BEFORE THE
DEPARTMENT OF CORPORATIONS
STATE OF CALIFORNIA

In the Matter of the DESIST and REFRAIN ORDER Issued to: Kenneth W. Keegan Faber Laine Johnston Brandon Taylor Guardian Capital Management 450 Salmar Avenue Campbell, CA 95008 Consolidated Management Group, LLC Consolidated Leasing Anadarko Joint Venture Consolidated Leasing Hugoton Joint Venture #2 410 Urban Drive Hutchinson, KS 67501 Respondents.	File No.: 7335 OAH No.: N2006020680

DECISION

The attached Proposed Decision of the Administrative Law Judge is hereby adopted by the Commissioner of Corporations as its Decision in the above-entitled matter.

This Decision shall become effective on July 20, 2006.

IT IS SO ORDERED this 19th day of July 2006.

CALIFORNIA CORPORATIONS COMMISSIONER

Preston DuFauchard

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PROPOSED DECISION

Administrative Law Judge David L. Benjamin, State of California, Office of Administrative Hearings, heard this matter in Oakland, California, on March 6 and 7, 2006.

Edward Kelly Shinnick, Corporations Counsel, represented complainant Wayne Strumpfer, Acting California Corporations Commissioner.

Joel Held and Laura J. O'Rourke, Attorneys at Law, Baker & McKenzie LLP, 2300 Trammell Crow Center, 2001 Ross Avenue, Dallas, Texas 75201, represented respondents Consolidated Management Group, LLC (Consolidated), Consolidated Leasing Anadarko Joint Venture (Anadarko) and Consolidated Leasing Hugoton Joint Venture #2 (Hugoton), jointly referred to as the "Consolidated Respondents."

On March 2, 2006, Kenneth W. Keegan, Faber Laine Johnston, Brandon Taylor, and Guardian Cpital Management withdrew their requests for hearing. This proceeding is only against the remaining respondents. (See Factual Finding 2.)

The record was held open to receive written briefs, which were timely filed. The commissioner's post-hearing brief was marked Exhibit L; the Consolidated Respondents' response was marked Exhibit 16; and the reply brief of the commissioner was marked Exhibit M. The matter was deemed submitted on April 5, 2006.

SUMMARY

In 2005, Consolidated notified the commissioner that it intended to issue two securities in California – joint venture interests in Anadarko and Hugoton. Consolidated informed the commissioner that Anadarko and Hugoton were organized for the purpose of purchasing and leasing natural gas drilling equipment. Consolidated filed a statement with the commissioner, a "Form D," stating that the securities would be offered for sale in California under the exemption for "private offerings" established by federal securities law. Guardian Capital Management is the Consolidated Respondents' exclusive Northern California agent to sell the joint venture interests.

The commissioner alleges that the manner in which those securities were offered did not comply with the federal rules that govern private offerings. Specifically, the commissioner contends that Guardian Capital Management, on behalf of the Consolidated Respondents, sold or offered the securities for sale through a general solicitation of over 200 members of the Los Gatos Chamber of Commerce, and one other individual. The commissioner believes that, by virtue of the alleged general solicitation, the Anadarko and Hugoton securities lost their federal exemption. The commissioner seeks an order directing the Consolidated Respondents to "refrain from the further offer or sale in the State of California of securities, including but not limited to joint venture interests, unless and until qualification has been made under the law or unless exempt."

The Consolidated Respondents contend that the commissioner's action is preempted by the federal National Securities Market Improvement Act of 1996 (NSMIA). They assert that they have complied with the requirements of that act, and that the commissioner is preempted from taking any further enforcement action against them. The Consolidated Respondents also claim that Anadarko and Hugoton are not securities at all. They contend that Anadarko and Hugoton are general partnerships, and that general partnership interests are not securities. Finally, the Consolidated Respondents maintain that, if the interests in Anadarko and Hugoton are securities, they are exempt securities under the federal private offerings exemption.[1] The Consolidated Respondents deny that they offered to sell interests in Anadarko or Hugoton through a general solicitation.

The issues to be decided are: 1) Is the commissioner preempted by federal law from taking enforcement action against the Consolidated Respondents? 2) Are the interests in Anadarko and Hugoton "securities" under California law? 3) If they are securities, are they

[1] California law also establishes an exemption for private offerings, but the Consolidated Respondents do not contend that Anadarko and Hugoton are exempt under California law.

exempt under the federal rules that govern private offerings? 4) Is there cause for issuance of the commissioner's Order and, if so, what is the proper scope of the Order?

APPLICABLE LAW

Under Corporations Code section 25110, it is unlawful for any person to "offer or sell in this state any security in an issuer transaction . . . unless such sale has been qualified . . . or unless such security or transaction is exempted . . . ." The term "offer" includes "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security for value." (Corp. Code, § 25017, subdivision (b).)

Not subject to Corporations Code section 25110 are securities offered under section 18(b)(4)(D)[2] of the federal Securities Act of 1933 (the "1933 Act"). Section 18(b)(4)(D), as it relates to section 4(2)[3] of the 1933 Act, exempts "transactions by an issuer not involving any public offering." This is commonly referred to as the "private offering exemption." An issuer claims the private offering exemption by filing a "Form D" with the United States Securities and Exchange Commission. (17 C.F.R. § 239.500.) Corporations Code section 25102.1, subdivision (d), states that:

> The following transactions are not subject to [section] 25110 . . .
>
> [¶] . . . [¶]
>
> (d) Any offer or sale of a security with respect to a transaction that is exempt from registration under the Securities Act of 1933 pursuant to Section 18(b)(4)(D) of that act, if all of the following requirements are met:
>
> (1) A notice in the form of a copy of the completed Form D . . . is filed with the commissioner . . . .
>
> (2) A consent to service of process . . . is filed . . . .
>
> (3) Payment of the notice filing fee . . . is made.

The Securities and Exchange Commission has adopted regulations that govern the private offering exemption. (17 C.F.R. §§ 230.501-230.506, commonly referred to as "Regulation D.") Regulation D establishes the terms and conditions under which private offerings can be made, two of which are pertinent to this case. The first is a prohibition against "general solicitation." The regulations of the SEC state:

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[2] 15 U.S.C. § 77r(b)(4)(D).

[3] 15 U.S.C. § 77d(2).

> . . . neither the issuer nor any person acting on its behalf shall offer or sell the securities by an form of general solicitation or general advertising, including, but not limited to, the following: [¶]
>
> (2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising. (17 C.F.R. § 230.502(c).)

Second, a private offering may be sold to a limited number of purchasers, but to an unlimited number of "accredited investors." (17 C.F.R. §§ 230.506, 230.501(e)(iv).) Generally speaking, an "accredited investor" is an institutional investor, or an individual with a net worth that exceeds $1,000,000. (17 C.F.R. § 230.501.)

Corporations Code section 25019 defines a "security" by enumerated examples, followed by the phrase "or, in general, any interest or instrument commonly known as a "security."[4] There is no material difference between California's definition of "security" and the definition of"security" in section 2(a)(1) of the 1933 Act.[5] Both definitions include "investment contracts," but neither includes general partnership interests. The fact that an enterprise is labeled a "general partnership," however, does not put it beyond the reach of the securities laws; the term "security" is to be interpreted broadly to protect the public from speculative or fraudulent investments. (*People v. Graham* (1985) 163 Cal.App.3d 1159, 1164; *Securities and Exchange Commission v. W.J. Howey* (1946) 328 U.S. 293, 297-300.) Under both state and federal law, the courts may, upon a sufficient factual showing, look past the general partnership form of an enterprise and treat the interests in the enterprise as investment contracts, and therefore as securities. (*People v. Graham*, *supra*, 163 Cal.App.3d at pp. 1164-1169 (applying state law); *Williamson v. Tucker* (5th Cir. 1981) 645 F.2d 404, *cert. denied*, 454 U.S. 897 (1981), *Holden* v. *Hagopian* (9th Cir. 1992) 978 F.2d 1115 (applying federal law).)

FACTUAL FINDINGS

1. On January 19, 2006, Wayne Strumpfer, Acting California Corporations Commissioner, issued a Desist and Refrain Order to Kenneth W. Keegan, Faber Laine Johnston, Brandon Taylor, Guardian Capital Management, Consolidated, Anadarko, and Hugoton. The Order alleges (in relevant part) that respondents have engaged in general

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[4] "'Security' means 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; collateral trust certificate; preorganization certificate or subscription; transferable share; investment contract; . . . or, in general, any interest or instrument commonly known as a 'security' . . . ."

[5] 15 U.S.C. § 77b(1).

solicitations to the public to offer and sell joint venture interests in Anadarko and Hugoton. The Order further alleges that the joint venture interests in Anadarko and Hugoton are securities and are subject to qualification under the California Corporate Securities Law of 1968, and that the securities have been offered and sold without being qualified in violation of Corporations Code section 25110, and are not exempt.

2. All respondents requested a hearing. On March 2, 2006, Kenneth W. Keegan, Faber Laine Johnston, Brandon Taylor, and Guardian Capital Management withdrew their requests for hearing.

3. At some time prior to August 18, 2005, Consolidated filed a Form D with the Securities and Exchange Commission for Hugoton, with Consolidated as the issuer.

On August 18, 2005, Lloyd Nuns, the manager of Consolidated, filed two copies of the Hugoton Form D with the commissioner. Nuns included a check for the notice filing fee and a consent to service of process. In a cover letter to the commissioner, Nuns stated that the Form D related to the sale of interests in Kansas energy equipment leasing ventures to California accredited investors. Nuns stated that the first sale in California was made on August 15, 2005. Nuns informed the commissioner that the sale was made "under Rule 506 of Federal SEC Regulations D, only to accredited investors and the leasehold interest [sic] are covered securities as defined in Section 18(b)(4)(D) of the Securities Act of 1933."

4. At some time prior to November 16, 2005, Consolidated filed with the Securities and Exchange Commission a Form D for Anadarko, with Consolidated as the issuer.

On November 16, 2005, Nuns filed two copies of the Anadarko Form D with the commissioner, accompanied by a check for the notice filing fee and a consent to service of process. Nuns included a cover letter to the commissioner that was identical to the Hugoton cover letter, except that it noted that the first sale of Anadarko in California occurred on October 27, 2005.

5. The joint venture interests in Anadarko and Hugoton were not qualified for sale in California.

6. Kenneth Keegan is the president of Guardian Capital Management, which Keegan describes as a "capital development" company. At all times relevant to this proceeding, Guardian Capital has been the exclusive northern California agent to sell joint venture interests in Anadarko and Hugoton.

Keegan joined the Los Gatos Chamber of Commerce in mid-2005. Soon after that, he purchased from the chamber pre-printed mailing labels with the names of all of the chamber's members, about 430. From the 430 members, Keegan selected about 200, and mailed to each of them an invitation to attend one of several luncheons in Los Gatos. The

purpose of the luncheons was to "develop interest" in Anadarko and Hugoton. Keegan also invited Ronee Nassi, the manager of the Los Gatos Chamber of Commerce.

Asked how he selected the 200 invitees, Keegan testified that they were individuals who were "possibly accredited." Keegan stated that anyone who has lived in Los Gatos for more than 20 years, and who has purchased a home, is "a multi-millionaire." He knew many of the 200 people he selected from Rotary, or from the time he owned an imported car dealership; he knew others through his wife's membership in the Los Gatos Racquet Club and other social organizations; and he knew still others from his son's volunteer work with the Make-A-Wish Foundation. Keegan acknowledges that he did not have a pre-existing business relationship with all of the persons to whom the invitations were sent, that some of the participants – including Nassi – had no knowledge of oil and gas, and that he was trying to get the participants to invest in equipment that would be located "many states away."

At the luncheons, Keegan gave a PowerPoint presentation on the ventures. At the luncheons, Keegan offered participants the opportunity to invest; if they were interested, he would give them the confidential information memorandum, the joint venture agreement, the business experience/accredited investor questionnaire, and an application. Keegan required all prospective venturers to listen to a nationwide conference call with the principals of Consolidated, and he offered them the opportunity to visit Consolidated's office in Kansas. Keegan did not allow anyone but an accredited investor to purchase an interest in Anadarko or Hugoton.

7. On December 1, 2005, Department of Corporations investigator Jon Wroten was conducting an undercover investigation of an individual identified as H. W. on matters unrelated to this case. Wroten was posing as the owner of a sheetrock company with $20,000 to $30,000 to invest. Wroten did not give H. W. any other information on his "company" or his own business background, and did not represent himself as an accredited investor.

On December 1, 2005, H.W. called Wroten and asked him if he was interested in receiving information about another investment; Wroten said "yes." Within minutes, Wroten received a call from Faber Johnston, Director of New Business Development for Guardian Capital Management; Johnston is also Keegan's son-in-law. Wroten did not know Johnston. Johnston told Wroten that Guardian Capital was the consultant to Consolidated to market Anadarko, an investment with the potential to return 21% annually. Johnston described Consolidated's background and gave Wroten an overview of Anadarko's proposed operations. Johnston asked if Wroten would like to receive information about the investment opportunity, and Wroten said he would. Johnston also invited Wroten to participate in a nationwide conference call that afternoon, and gave Wroten a phone number and a pass code. During the conversation, Johnston asked Wroten what he did for a living, and Wroten told him that he owned a drywall company. The subject of "accredited investor" never came up in their conversation.

A short time later, Wroten received in the mail from Johnston a number of documents concerning Anadarko, including:

- A 27-page confidential information memorandum, describing the nature of the Anadarko venture, its proposed operations, its legal structure, and its risks.

- A joint venture agreement.

- A questionnaire that asks the prospective venturer to verify that he or she possesses "extensive experience and knowledge in business affairs," and is capable of intelligently exercising the management powers of a venturer. The questionnaire also asks the prospective venturer to state whether he or she is an accredited investor.

- An application agreement to participate in the venture in the amount of $62,000 per unit.

Wroten and Johnston did not talk again after December 1, 2005, but Johnston left voice-mail messages for Wroten concerning Anadarko, and sent him additional written materials relating to Anadarko.

8. Consolidated is a Kansas partnership. Its management team has over 100 combined years of experience in the energy industry. Consolidated has formed six prior joint ventures and five prior equipment leasing ventures. Consolidated believes that there is a shortage of drilling equipment for natural gas that is expected to last 10 years or more, that there is an increasing need for natural gas, and that the tax environment favors the development of natural gas. Based on these considerations, and others, Consolidated informed potential participants in Anadarko that they could expect an "equity return on investment . . . 6 to 10 times multiple in 3 to 5 years."

The Anadarko and Hugoton joint ventures are organized as general partnerships under Kansas law. Individuals invest in the ventures– and become "venturers" – by purchasing "units" of participation. Participation in Anadarko is based upon the amount of $62,000 per unit, and participation in Hugoton is based upon $50,000 per unit; both ventures hope to sell 100 units. All venturers become general partners of the enterprise. Consolidated is the managing venturer of both ventures. As the managing venturer, Consolidated will have "plenary power" to conduct the day-to-day activities of the venture, including the power to "acquire on behalf of the Joint Venture oil and gas operating equipment upon such terms as it deems advisable"; to act as the lessor of the oil and gas equipment; to maintain leases; and to "take and hold title to property [and] execute evidences of indebtedness . . . in its name or the name of a nominee all on behalf of the Joint Venture and with or without disclosing the true owner or party in interest thereto." If any provision of the partnership agreement is unclear or ambiguous, Consolidated has the "sole and absolute discretion" to interpret the provision. A majority vote of the venturers is required to "acquire investment opportunities" for the

venture, and to approve leases. Upon a majority vote of the venturers, the venturers may replace Consolidated as managing venturer.

Anadarko and Hugoton have the same business purposes and organization; indeed, except for the fact that the two ventures intend to acquire different equipment and have different capitalization goals, their confidential information memoranda and joint venture agreements are virtually identical. Their business purpose is to acquire deep drilling rigs used to drill for natural gas, and associated equipment, and to lease that equipment to operators in the field. Consolidated proposes to obtain the equipment, on behalf of the ventures, from affiliates of Consolidated – companies which have the same principals as Consolidated – and lease the equipment, on behalf of the ventures, to affiliates of Consolidated, at prices that have not been the subject of arm's length transactions; in the case of Anadarko, Consolidated informed prospective venturers that it had already obtained commitments for the equipment from operators in the field. Both ventures have the same business office in Kansas; both ventures will conduct their operations in Kansas, Oklahoma, and Colorado.

In capital letters and bold print, the confidential information memoranda for Anadarko and Hugoton advise prospective venturers that the ventures involve a high degree of risk, and expose the venturers to unlimited liability as general partners. Prospective venturers are informed that, before they will be allowed to participate, they must represent that they have the business knowledge and ability to replace the managing venturer– Consolidated – and that they will not rely on Consolidated for the success of the venture. The confidential information memoranda state that, in Consolidated's view, interests in the ventures are not securities.

9. By reason of the matters set forth in Factual Findings 6, 7, and 8, Guardian Capital Management, Keegan, and Johnston offered or sold, in California, joint venture interests in Anadarko and Hugoton, on behalf of the Consolidated Respondents.

LEGAL CONCLUSIONS

1. *Is the commissioner preempted from enforcing Corporations Code section 25110 against the Consolidated Respondents?*

The Consolidated Respondents move to dismiss the Desist and Refrain Order on the ground that the commissioner is preempted by NSMIA (Pub.L. No. 104-290) from enforcing Corporations Code section 25110. They contend that under section 18(b)(4)(D) of the 1933 Act, which was added by NSMIA, and under Corporations Code section 25102.1, subdivision (d), which followed the enactment of NSMIA, California can only require that the Consolidated Respondents file a copy of their Form D with the commissioner, file a consent to service of process, and pay the notice filing fee– all of which they have done. The Consolidated Respondents argue that, under NSMIA, California has no authority to determine whether Anadarko and Hugoton meet, or do not meet, the requirements of

Regulation D. Except in the case of fraud, they maintain, which is not alleged here, only the federal government may determine compliance with Regulation D. The Consolidated Respondents rely on several federal district court decisions, including one from the Northern District of California, and two federal appellate decisions, [6] to support their argument.

The commissioner argues that the preemptive effect of federal law applies only to securities that *are* exempt under Regulation D, and that California retains the authority to determine whether the offerings of any issuer are exempt. The commissioner relies on a decision from the Alabama state supreme court to support his argument.

While the issue of federal preemption may be raised in an administrative proceeding, it cannot be decided here. Article III, section 3.5, of the California Constitution provides, in relevant part, as follows:

> An administrative agency . . . has no power:
>
> [¶] . . . [¶]
>
> (c) To declare a statute unenforceable, or to refuse to enforce a statute on the basis that federal law or federal regulations prohibit the enforcement of such statute unless an appellate court has made a determination that the enforcement of such statute is prohibited by federal law or federal regulations.

This provision applies to a claim that enforcement of a state statute is preempted by federal law. (*Southern Pacific Transportation Co. v. Public Utilities Commission of the State of California* (9th Cir. 1983) 716 F.2d 1285, 1290-1291.) The appellate decisions cited by the Consolidated Respondents do not address the issue presented here: whether NSMIA precludes a state from enforcing the terms of the Regulation D exemption claimed by an issuer; indeed, both cases arise under the Securities Litigation Uniform Standards Act of 1998, not NSMIA, and neither case concerns the private offering exemption. The Consolidated Respondents' motion to dismiss on the ground of federal preemption is denied.

2. *Are the joint venture interests in Anadarko and Hugoton securities?*

The Consolidated Respondents argue that the joint venture interests in Anadarko and Hugoton are not securities.[7] They assert that, because general partnership interests are not

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[6] *Lander v. Hartford Life & Annuity Insurance Co.* (2nd Cir. 2001) 251 F.3d 101, *Merrill Lynch Pierce, Fenner & Smith, Inc. v. Dabit* (2006) 547 U.S.___, [126 S.Ct. 1503, 164 L.Ed.2d 179].

[7] The commissioner asserts that this argument should be rejected "out of hand" because, in their filings with the SEC and the commissioner in 2005, the Consolidated Respondents represented that the joint venture interests *are* securities. The Respondents' argument is indeed troubling: after offering the

included in the definition of "security," the interests in Anadarko and Hugoton are presumed *not* to be securities. They contend that, to prove that the interests are securities, the commissioner must produce evidence to meet a three-part test, adopted by the Fifth Circuit Court of Appeals in *Williamson v. Tucker*, *supra*, 645 F.2d 404, and approved by the Ninth Circuit Court of Appeals in *Holden v. Hagopian*, *supra*, 978 F.2d 1115, to prove that the venturers are dependent upon Consolidated "for the effective exercise of their partnership powers."[8] (*Williamson v. Tucker*, *supra*, 645 F.2d at p. 422-423.) Extensive argument was offered by the Consolidated Respondents and the commissioner on whether the interests in Anadarko and Hugoton are securities under *Williamson*, *Holden*, and other federal cases. Not all federal circuits have followed *Williamson*. (See, *Securities and Exchange Commission v. Aqua-Sonics Products Corp.* (2nd Cir. 1982) 687 F.2d 577.)

The issue is what test California courts would apply to determine whether the Anadarko and Hugoton general partnerships are securities under California law. To date, California courts have not commented on the *Williamson* test. In *People v. Graham*, *supra*, 163 Cal.App.3d at pp. 1164-1169, however, the California Court of Appeal expressly adopted the test set forth in *Securities and Exchange Commission v. Glenn W. Turner Enterprises, Inc.* (9th. Cir. 1973) 474 F.2d 476. In *Glenn W. Turner*, *supra*, at page 482, the court held that an enterprise cannot evade the reach of the securities laws by requiring that investors supply a "modicum of effort" to the enterprise:

> Rather we adopt a more realistic test, 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.

The court in *People v. Graham* noted that prior California decisions had applied the "risk capital" test to determine whether an investment is a security. Under that test, California's security laws were "implicated whenever investors provide capital which will be risked in the promoter's venture or enterprise." (*People v. Graham*, *supra*, 163 Cal.App.3d at pp.

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joint venture interests for sale under Regulation D, the Respondents now contend, in essence, that they cannot be held to Regulation D's requirements. But there is no evidence that the Consolidated Respondents gained an advantage by their Form D filings, or that the commissioner was prejudiced by their filings. It is determined, therefore, that the Consolidated Respondents are not precluded from claiming that the joint venture interests in Anadarko and Hugoton are not securities.

[8] In *Williamson*, the court held that "[a] general partnership or joint venture interest can be designated a security if the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or management ability of the promoter or manager that he cannot replace the manger of the enterprise or otherwise exercise meaningful partnership or venture powers." (645 F.2d at p. 424.)

1166-1167.) The court found, however, that the *Glenn W. Turner* test is implicit in the risk capital test. (*Id.* at pp. 1167-1168.)

Under the *Glenn W. Turner* test and the risk capital test, the interests in Anadarko and Hugoton are securities. It is true that the venturers in both enterprises retain broad power to approve or reject transactions proposed by Consolidated, and that the venturers may replace Consolidated upon a majority vote.[9] But the evidence also establishes that the efforts of Consolidated, not the investors, are the "undeniably significant ones . . . [the] essential managerial efforts which affect the failure or success of the enterprise." Consolidated is the promoter of the ventures, and the source of representations to prospective venturers concerning the return they might expect on their investments. Consolidated brings to the ventures its 100 years of industry knowledge and experience, and its experience managing six similar joint ventures. As managing venturer, Consolidated will have plenary authority over day-to-day operations. Consolidated brings its "affiliates" to the ventures, from whom the ventures will purchase the drilling equipment and to whom the ventures will lease the equipment, in non-arm's length transactions conducted by Consolidated; indeed, Consolidated had obtained commitments from lessees for Anadarko's equipment before Anadarko was fully subscribed. Consolidated is located in Kansas, the area where the operations of the ventures will take place. Keegan's marketing efforts–which were based on assumptions about a venturer's financial condition, and not at all on the venturer's energy industry experience – confirm that the Consolidated Respondents seek venturers' risk capital, not their managerial capabilities.

3. *Are the securities offered for sale by the Consolidated Respondents exempt under Regulation D?*

The Consolidated Respondents contend that Anadarko and Hugoton are exempt private offerings under section 18(b)(4)(D) of the 1933 Act. The Respondents have the burden of proving that they are entitled to the exemption. (*Securities and Exchange Commission v. Ralston Purina Co.* (1953) 346 U.S. 119, 126-127.)

The purpose of the private offering exemption is to permit the sale of securities to those persons who do not need the protection of the securities laws. (*Securities and Exchange Commission v. Ralston Purina Co., supra,* 346 U.S. at pp. 122-125.) An offering to persons who are not "able fend for themselves" with respect to the purchase of securities falls outside the exemption. (*Id.* at p. 125.) Under Regulation D, the Securities and Exchange Commission prohibits an issuer, and anyone acting on the issuer's behalf, from offering or selling securities "by any form of general solicitation . . . including, but not limited to, . . . [a]ny seminar or meeting whose attendees have been invited by any general solicitation or general advertising . . . ." (17 C.F.R. § 203.502(c).)

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[9] The power to replace the managing venturer upon a majority vote, however, is no greater than the power of limited partners in a limited partnership. (Corp. Code, § 15636, subd. (f)(2).) Limited partnership interests are generally considered to be securities. (*Securities and Exchange Commission v. Murphy* (9th Cir. 1980) 626 F.2d 633, 640-641.)

Since 1935, the SEC has taken the view that the relationship between the issuer and the offeree is a key element in assessing whether an offering is public or private. (See, *Securities and Exchange Commission v. Ralston Purina Co., supra,* 346 U.S. 119 at p. 126, fn. 12.) In its "no-action" letters over the past 20 years, the SEC staff has emphasized that, to avoid a general solicitation, there must be a pre-existing, "substantive" relationship between the offeror and the offeree before an offer is made. (Securities and Exchange Com., No-Action Letter, August 9, 1982, 1982 SEC No-Act. LEXIS 2662, hereafter Woodtrails No-Action Letter; see also, Securities and Exchange Com., No-Action Letter, December 3, 1985, 1985 SEC No-Act. LEXIS 2917, hereafter Hutton No-Action Letter, and Securities and Exchange Com., No-Action Letter, January 16, 1990, 1990 SEC No-Act. LEXIS 45.) A "substantive" relationship is one that allows the offeror to determine that "each of the proposed offerees currently has such knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of the prospective investment." (Woodtrails No-Action Letter.) Although a substantive relationship is typically established by a business relationship, it may also be established by a questionnaire that allows the offeror to evaluate the offeree's sophistication and financial circumstances (Securities and Exchange Com., No-Action Letter, May 1, 1987, 1987 SEC No-Act. LEXIS 2004; Hutton No-Action Letter); the relationship is not preexisting, however, if the questionnaire and the offer are distributed at the same time. (Hutton No-Action Letter.) A pre-existing, substantive relationship must be present even in those cases where the offeror has reason to believe that the offerees are persons of financial means and experienced in business affairs. (Securities and Exchange Com., No Action-Letter, February 7, 1987, 1987 SEC No-Act. LEXIS 1595; see also, Securities and Exchange Com., Order In the Matter of Kenman Corporation and Kenman Securities Corporation, April 19, 1985, 1985 SEC LEXIS 1717.) While not entitled to the same deference as a rule, the SEC no-action letters may be treated as persuasive on the proper interpretation of the prohibition against general solicitations. (See, *New York City Employees' Retirement System, et al. v. Securities and Exchange Commission* (2nd Cir. 1994) 45 F.3d 7, 13.)

The evidence fails to establish that there was a pre-existing, substantive relationship between Keegan and each of the persons to whom he offered the securities. It is true that Keegan knew many of them, and even had reason to believe that many of them were affluent and possessed some degree of business sophistication. But it is clear that there was no *substantive* relationship between Keegan and each of the offerees that would have allowed Keegan to conclude that each offeree had sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of the joint ventures; indeed, Keegan candidly acknowledged that he had no pre-existing relationship at all with some of the offerees. Even if every offeree owned a home in Los Gatos, home ownership is not an adequate substitute for a prior, substantive relationship: it is only a rough indicator of net worth, and it is no indication that the owner has sufficient experience in financial and business matters to evaluate the merits of a privately-offered security. The Consolidated Respondents assert that every *purchaser* was required to complete the business experience questionnaire, and that only accredited investors were allowed to purchase interests. Regulation D, however, protects offerees, not just purchasers; even in the case of purchasers,

a business experience questionnaire completed at the same time that an offer is made is not sufficient to establish a pre-existing, substantive relationship.

The evidence also fails to establish that a pre-existing, substantive relationship existed between Johnston and Wroten before Johnston called him and sent him the materials on Anadarko. It is true that Wroten gave H. W. his consent to be contacted. But Johnston did not establish a substantive relationship with Wroten before soliciting an offer from him. The evidence establishes that Johnston's contact with Wroten was not an isolated event, but part of a broader solicitation of venturers that had begun in the summer of 2005.

The evidence fails to establish that Anadarko and Hugoton are exempt private offerings under federal law.

4. *Cause for issuance, and scope of, the commissioner's Order.*

Cause exists for the issuance of the commissioner's Desist and Refrain Order. The joint venture interests in Anadarko and Hugoton are securities. The securities were sold, or offered for sale, in California, without being qualified, and they are not exempt.

The scope of the Order, however, is broader than that authorized by Corporations Code section 25532. The Order directs the Consolidated Respondents to "desist and refrain from the further offer or sale in the State of California of *securities, including but not limited to joint venture interests*, unless and until qualification has been made under the law or unless exempt." (Emphasis added.) Section 25532, subdivision (a)(1), states:

> If, in the opinion of the commissioner, [¶] the sale of a security is subject to the requirements of Section . . . 25102.1 and the security is being or has been offered or sold without first meeting the requirements of those sections, the commissioner may order the issuer or offeror of that security to desist and refrain *from the further offer or sale of the security* until those requirements have been met. (Emphasis added.)

The Desist and Refrain Order, which seeks to restrict offers or sales of securities other than Anadarko and Hugoton, exceeds the authority granted to the commissioner under section 25532, subdivision (a)(1), and the Order must be modified to comport with that section.

ORDER

The Desist and Refrain Order is modified as follows: "Consolidated Management Group, LLC, Consolidated Leasing Anadarko Joint Venture and Consolidated Leasing Hugoton #2 are hereby ordered to desist and refrain from the further offer or sale of Consolidated Leasing Anadarko Joint Venture and Consolidated Leasing Hugoton #2 unless

and until qualification has been made under the law or unless exempt." As modified, the Desist and Refrain Order is affirmed.

DATED: May 5, 2006

DAVID L. BENJAMIN
Administrative Law Judge
Office of Administrative Hearings