COURT OF APPEALS STATE OF COLORADO 2 East 14th Avenue Denver, CO 80203	
District Court, City and County of Denver Honorable Michael Martinez, Judge Case No. 2009CV7181	▲ COURT USE ONLY ▲
Plaintiff: GERALD ROME, Acting Securities Commissioner for the State of Colorado v. Defendants: HEI RESOURCES, INC. f/k/a HEARTLAND ENERGY, INC., CHARLES REED CAGLE, BRANDON DAVIS, HEARTLAND ENERGY DEVELOPMENT CORPORATION, BEDROCK ENERGY DEVELOPMENT, INC., JOHN SCHIFFNER, and JAMES POLLAK	Case Number: 13CA2090
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OPENING BRIEF OF *AMICUS CURIAE* NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

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CERTIFICATE OF COMPLIANCE

I hereby certify that this brief complies with all requirements of C.A.R. 28 (g) and (k) and C.A.R. 32, including all formatting requirements set forth in these rules. Specifically, the undersigned certifies that:

The brief complies with C.A.R. 28(g), because it contains only 5,774 words.

The brief complies with C.A.R. 28(k), because North American Securities Administrators Association was not the party raising the issues on appeal.

/s/ Paul L. Vorndran

I. STATEMENT OF *AMICUS CURIAE* ISSUE

Is the application of a presumption that joint venture and general partnership interests are not securities consistent with Colorado's application of an economic realities test when determining whether a transaction involves the offer or sale of a security?

II. STATEMENT OF THE CASE

The relevant background facts and procedural history are set forth in the Appellant's Brief.

III. IDENTITY OF *AMICUS CURIAE*

The North American Securities Administrators Association, Inc. ("NASAA") is the non-profit association of state, provincial, and territorial securities regulators in the United States, Canada, and Mexico. NASAA's membership includes the securities regulators in all 50 states (including the Colorado Division of Securities), the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. Formed in 1919, NASAA is the oldest international organization devoted to protecting investors from fraud and abuse in connection with the offer and sale of securities.

NASAA's U.S. members are responsible for regulating securities transactions under state securities statutes, commonly referred to as "Blue Sky"

laws. Their fundamental mission is protecting investors, and their principal activities include registering certain securities offerings; licensing the firms and agents who offer and sell securities and offer investment advice; investigating violations of applicable state securities law; and, where appropriate, pursuing enforcement actions for violations of state law. State securities regulators also educate the public about investment fraud and advocate for the adoption of strong, fair, and consistent securities laws and regulations at both the state and federal level.

NASAA supports the work of its members by coordinating multi-state enforcement actions, conducting training programs, publishing investor education materials, and presenting the views of its members in testimony before Congress on matters of securities regulation. Another core function of NASAA is to represent its membership's position, as *amicus curiae*, in significant cases involving the interpretation of securities laws and the rights of investors. NASAA has appeared as *amicus curiae* in support of the Colorado Securities Division on two prior matters before Colorado appellate courts.[1]

[1] NASAA has filed *amicus curiae* briefs in *Joseph v. Mieka Corp.*, 282 P.3d 509, 513 (Colo. App. 2012), and in *Cagle v. Mathers Family Trust*, 295 P.3d 460 (Colo. 2013). NASAA also appeared as *amicus curiae* when *Cagle v. Mather Family Trust* was before this court. *See Mathers Family Trust v. Cagle*, 297 P.3d 943 (Colo. App. 2011).

IV. INTEREST OF *AMICUS CURIAE*

NASAA is particularly interested in the instant case because investor protections in Colorado and nationwide will be severely weakened if the joint venture interests offered and sold by Respondents-Appellees are found not to be securities.[2] Fraudulent investment schemes are increasingly being organized as general partnerships and joint ventures to avoid regulation and detection by state and federal securities regulators. *See generally*, Kenneth L. MacRitchie, *General Partnership and Similar Interests as "Securities" Under Federal and State Law*, 32 Lincoln L. Rev. 29 (2004-05). A decision by this Court adopting a restrictive and inflexible approach to the definition of a security will further equip promoters and fringe financiers with a valuable tool in their efforts to evade regulatory scrutiny.

Consistent with its mission of promoting investor protection, NASAA is also particularly concerned about the potential impact the instant case will have on the rising trend of fraudulent oil and gas offerings. High-pressure marketing tactics touting the potential for great wealth associated with untapped oil and gas reserves and projections of bountiful production runs have earned oil and gas investments a

[2] The interests sold by Appellees were interests in around 100 joint ventures that were organized under Texas' general partnership laws. R. CF p. 3210, Tr. Ct. Order dated Jan. 6, 2011 at 5.

perennial spot on NASAA's list of the top ten investor traps.[3] The Securities and Exchange Commission has also warned the investing public about these risky investments.[4] Despite such efforts, oil and gas frauds continue to be a favored tool of those looking to separate investors from their hard-earned money. Given the inherently complex and speculative nature of oil and gas ventures, it is difficult for investors to distinguish between legitimate deals and fraudulent schemes.

Oil and gas scams have become increasingly common in Colorado in recent years. A review of the Colorado Division of Securities' website revealed that approximately thirty-one percent of the eighty-one Cease and Desist Orders issued by the Colorado Securities Commissioner between January 1, 2007, and December 31, 2013, were issued against oil and gas companies or companies offering investment interests in the proceeds from oil and gas operations.[5]

Colorado has a long and well-known history in the oil and gas industry.[6] As a result, Coloradans are particularly at risk of falling victim to promoters who use

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[3] NASAA Top Investor Traps, *available at* http://www.nasaa.org/3752/top-investor-traps.

[4] U.S. Securities and Exchange Commission, *Oil and Gas Scams: Common Red Flags and Steps You Can Take to Protect Yourself, available at* http://www.sec.gov/investor/alerts/ia_oilgas.pdf.

[5] Colorado Division of Securities Enforcement Actions, *available at* http://www.dora.state.co.us/securities/enforcement.htm.

[6] Colorado was the second state to commercially produce oil, beginning in 1862, and since that time has remained one of the top oil producing states. Tom Noel,

this history to their advantage. What most individuals do not understand is that oil and gas ventures are complex financial transactions that unscrupulous promoters indiscriminately push on the investing public, typically via cold-calling and high-pressure sales tactics. A strong regulatory framework is essential to protect prospective investors in such complex transactions. The registration and review process under the securities laws is a strong deterrent to unscrupulous persons who might otherwise attempt fraudulent offerings. This process provides the regulatory experts at the Colorado Division of Securities the opportunity to review offerings proactively, and take steps to stop those offerings that might be harmful to the investing public. Further, the securities regulatory regime provides important enforcement remedies to address illicit securities-related activities. In sum, the Colorado securities laws serve to strengthen the financial health of Colorado's citizens and the legitimate business community. It is, therefore, imperative that the Colorado Division of Securities maintain its ability to regulate these transactions.

Given NASAA's expertise in the regulation of securities and the significant experience offered by the regulators across the country, NASAA's participation as

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"Oil Drilling in Colorado Isn't Likely to Go Away," Denver Post, April 27, 2013, *available at* http://www.denverpost.com/ci_23116194/noel-oil-drilling-colorado-isnt-likely-go-away#.

amicus curiae will contribute to the Court's understanding of the issues and the potential nationwide impact of the Court's decision in this matter.

V. SUMMARY OF ARGUMENT

Colorado securities law jurisprudence adheres to the three-pronged *Howey* test to determine if a transaction involves the offer or sale of a security. When examining *Howey's* third prong—whether an investor expected profits to be derived from the efforts of others—Colorado rejects the *Williamson* "presumption" in favor of a fact-based, "economic realities" approach. Colorado courts have not adopted the rigid so-called *Williamson* "presumption" that a joint venture or general partnership interest is not a security, and instead have used components of *Williamson* as a guide when examining the economic realities of transactions. In fact, a careful reading of *Williamson* reveals that it never established an evidentiary presumption, and to the extent that other state and federal courts have interpreted their own jurisdictions' laws in such a way, those decisions are not controlling in Colorado and are at odds with Colorado precedent and statute. Moreover, because the *Williamson* "presumption" fails to examine economic realities of transactions it is unnecessary, outdated, and facilitates fraud.

Even if the *Williamson* "presumption" were applicable in Colorado, the trial court erred by adopting the Ninth Circuit's approach when it looked to the

investors' general business experience when examining *Williamson's* second factor. The Fifth Circuit's approach that looks to investors' knowledge and experience in the business of the venture when examining *Williamson's* second factor is more consistent with the original holding in *Williamson*, the Supreme Court's decision in *Howey*, and Colorado's economic realities test.

VI. ARGUMENT

A. Colorado Jurisprudence Rejects the *Williamson* Presumption in Favor of a Fact-Based Economic Realities Analysis.

1. Colorado Looks to the Economic Realities of a Transaction when Determining whether a Security Exists.

The instant case involves a controversy over whether the joint venture interests, organized as general partnerships, sold by the Appellees are "securities" under the Colorado Securities Act. The term securities is defined broadly in C.R.S. § 11-51-201(17), though general partnerships and joint ventures, *per se*, are not included in that definition. *Joseph v. Mieka Corp.*, 282 P.3d 509, 513 (Colo. App. 2012). Rather, a general partnership or joint venture interest, is a "security" pursuant to C.R.S. §11-51-201(17) if it is an "investment contract." *Joseph v. Viatica Mgmt., LLC*, 55 P.3d 264, 266 (Colo. App. 2002).

In Colorado, "[w]hether a particular transaction involves a security depends on the substantive economic realities underlying the transaction, not on the nature

or the form of the instrument." *Mieka*, 282 P.3d at 513 (citing *Viatica*, 55 P.3d at 266.). To determine whether an interest in an enterprise is an "investment contract," Colorado follows the test articulated by the Supreme Court in *SEC v. WJ Howey Co.*, 328 U.S. 293 (1946). *Lowery v. Ford Hill Inv. Co.*, 192, Colo. 125, 130, 556 P.2d 1201, 1205 (Colo. 1976). In *Howey*, the Supreme Court determined that "an investment contract for purposes of the Securities Act means [1] a contract, transaction or scheme whereby a person invests his money [2] in a common enterprise and [3] is led to expect profits solely from the efforts of the promoter or a third party . . .." *SEC v. WJ Howey Co.*, 328 U.S. at 298-99. The Supreme Court further described its test as "a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits," *id*. at 299, making it consistent with Colorado's economic realities analysis. Specifically, at issue in the instant case is whether the joint venture interests sold by the Appellees satisfy *Howey's* third element, as no dispute exists as to whether an investment of money was made in a common enterprise. R. CF at p. 3208, Tr. Ct. Order dated Jan. 6, 2011 at 3.

When examining the third prong in *Howey*, Colorado courts look to the commercial or economic realities of a transaction. *Toothman v. Freeborn & Peters*,

80 P.3d 804, 811 (Colo. App. 2002). The federal case most relied upon in determining if general partnership or joint venture interests satisfy the third *Howey* prong—making such interests securities—is *Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981). In *Williamson*, the Fifth Circuit reversed a district court's dismissal of a case for want of subject matter jurisdiction, overturning the lower court's decision that the joint venture interests at issue were not securities. *Id*. at 417. The Fifth Circuit went to considerable lengths to describe the ways in which general partnership or joint venture interests can meet the definition of a security.

The Fifth Circuit began its analysis with *Howey*, as the plaintiffs asserted their joint venture interests were investment contracts, and concluded that the determination of whether the interests where investment contracts, and thus securities, hinged on *Howey's* third prong—the "expectation of 'profits solely from the effort of (others)'" prong. *Id* at 418. In examining *Howey's* third prong, the Court first reviewed the typical powers that are exercised by general partners. *Id*. at 422-23. The court observed that a traditional general partnership interest is not usually a security because the partners are active in the management of the business and do not rely upon the efforts of others for their profits. *Id*. According to the court, when a general partner retains "substantial control" over the investment and is in a position to protect his or her own interests, the partner "has a

difficult burden to overcome" to establish that the general partnership interest is an investment contract, and thus a security. *Id.* at 424.

The Fifth Circuit's mention of a "difficult burden" has given rise to the misleading notion of a *Williamson* "presumption." Other courts have used that phrase, but nowhere in the original decision did the *Williamson* court use the term presumption or discuss a requisite evidentiary burden. In the absence of specificity as to the extent of this "difficult burden," courts have construed it differently resulting in a "presumption" with varying levels of strength. *See generally*, MacRitchie, *supra*. .

Following its conclusion that general partnership interests are not typically securities because the partners are generally in a position to protect themselves and are not reliant on the efforts of others for profit, the *Williamson* court articulated its true test: "an investor must demonstrate that, in spite of the partnership form which the investment took, he was so dependent on the promoter or on a third party that he was in fact unable to exercise meaningful partnership powers." *Williamson*, 645 F.2d at 424. The court then provided, by way of example, a list of three non-exhaustive factual scenarios that would satisfy its test and establish that a general partnership interest is a security:

> (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes

> power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.

Id. While noting that these were the only relevant factors in the *Williamson* case, the court pointed out that other factors could also "give rise to such a dependence on the promoter or manager that the exercise of partnership powers would be effectively precluded," *id*. at n.15, further indicating that the three listed factors were non-exhaustive.

While the *Williamson* court intended its test to be one based on the economic realities of the transactions being examined, in practice, courts have misapplied *Williamson's* true test, instead applying a "presumption" that shifts the burden to the party attempting to establish the existence of a security, requiring the affirmative proof of one of the three factors articulated in *Williamson*. This misapplication of *Williamson* leads courts to focus on the form of a transaction, not its economic realities, which is the focus required by Colorado law and the approach adopted by the U.S. Supreme Court. *See United Housing Found., Inc. v. Forman*, 421 U.S. 837, 848 (1975) ("[W]e adhere to the basic principle that . . . '(i)n searching for the meaning and scope of the word security in the Act(s), form

should be disregarded for substance and the emphasis should be on economic reality.'" (quoting *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967))).

2. The *Williamson* "Presumption" Conflicts with Colorado Jurisprudence.

The trial court's application of the *Williamson* "presumption" is contrary to Colorado law. No Colorado appellate courts have adopted the *Williamson* "presumption" or construed *Williamson* to shift the burden of proof that is required to demonstrate that a general partnership interest is an investment contract.[7] *Mieka*, 282 p.3d at 514. By refusing to adopt the *Williamson* "presumption," Colorado courts have stayed true to the flexible substance over form analysis required by the Colorado Securities Act and the U.S. Supreme Court. *See Griffin v. Jackson*, 759 P.2d 839, 842 (Colo. App. 1988) ("The statutory definition of a 'security' is intended to provide the flexibility needed to regulate various schemes devised by those who seek the use of money of others with the lure of profits. Because the Securities Act is remedial in purpose and designed to protect the public from speculative or fraudulent schemes, we apply a broad definition to the

[7] The court in *Toothman*, in examining whether a limited liability partnership was a security, stated "an interest in a general partnership is presumed not to be an investment contract." *Toothman*, 80 P.3d at 811. However, as was pointed out in *Mieka*, "the *Toothman* division did not expressly rule on the applicability of the *Williamson* presumption" *Mieka*, 282 P.3d at 514, and cannot be relied upon for the application of the *Williamson* presumption in Colorado.

term 'security.'" (citation omitted)); *see also United Housing Found., Inc.*, 421 U.S. at 848 ("Because securities transactions are economic in character Congress intended the application of [the Federal Securities] statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto.").

Colorado courts have used the *Williamson* analysis simply as a guide for identifying relevant facts in examining the economic realities of a transaction to determine whether an investor in a joint venture or general partnership relied upon the efforts of others for the success of the enterprise. *Feigin v. Digital Interactive Assoc., Inc.*, 987 P.2d 876, 881-82 (Colo.App. 1999); *Toothman*, 80 P.3d at 811-12 (Colo. App. 2002); *People v. Pahl*, 169 P.3d 169 (Colo. App. 2006); *People v. Robb*, 215 P.3d 1253, 1261 (Colo. App. 2009); *Mieka*, 282 P.3d 509 at 514. The trial court below did not simply look to *Williamson* for guidance as other Colorado courts have—it adopted fully the *Williamson* "presumption." In doing so, the trial court abandoned the well-established economic realities test applied in Colorado, and its decision should therefore be reversed.

3. The *Williamson* "Presumption" Conflicts with the Principle that the Colorado Securities Act is to be Construed Broadly to Effectuate its Purposes.

This Court has consistently recognized that "[w]hether a particular transaction involves a security depends not on the name or the form of the

instrument, but on the substantive economic realities underlying the transaction." *Viatica* 55 P.3d at 266 (citing *Griffin*, 759 P.2d at 839; *see also Robb*, 215 P.3d at 1261. The *Williamson* "presumption" prioritizes form over substance by placing the emphasis on the label used to describe the investment while discounting the true structure of the scheme. The more appropriate analysis should be driven by the factual reality of the investment and not its moniker. Placing substance over form is essential to keep up with rapid developments in both legitimate and fraudulent product innovations in our securities markets. Therefore, NASAA strongly urges this Court to reject the *Williamson* "presumption" as being inconsistent with its prior holdings that value substance over form.

In addition, the Colorado Securities Act expressly states that it "is to be construed broadly to effectuate its purposes." C.R.S. § 11-51-101(2). Those purposes are stated explicitly: to (1) "protect investors"; (2) "maintain public confidence in the securities markets"; and (3) avoid "unreasonable burdens on participants in capital markets." *Id*. It is imperative that the stated purposes of the Act are not relegated to the status of mere slogans.

Protecting Investors

The first purpose of the Colorado Securities Act is to "protect investors." As the agency in charge of enforcing the Colorado Securities Act, the Colorado

Division of Securities can only protect investors from fraudulent offerings in financial products that fall under the Act. By incorporating an unjustifiably rigid definition of an investment contract security, the *Williamson* "presumption" allows promoters to remove an offering from the purview of the Act by superficially labeling it a general partnership or joint venture, thereby preventing the Colorado Division of Securities from doing its job of protecting investors.

Maintaining Public Confidence in the Markets

The second purpose of the Colorado Securities Act is "maintaining public confidence in the securities markets." Confidence in the securities markets requires a robust system of regulation in order to deter, punish, and prevent fraud. As discussed above, the *Williamson* "presumption" allows those seeking to perpetrate a fraud on the public to avoid regulation at the outset by organizing as a general partnership or joint venture. Thus, potential fraudsters have the opportunity to solicit the money and run before the Colorado Division of Securities can impose any regulatory protection. When investors are defrauded, the public loses confidence in the securities markets.

Avoiding Unreasonable Burdens on Market Participants

The third purpose of the Colorado Securities Act is to avoid "unreasonable burdens on participants in capital markets." Requiring general partnerships to

meet the standards of a bona fide general partnership is hardly an unreasonable burden, especially when balanced with the increased level of investor protection gained by rejecting the *Williamson* "presumption." The fact-based approach inherent in prevailing case law is sufficient to meet the needs of businesses, while being vastly superior at "protecting investors" and "maintaining public confidence in the securities markets."

Therefore, consistent with the three goals set forth in C.R.S. § 11–51–101(2), NASAA urges that this Court reverse the trial court's use of the narrow *Williamson* "presumption."

4. The *Williamson* "Presumption" is Unnecessary and Outdated.

Today, *Williamson* provides a useful analytical framework that assists a fact-finder in determining whether a general partner expected profits that were to be derived from the significant efforts of someone else, but an evidentiary presumption is simply not needed. While it may have made sense for courts to interpret *Williamson* as creating a rebuttable evidentiary presumption when the case was originally decided, subsequent developments in partnership law have negated its utility. J. William Callison, *Changed Circumstances: Eliminating the Williamson Presumption that General Partnership Interests are not Securities*, 58 Bus. Law 1373, 1384 (2003).

Callison explained the utility of rebuttable presumptions as follows:

> Rebuttable presumptions, such as a presumption that general partnership interests are not securities, are intended to promote results that conform the probable connection of a basic fact (i.e., the issuance of a general partnership interest) with a presumed fact (i.e., the interest is not a security). On this analysis, the *Williamson* presumption should be reevaluated when it is no longer highly probable, due to changes in partnership law or otherwise, that general partnership interests are not securities.

Id. at 1381 (citations omitted). There have been significant changes to partnership law since the *Williamson* decision was rendered, making a re-examination of the *Williamson* "presumption" apt. For example, general partnerships can now elect to be treated as limited liability partnerships, and the resulting limitation of liability decreases the incentive for partners to be actively engaged in the management of the business. *Id*. at 1382. Additionally, state-by-state variations in partnership law now permit the modification or elimination of important agency and management attributes. *Id.* In light of these significant changes in partnership law, which have resulted in a framework where partnership members have less incentive to actively participate, Callison convincingly argues that the *Williamson* "presumption" "should be abandoned in favor of a more pragmatic, fact-based approach." *Id.* at 1381.

5. The *Williamson* "Presumption" Facilitates Fraud.

The *Williamson* "presumption" that a general partnership is not a security allows unscrupulous promoters of fraudulent offerings to evade securities regulators. For securities regulators, disclosure is key—for potential investors and regulators alike. In jurisdictions that recognize this "presumption," it gives those looking to defraud investors the ability to avoid the securities regulators by depriving regulators of the opportunity to review offerings *before* investors commit their capital. MacRitchie, *supra*, at 79. This evasion of regulatory review can be disastrous for investors because investor funds are often long gone by the time the fraud is discovered.

By the early 1990s, Colorado fraudsters discovered the utility of establishing fraudulent tech industry investments as general partnerships, joint ventures, LLCs, or LLPs. In a series of notable cases, Coloradans were robbed of the essential protection of initial review by the Colorado Division of Securities because the offerings claimed not to be securities by virtue of being general partnerships, LLCs, or LLPs. *See State of Colorado v. Riggle,* No. 95CA1476 (Colo. App. 1998) (offering of partnership units in a wireless cable system); *Feigin v. Digital Interactive Assoc.s, Inc.,* 987 P.2d 876 (Colo. App. 1999) (involving the sale of general partnership interests in IVDS Interactive Acquisition Partners, a company

formed to participate in an auction to be conducted by the Federal Communications Commission at which licenses to operate interactive video and data services were to be sold); *Toothman*, 80 P.3d at 807 (involving 53 LLPs established to sell prepaid cellular telephone services). Although none of these cases expressly adopted the *Williamson* "presumption," the lack of clarity encouraged future fraudsters to adopt similar strategies. MacRitchie, *supra*, at 56-57, 78.

Investments in oil and gas partnerships remain particularly susceptible to such frauds. Gas prices remain high and new forms of energy exploration have made investors susceptible to get-rich-quick schemes, especially those with little experience in energy exploration. In addition to the instant case, the Colorado Division of Securities has brought several actions alleging violations of the state's securities laws in other oil and gas matters involving the use of general partnership and joint venture interests. *See, e.g.*, *Millennium Exploration Co., LLC and Richard Monroy*, Case No. XY 13–CD–01 (Consent Order entered upon allegations of failure to register oil and gas joint ventures); *In the Matter of Pathfinder Res., LLC and Anthony L. Martin*, No. XY 08-CD-03 (Verified Petition to Show Cause and Consent Cease and Desist Order, alleging violations of Colorado securities registration and anti-fraud statutes for offering joint venture

interests in an oil venture); *In the Matter of Legacy Capital Energy Group, LLC,* No. XY 09-CD-01 (finding violations of registration and anti-fraud statutes in connection with a "cold call" offering of joint venture interests in an oil and gas lease).

Although no Colorado appellate court has expressly adopted the *Williamson* "presumption," other courts' tolerance of the *Williamson* "presumption" has created a hazard wherein "defendants reckon[] that they might get away with fraud if they establish[] their offerings as general partnerships, LLCs, or LLPs." MacRitchie, *supra,* at 78. Accordingly, commenters have argued that the *Williamson* "presumption" should be discarded in favor of a more fact-based approach. *See id*. at 84; *see also* Callison, *supra*, at 1376.

Those seeking to defraud investors are constantly adapting their methods to circumvent regulations designed to protect investors. Although the hot investment product may change as the economy takes a new direction, fraudsters continue to confuse even the most highly-educated investors with increasingly complex offerings, and they continue to seek out and find potential loopholes to avoid detection by regulators. For the Colorado Division of Securities to stay one step ahead of these frauds, Colorado securities law needs to be as flexible as the fraudulent schemes. Thus, NASAA urges this Court to expressly reject the

Williamson "presumption" and reverse the trial court, as the "presumption" creates the perfect roadmap for those looking for a clear path to a successful scam.

Moreover, investors in joint ventures and general partnerships face additional potential harm in the form of the nearly unlimited liability they face as a general partner in a joint venture. *See* Unif. P'ship Act § 306 (1997). Due to the particularly complex nature of oil and gas ventures like those sold in this case, investors are subject to significant potential liability, and unscrupulous promoters have little incentive to ensure investors are informed of this risk. By organizing their ventures as general partnerships and claiming they are not securities, promoters not only deprive investors of the protections of the securities laws, but expose them to unknown liability—a fact that would be disclosed to investors if such transactions were registered as securities.

B. The Trial Court Erred in Applying the *Williamson* "Presumption's" Second Factor.

While the trial court erred in applying the *Williamson* "presumption" instead of Colorado's economic realities test, the trial court erred further by misapplying the *Williamson* "presumption's" second factor.[8] To rebut the *Williamson*

[8] The first and third factors used to overcome the *Williamson* "presumption" were eliminated by the trial court upon summary judgment. R. CF at p. 3207, Tr. Ct. Order dated Jan. 6, 2011 at 2. While NASAA believes those determinations were

"presumption" that general partnerships are not securities, courts applying the "presumption" have required parties to satisfy one of three factors. At issue in the instant case is the second factor, which states that a general partnership is a security if "the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers." *Williamson,* 645 F.2d at 424.

In applying the *Williamson* "presumption's" second factor the trial court stated, "a partner in a general partnership must have experience and knowledge in business affairs *generally*, and a partner is not required to have industry specific knowledge in order to preclude a finding that a joint venture interest is a security." R. CF p. 8089, Tr. Ct. Order dated Oct. 13, 2013 at 29 (emphasis in original). In adopting the general business knowledge or experience standard, the trial court cited "overwhelming federal authority." *Id.* The federal authority on this issue is split, however. While the trial court primarily points to cases from the Ninth Circuit, *id*. (citing *Deutsch Energy Co. v. Mazur*, 813 F.2d 1567, 1568 (9th Cir. 1987); *Holden v. Hagopian*, 978 F.2d 115, 1121 (9th Cir. 1992); *Koch v. Hankins*,

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made in error, such arguments are outside the scope of NASAA's role as *amicus curiae* and are better left to the parties to argue in their merit briefs.

928 F.2d 1471, 1479 (9th Cir. 1991)), the Fifth Circuit—the Court that decided *Williamson*—takes a different approach.[9]

In *Long v. Schultz Cattle Co.*, 881 F.2d 129 (5th Cir. 1989), the Fifth Circuit reiterated that *Williamson's* roots lie in *Howey's* third prong. *Id*. at 133. The court went on to describe *Williamson*:

> In *Williamson* [] we held that an investor's formal power to make managerial decisions did not automatically preclude a finding that the investor relied solely on the efforts of others. Rather, consistent with the principle that substance must govern over form, we held that even where an investor formally possesses substantial powers, the third prong of the *Howey* test may be met if the investor demonstrates that he "is so inexperienced and unknowledgeable" *in the field of business at issue* that he "is incapable of intelligently exercising" the rights he formally possessed under the agreement.

Id. at 133-34 (citations omitted) (emphasis added). The Fifth Circuit acknowledged that "the test stated in *Williamson* . . . refers to the investor's experience in 'business affairs,' without referring to specialized knowledge." *Id*. at 134 n.3. However, according to the *Long* court, "our analysis in *Williamson* [] clearly requires that the investors' knowledge and experience be evaluated with

[9] The Tenth Circuit, on February 24, 2014, also adopted the Fifth Circuit's approach. *See SEC v. Shields*, No. 12-1438, 2014 WL 685369, at *10 (10th Cir. Feb. 24, 2014) ("The experience and knowledge referred to in *Williamson* "focus[es] on the experience of investors in the particular business, not the general business experience of the partners." This is so because "[r]egardless of investors' general business expertise, where they are inexperienced in a particular business, they are likely to be relying solely on the efforts of the promoters to obtain their profits."" (internal citations omitted)).

reference to the nature of the underlying venture. Moreover . . . any holding to the contrary would be inconsistent with *Howey*." *Id*. As the court in *Long* correctly pointed out, "*Howey* itself establishe[d] that an investor's generalized business experience does not preclude a finding that the investor lacked the knowledge or ability to exercise meaningful control of the venture." *Id*. at 134-35. While the Supreme Court noted the investors in *Howey* were knowledgeable in general business affairs, the Supreme Court emphasized that the investors did not have the experience or capabilities to successfully farm orange groves—the specific venture in which they invested. *Long*, 881 F.2d at 135 (citing *Howey*, 328 U.S. at 296). Just as the Supreme Court focused on the investors' ability to operate citrus groves in *Howey*, the Fifth Circuit focused on "the partners' prior experience with similar real estate ventures" in *Williamson. Long*, 881 F.2d at 134 n.3. The trial court below, so too, should have focused on the investors' knowledge and experience in the operation of oil wells.

The Fifth Circuit's "knowledge or experience in the venture" approach, as persuasively articulated in *Long*, can be traced directly back to the Supreme Court's original analysis in *Howey*—the ultimate test used in Colorado to determine the existence of a security. *Lowery*, 556 P.2d at 1205. Because the Fifth Circuit's approach traces its lineage directly from *Howey*, a number of states have

adopted its approach instead of the Ninth Circuit's approach. *See, e.g. Consol. Mgmt. Grp., LLC v. Dep't Corps.*, 75 Cal. Rptr. 3d 795, 807 (Cal. Ct. App. 2008) (adopting the Fifth Circuit approach, stating that the standard is in line with *Howey*, the purpose of the securities laws, and addresses the fact that general business experience might not allow an investor to manage a specific investment); *Nutek Info Sys., Inc. v. Ariz. Corp. Comm'n*, 977 P.2d 826, 832 (Ariz. Ct. App. 1998) (expressly adopting the Fifth Circuit's approach requiring that investors have knowledge of the specific business in which they are investing); *Corp. East Assocs. v. Meester*, 442 N.W.2d 105, 108 (Iowa 1989) (linking the defendant's past real estate, not general, investment experience to *Williamson's* second factor).

Even more persuasive is this Court's observation regarding *Williamson's* second factor. In *Mieka*, this Court commented that *Williamson's* second factor referred to "the level of experience and knowledge of the partners *in the partnership's business affairs*." *Mieka*, 282 P.3d at 514 (emphasis added). The trial court below failed to even acknowledge, let alone distinguish, this Court's description of *Williamson's* second factor, instead relying on federal authority as the basis of its ruling. R. CF p. 8088-90, Tr. Ct. Order dated Oct. 13, 2013 at 28-30. The trial court should have taken heed of this Court's view of *Williamson's* second factor and not doing so was error.

The trial court's reliance on the Ninth Circuit case law looking only to the investors' general business experience and knowledge is misplaced and fails to comport with Colorado's economic realities approach to analyzing transactions that may involve the offer or sale of a security. The approach more in line with Colorado's jurisprudence is that of the Fifth Circuit, which requires investors to have experience in the business of the partnership in which they invest—something this Court has described *Williamson's* second factor as requiring. The trial court erred by only considering the general business experience of the investors' and not their relevant and meaningful knowledge and experience in the business of the partnership. The decision should be reversed.

VII. CONCLUSION

For the reasons stated above, NASAA respectfully requests that this Court reverse the trial court's decision and remand the case for further consideration consistent with Colorado's economic realities approach.

Respectfully submitted this 14th day of April, 2014.

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