MAY HAVE BEEN A VIOLATION OF SECTIONS 11-51-604(1), (3), OR (4), AN OFFER TO REPURCHASE THE SECURITY FOR CASH, PAYABLE ON DELIVERY OF THE SECURITY, EQUAL TO THE CONSIDERATION PAID, AND INTEREST AT THE STATUTORY RATE FROM THE DATE OF THE PURCHASE, LESS THE AMOUNT OF ANY INCOME RECEIVED ON THE SECURITY, OR, IF THE PURCHASER NO LONGER OWNS THE SECURITY, AN OFFER TO PAY THE PURCHASER UPON ACCEPTANCE OF THE OFFER, DAMAGES IN AN AMOUNT THAT WOULD BE RECOVERABLE UPON A TENDER, LESS THE VALUE OF THE SECURITY WHEN THE PURCHASER DISPOSED OF IT, AND INTEREST AT THE STATUTORY RATE FROM THE DATE OF THE PURCHASE, IN CASH EQUAL TO THE DAMAGES COMPUTED IN THE MANNER PROVIDED IN THIS SUBSECTION;

(III) IF THE BASIS FOR RELIEF UNDER THIS SECTION MAY HAVE BEEN A VIOLATION OF SECTION 11-51-604(2), AND IF THE CUSTOMER IS A PURCHASER, AN OFFER TO PAY AS SPECIFIED IN SUBPARAGRAPH (II);

(IV) IF THE BASIS FOR RELIEF UNDER THIS SECTION MAY HAVE BEEN A VIOLATION OF SECTION 11-51-604(2.5), AN OFFER TO REIMBURSE, IN CASH, THE CONSIDERATION PAID FOR THE ADVICE AND INTEREST AT THE STATUTORY RATE FROM THE DATE OF PAYMENT;

(V) IF THE BASIS FOR RELIEF UNDER THIS SECTION MAY HAVE BEEN A VIOLATION OF SECTION 11-51-604(2.6), AN OFFER TO REIMBURSE, IN CASH, THE CONSIDERATION PAID FOR THE ADVICE, THE AMOUNT OF ANY ACTUAL DAMAGES THAT MAY HAVE BEEN CAUSED BY THE CONDUCT, AND INTEREST AT THE STATUTORY RATE FROM THE DATE OF THE VIOLATION CAUSING THE LOSS;

(b) ~~If, after acceptance, a rescission offer is not performed in accordance with its terms, the buyer may obtain relief under this section without regard to the rescission offer~~ THE OFFER UNDER PARAGRAPH (a) OF THIS SUBSECTION STATES THAT IT MUST BE ACCEPTED BY THE PURCHASER, SELLER OR RECIPIENT OF INVESTMENT ADVICE WITHIN 30 DAYS AFTER THE DATE OF ITS RECEIPT BY THE PURCHASER, SELLER OR RECIPIENT OF INVESTMENT ADVICE OR ANY SHORTER PERIOD OF NOT LESS THAN THREE DAYS THAT THE SECURITIES COMMISSIONER MAY, BY ORDER, SPECIFY;

> (c) THE OFFEROR HAS THE PRESENT ABILITY TO PAY THE AMOUNT OFFERED OR TO TENDER THE SECURITY UNDER SUBSECTION (a) OF THIS SECTION;
>
> (d) THE OFFER UNDER PARAGRAPH (a) OF THIS SUBSECTION IS DELIVERED TO THE PURCHASER, SELLER OR RECIPIENT OF INVESTMENT ADVICE, OR SENT IN A MANNER THAT ENSURES RECEIPT BY THE PURCHASER, SELLER OR RECIPIENT OF INVESTMENT ADVICE; AND
>
> (e) THE PURCHASER. SELLER OR RECIPIENT OF INVESTMENT ADVICE THAT ACCEPTS THE OFFER UNDER PARAGRAPH (a) OF THIS SUBSECTION, IN A RECORD WITHIN THE PERIOD SPECIFIED UNDER PARAGRAPH (b) OF THIS SUBSECTION, IS PAID IN ACCORDANCE WITH THE TERMS OF THE OFFER.

Recommendation 8 – Repeal the requirement that, on an annual basis, the Securities Board submit to DORA's Executive Director, an evaluation of the Commissioner.

Section 11-51-702.5(6)(b), C.R.S., directs the Board,

> Commencing July 1, 1995, and once every year thereafter, the securities board shall submit to the executive director of the department of regulatory agencies its evaluation of the performance of the Commissioner for the preceding year.

These evaluations are typically timed so as to coincide with the Executive Director's annual performance evaluation of the Commissioner, which occurs in April or May of each year.

Conversations with DORA's Executive Director reveal that these statutorily mandated evaluations by the Board are of very little value. They are generally quite positive and they do no harm, but they are not necessary.

Furthermore, the Board is a policy-making body. It is not involved in personnel decisions, and it does not supervise the Commissioner. The Executive Director supervises the Commissioner.

Neither the Colorado Constitution nor Colorado law require the Executive Director to take into consideration the evaluations prepared by the Board. Indeed, the Colorado Supreme Court has ruled that "The purpose of civil service legislation is to protect employees from arbitrary and capricious political action and to insure employment during good behavior." *Coopersmith v. City and County of Denver,* 399 P.2d 943, 948 (Colo. 1965).

It has been argued that the annual evaluation is a vehicle by which the Board can communicate with the Executive Director. However, the members of DORA's multitude of other boards have no such statutory mandates and are able to communicate with the Executive Director as needed.

Because the Board's evaluations do not have any impact on the Executive Director's performance evaluation of the Commissioner and because the Board can always initiate less regimented communications with the Executive Director, the General Assembly should repeal the requirement that the Board prepare annual evaluations of the Commissioner.

Recommendation 9 – Impose on the members of the Securities Board a two term limit.

The Colorado Act goes to great lengths to outline the composition of the Board and the duties and responsibilities of the Board. It even specifies that Board member terms are to last three years. The Colorado Act, however, does not specify the number of terms an individual may serve.

Term limits have become the norm in Colorado political life. The Governor is limited to two terms and members of the General Assembly even have term limits. Additionally, virtually all of the members of the professional licensing boards in DORA are subject to term limits.

Proponents of term limits argue that they ensure that new people are given the opportunity to serve. They also argue that term limits help to reduce the likelihood of boards becoming dominated by a single, long-serving member.

Opponents of term limits often argue that term limits help to eliminate institutional memory because turnover eliminates the long-serving members that possess the institution's memory.

However, the arguments against term limits are far less convincing when it comes to service on regulatory boards. The Division's staff provides the institutional memory. Additionally, the Board is primarily an advisory body, which lends credence to the proposition that new people should be afforded the opportunity to serve.

For the foregoing reasons, the General Assembly should establish term limits for members of the Board such that no member may serve more than two, three-year terms.

Recommendation 10 – Require the Municipal Bond Advisory Committee to meet at least annually, rather than quarterly.

Section 11-59-105, C.R.S., creates the Municipal Bond Advisory Committee (Advisory Committee) and directs that it meet at least quarterly.

Although the Municipal Bond Act is arguably outside the scope of this sunset review, it is administered by the Division and the Commissioner. Pursuant to this line of reasoning, a DORA representative attended several of the Advisory Committee's meetings.

Advisory Committee meetings typically last only an hour and are generally held during the lunch hour. They afford the Division an opportunity to update the municipal bond industry as to its recent activities and, concomitantly, afford the municipal bond industry an opportunity to ask questions of the Division's staff and the Commissioner. The meetings also provide both sides with the opportunity to discuss perceived trends in the municipal bond markets.

However, these meetings typically last only an hour because there is rarely enough to discuss to occupy more time. Additionally, members of the Advisory Committee have asked that they not be required to meet as often as quarterly.

Importantly, an amendment to the Municipal Bond Act to require the Advisory Committee to meet at least annually would not preclude more frequent meetings. Such an amendment would simply remove the requirement that the Advisory Committee meet more frequently when there is no need to do so.

For the foregoing reasons, the General Assembly should amend section 11-59-105, C.R.S., so as to require the Advisory Committee to meet at least annually.

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 regulation;

(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 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 not 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 the public interest.