

**IN THE
SUPREME COURT OF VIRGINIA
AT RICHMOND**

Record Nos. 020938, 020939 and 020940

DAVID R. TANNER,
JAMES C. PERRY,
BRIAN W. KREIDER,

Appellants,

v.

STATE CORPORATION COMMISSION

Appellee.

**MOTION OF
THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.
FOR LEAVE TO FILE BRIEF AS *AMICUS CURIAE***

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February 10, 2003

The North American Securities Administrators Association, Inc. (“NASAA”) hereby respectfully moves this Court for leave to file the accompanying brief as *amicus curiae*, pursuant to Rule 5:30 of the Rules of the Supreme Court of Virginia, in support of the Petition for Rehearing filed by the State Corporation Commission (“the Commission”) in this appeal. NASAA submits the following grounds in support of its request.

**NASAA’S INTERESTS IN THIS CASE ARE ASSURING INVESTOR PROTECTION
AND
PROMOTING UNIFORMITY**

NASAA is the oldest international organization devoted to the protection of investors in securities. It is a voluntary association organized in 1919 that now has a membership comprised of 66 state, provincial, and territorial securities regulators, including members in all 50 states and the District of Columbia. State securities regulators are responsible for ensuring that securities are offered and sold only in accordance with state securities laws and regulations, which have been adopted in some form in every state, protecting investors from fraud and abuse. NASAA seeks to enhance investor protection and increase uniformity in the interpretation of state securities laws. The Court’s decision as rendered in this case would negatively impact the achievement of both missions.

I. Protecting Investors

NASAA has an interest in protecting investors in Virginia by helping to ensure that those who invest in securities continue to receive the regulatory

safeguards provided under the Virginia Securities Act. Va. Code §§ 13.1-501 *et seq.* Along with other state securities regulators, the Commission, and the Securities and Exchange Commission (“SEC”), NASAA views securities issued under SEC Regulation D, Rule 504¹ *not* to be “covered securities,” and thus *not* to be exempt from state registration under the Virginia Securities Act. Accordingly, Virginia citizens considering investing in Rule 504 securities have been receiving important protections under the Virginia Securities Act, including registration of investments, pre-purchase disclosure of material information, and strong remedial and punitive sanctions against violators. The Court should grant the Commission’s Petition for Rehearing to confirm that securities issued under Rule 504 are not deemed exempt from state registration, assuring these safeguards will continue for public investors in Virginia.

NASAA’s interest in seeing that securities issued under Rule 504 are properly regulated stems from a simple fact: over the last 30 years, there have been many abuses in the marketing of unregistered securities, and as a consequence, thousands of investors have lost money. While NASAA is not suggesting that fraud was involved in the offerings that are the subject of the rehearing petition, numerous instances have been publicly described where

¹ 17 C.F.R. § 230.504 (2002).

investors were promised high returns from what ultimately proved to be fraudulent investments.² Often those losing large sums in these schemes are elderly.

Rule 504, as a federal exemption, was intended to work hand-in-glove with state registration, providing an early-warning system to alert local regulators to potentially fraudulent activity. NASAA seeks in this case to ensure that Rule 504 is interpreted as it was intended, as a federal exemption coordinated with state registration. Under the Virginia Securities Act and its implementing rules securities generally must be registered, a process which includes review by Commission staff. *See* Va. Code § 13.1-507; *see also* 21 Va. Admin. Code § 5-30-90. The review and registration process assures that investors receive full disclosure of the risks associated with their investments and it can expose fraudulent investment schemes before they happen.

Virginia imposes a broad array of sanctions for securities violations. The Virginia Securities Act criminalizes not only fraud, but also willful registration violations. *See* Va. Code § 13.1-520. One of the most important remedial provisions in the Virginia Securities Act gives investors the right to sue for rescission if they have been sold an unregistered security. *See* Va. Code § 13.1-522. NASAA has an interest in seeing that the citizens of Virginia continue to receive all of these protections.

² Section 504 offerings are particularly subject to manipulation if not properly registered. *See* INVESTOR TIPS: MICROCAP FRAUD at http://www.nasaa.org/nasaa/scripts/prel_display.asp?rcid=57. Links to NASAA press releases describing a variety of enforcement actions against violators of state securities laws can be found at http://www.nasaa.org/nasaa/invedu/investor_ed_overview.asp?nav_id=10.

II. Promoting Uniformity

Granting a rehearing also would allow the Court the opportunity to reconsider this decision that separates Virginia from other states in a uniform system of regulation. Two benefits will flow from promoting uniformity. As noted above, the SEC and the Commission are of the view that Rule 504 offerings are not “covered securities” and therefore are subject to Virginia’s registration requirements. NASAA knows of no state that treats Rule 504 offerings as “covered securities.”³ A contrary decision by this Court would place Virginia out of conformity with the law as it is commonly understood at both the state and federal levels.

Uniformity is important for another reason. It helps ensure that the citizens of every state receive investor protection in roughly equal measure, so that no state becomes a prime target for financial fraud. If it is held that Virginia law does not require registration of Rule 504 offerings, and if there is a higher incidence of fraud in such offerings, then it follows that Virginia citizens will be victimized to a greater degree by promoters seeking to avoid regulatory scrutiny of their activities. The Court should not allow a gap to develop in Virginia securities law that makes

³ A few states have provided by statute or regulation for an exemption from registration of this type of offering, but that is not the case in Virginia. *See* Press Release, SEC, Adoption of Amendments to Rule 504: Fact Sheet (February 19, 1999), <http://www.sec.gov/news/extra/micro504.txt>.

the state more attractive to financial predators than other jurisdictions. By promoting uniformity in the interpretation of their laws, NASAA seeks to prevent any state from becoming a target of fraud and financial abuse. If the Court opens a Virginia loophole in Rule 504 offerings, Virginia investors will be denied the same level of protection that investors possess in other states.

NASAA’S BRIEF WILL ASSIST THE COURT

NASAA respectfully submits that its Brief will assist the Court in two ways. First, the Brief supplements the Commission’s legal argument by describing in detail the genesis of SEC Regulation D, including the two distinct authorities under which different rules in Regulation D were promulgated. The Brief also explains the rationale for varying registration standards for Rules 504 and 506 securities. These points are set forth in the Brief to assist the Court in analyzing Rule 504 and its genesis and in reaching a decision consistent with the goal of state securities laws in achieving investor protection.

NASAA’s Brief also discusses precedents for granting a Petition for Rehearing that may be helpful to the Court.

For the foregoing reasons, NASAA requests that the Court grant its Motion and permit the accompanying Brief to be filed in this case.

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CERTIFICATE OF SERVICE

The undersigned certifies a copy of the foregoing Motion, together with three copies of the *Amicus Curiae* Brief, was served upon the following attorneys of record for all parties to the above cause by U.S. mail, postage prepaid on this the 10th day of February, 2003:

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ISSUES PRESENTED

I. Whether securities issued under Securities and Exchange Commission (“SEC”) Regulation D, Rule 504, are subject to state registration requirements because they are not federal “covered securities?”

II. Whether the Court should grant rehearing to correct an error of law in its prior holding, as permitted under Virginia law and the rules of this Court, where the correction will protect investors from fraud and abuse?

STATEMENT OF INTEREST OF AMICUS CURIAE

As discussed in detail in our Motion for leave to file this brief, the North American Securities Administrators Association, Inc. (“NASAA”) seeks to enhance investor protection and increase uniformity in the interpretation of state securities laws. Both of these goals are implicated in this case.

SUMMARY OF ARGUMENT

Under Virginia law, it is unlawful for a company to offer or sell any security unless “(i) the security is registered under this chapter, (ii) the security or transaction is exempted by this chapter, or (iii) the security is a federal covered security.” Va. Code § 13.1-507 of the Virginia Securities Act. Federal “covered security” is defined in section 18(b)(4)(D) of the Securities Act of 1933 (“the Securities Act”), 15 U.S.C. § 77r(b)(4)(D), to include securities issued pursuant to section 4(2) of that statute, but not section 3(b).

The Court, the State Corporation Commission (“Commission”) and the appellants all agree that the securities involved in this case were issued under Federal Regulation D, Rule 504,¹ 17 C.F.R. §§ 230.501-508 (“Regulation D”). Rule 504 clearly was promulgated under the authority of section 3(b) of the Securities Act, 15 U.S.C. § 77c(b), not section 4(2) of that Act, 15 U.S.C. § 77d(2). The Rule itself even references section 3(b).

Contrary to the Court’s ruling, securities issued under Rule 504 are not federal “covered securities” and the securities are not exempt under any provision of the Virginia Securities Act. It is therefore unlawful to offer or sell these securities in Virginia unless they are registered with the Commission.

The Court’s prior ruling therefore warrants granting the Commission’s Petition for Rehearing.

¹ “As part of its response, the issuer’s attorney, by letter introduced into evidence by the Commission, stated that the notes were issued pursuant to a Rule 504 Regulation D filing with the Securities and Exchange Commission”. *Tanner v. State Corp. Comm’n*, 2003 Va. Lexis 6, *2 (Jan. 10, 2003).

ARGUMENT

I. Rule 504 Securities Are Not “Covered Securities” Under Federal Law and Therefore Must be Registered Under Virginia Law to be Sold in Virginia

A. There is a Significant Difference Between Sections 3(b) and 4(2) of the Securities Act of 1933

Section 3 of the Securities Act exempts certain enumerated types of *securities* from *federal* registration. 15 U.S.C. § 77c. It also gives the SEC authority to grant additional federal exemptions for other public offerings, as follows—

The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this title with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds \$5,000,000.

Section 3(b) of the Securities Act, 15 U.S.C. § 77c(b) (“Section 3(b”).

Section 4 of the Securities Act exempts certain *transactions* from *federal* registration, including “transactions by an issuer not involving any public offering.” Section 4(2) of the Securities Act, 15 U.S.C. § 77d(2) (“Section 4(2)”).²

² NSMIA gave the SEC a third, general authority to create exemptions by adding Section 28 to the Securities Act, 15 U.S.C. § 77z-3. Rule 504 has not been re-promulgated under Section 28. However, even if Rule 504 had been re-promulgated under Section 28, it would not be a “covered security” exempt from state registration.

While both provisions exempted either securities or transactions from federal registration, nothing in the statute before 1996 exempted these securities or transactions from *state* registration. Subsection 18(b) was added to the Securities Act by the National Securities Markets Improvements Act of 1996 (“NSMIA”). 15 U.S.C. § 77r(b). Subsection 18(b) created a category of securities called “covered securities” that are exempt from state registration requirements. Among other things, subparagraph 18(b)(4)(D) expressly exempts from state registration requirements securities exempt from federal registration pursuant to—

Commission rules or regulations issued under section 4(2), except that this subparagraph does not prohibit a State from imposing notice filing requirements that are substantially similar to those required by rule or regulation under section 4(2) that are in effect on September 1, 1996.

Section 18(b)(4)(D) of the Securities Act, 15 U.S.C. § 77r(b)(4)(D) (“Section 18(b)(4)(D)”). The rationale given for the new provision was as follows—

With respect to securities offerings, the Managers have allocated regulatory responsibility between the Federal and state governments based on the nature of the securities offering. Some securities offerings, such as those made by investment companies, and *certain private placements* are inherently national in nature, and are therefore subject to only Federal regulation. *Smaller, regional, and intrastate securities offerings remain subject to state regulation.*

H. Con. Rep. No. 104-864 at 40 (1996) (emphasis added).

Neither NSMIA, nor any subsequent legislation, designated as “covered securities” any security issued under exemptions promulgated under the authority of Section 3(b) of the Securities Act.

B. Rule 504 Was Promulgated Pursuant to Section 3(b), Not Section 4(2) of the Securities Act of 1933

Following enactment of the Small Business Investment Act of 1980, the SEC undertook a general examination of the exemptive scheme under the Securities Act. It announced it was reviewing the relationship between the efficacy of certain registration exemptions as they relate to the capital formation needs of small businesses.³

The SEC then proposed modifying many of its regulations constraining the ability of small businesses to raise capital and incorporating them in a new “Regulation D.”⁴ Eight months later, the SEC adopted Regulation D.⁵

Regulation D is a series of six rules, designated as Rules 501-506, that established two exemptions and one “safe harbor.” Rules 501-503 set forth definitions common to Rules 504-506. Rules 504 and 505 replaced former “[R]ules 240 and 242, respectively, and provide exemptions from registration *under Section 3(b) of the Securities Act.*” 47 F.R. at 11252 (emphasis added). Section 506 is the “safe harbor” provision that succeeded former “[R]ule 146 and relates to transactions that are deemed to be exempt from registration under Section 4(2) of the Securities Act.” *Id.*

³ Release No. 33-6274, 46 F.R. 2631, Jan. 12, 1981.

⁴ Release No. 33-6339, 46 F.R. 41791, Aug. 18, 1981.

⁵ Release No. 33-6389, 47 F.R. 11251, Mar. 16, 1982.

Other such references to the authority pursuant to which Rule 504 was promulgated are included in the initial SEC Release. For example—

E. *Rule 504—Exemption for Offers and Sales Not Exceeding \$500,000*

Rule 504, which replaces rule 240, provides an exemption *under section 3(b)* of the Securities Act for certain offers and sales not exceeding an aggregate offering prices of \$500,000.

47 F.R. at 11257 (emphasis added).

The Regulation D rulemaking process also has been described as follows:

In 1982 the SEC amalgamating its exemptions for small and private offerings in a set of rules known as “Regulation D — affectionately “Reg D.” These rules give detailed guidance on when an offering qualifies for the § 4(2) private placement exemption (Rule 506) and create additional exemptions for “small offerings” as authorized by § 3(b) (Rules 504 and 505).

Rule 504: Small offering subject to state blue sky laws. Nonpublic companies can sell up to \$1 million in securities in any 12-month period. *** In adopting this broad exemption, the SEC assumed that state securities laws provide sufficient protection to investors and that the burden of SEC regulation is unwarranted.

Alan R. Palmiter, *Securities Regulation* §5.2.4 (1998); *see also* III Louis Loss & Joel Seligman, *Securities Regulation*, 1337-38 (3d ed. 1999) (listing Rule 504 as one of the SEC regulations promulgated pursuant to section 3(b)).

NSMIA and subsequent legislation did not change the character of Section 3(b), or otherwise turn securities issued under Rule 504 into “covered securities.”

For example, an SEC explanation of changes proposed in 1998 states—

Rule 504 offerings are aggregated for this purpose with all other offerings exempt pursuant to Section 3(b) (e.g., Rule 504 or 505 offerings)...

Release No. 33-7541, 63 F.R. at 29169 n.6, May 28, 1998.⁶

Rule 504 itself also refers to Section 3(b). Subsection (a) expressly exempts certain offers and sales of securities “under section 3(b) of the [Securities] Act.” 17 C.F.R. § 230.504(a)(3). Subsection (b), “Conditions to be met,” prohibits aggregation of multiple offerings “in reliance on any exemption under Section 3(b).” 17 C.F.R. § 230.504(b)(2).

Because Rule 504 was promulgated under the SEC’s authority contained in Section 3(b) of the Securities Act, a security issued under Rule 504 is not a “covered security” that is exempt from state registration. The only Regulation D provision that meets this test – because it was issued under the SEC’s separate Section 4(2) authority – is Rule 506.

There is a clear reason why these two types of securities should be treated differently for state registration purposes. A purchaser of a Rule 506 private offering is generally required to be an “accredited investor”⁷ or to possess “such knowledge and experience in financial and business matters that he is capable of

⁶ See also C. Steven Bradford, *Securities Regulation and Small Business: Rule 504 and the Case for an Unconditional Exemption*, 5 J. Small & Emerging Bus. L. 1, 33 (Spring 2001) (highlighting the fact that “states remain free to regulate offerings that Rule 504 exempts from the federal registration requirements,” and assuming that securities under Rule 504 are not “covered securities”).

⁷ “Accredited investor” is defined in Rule 501(a), 17 C.F.R. § 230.501(a). Individuals can qualify only if they meet specific net worth or income requirements.

evaluating the merits and risks of the prospective investment.” 17 C.F.R. § 230.506(b)(2)(ii). No general solicitation or advertising is permitted.

Investors in Rule 504 securities, on the other hand, need not meet any net worth or prior investment experience requirements. Broad public solicitation and advertising generally are permitted. Unsophisticated individuals who hear about an investment opportunity from an advertisement or a sales call are in need of protections that can be afforded by state registration.

The record also demonstrates the Postmistress General and Postal Flyers, Inc.com promissory notes at issue here could not fit under Section 4(2) of the Securities Act. As noted *supra*, Section 4(2) “covered securities” are “transactions by an issuer not involving any public offering.” This was, in fact, a public offering. *See* marketing materials, App. 251-70.

C. The Court’s Conclusion Was Erroneous

In Section VI of its opinion in the instant case, the Court addresses the question of “whether the Commission erred in ruling that the Postmistress General and Postal Flyers Notes were not exempt from registration under the Act.” *Tanner v. State Corp. Comm’n*, 2003 Va. Lexis 6, *11 (Jan. 10, 2003) (“*Tanner*”). The Court proceeds to correctly describe the creation of “federal covered securities” by Section 18(b) of the Securities Act. *Id.* The Court also correctly states that securities issued under authority of Section 4(2) of the Securities Act are “covered securities.” *Id.* However, the Court then incorrectly concludes, without citing

authority, that “Rule 504 Regulation D was issued under the authority of 15 U.S.C § 77d(2) (2000).” *Id* at *12.

It is clear that Section 504 was *not* promulgated pursuant to the SEC’s authority under Section 4(2), 15 U.S.C § 77d(2); instead it was promulgated pursuant to the SEC’s entirely separate authority under Section 3(b), 15 U.S.C. § 77c(b). Securities issued under Section 3(b), 15 U.S.C. § 77c(b) are not “covered securities” and must be registered under § 13.1-507 of the Virginia Securities Act to be sold in Virginia.

The *Amicus Curiae* respectfully suggests that the Court was mistaken as a matter of law when it concluded that the Commission erred in ruling that the notes in question were not exempt. The securities should have been registered in accordance with § 13.1-507 of the Virginia Securities Act.

II. Rehearing is Appropriate to Correct an Error of Law

With respect to rehearing, the Virginia Code states in pertinent part—

The Supreme Court, on the petition of a party, shall rehear and review any case decided by such court if one of the justices who decides the case adversely to the petitioner certifies that in his opinion there is good cause for such rehearing.

Va. Code § 8.01-675.2.

Similarly, the Court's Rules provide—

No petition for rehearing shall be allowed unless one of the justices who decided the case adversely to the applicant is of the opinion that there is good cause for such rehearing. The proceedings upon such rehearing shall be in accordance with §8.01-675.2 of the Code.

Rules of Supreme Court of Virginia, 5:39(d); *see also* Rules of Supreme Court of Virginia, 5A:33(d). The remainder of the text is procedural.

Granting a rehearing is totally within the discretion of the Court. *See Conboy v. First National Bank*, 203 U.S. 141, 145, 27 S. Ct. 50, 52 (1906).

Rehearing also has long and regularly been used to correct errors.

This is no special or unusual power, but merely the inherent right and power of every court to correct its own errors or possible injustices. A rehearing, as this court understands it, is simply a renewed inquiry into matters which the court has once acted on. And whenever matter is presented to a court indicating that the previous action was based on a misconception of facts or law, the court has the power to open up the matter for reexamination. The granting of a rehearing is merely indication of a willingness to have the matter further inquired into with a view to correcting any error if any has been made.

In re Cury, 34 F.Supp. 526, 528 (W.D. Va. 1940), *citing In re Sheets*, no published opinion.

Rehearing presents the best opportunity to correct such error in this case, since there is no appeal to a higher tribunal to interpret application of State law. “A petition to rehear is a method of bringing error to the attention of the ... court before final decree, whether the error be of law or fact....” *Royall v. Peters*, 180 Va. 178, 187, 21 S.E. 2d 782, 786 (1942). “The petitioner’s right to relief on such

rehearing depends upon his ability to point out some error on the face of the record....” *Downing v. Huston*, 149 Va. 1, 9, 141 S.E. 134, 136 (1927).

Rehearing is not being sought for the purpose of introducing new argument that has not been made before, but rather to clarify the Court’s error on a point of law. *See Coleman v. City of Richmond*, 6 Va. App. 296, 297, n.1, 368 S.E. 2d 298, 300, n.1 (1988). The question was briefed by the parties, though the Commission apparently believed the matter to be so well settled that there was no need to recite circumstances describing the original Rule 504 promulgation. Neither the appellants nor the Court cites any authority for the proposition that Rule 504 offerings are covered securities. The Court summarizes in its opinion—

[Appellant] Kreider contends that securities issued pursuant to Rule 504 Regulation D are covered securities as defined by § 18 of the Securities Act of 1933 and, therefore, exempt from registration under the [Virginia Securities] Act. The Commission, on the other hand, contends that only Rule 506 Regulation D securities are covered securities exempt from registration under the Act.

Tanner at *12.

The Court states in Section III of its opinion that the Commission’s decisions are accorded the respect due “a tribunal informed by experience, and its decision will not be disturbed when ‘based upon the application of correct principles of law.’” *Tanner* at *4 (*citations omitted*). NASAA respectfully submits that the Commission’s ruling was based upon “application of correct principles of law” and should have been upheld in this matter. *Id.*

The Court's error of law clearly merits granting the Commission's Petition for Rehearing.

CONCLUSION

As a matter of law, because Rule 504 was issued pursuant to the SEC's authority under Section 3(b) of the Securities Act (15 U.S.C. § 77c(b)), not Section 4(2) of that Act (15 U.S.C. § 77d(2)), securities issued under Rule 504 are not "covered securities" and are not exempt from State registration.

The *Amicus Curiae* prays that the Court grant the Petition for Rehearing, as requested by the State Corporation Commission.

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