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IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA
FOURTH APPELLATE DISTRICT,
DIVISION THREE

RONALD EDWARD REISWIG, JANET SUE REISWIG, FEP, INC. DBA FAMILY ESTATE INSURANCE SERVICES, FIDELITY INSURED DEPOSITS, INC., RICK ANDREW LEON and DONALD ANTHONY FRACCHIA, Petitioners and Respondents, vs. DEPARTMENT OF CORPORATIONS FOR THE STATE OF CALIFORNIA, WILLIAM P. WOOD, California Corporations Commissioner, Respondents and Appellants.	Court of Appeal No: G036509 Superior Court No.: 04CC11740 (Related Cases 05CC02355 and 05CC00010) COURT OF APPEAL-4TH DIST. DIV 3 FILED MAR 20 2006 Deputy Clerk

APPELLANTS' OPENING BRIEF

On Appeal From the Judgment of the Superior Court of California,
County of Orange
The Honorable Ronald L. Bauer, Judge

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I. INTRODUCTION

This appeal involves a set of facts and circumstances different than most securities cases decided under federal and state law. In the case at hand, Fidelity Insured Deposits, Inc. ("Fidelity Insured Deposits") placed advertisements in major newspapers offering an investment package consisting of a certificate of deposit (CD) from a bank insured by the Federal Deposit Insurance Corporation (FDIC) plus a "bonus" paid by Fidelity Insured Deposits, which resulted in a very attractive rate of return when combined.

Unlike most securities cases, however, Fidelity Insured Deposits had no desire to actually complete the sale of the advertised instrument. Instead, it used the advertised high rates of return as a ruse to lure senior citizens into its offices, where its sales agents would then attempt to persuade the purchase of an annuity instead. While Fidelity Insured Deposits, FEP, Inc. ("FEP") and their affiliates can offer many types of incentives to attract customers to purchase annuities, they cannot offer a "security" to attract customers except in compliance with the securities laws.

This appeal involves a single issue: whether the investment package advertised by Fidelity Insured Deposits constitutes a security under California law.

Fidelity Insured Deposits, FEP and certain of their officers and agents (collectively, "Fidelity") petitioned for a writ of administrative mandamus in response to a desist and refrain order issued by the Department of Corporations (the "Department") and subsequently upheld by an administrative law judge. (Clerk's Transcript ("CT") 6-12.) In its ruling on the writ pursuant to Code of Civil Procedure section 1094.5, the superior court held that the investment package did not constitute a security under the Corporate Securities Law of 1968 and granted Fidelity's petition for the writ, which ordered the Department to set aside the desist and refrain order. (CT 424-33, 449-50.) The Department now appeals the final judgment of the superior court.

II. STATEMENT OF THE FACTS

A. There is no substantial dispute regarding the facts

The superior court stated in its minute order that there is no substantial dispute about the operative facts described in the proposed decision of the administrative law judge. (CT 425.) Counsel to Fidelity similarly acknowledged the lack of any dispute as to the factual findings of the administrative law judge. (CT 68 ("Petitioners did not request preparation of the administrative record or a transcript because they intended to rely on the administrative law judge's summation of the facts").)

B. Persons subject to the desist and refrain order

Ronald Edward Reiswig is the owner and chief executive officer of FEP, Inc., which is licensed by the Department of Insurance and operates under the name Family Estate Insurance Services. (CT 362.) FEP's only business is selling annuities and its only source of income is from commissions earned from sales of those annuities. (CT 362.)

Janet Sue Reiswig is the owner and president of Fidelity Insured Deposits and the wife of Ronald Reiswig. (CT 362.) Fidelity Insured Deposits exists for the sole purpose of generating business for FEP and is not licensed by the Department of Insurance or any other regulatory body nor insured by the FDIC. (CT 362-63.) Fidelity Insured Deposits has no income and incurs significant expenses for advertising and staffing in order to support the annuity sales operations of FEP. (CT 363-64, 380.)

Rick Leon and Donald Fracchia were each licensed by the Department of Insurance as life agents and were authorized to transact insurance business on behalf of FEP in offices of Fidelity Insured Deposits located in West Los Angeles and Palm Desert, respectively. (CT 16.) If an investor insisted upon the investment package advertised by Fidelity Insured Deposits, sales agents like Rick Leon and Donald Fracchia would assist the investors in completing the purchase of a CD from a bank or other financial institution identified by Fidelity and receiving their subsequent bonus payment. (CT 425.)

C. Fidelity Insured Deposits attracted individuals through newspaper advertisements offering purported high returns on FDIC-insured certificate of deposits

In order to attract prospective customers, Fidelity Insured Deposits advertised the availability of CDs with very attractive interest rates. (CT 424.) Fidelity hoped that such prospects could then be convinced that an annuity offered by FEP would be a superior investment and purchase. (*Id.*)

During the period in question, Janet Reiswig conducted daily Internet research on rates of return being offered for FDIC-insured CDs and then determined a rate to be advertised by Fidelity Insured Deposits. (CT 362.) The advertised rate generally offered a return substantially higher – in most cases, twice the rate – than those offered by FDIC-insured banks. (CT 362-363.) Janet Reiswig chose rates that she believed were most likely to attract the attention of depositors and cause them to call Fidelity's sales agents. (CT 363.)

Any person who responded to the advertisements was required to make a personal appointment with a Fidelity sales agent, during which the sales agent would attempt to sell the investor an annuity. (*Id.*) The sales agent would inform the person that the advertised investment package was limited to a maximum of $5,000. (CT 364.) The sales agent would then inquire whether the person had more than $5,000 to invest, which was usually the case, and whether the investor would be interested in a product that offered an even greater return. (*Id.*) If a sales agent was successful in convincing the person to purchase an annuity, the sales agent would be rewarded with an amount equal to 40% of the commission received by FEP for the sale of the annuity. (*Id.*) On the other hand, the sales agent would make "not one dime on the sale" of the advertised CD plus bonus. (CT 380.)

If an investor insisted on purchasing the advertised investment product, the sales agent would refer the investor to an FDIC-insured bank and then calculate the difference between the return offered on the bank CD and the return advertised in the newspaper. (CT 363.) The amount of the difference would be paid to the investor in the form of a "bonus" check paid by Fidelity Insured Deposits within seven days of the investor returning proof that the CD was actually opened. (*Id.*) Since Fidelity Insured Deposits had no income or revenue, FEP provided the funds for such "bonus" checks. (*Id.*) Under this arrangement, Fidelity Insured Deposits had no economic incentive to sell the advertised investment package as each such sale actually represented a financial loss. (*Id.*)

During the six-month period between February and August in 2004, FEP sold nearly $36 million in annuities, upon which it received commissions ranging between 6.75% and 9.75%. (CT 364.) During the same period, over 16,000 telephone inquiries were made to Fidelity Insured Deposits in response to the advertisements that resulted in about 2,900 personal appointments. (*Id.*) As a result of the appointments, Fidelity arranged for the sale of 542 CD packages and completed the sale of 952 annuities. (*Id.*) Fidelity Insured Deposits spent about $100,000 per month in advertising fees and paid bonuses on CDs at the rate of $20,000 per month. (*Id.*)

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III. PROCEDURAL HISTORY

In response to complaints that elderly investors seeking safe and secure CDs were being misled by the advertisements placed by Fidelity Insured Deposits, the Department undertook an investigation. As a result of its investigation, the California Corporations Commissioner (the "Commissioner") issued a desist and refrain order against Fidelity, finding that the advertised investment products were securities and that Fidelity had violated Corporations Code sections 25110, 25210, and 25401. (CT 238-244.)

At the request of Fidelity, Administrative Law Judge Timothy S. Thomas of the Office of Administrative Hearings conducted a hearing and issued a proposed decision upholding the desist and refrain order, finding that the investment package of the CD and bonus were "securities." (CT 361-386.) The Commissioner adopted the proposed decision of Judge Thomas with minor technical changes. (CT 388-389.)

Subsequently, Fidelity petitioned for a writ of administrative mandamus under Code of Civil Procedure section 1094.5. (CT 6-12.) The superior court ruled in favor of the petitioners and ordered the Commissioner to set aside his decision. (CT 424-433, 453-454.) The Commissioner now appeals the final judgment of the superior court. (CT 467-469.)

IV. ARGUMENT

The superior court erred when it concluded that the investment package consisting of a CD plus bonus advertised by Fidelity Insured Deposits was not a security.

A. The standard of review is independent review

The appropriate standard of review is the independent appellate, or *de novo*, review. The superior court found that there was no substantial dispute about the operative facts as described by the administrative law judge. (CT 425.) Counsel to Fidelity similarly has argued the lack of any dispute as to many of the factual findings by the administrative law judge. (CT 68-69, 419-420.)

In reviewing the superior court's decision on a writ of mandate, the standard of review for the appellate court is generally the substantial evidence test. (See *Fukuda v. City of Angels* (1999) 20 Cal. 4th 805, 824.) However, the substantial evidence test does not apply to resolution of questions of law where the facts are undisputed; in such cases, the appellate court is not bound by the superior court's decision, but may make its own independent determination. (*Evans v. Unemployment Insurance Appeals Board* (1985) 39 Cal. 3d 398, 407; accord, *Anserv Insurance Services v. Kelso* (2000) 83 Cal. App. 4th 197, 204.)

B. A security is broadly defined under the securities laws

The offer or sale of securities in California must be qualified with the Commissioner or otherwise be exempt or not subject to qualification. (Corp. Code, § 25110.) Persons who offer or sell securities in California must obtain a certificate as a broker-dealer from the Commissioner unless otherwise exempt. (Corp. Code, § 25210.) It is unlawful to offer or sell a security in California by means of any written or oral communication that includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. (Corp. Code, § 25401.)

Corporations Code section 25019 defines "security," but the definition is not applied literally.[1] The California Supreme Court has

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[1] With exceptions not here relevant, section 25019 defines "security" as meaning "any note; stock; treasury stock; membership in an incorporated or unincorporated association; bond; debenture; evidence of indebtedness; certificate of interest or participation in any profit-sharing agreement;

observed that the cases interpreting the definition have adhered to the principle that substance governs over form and that mere inclusion in section 25019 is not definitive by itself. (See *People v. Figueroa* (1986) 41 Cal. 3d 714, 734.) The "critical question" that needs to be resolved is "whether a transaction falls within the regulatory purpose of the law regardless of whether it involves an instrument which comes within the literal language of the definition." (*Id.* at 735.)

Thus, in determining whether an instrument is a security, "the courts have been mindful that the general purpose of the [Corporate Securities Law] is to protect the public against the imposition of unsubstantial,

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collateral trust certificate; preorganization certificate or subscription; transferable share; investment contract; viatical settlement contract or a fractionalized or pooled interest therein; life settlement contract or a fractionalized or pooled interest therein; voting trust certificate; certificate of deposit for a security; interest in a limited liability company and any class or series of those interests (including any fractional or other interest in that interest), except a membership interest in a limited liability company in which the person claiming this exception can prove that all of the members are actively engaged in the management of the limited liability company; provided that evidence that members vote or have the right to vote, or the right to information concerning the business and affairs of the limited liability company, or the right to participate in management, shall not establish, without more, that all members are actively engaged in the management of the limited liability company; certificate of interest or participation in an oil, gas or mining title or lease or in payments out of production under that title or lease; put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof); or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency; any beneficial interest or other security issued in connection with a funded employees' pension, profit sharing, stock bonus, or similar benefit plan; or, in general, any interest or instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. All of the foregoing are securities whether or not evidenced by a written document. . . ."

unlawful and fraudulent stock and investment schemes and the securities based thereon." (*Id.* at 736 (citing *People v. Syde* (1951) 37 Cal. 2d 765, 768). To that end, the term "security" is employed in the broadest possible sense and includes within its ambit any "investment contract" in order to regulate novel, uncommon or irregular devices offered as investments." (*People ex rel. Bender v. Wind River Mining Project* (1990) 219 Cal. App. 3d 1390, 1398 (citing *SEC v. Joiner Leasing Corp.* (1943) 320 U.S. 344, 351 [88 L. Ed. 88, 64 S. Ct. 120].)

This appeal focuses solely on the conduct surrounding the offer by Fidelity of the CDs plus bonuses. The Department does not claim that the annuities sold by FEP are securities subject to the Department's jurisdiction. On the other hand, the fact that the real objective of Fidelity is to lure customers to their offices in order to convince them to purchase annuities instead does not make the advertised investment package of a CD plus bonus any less of a security.

C. Cases interpreting the federal securities laws have persuasive authority in California and federal cases similarly provide for a broad construction of "security"

The definition of "security" under section 2(a)(1) of the federal Securities Act of 1933 (15 U.S.C. 77(b)(1)) served as the model for the definition of "security" under the Corporate Securities Law. (*Figueroa, supra*, 41 Cal. 3d at 727 fn. 14.) As such, decisions interpreting the federal definition are helpful in interpreting state law. (*Id.*; see also *Moreland v. Department of Corporations* (1987) 194 Cal. App. 3d 506, 512 ["In these situations, the federal cases interpreting the federal law offer *persuasive* rather than controlling authority in construing the state law."].)

Similar to the California Supreme Court's statements in *Figueroa*, the U.S. Supreme Court recently re-affirmed that the definition of security under the federal laws should be broadly construed since the purpose of

Congress "in enacting the securities laws was to regulate *investments*, in whatever form they are made and by whatever name they are called." (*SEC v. Edwards* (2004) 540 U.S. 389, 393 [157 L. Ed. 2d 813, 124 S. Ct. 892] (quoting *Reves v. Ernst & Young* (1990) 494 U.S. 56, 61 [108 L. Ed. 2d 47, 110 S. Ct. 945].) Thus, the definition of security is sufficiently broad "to encompass virtually any instrument that might be sold as an investment." (*Edwards, supra*, 540 U.S. at 393.)

D. An integrated package of a CD with a bonus is an "investment contract"

The parties are in general agreement that if the investment package consisting of a CD and a bonus payment is a security, then it is a security in the form of an "investment contract." (CT 382, 431.) In determining whether an investment is an "investment contract," California courts have applied two separate, but distinct, tests: the "risk capital" test set forth in *Silver Hills Country Club v. Sobieski* (1961) 55 Cal. 2d 811, 815 and the federal test set forth in *SEC v. W.J. Howey Co.* (1946) 328 U.S. 293, 298-99, [90 L. Ed. 1244, 66 S. Ct. 1100]. (*Moreland, supra*, 194 Cal. App. 3d at 513; see generally 1 Marsh & Volk, Practice Under the California Corporate Securities Law of 1968 (2005) § 5.19.) An investment is a security if it satisfies either test. (*Moreland, supra*, 194 Cal. App. 3d at 513 fn. 3.)

In describing the risk capital test, the California Supreme Court stated that the objective of the securities law is to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures, whether or not they expect a return on their capital in one form or another. (*Silver Hills, supra*, 55 Cal. 2d at 815.) The risk capital test would therefore be satisfied in a situation where funds are sought to develop a business for profit. (*Id.*) The risk capital test, however, is a general test and is not applicable in all situations. (*People v. Smith* (1989) 215 Cal. App. 3d 230, 237.) The federal *Howey* test is also used to determine whether an investment is a security when appropriate. (*Id.*)

Under the federal securities laws, the test for an investment contract is "whether the scheme involves an investment of money in a common enterprise with profits solely from the efforts of others." (*Edwards, supra,* 540 U.S. at 393 (quoting *Howey, supra,* 328 U.S. at 301).) The *Howey* test is 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." (*Edwards, supra,* 540 U.S. at 393 (quoting *Howey, supra,* 328 U.S. at 299).) Both the U.S. Supreme Court and the U.S. Court of Appeals for the Ninth Circuit have rejected attempts to prevent investment vehicles from being deemed an investment contract by simply breaking up an investment into components that might, individually, not be a security, but when combined constitute an investment contract. (*SEC v. Rubera* (9th Cir. 2003) 350 F. 3d 1084, 1091.)

In *Safeway Portland Employees' Federal Credit Union v. C.H. Wagner & Co.* (9th Cir. 1974) 501 F. 2d 1120, the court concluded that the combination of a bank-issued CD with a bonus payment constituted an "investment contract" under the federal securities laws. For purposes of the court's analysis, it assumed that a bank-issued CD was <u>not</u> a security. (*Id.* at 1123.) The court held the combination of the CD with the bonus was an integrated investment package that is fundamentally different than the underlying bank-issued CD, even though the difference in the rates of return was a miniscule 5/8% – from 7-1/2% for the CD alone to 8-1/8% for the CD plus bonus. (*Id.* at 1122-23.)

Subsequently, the U.S. Supreme Court confirmed what was assumed in the *Safeway* decision. In *Marine Bank v. Weaver* (1982) 455 U.S. 551

[71 L. Ed. 2d 409, 102 S. Ct. 1220] the Court ruled that an FDIC-insured CD was not a security under federal law. The Court based its decision on the fact that federally-regulated banks were subject to a comprehensive set of regulations and that FDIC insurance virtually guaranteed the payment in full of the CD. (*Id.* at 558.)

However, contrary to any assertion that *Marine Bank* gave a blanket approval to the legal principle that CDs were never securities, the U.S. Supreme Court cautioned that:

> it does not follow that a certificate of deposit or business agreement between transacting parties invariably falls outside the definition of a "security" as defined by the federal statutes. Each transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole.

(*Marine Bank*, *supra*, 455 U.S. at 560 fn. 11 [emphasis added].) Thus, it is appropriate to analyze whether the investment package advertised by Fidelity Insured Deposits is an investment contract under the *Howey* test.

1. Investment of money

To have an investment of money, it is necessary in California only to show that "a person entrusted money or other capital to another." (*Smith*, *supra*, 215 Cal. App. 3d at 236.) In order to receive the advertised rate of return, each investor would have to open a CD account with a bank and deposit up to $5,000. (CT 364.) Thus, Fidelity Insured Deposits caused each investor who wanted the advertised offer to entrust their money to another – the bank – and the first prong under *Howey* is satisfied.

2. In a common enterprise

A common enterprise has been described in the Ninth Circuit as:

> [A] venture "in which the 'fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment . . . .'" It is not necessary that the funds of investors are pooled; what must be shown is that

> the fortunes of the investors are linked with those of the promoters, thereby establishing the requisite element of vertical commonality. Thus, a common enterprise exists if a direct correlation has been established between success or failure of [the promoter's] efforts and success or failure of the investment.

(*SEC v. Eurobond Exchange* (9th Cir. 1994) 13 F. 3d 1334, 1338-39 (quoting *SEC v. Goldfield Deep Mines Co.* (9th Cir. 1985) 758 F. 2d 459, 463) (quoting *Brodt v. Bache & Co.* (9th Cir. 1978) 595 F. 2d 459, 460) (quoting *SEC v. Glenn W. Turner Enterprises* (9th Cir. 1973) 474 F. 2d 476, 482 n.7, cert. denied (1973) 414 U.S. 821, 38 L. Ed. 2d 53, 94 S. Ct. 117 [other citations omitted]).

The ability of Fidelity Insured Deposits to pay the bonuses is entirely dependent upon the continued success of FEP in selling annuities and Fidelity Insured Deposits has no means to pay the bonuses other than by the funding derived from FEP. (CT 362-64.) The funds provided by FEP are earned solely from commissions on sales of annuities to a prospective customer base created from the response to the advertisements of CDs plus bonus placed by Fidelity Insured Deposits. (CT 362, 364.)

Thus, the offers of the CDs plus bonuses by Fidelity Insured Deposits and the sale of annuities by FEP are completely intertwined and there is a common enterprise. In this respect, the common enterprise is similar to Ninth Circuit's description of *Glenn W. Turner Enterprises*, in which a common scheme was found where its success was directly dependent upon the collective sales efforts of the organization. (*Great Western Bank & Trust v. Kotz* (9th Cir. 1976) 532 F. 2d 1252, 1259 fn. 7.)

3. With profits solely from the efforts of others

The third prong of *Howey* requires that the investor be "led to expect profits solely from the efforts of the promoter or a third party." (*Howey*, *supra*, 328 U.S. at 299.) The Ninth Circuit has interpreted the third prong to focus on "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." (*Rubera*, *supra*, 350 F. 3d at 1091-92 (quoting *Glenn W. Turner Enterprises*, *supra*, 474 F. 2d at 482).)

Similarly, in *Smith*, *supra*, 215 Cal. App. 3d at 237, the court quoted *United Housing Foundation, Inc. v. Forman* (1975) 421 U.S. 837, 852 [44 L. Ed. 2d 621, 95 S. Ct. 2051] when it held that an investment contract depends upon there being a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others.

The record shows that significant managerial and entrepreneurial efforts are required by FEP and its sales agents to sell annuities in order to generate sufficient funds to pay the estimated $100,000 per month advertising expenses and $20,000 per month for CD bonus payments incurred by Fidelity Insured Deposits. (CT 362-68.) As a result, during a six-month period in 2004, FEP sold nearly $36 million in annuities, upon which it received a commission equal to 6.75% to 9.75% of that amount. (CT 364.)

Thus, this court should follow the findings of the administrative law judge, who reasonably concluded that:

> The [Fidelity] clients are completely dependent upon both the entrepreneurial and managerial efforts of [Fidelity] in order to realize the advertised returns on their investments. The fact that most of the entrepreneurial efforts of [Fidelity] occurred pre-purchase does not render them irrelevant, nor minimize either the managerial efforts nor the risk of FEP's solvency taken, if unknowingly, by the investors.

(CT 384.)

a) The superior court erred by too narrowly defining the entrepreneurial and managerial efforts of Fidelity

In the superior court, Fidelity argued that there was an absence of any post-transaction entrepreneurial activity and that the only effort was the ministerial step of sending the bonus check to the purchaser of a CD. (CT 69-73.) The superior court agreed with Fidelity when it found that the requisite efforts "cannot be merely the attempt to stay alive or to stay in business or to go to the post office to mail a payment." (CT 431.)

The superior court erred by too narrowly construing the efforts of Fidelity as only requiring a check to be sent in the mail. Instead, the superior court, in applying the substance over form analysis required by *Figueroa*, should have considered Fidelity's entire business operation since the advertisements of the CDs plus bonuses are inseparable from the sale of annuities.

Some might argue that by including Fidelity's sales activities of annuities, the Department is attempting to exercise jurisdiction over an insurance product outside of its jurisdiction. This, however, is not true. The annuity sales are only relevant because they demonstrate the significant entrepreneurial and managerial activities required under *Smith*, which would then satisfy the third prong of the *Howey* test.

Without the inducement provided by the high-yielding advertisements of the CDs plus bonuses, prospective investors would have no reason to call Fidelity Insured Deposits. Without the steady customer pool of investors seeking higher rates of return, FEP would not have the opportunity to make a sales pitch for the annuities.

Similarly, the investors who respond to the advertisements of Fidelity Insured Deposits and select the CD plus bonus package rely on significant entrepreneurial and managerial efforts on the part of Fidelity. Purchasers of the CD plus bonus package are completely relying upon agents of FEP to convince <u>other persons</u> who respond to the advertisements to purchase an annuity. Failure to sell the annuities would mean that funds from the enterprise would not be available to pay the bonuses.

Thus, the offer and sale of the CDs plus bonuses are interdependent with the sales of annuities and the superior court improperly concluded as a matter of law that the annuity sales did not constitute sufficient entrepreneurial or managerial efforts.

b) The superior court also erred when it failed to consider the significant pre-purchase managerial activities undertaken by Fidelity

Even if the CD plus bonus activities of Fidelity were considered on a stand-alone basis, the superior court should have followed the U.S. Court of Appeals for the Eleventh Circuit, which held that "significant pre-purchase managerial activities undertaken to insure the success of the investment may also satisfy *Howey*." (*SEC v. Mutual Benefits Corp.* (11th Cir. 2005) 408 F. 3d 737, 743.) The Eleventh Circuit further observed that "courts have found investment contracts where significant efforts included the pre-purchase exercise of expertise by promoters in selecting or negotiating the price of an asset in which investors would acquire an interest." (*Id.* at 744 (citations omitted); see also *Eurobond Exchange*, *supra*, 13 F. 3d at 1341 (finding various pre-purchase activities sufficient to satisfy the third prong of *Howey*).)

The Department notes that the Eleventh Circuit's decision conflicts with the decision of the U.S. Court of Appeals for the D.C. Circuit in *SEC v. Life Partners, Inc.* (D.C. Cir. 1996) 87 F. 3d 536, rehearing denied 102 F. 3d 587, which considered whether viatical settlements were investment contracts.[2] The D.C. Circuit found that the sponsors of the investments performed only ministerial post-purchase functions that did not have a

[2] A viatical settlement is an investment contract pursuant to which an investor acquires an interest in the life insurance policy of a terminally ill person at a discount. When the insured dies, the investor receives the proceeds of the insurance policy. (*Life Partners*, *supra*, 87 F. 3d 536, 537.)

material impact upon the profits of investors. (*Life Partners*, *supra*, 87 F. 3d at 547.) Subsequently, the D.C. Circuit clarified its decision, stating that "ministerial functions should receive a good deal less weight than entrepreneurial activities" and that its decision was based on the absence of any entrepreneurial post-purchase efforts. (*Life Partners*, *supra*, 102 F. 3d at 588.)

As noted in the administrative law judge's proposed decision, *Life Partners* has been subjected to significant criticism. (CT 383.) The *Life Partners* test was specifically rejected by the Eleventh Circuit:

> We decline to adopt the test established by the *Life Partners* court. We are not convinced that either *Howey* or *Edwards* require such a clean distinction between a promoter's activities prior to his having use of an investor's money and his activities thereafter.

(*Mutual Benefits Corp.*, *supra*, 408 F. 3d at 743.) Given the criticism of the *Life Partners* decision,[3] California should follow *Mutual Benefits* rather than *Life Partners* and consider whether there was significant pre-purchase managerial activities.

The facts demonstrate that Fidelity engaged in significant pre-purchase entrepreneurial and managerial activities. Janet Reiswig selected the advertised rate of return on the CD plus bonus product and, at the time in question, these rates were substantially higher than the rates being offered by banks on legitimate FDIC-insured CDs. (CT 362-63.) Janet Reiswig's primary criterion was to select a rate most likely to attract depositors and cause them to call her sales agents. (CT 363.) Fidelity also conducted market research on banks offering CDs, directed investors to such banks, and even had its agents assist the investors in making the CD purchase. (CT 425.)

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[3] See also *Wuliger v. Mann* (N.D. Ohio 2005) 2005 U.S. Dist. [LEXIS 13021, Fed. Sec. L. Rep. (CCH) P93284] and *Siporin v. Carrington* (Ariz. Ct. App. 2001) 200 Ariz. 97, 103 [23 P. 3d 92.]

Although the $150 amount of a typical individual bonus payment is relatively small (CT 425.), it is important to note that the rate of return advertised by Fidelity Insured Deposits were typically twice the rate offered by FDIC-insured banks. (CT 362-63.) Under such circumstances, Fidelity would be responsible for providing up to 50% of the investor's profit.

This activity by Fidelity creates a significant and crucial distinction from *Noa v. Key Futures, Inc.* (9th Cir. 1980) 638 F. 2d 77, the case primarily relied upon by Fidelity's counsel and the superior court as to why the CDs plus bonuses offered by Fidelity were not investment contracts. (CT 429-30.) In *Noa*, the sponsors agreed to purchase and store silver bars on behalf of the investors and also promised to repurchase the silver at any time at the spot price quoted in the Wall Street Journal. (*Noa*, 638 F. 2d at 79.) Thus, the court found that the scheme failed the third prong of the *Howey* test, since the expected profits derived from fluctuations of the silver market and not due to the managerial efforts of the promoters.[4] (*Id.* at 77. See also *SEC v. Belmont Reid & Company, Inc.* (9th Cir. 1986) 794 F. 2d 1388, 1391 (finding that profits on gold coins depended on fluctuations in the gold market and not on the managerial efforts of the promoter).)

One California appellate case similarly follows the reasoning of *Noa* and *Belmont Reid*. In *Moreland*, the California Court of Appeal for the Fifth Appellate District found that an offer to sell and refine gold ore was not an investment contract, finding that the investor's profit would depend on the price of gold and not the managerial efforts of the promoters. (*Moreland*, *supra*, 194 Cal. App. 3d at 515-19.)

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[4] The court further found that purchase of the silver and the free storage did not amount to the efforts required by *Glenn W. Turner Enterprises*. *Noa*, *supra*, 638 F. 2d at 80.

The superior court and counsel for Fidelity fundamentally misapplied the holding of *Noa* by injecting the concept of risk into the third prong of the test. (CT 429-30; 71 ("The risk [the buyers] assumed was that which any buyer takes when he pays in advance for goods to be delivered in the future")). Risk is not an element of the third prong of the *Howey* test. *Noa* simply states that there cannot be any managerial efforts for purposes of *Howey* if the expected profits will be derived only from changes in market prices determined independently of the efforts of the promoter.

In the instant case, the facts are clear that Fidelity determined the "bonus" yield, meaning the difference between the bank rate on CDs and the rate advertised by Fidelity Insured Deposits, that Fidelity selected the banks to which it directed investors, and that agents of Fidelity assisted investors in purchasing the CDs. These actions constituted significant pre-purchase entrepreneurial and managerial efforts undertaken to ensure the success of the investment under *Mutual Benefits*, thereby satisfying the third prong of the *Howey* test.

E. The court should follow the decision of the Ninth Circuit in *Safeway*, which held that an integrated package of a CD plus a bonus is an "investment contract"

In a factual situation very similar to this case, the Ninth Circuit analyzed whether the combined package of a CD plus a bonus is a security under the federal law. (*Safeway*, *supra*, 501 F. 2d at 1122.) In *Safeway*, a broker solicited investors to purchase CDs bearing 7-1/2% with a 5/8% bonus to be paid by the broker, resulting in a total yield of 8-1/8%. (*Id.*) The Ninth Circuit found that the "combination of the two created an integrated investment package which must be viewed in its entirety in determining whether it is within or without the Act" and "differs fundamentally from the CDs issued by Bank in that there is a greater rate of return." (*Id.* at 1123 (emphasis added).)

The Ninth Circuit then focused on the importance of total return, finding that the "nature of economic inducement is of great significance." (*Id.*) Thus, the Ninth Circuit concluded, "there is no doubt but that the inducement for the purchase was the total combined rate of interest to be realized." (*Id.*) Likewise, in the instant case, as thirteen of the fourteen witnesses testified at the administrative hearing specifically testified, the only reason they responded to the Fidelity advertisements was due to the very attractive rates of return being offered, which were much higher than those being offered by FDIC-insured banks. (CT 368-379.)

It might be argued that there are differences of legal significance between the instant facts and *Safeway*, such as the timing of the payment and the non-receipt of a commission, which would dictate a different outcome. (See Reporter's Transcript ("RT") 9:14-20.) These arguments are without merit.

In *Safeway*, the bonus was paid upon maturity of the CD. (*Safeway*, *supra*, 501 F. 2d at 1122 fn. 3.) In Fidelity's case, the bonus was paid within seven days after the CD purchaser returned proof that a CD had actually been acquired. (CT 363.) This distinction does not change the analysis under *Safeway*. The facts in *Safeway* are somewhat similar to the instant case in that the Ninth Circuit noted "in most instances the bonus is paid by the [broker] at the time of purchase" but that the purchaser had requested that payment of the bonus to be deferred until maturity. (*Safeway*, *supra*, 501 F. 2d at 1122 fn. 3.) In analyzing the Ninth Circuit's decision, however, the timing of the payment was apparently not a factor in determining whether the package was an investment contract. Otherwise, the court probably would have addressed the legal significance of the timing of the payment. Furthermore, as counsel to Fidelity was forced to concede in oral argument before the superior court, there is a risk of insolvency during the waiting period for the bonus, just like in *Safeway*. (RT 10:7-15.)

Counsel for Fidelity also tried to distinguish *Safeway* by arguing that no Fidelity sales agent received a commission on the sale of the CD plus bonus. (RT 9:14-20.) The administrative law judge correctly addressed this argument in his proposed decision when he concluded that Fidelity's motives in ultimately receiving commissions on the sales of annuities did not differ conceptually from the receipt of commission on the sale of the CDs in *Safeway*. (CT 382.)

Finally, it could be argued that the subsequent decision of the U.S. Supreme Court in *Marine Bank* finding that FDIC-insured CDs are not securities for purposes of federal law somehow invalidated the Ninth Circuit's earlier decision in *Safeway*. This would be an inappropriate conclusion, because the Ninth Circuit assumed in *Safeway* that CDs were either not securities or exempt securities under the federal securities laws. (*Safeway*, *supra*, 501 F. 2d at 1123 ["Even if it be assumed that the CDs are not securities or that they are exempt securities . . . it does not follow that only the [bonus] violated the [Securities] Act."].)

F. The superior court's reliance on the fact that the "bonus" was a fixed obligation contradicts both U.S. Supreme Court and California precedents

The superior court supported its decision, finding that the CDs plus bonuses advertised by Fidelity were not securities, by focusing its analysis on the fact that the bonuses were for a fixed amount and that investors only bore ordinary risks comparable to a consumer transaction. (CT 431-32.) The superior court's analysis, however, is not consistent with U.S. Supreme Court precedent as well as a prior decision by California courts.

In 2004, the U.S. Supreme Court specifically addressed whether a scheme is excluded from the term "investment contract" simply because it offered a contractual entitlement to a fixed, rather than variable, return when applying the *Howey* test. (*Edwards*, *supra*, 540 U.S. at 391.) The Court noted that there had been some confusion among the judiciary as to whether the "profits" prong of the *Howey* test could only be satisfied through capital appreciation or a participation in earnings of an enterprise. (*Id.* at 395-96.)

The Court held that there was no reason to distinguish between fixed and variable returns for purposes of the *Howey* test, since in both cases, the investing public is attracted by representations of investment income. (*Id.* at 394.) Moreover, the Court observed "investments pitched as low-risk (such as those offering a 'guaranteed' fixed return) are particularly attractive to individuals more vulnerable to investment fraud, including older and less sophisticated investors." (*Id.*)

If a fixed return was excluded under the *Howey* test, the Court continued, then "unscrupulous marketers of investments could evade the securities laws by picking a rate of return to promise. <u>We will not read into the securities laws a limitation not compelled by the language that would so undermine the laws' purposes</u>." (*Id.* at 394-95 (emphasis added).)

The Court also specifically rejected the contention that, because the investor had a contractual entitlement to a return, the instrument was no longer a security. (*Id.* at 397.) The fact that an investor has bargained for a rate of return on investment does not mean that such rate of return is not also expected to come solely from the efforts of others. (*Id.*)

California law regarding the treatment of fixed returns is similar. In fact, the *Edwards* decision recognized that *Howey*, in creating the federal test for an investment contract, had cited as support a California Supreme Court case, *People v. White* (1932) 124 Cal. App. 548, which involved an agreement with a fixed return that was held to be an investment contract. (*Edwards*, *supra*, 540 U.S. at 395.) The California Court of Appeal for the

Third Appellate District has also stated that the "unwary investor lured by promises of fixed fees deserves the same protection as a participant in a profit sharing plan." (*Hamilton Jewelers v. Department of Corporations* (1974) 37 Cal. App. 3d 330, 334 (quoting *State v. Hawaii Market Center, Inc.* (1971) 52 Hawaii 642, 651 [485 P. 2d 105, 110].)

Thus, the superior court's analysis was wrong when it focused on the fact that a person who acquired the CD plus bonus from Fidelity was entitled to a fixed return and will be "received if [Fidelity Insured Deposits and FEP] stay alive, stay in business, don't go bankrupt, and aren't a fraud." (CL 432.) Instead, the analysis by the superior court under *Howey* should have been whether the bonus was based solely on the efforts of others. As the facts have previously discussed, the ability to finance the bonus was based solely on the efforts of Fidelity to persuade a number of those persons responding to the CD plus bonus advertisements to purchase an annuity.

G. The superior court misread *Noa* by focusing on the risk that the bonus would not be paid rather than whether profits were based solely on the efforts of others

The superior court's decision misread the central holding of the Ninth Circuit in *Noa* and instead relied upon dicta, which resulted in the superior court applying a level of risk test that is not called for under *Howey*. The key passage in the superior court's opinion stated:

> To repeat the *Noa* comment: "the risk they [buyers] assumed was that which any buyer takes when he pays in advance for goods to be delivered in the future." At once this seems so simple that it need not be said, but it is apparently so elusive that repetition is appropriate.

(CT 430.) The superior court then analyzed the type of risk faced by prospective investors with respect to the payment of the bonus by Fidelity.

The holding in *Noa* was that when expected profits depend upon a fluctuating market price, not the managerial efforts of the promoter, then the *Howey* test will not be satisfied. (*Noa*, 638 F. 2d at 79-80.) Thus, the Ninth Circuit concluded that because profits on the silver bars were dependent upon the spot price for silver and not the managerial efforts of the promoters, an investment contract did not exist. (*Id.*)

In dicta, the Ninth Circuit addressed the investors' contention in *Noa* that they were at "risk" because the promoter might fail to deliver the promised silver. (*Id.* at 80.) But because the "risk" of failing to deliver the silver would not affect profitability of the investment (which would be determined by the fluctuating market price), the Ninth Circuit concluded that such risk was no different than an ordinary consumer transaction and thus prompting the comment upon which the superior court relied heavily. (*Id.*)

In the instant case, the significant and critical legal difference is that Fidelity had total and absolute discretion as to determine the size of the bonus prior to making the advertisement. (CT 363.) Therefore, the investors' expected profit was based solely on the decisions of Fidelity and <u>not</u> the market price.

The superior court's analogies involving the risk of certain consumer transactions – the purchase over the Internet of a book, the down payment to a local dealer on a new car, and the purchase of a vegetable chopper with a set of bonus steak knives to be sent later – are misplaced. (CT 431.) The U.S. Supreme Court recognized this important distinction:

> What distinguishes a security transaction . . . is an investment where one parts with his money in the hope of receiving profits from the efforts of others, and not where he purchases a commodity for personal consumption or living quarters for personal use.

(*Forman*, *supra*, (1975) 421 U.S. 837, 858.) Each of the examples given by the superior court is clearly a consumer transaction and the Department acknowledges that such transactions are not covered by the securities laws. However, it does not follow that just because an investment may have the same level of risk as a consumer transaction, that such investment is automatically removed from coverage under the securities laws.[5]

H. Arguments that the CD plus bonus offered by Fidelity is substantially identical to an FDIC-insured CD and not a security should be rejected

One should not be tempted to succumb to an argument that, notwithstanding the *Howey* test, a CD plus bonus is not significantly different than the FDIC-insured CD was held not to be a security under *Marine Bank*. Judge Sneed of the Ninth Circuit expressed such a sentiment in his concurring opinion in *Safeway*, in which he stated that he had "grave doubts, for example, that the 5/8% bonus offered by Wagner *alone* is sufficient to transform the *entire package* into a nonexempt investment contract." (*Safeway*, *supra*, 510 F. 2d at 1125.)

Under *Marine Bank*, a clear line was drawn by the U.S. Supreme Court to create an exception for FDIC-insured CDs from the securities laws. The Supreme Court's rationale was based on the fact that federally regulated banks were subject to a comprehensive set of regulations, including reserve, reporting and inspection requirements, regulations on advertising, and the virtual guarantee of payment of principal and interest

[5] The Department also observes that counsel for Fidelity asserted to the superior court that not a single person had missed receiving his or her bonus payment, which was indicative of the lack of risk involved in the CD plus bonus offering. (CT 10; RT 34:3-7). Whether an investor actually suffers a monetary loss, however, is not relevant as long as there is a risk of loss. (*Rubera*, *supra*, 350 F. 3d at 1090.)

provided by the FDIC in the event of bank failure. (*Marine Bank*, *supra*, 455 U.S. at 557-58.)

In contrast, the sale of CDs plus bonuses by Fidelity fall under no comprehensive regulatory scheme. Fidelity Insured Deposits is not regulated as a bank or other financial institution or as an insurance broker nor does the FDIC guarantee the bonus obligations. At best, Fidelity Insured Deposits might be a deposit broker dealing only in FDIC-insured deposits, as its counsel argued in its trial brief to the administrative law judge. (CT 263, 346.) Yet deposit brokers are not subject to any significant regulation:

> [Certificate of deposit] brokers do not have to go through any licensing or certification procedures, and no state or federal agency licenses, examines, or approves them. Since anyone can claim to be a deposit broker, you should always check whether your broker or the company he or she works for has a history of complaints or fraud.

U.S. Securities and Exchange Commission, "Certificates of Deposit: Tips for Investors" available at www.sec.gov/investor/pubs/certific.htm.

In fact, the FDIC specifically repealed regulations in 2001 that required deposit brokers to notify the FDIC that they were engaging in deposit activities and to maintain certain records and reports. (Rescission of Deposit Broker Notification, Recordkeeping and Reporting Requirements (2001) 66 Fed. Reg. 17621.[6]) Thus, there is no regulatory role of the FDIC regarding deposit brokers in any form comparable to the bank regulation scheme outlined by the Supreme Court in *Marine Bank*.

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[6] The FDIC noted that, in the past, some deposit brokers had advertised themselves as "FDIC-registered," suggesting "that the broker had been approved or examined by the FDIC. Such suggestions were incorrect. . . . . Brokers should no longer advertise that they are 'FDIC-registered' or otherwise indicate that they are somehow approved by the FDIC." 66 Fed. Reg. at 17621.

The U.S. Supreme Court carved out an exception for FDIC-insured CDs from the securities laws due to the extensive federal regulatory system in place. Fidelity would ask that this exception be expanded by judicial rule to cover investment packages that it believes are low-risk and similar to CDs, despite the absence of any comparable regulatory system. Such a request goes too far. Any such carve-outs from the securities laws should be left to the legislature or the appropriate regulatory agency.

V. CONCLUSION

The securities laws were designed to protect investors when they engaged in investment transactions, in whatever form they make take or by whatever name they are called. The definition of a security is a flexible concept, one capable of adapting to the countless schemes devised by those who seek to separate investors from their money.

Keeping in mind the general purpose of the securities laws, the Commissioner believes the findings of the administrative law judge regarding the advertisements made by Fidelity Insured Deposits are significant:

> Reasonable minds cannot differ, and respondents do not really dispute, that the advertisements are intended to "grab" the attention of investors, particularly elderly investors who seek the safest investments.

(CT 385.)

The CDs plus bonuses offered by Fidelity Insured Deposits are not banking products regulated by banking regulators and are not fully insured by the FDIC. They also are not insurance products regulated by the insurance regulators. They are, however, investments. In light of the facts and circumstances, this court should find that they are investment contracts subject to the securities laws and remand the case to the superior court for disposition in a manner consistent with such finding.