

STATEMENT OF POLICY

WHEN ARE "NOTES" SECURITIES UNDER THE NEW HAMPSHIRE UNIFORM SECURITIES ACT

INTRODUCTION

The collapse of Financial Resource Mortgage, Inc. ("FRM") has raised questions as to when "notes" are to be considered securities under the New Hampshire Uniform Securities Act. The collapse of FRM has resulted in a number of investigations and reports. The first FRM Report was issued by the Securities Bureau in April 2010.

At the time of the Bureau's Report, the Attorney General was concluding his FRM investigation. Subsequent to the Bureau's Report, the Attorney General issued his report questioning the Bureau's conclusion that the *second group* of FRM notes were not securities.¹ The Attorney General subsequently issued a second supplemental

¹The first group of FRM securities involved the sale by FRM of preferred stock and *unsecured* promissory notes, issued roughly in the period from 2000 until 2004. Based upon an earlier case, *In re Flexible Mortgage*, Order No. IVT 95-027 (N.H. Bur. Sec., June 1995 and Sept. 13, 1996), where the Bureau had held that similar *unsecured* promissory notes were securities, the Bureau Staff determined that the FRM interests were securities and petitioned the Director of the Bureau to take action against Scott D. Farah and FRM. Staff Petition for Relief, Case No. IVT 00-007 (Nov. 5, 2001). The Director granted the Staff Petition and set the case down for an Adjudicatory Hearing. Notice of Order, Case No. IVT 00-007 (Nov. 8, 2001).

Because of more than 10 postponements, most at the request of Farah and FRM, the hearing did not get underway until 2003. At this point, it became clear to the hearing officer that the instruments sold by FRM were securities and were not registered or exempt. Therefore, the Bureau Staff was entitled to have the transaction rescinded as requested in its Petition.

However, the hearing officer realized that if he ordered rescission and the return of 100% of the investors' purchase price immediately upon entry of his order, that the company would fail, go into bankruptcy, and be liquidated. And, as a result, the investors would lose almost all their investment.

The Bureau entered into an informal settlement agreement with FRM. Under

report. The Banking Department also filed a report.

Through the summer and early fall of 2010, a Joint Legislative Committee held an investigation into the FRM matter and issued a proposed Report. The Bureau and its former Director Mark Connolly, filed objections to the Joint Committee's Proposed Report.

Because the Bureau was dissatisfied by the previous investigations, the Bureau decided to conduct its own public investigatory hearing, as authorized by Section 421-B:22(l)(a). In preparation for this investigatory hearing, the Bureau has learned that the treatment of promissory notes, especially those coupled with a real or chattel mortgage, has become a national problem because of the increasing number of these notes being offered and sold to the general public in what is known as "person to person" lending.²

the 2003 informal settlement agreement, FRM was obligated to return 100% of the investors' purchase price, but would do so, over a period of time. As long as FRM was performing on its refund obligations, the hearing was suspended, but the temporary informal settlement agreement would remain in place. If FRM did not make good on its promises, the informal agreement would be terminated and the case would proceed to judgment. However, by 2007, FRM had fulfilled its obligation to return each and every investor's investment under the 2003 informal agreement. Therefore, a permanent cease and desist order by stipulation, was entered. Because the Final Order was entered into by settlement, the hearing officer did not enter either findings of fact or conclusions of law. Upon the execution of the final settlement, the case was closed.

²In "person to person" lending, a broker-dealer locates a person needing money and who may be willing to issue a secured promissory note to get the loan. The broker-dealer then finds individual investors willing to loan money. The broker-dealer then matches the borrower with the investor.

In some cases, multiple investors will be given interests in a single note and mortgage. In such cases, for ease of administration, the mortgage will be placed in trust. This transaction is similar to a "loan participation" commonly used in commercial financial transactions. As will be seen below, under federal law, these transactions are *not* considered to involve the sale of a security, either under the category of a promissory note or under the category of an investment contract.

Because of the growing national problem, as well as the confusion by both the Attorney General and Joint Committee over how the second FRM instruments should be treated *under present law and*, to support its investigatory hearing, the Bureau believes it is appropriate for it to outline its *official* position as to the coverage of promissory notes under the New Hampshire Securities Act.

A “security” is a defined term under the Securities Act. See Section 421-B:2(XX)(a). The term “notes” is included in this statutory definition. However, the statutory definition is of limited use in solving the issue of what notes are to be considered “securities.” It is nothing more than a laundry list of items to be considered to be securities. No further definition of “notes” is found in the Securities Act. Further, no guidance can be obtained from Rules or Regulations under the Act as there are no such Rules or Regulations.

Likewise, the Bureau has no guidance on this issue from the New Hampshire courts because the Bureau has found no reported decision of the state courts discussing coverage of promissory notes.³ Since there is no guidance from the Legislature or the Courts on coverage of promissory notes under the Securities Act,⁴ the

In other cases, the investor may be sold an interest in a pool of mortgages. In this case, the mortgages are placed in a trust. As a result, the investor technically receives an interest in the trust. See *e.g.*, *In re Hoss Mortg. Investors, Inc.*, 2010 WL 4371351 (Wash. Sec. Div. Sept. 21, 2010).

³There is one federal court decision, *Manchester Bank v. Connecticut Bank & Trust Co.*, 497 F.Supp. 1304 (D.N.H. 1980), which provides some guidance on the coverage of promissory notes. This decision is discussed in detail below.

⁴Because of both the exclusivity provision discussed in the next note and the administrative gloss doctrine, the Attorney General has no authority to second guess the Bureau’s interpretation of the Act. N.H. AG Op. No. 09-01, 2009 WL 2702827 (July 20, 2009).

Bureau, as the agency charged with the enforcement of the Act, must make this important determination.⁵

In doing so, the Bureau fully recognizes the power of the Legislature to overrule the Bureau's interpretation *prospectively by statutory change*. Likewise, since the Bureau elected to promulgate its position by the Statement of Policy, rather than the more formal rulemaking process, the New Hampshire courts retain their full power to overrule the Bureau's interpretation. The court's review, as a result, would be *de novo*.⁶ See *e.g.*, *In re Parker*, 158 N.H. 499, 969 A.2d 322 (2009).

This Statement of Policy outlines the Bureau's position as to whether unsecured promissory notes are securities under the New Hampshire Securities Act. Second, it deals with the special issues as to the treatment of promissory notes coupled with a whole, real or chattel mortgage.

I. THE BUREAU'S POSITION IS THAT ALL UNSECURED PROMISSORY NOTES ARE SECURITIES

The Bureau takes the position that *all unsecured promissory notes are securities*. In reaching this conclusion, the Bureau specifically *rejects* the analysis of the United

⁵Section 421-B:21(I)(a) provides the Bureau with exclusive authority and jurisdiction over securities professionals. Further, Section 421-B:21(II) provides that the Bureau, as the designee of the Secretary of State, "shall have all powers specifically granted and reasonably implied in order to perform the substantive responsibilities imposed under this title." Finally, Section 421-B:28(I)(d) allows the Bureau to make rules defining terms.

⁶However, had the rulemaking process been used, court review would be limited to determining whether the Bureau had authority to adopt the Rule. See *e.g.*, *Rich v. Powell*, 130 N.H. 455, 544 A.2d 29 (1988), and *Opinion of the Justices*, 121 N.H. 552, 431 A.2d 783 (1981). Once adopted, the Rule becomes part of the statute unless the Bureau lacks authority to adopt the Rule or the Rule exceeds the Bureau's rulemaking authority. See *e.g.*, *Appeal of Marion Anderson*, 147 N.H. 181, 784 A.2d 1205 (2001).

States Supreme Court in *Reves v. Ernst & Young*, 494 U.S. 56, 110 S.Ct. 945 (1990). The family-resemblance test, adopted by the *Reves* case, as a result of this Statement of Policy, *is not the law under the New Hampshire Securities Act. The Bureau elects to reject the Reves family-resemblance test for the more traditional approach that all promissory notes are securities because of the statutory definition. If further analysis is necessary, the Bureau will use the Howey test⁷ for investment contracts,⁸ which it believes is the proper definition for all securities.⁹*

A. The *Reves* Analysis

The *Reves* court started with the presumption that all promissory notes were securities based upon the language of the statutory definition. It then held that this presumption was rebuttable and could be overcome. However, it then held that the presumption had been overcome in seven discreet categories of transactions involving promissory notes. As a result, the notes in these transactions were *per se* not securities

⁷See e.g., *Memo to Brian Tierney (N.H. Attorney General's Office) From N.H. Bureau of Securities, In re Flexible Mortgage Corporation*, dated March 1996. An investment contract is one where the investor invests money or moneys' worth in a common enterprise with the expectation of receiving a profit on his investment where the profit is created by the managerial efforts of the promoter or some third party.

⁸See e.g., *SEC v. Novus Techn., LLC*, 2010 WL 4180550 (D.Utah Oct. 20, 2010); *SEC v. Cross Fin. Servs., Inc.*, 908 F.Supp. 718, 726 (C.D.Cal. 1995). Interestingly enough, even though the Bureau has rejected the *Reves* test, both state and federal courts have reached the same conclusion under *Reves* that unsecured promissory notes are securities. In *Reves* itself, the Court held that the unsecured notes involved were securities. See also, *Grotjohn Precise Connexiones Intern'l., S.A. v. JEM Fin., Inc.*, 12 S.W.3d 859 (Tex. Civ. App., Texarkana 2000); *Caucus Dist., Inc. v. State, Dept. of Commerce & Econ. Dev., Div. of Banking, Securities, & Corp.*, 793 P.2d 1048 (Alas. 1990); *Caucus Dist., Inc. v. Maryland Sec. Comm'r.*, 320 Md. 313, 577 A.2d 783 (1990).

⁹See e.g., *American Fletcher Mortg. Co., Inc. v. U.S. Steel Credit Corp.*, 635 F.2d 1247 (7th Cir. 1980).

for federal purposes.

The seven categories are:

- (1) Notes delivered in consumer financing;
- (2) Notes secured by a mortgage on a home;
- (3) Short-term notes secured by a lien on a small business or some of its assets;
- (4) Notes evidencing a "character" loan to a bank customer;
- (5) Short-term notes secured by an assignment of accounts receivable;
- (6) Notes which simply formalize an open-account debt incurred in the ordinary course of business; and
- (7) Notes evidencing loans by commercial banks.

This list was largely drawn from *Exchange Nat'l. Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976). However, neither *Exchange Bank* nor *Reves* gave any explanation as to why these promissory notes should be excluded. Both courts simply established the categories by judicial fiat, and *assumed* that this conclusion was self-evident. The *Reves* Court then developed a four-part test¹⁰ to identify other promissory notes which have a "strong-family resemblance" to the seven

¹⁰These four factors are:

- (1) The motivations that would prompt a reasonable seller and buyer to enter into [the transaction];
- (2) The "plan of distribution" of the instrument;
- (3) The reasonable expectation of the parties that the securities act would apply to the transaction; and
- (4) Whether the transaction is subject to regulation under another regulatory statute, so that coverage under the securities act is not required.

identified types of notes so that the additional notes would also be classified as *not being securities per se*. This same four-part test was to be used in identifying additional categories of notes to be placed on the *per se* list of non-securities. The Bureau specifically rejects all three of these *Reves* holdings.

B. Legal Basis For The Bureau's Rejection Of The Family Resemblance Test

There is ample authority and public policy reasons for the Bureau's rejection of the three *Reves holdings*. First, it must be remembered that the decisions of the United States Supreme Court, construing language of the federal securities act, while persuasive, *are not binding on state agencies and courts when construing similar language in the state securities acts.*¹¹ See e.g., *Hoffer v. State*, 113 Wash.2d 148, 776 P.2d 963 (1989), citing with approval, *Haberman v. WPPSS*, 109 Wash.2d 107, 744 P.2d 1032 (1987) and *State ex rel. Mays v. Ridenhour*, 248 Kan. 919, 811 P.2d 1220 (1991),¹² both rejecting the federal *Pinter v. Dahl*¹³ test for seller in favor of the broader substantial factor test. In rejecting the Supreme Court's *Pinter* test, both courts pointed out that the focus of the federal securities acts is different than that of the state securities acts. The federal acts are aimed primarily at regulation of an orderly

¹¹While not considering the issue in the context of federal and New Hampshire Securities Act, the New Hampshire Supreme Court, in other settings, has made clear that federal decisions, including those of the United States Supreme Court, construing the text of a federal statute, does not control the interpretation of similar language in a state statute. See e.g., *Hill-Grant Living Trust v. Kearsarge Lighting Precinct*, 159 N.H. 529, 986 A.2d 662 (2009) and *Zola v. Kelley*, 149 N.H. 648, 826 A.2d 589 (2003).

¹²See also, *Roehrs v. FSI Holdings, Inc.*, 246 S.W.3d 796 (Tex.App.-Dallas, 2008); *State v. Montgomery*, 135 Idaho 348, 17 P.3d 292 (2001); and *O'Malley v. Boris*, 1999 WL 39548 (Del.Ch. Jan. 19, 1999).

¹³486 U.S. 622, 108 S.Ct. 2063 (1988).

securities market,¹⁴ and, in recent years, the raising of capital. To the contrary, the sole focus of the state securities laws has *always* been to protect investors. Thus, in *Ridenhour*, the court noted:

[T]he legislative intent and purpose for enacting the Kansas Securities Act was to place the traffic of promoting and dealing in speculative securities under rigid governmental regulation and control to protect investors and to prevent, to the extent possible, the sale of fraudulent or worthless speculative securities.

248 Kan. at 934, 248 P.2d at 1230.

The *Ridenhour* court then went on to state:

Therefore, although the same terms are used in the federal and state statutes..., the basic framework in which the statutes are formulated shows a different approach should be employed.

Id.

Second, the different focus between the federal and state securities acts suggest that the adoption of the *Reves* test is inappropriate. As the *Ridenhour* court noted, the sole focus of the state securities acts is the protection of investors. This goal can only be reached by giving the Act and the definition of a security a broad interpretation. See *e.g.*, *Perrysburg Township v. City of Rossford*, 103 Ohio St.3d 79, 82, 814 N.E.2d 44, 49 (2004).

Third, the treatment of *secured* promissory notes differs substantially under the state Uniform Securities Acts from that under the federal Securities Act of 1933. Under the *Reves* test, promissory notes, coupled with a home mortgage, a mortgage arising out of a consumer transaction, or a mortgage arising out of a commercial transaction,

¹⁴*Reves v. Ernst & Young*, 494 U.S. 56, 60, 110 S.Ct. 945, 949 (1990), quoting with approval *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 849, 95 S.Ct. 2051,

are all *per se not securities*. Yet, all three Uniform Acts have transactional exemptions covering all or part of these mortgage transactions. See Uniform Sec. Act (1956), §402(b)(5); Unif. Sec. Act (1985), §402(b)(7); and Unif. Sec. Act (2002), §2-202(11). Therefore, to follow *Reves* and hold these promissory notes *not securities*, would fly in the face of specific Uniform Act language that they *are securities, but exemption from the securities registration requirements*. New Hampshire has such an exemption in Section 421-B:17(II)(d).

Finally, the Bureau's research indicates that the *Reves* test has been expressly accepted by the state courts in only about fifteen states. While this number has been growing slowly, at this point, it is far from a majority position. Each new state to consider the issue must examine whether the *Reves* test serves the public policy goals of the state.

After examining these three factors, the Bureau has determined that the public policy goals behind the New Hampshire Securities Act require New Hampshire to adopt an interpretation of "promissory note" which deviates from the federal interpretation announced in the *Reves* case. Such deviation is required by state policy concerns. Both Washington and Kansas are uniform act states. Section 421-B:32 of the New Hampshire Act adopted the Uniform Act Statement of Policy, found in Section 415 of the 1956 Uniform Act, stating:

This chapter *shall be* so construed as to effectuate its general purpose to make uniform the laws of those states which enact it....

Therefore, New Hampshire will follow the lead of Washington and Kansas and reject the *Reves* test.

In summary, the Bureau *rejects* the *Reves* decision's main holding that some promissory notes are not securities. Instead, under New Hampshire law, *all unsecured promissory notes are securities*. See *In re Flexible Mortgage*, Order No. IVT 95-027 (N.H. Bur. Sec., June 1995 and Sept. 13, 1996).¹⁵

As a result of this rejection, it logically follows that the Bureau also rejects the idea that certain categories of promissory notes are *per se not* securities and that the *Reves* four-part test may be used to extend *per se* non-securities status to other securities or categories of securities.

C. Legal Basis For The Bureau's Rejection Of The "Context Otherwise Requires" Doctrine

The Bureau also specifically rejects the idea found in *Reves*, that the introductory clause to *all* definitions in Section 2 of the Securities Act of 1933, 15 U.S.C. §77b allows

¹⁵The *Flexible Mortgage* case is a classic example of how the regulatory system should work. The unsecured promissory notes were securities. The Bureau, through its then Director Peter C. Hildreth, took an enforcement action against the company and its principals. *In re Flexible Mortgage*, INV 95-027 (N.H. Bur. Sec., Dec. 5, 1995 and Sept. 13, 1996). Earlier, even though the Department claims not to regulate commercial lenders and *Flexible Mortgage* was a commercial lender, the State Banking Department issued a Cease and Desist Order for violations of the state banking act in connection with *Flexible Mortgage's* banking and brokerage licenses. This action resulted in the surrender of *Flexible Mortgage's* banking and brokerage licenses. Finally, the Attorney General criminally prosecuted the principals for the sale of unregistered securities. They plead guilty and served a prison sentence.

There is no difference between *Flexible Mortgage* and the sale of the FRM interests in the period of 2000-2004. The interests sold were securities, and the Bureau took action. The State Banking Commission and the Attorney General had jurisdiction as in the *Flexible Mortgage* case, but did not act.

In the subsequent sales of FRM interests, the interests were not securities. Therefore, the Bureau had no jurisdiction. However, again, both the State Banking Department and the Attorney General had jurisdiction as in the *Flexible Mortgage* case. But they did not act on the banking law violations and the Attorney General did not prosecute for criminal fraud.

the examination of the *context* surrounding the transaction to determine whether an instrument or agreement involves a security. This Section states: “When used in this chapter, unless the *context otherwise requires....*” While Section 421-B:2 of the New Hampshire Act contains similar language, the Bureau specifically rejects the *Reves* holding for a number of reasons.

First, the *Reves* approach is sophistry. The introductory clause is inserted to indicate that under certain circumstance *within the language of the statute itself* the general definition will not work.¹⁶ Depending upon the context in which the word is used in the statute, a different special definition is required. Thus, for most purposes within the act, the word will be given its general meaning as found in the definitional section. However, there may be a particular usage *within the statute itself* where the general definition will not work. In that limited situation, the context may require the application of a special definition. In such case, the introductory clause gives the courts and the securities agencies authority to apply a special definition.¹⁷

The Bureau believes that the inclusion of the introductory clause clearly was *not* intended to give the courts license to examine the intent of the parties, the facts surrounding the offer and sale of the instrument, or the regulatory environment in which

¹⁶Congressional intent to limit the function of this clause is illustrated by the fact that the original draft of the definitional section of what was to become the Securities Act of 1933 used the word “text” rather than “context.” Clearly, the word “text” means only the text of the statute and not the surrounding circumstance of the instrument’s offer or sale. One suspects that the change was made for stylistic reasons, having nothing to do with the intended purpose of the clause.

¹⁷The federal Internal Revenue Code is a good example of this concept. Many of its sections contain special definitions which differ from those found in the general definitions section.

it is offered and sold when determining the "securitiness" of a particular instrument.¹⁸ "Securitiness" is a theoretical and ideological concept. *Legislative* creation of *exclusions* from the statutory definition¹⁹ or *exemptions* from one or more parts of the regulatory scheme²⁰ is a practical decision, based upon public policy and political factors. Certainly, the above identified factors are proper considerations when determining exclusions and exceptions, but not when determining whether something is a security.

"Securitiness" needs to be determined at the time of the first offering²¹ of the

¹⁸The problem here can, in large measure, be eliminated by identifying the attributes common to all securities and then, crafting the statutory definition in terms of these attributes. The present definition is nothing more than a laundry list of instruments which are to be considered securities, without any attempt to identify why they are securities. The Bureau believes that the *Howey* test for investment contracts identifies the true elements of a security.

¹⁹An exclusion takes an instrument which would obviously be a security under the general definition and makes it a non-security by legislative fiat. Section 421-B:2(XX)(a) of the New Hampshire Act contains an example of this practice. It excludes insurance and endowment policies as well as annuity contracts from the definition of a security. These insurance products, otherwise, would be classified as securities. For example, both variable annuities and variable life insurance policies are considered securities at the federal level. See *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202, 87 S.Ct. 1557 (1967); *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 79 S.Ct. 618 (1959).

²⁰See Section 421-B:17 containing securities and transactional exemptions under the New Hampshire Act. In the case of an exemption, the instrument remains a security, but is exempted from one or more of the three regulatory features of the act, normally, the securities registration requirement. In such case, the other two parts of the regulatory scheme, licensing of securities professionals and the anti-fraud provisions, still apply.

²¹*Cf. First Citizens Fed. Sav. & L. Ass'n. v. Worthen*, 919 F.2d 510 (9th Cir. 1990). Most instruments qualifying as securities under the *Howey* test for investment contracts at the time of original sale will not meet that test when sold in the secondary market. However, this failure does not destroy their securitiness.

instrument and must remain consistent throughout the life of the instrument.²² Further, all instruments of the same type need to be treated alike, either as being securities or not being securities. If these basic concepts are violated, chaos results.

The following illustration proves the point.²³ A promoter is in the business of selling condominiums. Buyer A intends to live in the condominium full time and not rent it out. Buyer B buys a similar condominium as an investment with no intent to occupy the unit, but with the intent to make a profit through a management agreement with the promoter. Buyer C buys a similar condominium. However, his intent is mixed. He wants to occupy the unit for substantial periods during both the summer and winter, but needs to rent it out during periods of non-occupancy to be able to afford the purchase. Buyer D buys Buyer A's unit in the secondary market for investment purposes only, intending to make a profit through a management agreement with either the promoter or some third party management firm. Finally, Buyer E later purchases Buyer D's interest with the intent to only occupy the unit as a primary or secondary residence.

Which of these buyers have purchased securities? Under the "unless otherwise required" concept, federal law would hold that Buyer A has not bought a security.²⁴ Buyer B clearly has purchased a security in the form of an investment contract. Buyer

²²Transactional exemptions from the registration requirements, like those found in Section 421-B:17(II), may vary according to the circumstances of the transaction, but the underlying instrument always remains a security.

²³This illustration is based largely upon *Lowery v. Ford Hill Inv. Co.*, 192 Colo. 125, 556 P.2d 1201 (1976). See generally, 12 Joseph C. Long, *Blue Sky Law* §§ 2:58-2:59 (2010).

²⁴*Cf. United Housing Found., Inc. v. Forman*, 421 U.S. 837, 95 S.Ct. 2051 (1975).

C may or may not have bought a security, depending on whether his intent to occupy the unit is stronger than his investment motive.²⁵ Buyer D, who purchased his unit in the secondary market, has purchased a security because of his profit motive, even though Buyer A did not when he bought the unit in the primary market. Finally, Buyer E has not bought a security even though the unit was a security in Buyer D's hands. His use only motive makes the unit a non-security as it was in the hands of Buyer A.

The securities laws simply cannot operate upon such a system where an instrument shifts from a security to a non-security and back again, depending upon the circumstances of the transaction.²⁶ Nor can it work where the promoter has to determine the intent or motive *of each purchaser* to determine whether the particular sale is or is not a security. Businessmen and issuers need to have stability in order to intelligently decide whether the instruments they sell are securities, subject to the securities acts, or non-securities, which are not. The use of the "unless the context otherwise requires" concept deprives them of this stability. Only after the fact, when a judge decides whether to apply "the context otherwise requires" concept, will they know whether what they sold is or is not a security.²⁷

²⁵*International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551, 99 S.Ct. 790 (1979); *Teague v. Bakker*, 139 F.3d 892 (table case), full opinion, 1998 WL 168876 (4th Cir. Apr. 8, 1998); *Lowery v. Ford Hill Inv. Co.*, 192 Colo. 125, 556 P.2d 1201 (1976).

²⁶See *Mercer v. Jaffe, Snider, Raitt and Heuer, P.C.*, 736 F.Supp. 764 (W.D.Mich. 1990).

²⁷Remember that in most states, including New Hampshire, see Section 421-B:24(I), sale of an unregistered security is a felony. While Section 421-B:24(I) talks in terms of a "willful" violation, "willful," in this context, means only that the sale was a voluntary act. It does not mean that the violator knew what he was offering or selling was a security. See *12A Joseph C. Long, Blue Sky Law* §§ 10:14-10:16 (2010), collecting cases.

II. THE BUREAU'S POSITION IS THAT ALL SECURED PROMISSORY NOTES ARE NOT SECURITIES, EXCEPT THOSE SECURED PROMISSORY NOTES COVERED BY SECTION 421-B:17(II)(d)

The proper treatment of *secured* promissory notes is more difficult. As seen above, the federal *Reves* test would treat most, if not all, secured promissory notes as *non-securities*. However, historically, most states treated *secured* promissory notes like *unsecured* promissory notes, as *securities*. As a result, there is a difference of opinion over the proper treatment of secured promissory notes.

The majority state position was carried forward into the Uniform Securities Act (1956). The Uniform Act draftsmen intended *all promissory notes to be securities*, whether secured or unsecured. This position is confirmed by the inclusion of a transactional exemption from the Act's securities registration provisions for *some* secured promissory notes when offered or sold under defined conditions. See Section 402(b)(5) of the Uniform Securities Act (1956). Such an exemption would not be necessary, if the secured notes were not securities. If the secured notes do not qualify for the Section 402(b)(5) transactional exemption, the secured notes are still securities. *Rother v. La Renovista Estates, Inc.*, 603 F.Supp. 533 (W.D.Okla. 1984).

The above analysis, however, does not follow under the New Hampshire Act. New Hampshire was a *minority state as to the treatment of secured promissory notes*. As will be seen below, very early, by at least the early 1950's, New Hampshire had taken the position, by administrative gloss, that promissory notes *secured by real or chattel mortgages* would not be regulated as securities. The legislative history of the 1981 Act also shows the intent of the drafters and supporters of the 1981 Act to carry

this policy forward into the new Act.

However, the draftsmen, in adopting the New Hampshire version of the Uniform Act, did make one important change in the pre-existing policy governing the treatment of secured notes. They elected not to adopt the transactional exemption found in Section 402(b)(5) of the Uniform Act. Instead, they substituted a similar transactional exemption in Section 421-B:17(II)(d) of the new Act.

Given the well-recognized New Hampshire rule of statutory construction that the legislature does not enact redundant provisions, *Garand v. Town of Exeter*, 159 N.H. 136, 977 A.2d 540 (2009), or nonsensical and unnecessary provisions, *O'Brien v. O'Brien*, 141 N.H. 435, 684 A.2d 1352 (1996), the conclusion is inescapable that the draftsmen intended a limited change in the pre-existing policy of treating secured notes as non-securities. They intended that secured notes covered by the Section 421-B:17(II)(d) exemption would, in the future, be classified as *securities*, albeit *exempt securities*.

This change, however, gives no hint as to how secured promissory notes which *are not covered* by the Section 421-B:17(II)(d) exemption are to be classified. Are they securities because of the addition of Section 421-B:17(II)(d)? Or are they non-securities based upon New Hampshire's prior policy? This statutory ambiguity has been resolved by the administrative gloss developed both *before* and *after* 1981.

As will be seen below, the then Supervisor of Securities, Frank Giacoumis, continued to follow the pre-1981 position that these non-exempt secured promissory notes were not securities during the remainder of his tenure as Supervisor. After he

stepped down in 1984, the Bureau continued that policy until the present.

The records of the Bureau indicate that it has brought actions against mortgage brokers selling *unsecured* promissory notes, see *In re Financial Resources Mortgage*, Cease and Desist Order, Order No. INV 00-007 (N.H. Bur. Sec., Nov. 8, 2001), and *In re Flexible Mortgage*, Order No. IVT 95-027 (N.H. Bur. Sec., June 1995 and Sept. 13, 1996). But these same records also reveal that no enforcement action has ever been taken by the Bureau for non-registration of, or fraud in connection with the offer or sale of, a *secured* promissory note. Further, these records reveal that the Bureau has never registered such secured notes or persons selling them. Finally, the Bureau has never taken the position through a Statement of Policy or No-action Letter that such notes or the persons selling them *must* be registered.

Therefore, in the intervening twenty-five years since Supervisor Frank Giacoumis left office, the Bureau's policy has remained steadfastly that secured promissory notes, other than those covered by the Section 421-B:17(II)(d), were *not* securities.

With the passage of time, this position became administrative gloss. As administrative gloss, it becomes part of the legislative history of the Act. *New Hampshire Retail Assoc. v. State Tax Comm.*, 113 N.H. 511, 514, 309 A.2d 890, 892 (1973); *Win-Tasch Corp. v. Town of Merrimack*, 120 N.H. 6, 9-10, 411 A.2d 144, 145 (1980).

The Bureau is not happy with the above outlined position as it believes that at least some of, if not all, these secured notes should be regulated as securities. However, the Bureau's hands are tied. Once administrative gloss has been

established, the Bureau does not have the power to change it. *Anderson v. Motorsports Holdings, L.L.C.*, 155 N.H. 491, 926 A.2d 261 (2007). Therefore, in the past, and in the foreseeable future, unless the legislature amends the current Act to override the administrative gloss, secured promissory notes *not* covered by Section 421-B:17(II)(d), *are not securities in New Hampshire.*

A. Legal Basis For The Bureau's Holding That All Secured Promissory Notes Other Than Those Covered By The Section 421-B:17(II)(d) Exemption Are Not Securities

The Bureau's position that all secured promissory notes are *not* securities, other than those secured notes covered by the transactional exemption in Section 421-B:17(II)(d), is supported by two separate theories. The first theory is that the legislative history shows that the draftsmen of the statute and the supporters of the bill before the Legislature did not want the Securities Bureau to be involved in the regulation of notes secured by mortgages. The second theory is based upon the administrative gloss given over the years to the definition of securities. Both these sources lead to but one conclusion--the Securities Bureau was not intended to regulate secured promissory notes except those covered by Section 421-B:17(II)(b). Further, the Bureau has never considered that such notes were securities or that it had regulatory jurisdiction over them.

1. Legislative History

There is very limited recorded legislative history about the status of secured promissory notes in the general legislative history concerning the adoption of the present New Hampshire Securities Act in 1981.

However, the Bureau was able to interview the four individuals who drafted the present Securities Act, Ch. 421-B and who presented and managed its passage through the Legislature as Senate Bill 67. Senator Champange was the sponsor of Senate Bill 67. Senator Champange, as a law student, had worked at the State Insurance Department and was familiar with the then existing policy of the Securities Bureau and the Insurance Department that mortgage-secured promissory notes were not securities.

Then Assistant Insurance Commissioner Martin Mitchell actually drafted Ch. 421-B at the direction of then Insurance Commissioner Francis E. Whaland.²⁸ Then Assistant Attorney General Thomas Colantuono was consulted during the drafting process and spoke on behalf of the Bill before the Legislature.

Finally, then Supervisor of Securities,²⁹ Frank Giacoumis, was also consulted and participated in the drafting. Mr. Giacoumis had become Supervisor of Securities in the early 1970's, succeeding Mosely Kingsley Batcheldor. Mr. Batcheldor had been the head of securities for more than twenty (20) years, dating back to the early 1950's. Before assuming the position of Supervisor, Mr. Giacoumis had worked with, and been trained by, Mr. Batcheldor, for several years.

From these collective interviews, the Bureau was able to glean the following background of the Act, as well as the political and policy decisions, made in the drafting and passage of Senate Bill 67. First, the group all agreed that Insurance Commissioner Francis E. Whaland was the moving force behind the drafting and passage of what

²⁸At the time, the Bureau was a part of the State Insurance Department.

²⁹During this period, the Securities Bureau was basically a one man operation within the Office of the State Insurance Department.

became Ch. 421-B, the present securities act.

Second, the group pointed out that Commissioner Whaland's general approach to drafting legislation was to take a Uniform Act, in this case, the Uniform Securities Act (1956), as a starting point. He would then "New Hampshireize" the Uniform Act to reflect the current New Hampshire regulatory pattern, prevailing at the time of drafting. They agreed that this approach was followed in the case of 1981 Securities Act. As a result, Mr. Mitchell, the principal draftsman of the new Act, with the help of Colantuono and Giacoumis, was given the task of "New Hampshireizing" the Uniform Act language to conform to Commissioner Whaland's instructions.

All agreed that a political decision was made by Insurance Commissioner Whaland that the Securities Bureau would not regulate promissory notes secured by real property.³⁰ Regulation of these notes was to be the province of the State Banking

³⁰Commissioner Whaland's decision may not have been correct from the theoretical standpoint of defining a "security." However, at the time, it was an excellent decision from both a practical and political standpoint.

From a practical standpoint, the Bureau simply did not have the resources or skills to effectively manage the regulation of these secured promissory notes. The Bureau, at that time, consisted of a single professional, who was not knowledgeable in the regulation of the mortgage industry. The primary market for these secured promissory notes was largely confined to large commercial or professional lenders who had the capability to protect themselves by doing their own due diligence. It was only after the industry changed to selling these secured notes to the unsophisticated general public that investor protection became a major issue. Further, there was a very limited secondary market in these notes, usually involving the same large commercial or professional lenders who bought these instruments in the primary market.

Further, the focus of regulation of these notes, at that time, was largely limited to protecting the borrower from predatory lending practices. The securities acts are not well-suited to providing such regulation. This type of regulation is better handled by the Banking Commissioner or the Attorney General through the consumer protection act.

From a political standpoint, it is clear that neither the mortgage banking or the

Department.³¹ This conclusion is supported by the fact that the Banking Commissioner claims exclusive jurisdiction of mortgage bankers and mortgage brokers. If these secured notes were securities, all mortgage brokers would have to register with the Bureau as securities brokers and their employees as securities agents. Section 421-B:6(I). Further, at least some mortgage bankers might have to register as issuer-dealers. *In re Flexible Mortgage*, Order No. IVT 95-027 (N.H. Bur. Sec., June 1995 and Sept. 13, 1996).

The group further indicated that Commissioner Whaland's decision not to cover secured promissory notes was not new, but simply conformed to existing New Hampshire policy as outlined in *Manchester Bank v. Connecticut Bank & Trust Co.*, 497 F.Supp. 1304, 1315 (D.N.H. 1980), as more fully discussed below.

Mr. Mitchell indicated that he drafted the new Act to conform to Commissioner Whaland's instructions. The group all felt that the new Act, as modified, followed Commissioner Whaland's instructions and continued the existing policy that secured promissory notes were not securities. The only exception was those secured notes

consumer finance industries want to be regulated by the Securities Bureau. Likewise, leaving regulation of these notes in the hands of the Banking Commission avoids the need for dual regulation of the professionals handling these transactions, and, thus, a turf battle with the Banking Commission, which claims exclusive jurisdiction over mortgage banks and brokers. As a result of leaving regulation of these secured mortgages to others, two major potential opponents to passage of the new Act were eliminated.

³¹Regulation of consumer notes was left to the Consumer Protection Division of the Attorney General's Office. Unfortunately, regulation of notes involving mortgages on the commercial real property simply slipped through the regulatory cracks, and the industry handling such notes was left largely unregulated. The regulation of this industry needs to be addressed by the Legislature.

covered by the new Section 421-B:17(II)(d) transactional exemption.³²

2. Doctrine of Administrative Gloss

The New Hampshire courts have long recognized the doctrine of administrative gloss. See e.g., *Appeal of Public Serv. Co.*, 141 N.H. 13, 676 A.2d 101 (1996); *New Hampshire Retail Grocers Ass'n v. State Tax Commission*, 113 N.H. 511, 309 A.2d 890 (1973); *Wyatt v. State Bd. of Equalization*, 74 N.H. 552, 70 A. 387 (1908).

In 1973, in *New Hampshire Retail Assoc. v. State Tax Comm.*, 113 N.H. 511, 514, 309 A.2d 890, 892 (1973), the court described the doctrine of administrative gloss this way:

It is a well established principal of statutory construction that a longstanding practical and plausible interpretation given a statute of doubtful meaning by those responsible for its implementation without any interference [from] the legislature is evidence that such a construction conforms to the legislative intent.

Quoted with approval in *Win-Tasch Corp. v. Town of Merrimack*, 120 N.H. 6, 9-10, 411 A.2d 144, 146 (1980).

Quite recently, in *Anderson v. Motorsports Holdings, LLC*, 155 N.H. 491, 502, 926 A.2d 261, 270 (2007), the Court reaffirmed this doctrine.³³

³²The transactional exemption did change New Hampshire's policy to a limited extent. Prior to the adoption of Section 421-B:17(II)(d), *all secured promissory notes* were not securities. The adoption of Section 421-B:17(II)(d) changed this. The secured notes covered by the exemption became securities, but exempt from the registration process.

³³The Court in *Anderson* said:

An administrative gloss is placed on an ambiguous clause of a [statute] when those responsible for its implementation interpret the clause in a consistent manner and apply it to similarly situated applicants over a period of years without legislative interference.

3. The Effect of the Application of the Administrative Gloss Doctrine

Since the Bureau's determination is based, at least in part, upon the application of the administrative gloss doctrine, based upon a long-standing *informal interpretation by the Bureau and acquiescence by the Legislature*,³⁴ the effect of the application is far reaching.

Only the Legislature can change the Bureau's interpretation, and only *prospectively*. The Bureau, itself, lacks the authority to alter its interpretation once established. Administrative gloss, once established, becomes part of the legislative intent behind the statute.³⁵ Further, in *Tessier v. Town of Hudson*, 135 N.H. 168, 599 A.2d 1244 (1991), the Court held that an agency cannot change an interpretation created by administrative gloss by merely ignoring past policies. To alter the interpretation would be to act contrary to the newly established legislative intent. *Anderson v. Motorsports Holdings, LLC*, 155 N.H. 491, 502, 926 A.2d 261, 270 (2007). As the *Anderson* Court said:

If an administrative gloss is indeed found to have been placed on a clause, the [agency] may not change such de facto policy, in the absence of legislative action because to do so would presumably violate legislative intent.

See also, *DHB, Inc. v. Town of Pembroke*, 152 N.H. 314, 876 A.2d 206 (2005), and citing with approval, *Nash Family Inv. Prop.*, 139 N.H. 595, 660 A.2d 1102, 1108 (1995) and *Hansel v. City of Keene*, 138 N.H. 99, 104, 634 A.2d 1351, 1354 (1993).

³⁴See e.g., *Anderson v. Motorsports Holdings, LLC*, 155 N.H. 491, 502, 926 A.2d 261, 270 (2007); *DHB, Inc. v. Town of Pembroke*, 152 N.H. 314, 321, 876 A.2d 206, 214 (2005).

³⁵See also, *Win-Tasch Corp. v. Town of Merrimack*, 120 N.H. 6, 411 A.2d 144 (1980); *New Hampshire Retail Grocers Assoc. v. State Tax Comm.*, 113 N.H. 511, 514, 309 A.2d 890, 892 (1973).

Quoting with approval, *DHB, Inc. v. Town of Pembroke*, 152 N.H. 314, 321, 876 A.2d 206, 213 (2005).

Nor can another state agency such as the Attorney General overturn the Bureau's de facto interpretation.³⁶ N.H. Att'y Gen. Op. No. 09-01, 2009 WL 2702827 (July 20, 2009), held:

The doctrine of administrative gloss would also dictate that, to the extent there is any ambiguity in the statute, the long-standing interpretation of [the Bureau of Securities] is *conclusive*.

Id. at *3. [Emphasis added.], citing *DHB, Inc. v. Town of Pembroke*, 152 N.H. 314, 876 A.2d 206 (2005). See also *In re Appeal of Public Serv. Co.*, 141 N.H. 113, 676 A.2d 101 (1996).

Nor apparently can the courts. *Anderson, supra*, and *DHB, Inc., supra*, suggesting that the Supreme Court itself may not be able to change the position reached by administrative gloss because the courts do not have the power to alter legislative intent. Only the legislature can do that through statutory amendment.

4. The Doctrine Of Administrative Gloss Is Applicable

As outlined above, there are three things necessary for the administrative gloss doctrine to apply. First, the clause of the statute to be interpreted must be ambiguous. Certainly, the definition of "securities" in Section 421-B:2(XX)(a) meets this criteria. It is clearly ambiguous. Second, the informal *de facto* interpretation must actually exist and be of longstanding. Finally, the Legislature must not have indicated disagreement with the Bureau's informal *de facto* policy. These latter two requirements also meet as to the

³⁶*Cf. Tessier v. Town of Hudson*, 135 N.H. 168, 599 A.2d 1244 (1991).

treatment of secured promissory notes.

In *Manchester Bank v. Connecticut Bank & Trust Co.*, 497 F. Supp. 1304, 1315 (D.N.H. 1980), the court, based on the testimony of the Supervisor of Securities Division, held that, as of 1980, there was an existing *de facto* policy by the Division that secured promissory notes and loan participation interests, therein, were not considered securities.

During the summer of 2010, the Bureau interviewed former Supervisor Giacoumis about the existence of this informal *de facto* interpretation. He first confirmed his testimony in the *Manchester Bank* case. He indicated further that before becoming Supervisor, he worked with, and was trained by, Mr. Batcheldor, who had been in charge of the Bureau since the early 1950's. During this training, Mr. Batcheldor made Mr. Giacoumis aware of the *de facto* policy that New Hampshire did not consider notes secured by mortgages to be securities.³⁷ Further, Mr. Batcheldor indicated that the *de facto* policy went back, at least, to the early 1950's.

Mr. Giacoumis further stated that he followed this policy during his entire tenure as Supervisor, from 1972 until he left office in the mid-1980's, some four years *after* the passage of the present Securities Act in 1981.

He also told the Bureau that during his tenure as Supervisor, he never required the securities registration of a secured promissory note nor did he require the mortgage

³⁷This position had to be a *de facto* exclusion from the Act. The pre-1981 act did authorize the Commissioner to create securities exemptions by regulation or rule. However, the Bureau's research reveals that the Commissioner had *not* adopted any regulations or rules exempting any securities or securities transactions. Certainly, there was no exemption or exclusion for promissory notes secured by real or chattel mortgages.

banks and brokers who dealt in such notes to be registered as securities broker-dealers. Finally, he stated that the de facto interpretation was well-established when he took office in 1972, that he continued to follow it after the passage of the new Act in 1981, and that, as far as he knew, was still being followed today. This last statement is confirmed by the records of the Bureau, as outlined above.

The third element for applying the administrative gloss doctrine also exists. It is true that the new Act did include the Section 421-B:17(II)(d) transactional exemption from the registration requirements of the Act for certain secured notes in the secondary market. This adoption, the Bureau believes, shows a clear intent by the Legislature that the notes covered by the exemption would become "securities."

However, the Bureau, in light of the longstanding interpretation that secured promissory notes were not securities, has concluded that notes *not* covered by Section 421-B:17(II)(d) would remain non-securities. Therefore, the adoption of Section 421-B:17(II)(d) is not interference with, but reenforcement of, the Bureau's informal *de facto* interpretation.

B. Examples Of The Bureau's Position Where Secured Promissory Notes Are Not Securities

There are a number of transactions in promissory notes³⁸ coupled with real or chattel³⁹ mortgages which the Bureau *has considered, and will continue to consider*, as *not* involving the offer, sale, or purchase of "securities" under the New Hampshire

³⁸For the purposes of this statement of policy, the reader is reminded that the term "promissory note" shall include other forms of evidences of indebtedness *other than bonds or debentures*.

³⁹For the purposes of this Release, the term "mortgage" shall include contracts for deed or other form of security agreement.

Uniform Securities Act. The following examples, while not intended to be exclusive, are intended to aid the reader in understanding the Bureau's position on this point.

Example 1.

The purchaser of either commercial⁴⁰ or non-commercial real⁴¹ or personal property⁴² issues a promissory note, secured by a pledge of, or mortgage on, the property, and delivers both documents to the seller of the property, *in the original negotiation of the note and mortgage together.*

The Rationale for the Bureau's Position in Example 1

Based upon the above discussion, the transaction in this Example would not be covered by the New Hampshire Securities Act for any one of three separate reasons. First, holding the interests outlined to be securities would clearly run contrary to the administrative gloss established above.

Second, there are a number of unintended consequences that would flow from such holding. See *In re Flexible Mortgage*, Order No. IVT 95-027 (N.H. Bur. Sec., June 1995 and Sept. 13, 1996), outlining these consequences. The Bureau is convinced that the legislature did not intend the imposition of these consequences as a result of adopting the Section 421-B:17(II)(d) exemption.

The person giving the note would have to register the promissory note under Section 421-B:12, or find an exemption from such registration under Section 421-B:17. However, since the person buying the property is the "issuer" of the promissory note,

⁴⁰Such as manufacturing equipment, store or office building, or commercially-zoned undeveloped land.

⁴¹Such as a personal residence, vacation home, raw undeveloped land or intangible personal property, such as accounts receivables.

the exemption, found in Section 421-B:17(II)(d), for promissory notes and whole mortgages sold in a *non-issuer* transaction, would not be available, because it covers only non-issuer transactions. The illustration involves a sale by the *issuer*. As outlined in more detail below, the Bureau believes that the Legislature had no intent to impose a securities registration or exemption requirement on the purchaser of property, using a promissory note merely as a cash substitute in a consumer transaction.

Further, the issuer, if a New Hampshire resident, would have to register under Section 421-B:6(I), as he would appear to be an "issuer-dealer," as defined under Section 421-B:6(X)(III)(a). Again, the Bureau does not believe that the Legislature intended that the purchaser of a car or a house should have to register in the consumer transaction outlined in the example.

Also, if the seller of the property who receives the promissory note wishes to resell the promissory note, either to a private individual or commercial lender, the seller would have to register as a broker-dealer under Section 421-B:6(I). The seller comes within the statutory definition of a "broker-dealer." Section 421-B:2(III) defines a "broker-dealer" as "any person in the business of effecting transactions in securities ...for his own account." Again, the Bureau does not believe the Legislature contemplated such consequence.

Finally, of course, the anti-fraud provision of Section 421-B:3(I) would apply, prohibiting schemes to defraud; the making of material misrepresentations or omissions; or engaging in acts which would have the effect of operating as a fraud or deceit. Since this Section applies in connection with "the offer, sale, or purchase of a security," it

⁴²Such as an automobile, boat, refrigerator, or jewelry.

would apply to both the purchaser of the property who issued the note, and the seller of the property, who receives the note. Yet, the focus of the securities acts is directed toward protecting the *purchasers* of securities. It is unlikely that the Legislature thought that the seller of the property needed protection from the purchaser. Likewise, New Hampshire has a consumer protection statute which will provide protection to the purchaser of the property who is defrauded into issuing his promissory note. The Consumer Protection Act clearly applies, if the note is not a security. The Consumer Protection statute is a much more efficient way to deal with this problem rather than shoe-horning the transaction into the securities act.

Third, while the Bureau has specifically rejected the *Reves* family resemblance test, it should be noted that the same conclusion that the notes in Example 1 are not securities would have been reached under the *Reves* test. In Example 1, the note and mortgage being given to a seller of the property is in lieu of a cash payment. As noted above, the first two categories of *per se* excluded promissory notes under the *Reves* test are: (1) Notes delivered in consumer financing; and (2) Notes secured by a mortgage on a home. As the Court in *Reves* said: "We have consistently identified the fundamental essence of a 'security' to be its character as an 'investment.'"⁴³ 494 U.S. 56, 68-69, 110 S.Ct. 945, 953 (1990). Receipt of a secured promissory note in lieu of cash does not involve an investment on the seller's part. The transaction is purely commercial, rather than investment, in nature. Therefore, the secured promissory note in Example 1, arising from a purely commercial transaction, is not a security.

⁴³Earlier, the Court had said of the definition of a security, that Congress had intended it "to encompass virtually any instrument that might be sold as an *investment*." 494 U.S. at 61, 110 S.Ct. at 949.

The Bureau's opinion would not change if the purchaser of the property issued a series of notes, rather than a single note. Nor would it change if the mortgage covered less than all of the property.

Example 2.

The purchaser of commercial or non-commercial real or personal property issues a promissory note, secured by a pledge of, or mortgage on, the property, and delivers it to a mortgage broker, or other professional lender,⁴⁴ in the initial negotiation of the note and mortgage together.

The Rationale for the Bureau's Position in Example 2

The difference between this Example and Example 1 is that the purchaser obtains the funds to buy the property from a third party rather than from the seller. For example, when buying a new car, the purchaser elects to seek his funding from a bank or savings and loan, rather than have the car dealer "tote the note." Even if financing is obtained through the dealer, it normally will be obtained from a third-party lender, such as a finance company or bank, with the car dealer merely acting as the agent of the lender.

The rationale for excluding this transaction from securities coverage is much the same as in Example 1. The legislative history and administrative gloss makes clear that the Legislature did not intend that these transactions be covered by the Securities Act. Further, the same result would also be reached under the *Reves* test.

The purchaser is still making a consumer purchase. The mortgage broker or professional lender is merely facilitating the consumer purchase and views the

⁴⁴Such as a bank, insurance company, or pawn broker.

transaction as a commercial transaction rather than an investment. Therefore, the secured promissory note involved in the transaction is not a security. See e.g., *Davis v. Avco Fin. Serv., Inc.*, 739 F.2d 1057, 1063 (6th Cir. 1984); *South Carolina Nat'l. Bank v. Darmstadter*, 622 F. Supp. 226 (D.C.S.C. 1985).

Again, the Bureau's opinion would not change if the purchaser of the property issued a series of notes, rather than a single note. Nor would it change if the mortgage covered less than all of the property.

Example 3.

The owner of commercial or non-commercial real or personal property issues a promissory note, secured by a pledge of, or mortgage on, the property, and delivers it to a mortgage broker, or other professional lender,⁴⁵ in the *initial negotiation of the note and mortgage together*, the note is *not* a security.

The Rationale for the Bureau's Position in Example 3

Again, the primary rationale is that the legislative history and administrative gloss indicate that the New Hampshire Act was not intended to cover these transactions. Therefore, they are not securities.

The only difference between this Example and Examples 1 and 2 is that the creation of the promissory note and mortgage is not tied to the purchase of the property pledged or mortgaged. The property purchased is not a significant factor in whether the transaction involves a security. It is still a commercial transaction because the bank or professional lender is not making an investment. See *Carder v. Burrow*, 327 Ark. 545, 940 S.W.2d 429 (1997).

Example 4.

⁴⁵Such as a bank, insurance company, or pawn broker.

The owner or purchaser of commercial or non-commercial real or personal property issues a promissory note, secured by a pledge of, or mortgage on, the property, and delivers it to a third-party commercial lender, in the *initial negotiation of the note and mortgage together*, the secured promissory note, the note is *not* a security.

The Rationale for the Bureau's Position in Example 4.

Again, the Bureau's rationale for the conclusion in this Example is the same as in the previous Examples. First, the administrative gloss and legislative history of the Act require this conclusion. Second, even if the *Reves* test were adopted, the outcome would be the same.

The *Reves* test distinguishes consumer and commercial transactions from investment ones and excludes consumer and commercial transactions from coverage under the Securities Act of 1933. The *Reves* seventh category of promissory notes which are *per se* non-securities involves "notes evidencing loans by commercial banks." The rationale of the *Reves* case is that commercial or consumer transactions are to be treated differently from investment transactions. Notes generated in commercial or consumer transactions, as a result, are not securities. *Reves* then concluded that banks make commercial loans and, therefore, are lenders and not investors. Thus, the difference for the *Reves* analysis between this Example and the previous ones is the status of the person making the loan.

While *Reves* talks in terms of only commercial banks being covered by the seventh *per se* exclusion, there is no basis for distinguishing banks from other commercial lenders. Other courts have not made such distinction. See *e.g.*, *Carder v. Burrow*, 327 Ark. 545, 940 S.W.2d 429 (1997)(individual lender took commercial

promissory note to establish a floor plan for used furniture sales); *McVay v. Western Plains Ser. Corp.*, 823 F.2d 1395 (10th Cir. 1987)(original lender was a loan service company similar to FRM. It, in turn, resold the entire loan through a series of loan participations sold to savings and loans). Therefore, other commercial or professional lenders, such as mortgage and insurance companies, should also come within this *per se* exclusion. Further, the size and type of organization of a professional lender should not be controlling. An individual or group of individuals may also be a professional lender.

To summarize, the application of the *Reves* seventh *per se* exclusion rests upon the fact determination as to the status of the person or entity receiving the promissory note and mortgage. If this person or entity is a professional lender, the transaction does not involve the sale of a security. However, if the person or entity is a passive investor, then the transaction involves the sale of a security.

This Example is what makes most, if not all, of the secured promissory notes in the FRM deals not securities. All the FRM victims interviewed by the Bureau to date have all claimed that they are active professional lenders, who received a number of investment proposals from FRM. They reviewed the proposals, conducted their own due diligence, and selected which of the various proposals they wished to fund. These actions are those of an active professional or commercial lender, not a passive investor, taking whatever proposal FRM offered. See *Signature Bank v. Marshall Bank*, 2006 WL 2865325 (Minn. App. Dec. 20, 2006).

Example 5.

The owner or purchaser of commercial or non-commercial real or

personal property issues a promissory note, secured by a pledge of, or mortgage on, the property, and delivers it to a commercial or professional lender, who then issues loan participations to other commercial or professional lenders.

The Rationale for the Bureau's Position in Example 5

This Example differs from Example 4 only in that in this Example the note has been broken up into "loan participations."⁴⁶ The Bureau's basic rationale for concluding that the original note and the participations, therein, are not securities is the same as with the previous Examples. The legislative history and administrative gloss show that the Legislature did not intend for this type of transaction to be covered by the New Hampshire Securities Act. However, in this Example, there is specific case law to support the Bureau's conclusion.

In *Manchester Bank v. Commercial Bank & Trust Co.*, 497 F. Supp. 1304 (D.N.H. 1980), Commercial Trust, a Connecticut bank, provided New England Pulp and Paper, Inc. with a commercial loan to assist it in the production of newsprint from recycled wastepaper. Subsequently, it sold a participation in the loan to Manchester Bank. When the paper mill failed, the Manchester Bank sued under both the federal and New Hampshire Securities Acts, claiming the loan participation was a security. The court held that the loan participations were not securities under the New Hampshire Securities Act. It based its decision largely upon the affidavit of Frank Giacoumis, the then supervisor of the securities division of the New Hampshire Insurance Commission.

⁴⁶The use of loan participations is a very common commercial practice when very large promissory notes and mortgages on commercial property, such as shopping centers, are involved. The risk of these loans is too great for one lender to handle. Further, in the case of banks, the loan will usually exceed the lending limit that the bank can legally loan to one creditor. See *Grand Prairie Sav. & Loan v. Worthen Bank & Trust Co.*, 298 Ark. 542, 769 S.W.2d 20 (1989), and *South Carolina Nat'l. Bank v.*

He stated that loan participations, such as the one in Example 5, were not securities and never had been treated as securities under the New Hampshire law.

Again, even though the Bureau has rejected the *Reves* family resemblance test, application of *the Reves* test would reach the same conclusion, but on a different basis. *Manchester Bank v. Commercial Bank & Trust Co.*, *supra*. Other federal courts, relying on the rationale of the *Reves per se* category seven, a loan by a commercial bank, have also concluded that loan participations, under both state and federal law, are not securities, but commercial transactions. See e.g., *Banco Espanol de Credito v. Security Pac. Nat'l Bank*, 973 F.2d 51 (2d Cir. 1992); *American Fletcher Mortg. Co., Inc. v. U.S. Steel*, 635 F.2d 1247 (7th Cir. 1980); *C.N.S. Enterp., Inc. v. G & G Enterp., Inc.*, 508 F.2d 1354 (7th Cir. 1975). See also *Grand Prairie Sav. & Loan v. Worthen Bank & Trust Co.*, 298 Ark. 542, 769 S.W.2d 20 (1989). As the court held in *First Citizens Fed Sav. & Loan Ass'n v. Worthen*, 919 F.2d 570 (9th Cir. 1990), the loan takes on the characteristics of the underlying promissory note and mortgage. If it is a security, then the participation is. If it is not a security, then the loan participation is not.

As will be seen in more detail in the next example, for this reason and others, these loan participations also do not qualify as investment contracts. *Banco Espanol de Credito, supra*.

Example 6.

The owner or purchaser of commercial or non-commercial real or personal property issues a promissory note, secured by a pledge of, or mortgage on, the property, and delivers it to a commercial or professional lender, who then contributes the note and mortgage to a trust, which in turn issues interests in the trust to other commercial or professional lenders.

Darmstadter, 622 F.Supp. 226 (D.S.C. 1985), for the mechanics of loan participations.

The Rationale for the Bureau's Position in Example 6

This Example differs from Example 5 only in that here a trust is used to hold the note and mortgage. In the prior example, the commercial or professional lender retained title and simply issued the loan participations directly. In this Example, the purchaser gets an interest in the trust rather than a loan participation. This difference does not change the analysis or outcome. The same rationale outlined in all the previous Examples as to why the interests are not securities applies equally here.

Under the *Reves* test, the trust interests, like the loan participations in the previous Example, take on the characteristics of the underlying note and mortgage. If the note and mortgage is created as a part of a commercial loan or transaction, the trust interests are not securities.

Are the trust interests investment contracts? No. See *e.g.*, *Banco Espanol de Credito v. Security Pac. Nat'l Bank*, 973 F.2d 51 (2d Cir. 1992); *McVay v. Western Plains Ser. Corp.*, 823 F.2d 1395 (10th Cir. 1987); and *Manchester Bank v. Connecticut Bank & Trust Co.*, 497 F. Supp. 1304 (D.N.H. 1980), finding the various interests outlined in *all* of the interests covered by the Examples in this section not to be securities as either notes or investment contracts.

Trust interests are not investment contracts *per se*. Therefore, they are only investment contracts, if they otherwise meet the *Howey* test. They have been held not to meet the *Howey* test for a number of reasons. The economic reality of the transaction is that of a note and mortgage. The trust serves no independent function other than as a vehicle to hold title and for ease of administration. Titles do not need to

be given to a large number of people. Nor is the signature or consent of each interest holder required to file foreclosure or bankruptcy proceedings.

Further, one or more elements of the four-part *Howey* test are missing. To the extent that the purchasers of the interests are lenders and not investors, there is no investment of money. Also, the fourth element is missing. The purchasers are not looking to the efforts of the trustee, the issuer of the trust interests, to generate their profit, by employing the capital to generate funds to pay the expected profits. The original borrower is the source of the funds to pay the expected profits. He may or may not use the funds borrowed to generate these funds. For example, in the case of a home mortgage, the borrower is not going to use the house to generate the money to repay the loan. He would have to generate those funds by employment or profits off other investments.

The Bureau's position will not change if interests in the note and mortgage are assigned to the individual purchasers, who then contribute the interests individually to the trust. The reality of the transaction is the same, and the form the transaction takes will not control the "securitiness" of the instruments involved.

Example 7.

Any of the interests in the previous Examples are resold by the purchasers who acquired them in the original sale of the interests to the general public in a transaction that does not qualify for the transactional exemption in Section 421-B:17(II)(d)

The Rationale for the Bureau's Position in Example 7

These transactions need to be regulated as securities. The Bureau reluctantly concludes, because of the legislative history and administrative gloss, that it does not

have the present authority to require the registration of these interests. Interests sold under the Section 421-B:17(II)(d) transactional exemption are securities, but the non-issuer resale transaction does not have to be registered. However, the broker-dealer and agent licensing requirements do apply as do the anti-fraud provisions. However, consistent with the Bureau's position that the original transaction in these interests do not involve the offer and sale of securities, it cannot claim regulatory authority over secondary sales not covered by the Section 421-B:17(II)(d) exemption.

These secondary transactions would be covered under the *Reves* test. Under that test, an instrument can be a security in one transaction, but not in the next. This issue needs to be addressed by the Legislature to close the gap in coverage.

C. Transactions Involving Promissory Notes Coupled With A Real Or Personal Property Mortgage Which The Bureau Does Consider Involves The Offer Or Sale Of A Security

There is at least one transaction involving the sale of promissory notes⁴⁷ coupled with real or chattel mortgages which the Bureau *has considered, and will continue to consider*, as involving the offer, sale, or purchase of "securities" under the New Hampshire Uniform Securities Act. The following illustration, while not intended to be exclusive, represents an attempt by the Bureau to provide the reader with information as to how the Bureau interprets the New Hampshire Act.

Example 1.

A non-issuer⁴⁸ of promissory note(s) or bond(s), secured by a single

⁴⁷For the purposes of this statement of policy, the reader is reminded that the term "promissory note" shall include other forms of evidences of indebtedness *other than bonds or debentures*.

⁴⁸A person other than the owner or purchaser of the non-commercial real or personal property who issued the promissory note in the primary transaction.

pledge of, or mortgage on, non-commercial real or personal property, resells such note(s) and bond(s) and entire mortgage as a unit in a single sale in the secondary market.⁴⁹

The Rationale for the Bureau's Position in Example 1

This conclusion is mandated by Section 421-B:17(II)(d) of the statute. Section 421-B:17(II)(d) creates a transactional exemption for this type of transaction. It stands to reason that the Legislature would not create an exemption from the securities registration requirement of the statute for something that was not a security. A well-recognized New Hampshire rule of statutory construction is that the legislature does not enact nonsensical or unnecessary provisions. See *e.g.*, *O'Brien v. O'Brien*, 141 N.H. 435, 684 A.2d 1352 (1996).

The FRM secured notes do not come within the Section 421-B:17(II)(d) exemption. By its own terms, the exemption applies only to "non-issuer" transactions. "Non-issuer" is a defined term under the Act. "Non-issuer" means not directly or indirectly for the benefit of the issuer or an affiliate of the issuer." Section 421-B:2(XIV). By definition, if the transaction has to be a non-issuer transaction, it has to be a secondary market sale.

The FRM transactions were often referred to as "Table funding" transactions. Chapter 397-A deals with the regulation of nondepository first mortgage bankers and brokers. FRM was governed by this chapter. Section 397-A:1(XXIV) states:

"Table funding" means a settlement at which a loan is funded by a

⁴⁹This transaction would be exempt from *securities* registration under Section 421-B:17(II)(d). However, the broker-dealer selling it would still be subject to the broker-dealer registration provisions in Section 421-B:6(I). Further, the transaction would be subject to the "anti-fraud" provisions of Section 421-B:3(I). See *In re Flexible Mortgage*, Order No. IVT 95-027 (N.H. Bur Sec., June 1995 and Sept. 13, 1996).

contemporaneous advance of loan funds and an assignment of a loan to the person advancing the funds. *A table-funded transaction is not a secondary market transaction.* [Emphasis added.]

Then, Section 397-A:1(XXIII) states:

“Secondary market” means the market where lenders and investors buy and sell existing mortgages or mortgage-backed securities.

In summary, the FRM transactions were “issuer” transactions as defined by Section 421-B:2(XIII), rather than “non-issuer” transactions as defined by Section 421-B:2(XIV). Further, these transactions were primary, rather than secondary, transactions. Either fact would make the Section 421-B:17(II)(d) exemption *not available*.

Any questions or comments on this Statement of Policy should be directed to the Director of the Bureau of Securities Regulation, 107 N. Main Street, State House 204, Concord, NH 03301-4989.

WILLIAM GARDNER
SECRETARY OF STATE
By His Designee,

Joseph C. Long
Director of Securities Regulations

Dated: November 16, 2010
Concord, New Hampshire

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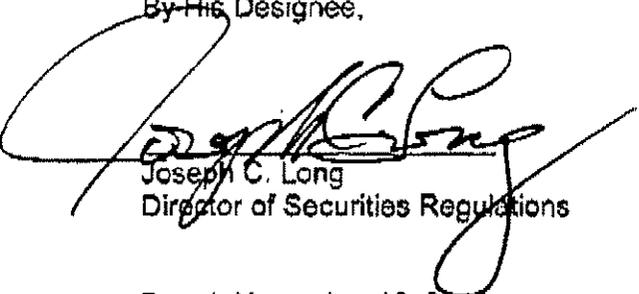
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