APPENDIX B

I. The promissory notes issued in the Farah/Dodge transactions were "securities" under the NH Securities Act

The starting point to determine if a note is a security if the definition quoted above which says that a note is a security "[u]nless the context otherwise requires."

The definition of a "security" under the NH Securities Act is essentially identical to the definition in the Uniform Securities Act of 1956 ("1956 Uniform Act"), and the federal Securities Act of 1933 (the "Federal Securities Act"). Therefore, interpretations from other state and federal courts are instructive.

The commentary accompanying the Uniform Securities Acts indicates that the drafters intended the interpretation of the term "security" under the Uniform Securities Act to evolve consistently with the interpretation of that term under the Federal Securities Act. The NH Securities Act, adopted in 1981, was based upon the 1956 Uniform Act.[1] The commentary accompanying the 1956 Act specifically says that the definition of a "security" under the 1956 Act is nearly identical to the definition in Federal Securities Act, and that such substantially similar definition – "particularly the phrase 'investment contract'—has been broadly construed by both state and federal courts." This theme was later amplified in the official commentary accompany the revision to the Uniform Securities Act in 1985. After noting that the definition of a security follows the 1956 Uniform Act's definition (with minor exceptions not relevant to this report), the commentary states:

> The Committee determined to retain the essential parts of the existing definition <u>because it has been broadly construed in federal and state courts</u> and seems adequate generally to embrace most investment vehicles that the human mind can conceive. * * * For other specific instruments, the "unless the content otherwise requires" language may require a further inquiry. The burden, however, still will be on the person claiming that the instrument is not a security to establish either that such instrument does not possess the essential attributes or that it bears a strong family resemblance to those instruments not commonly understood as being securities (e.g., notes issued in truly mercantile transactions as opposed to notes issued to investors). *See Exchange National Bank of Chicago v. Touche Ross & Co.*, 544 F.2d, 1126 (2nd Cir., 1976). * * * The introductory clause "unless the context requires otherwise," which modifies all the definitions in the Act, has been retained due in part to the relevance of that language to the various federal and state court decisions interpreting the definition of a "security."

The leading federal case interpreting whether a promissory note is a security is *Reves v. Ernst & Young*, 494 U.S. 56 (1990), in which the Supreme Court held that the analysis of whether a promissory note is a security begins with a presumption that every note is a

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[1] The 1956 Uniform Act has been adopted at one time or another, in whole or in part, by 37 jurisdictions.

security.[2] The presumption can be rebutted, however, only if the note in question bears a strong resemblance, in terms of four factors, to certain enumerated categories of instruments: (1) notes delivered in consumer financing; (2) notes secured by a home mortgage; (3) short-term notes secured by a lien on a small business or some of its assets; (4) a note evidencing a character loan to a bank customer; (5) short-term notes secured by an assignment of accounts receivable; (6) a note which simply formalizes an open account debt incurred in the ordinary course of business; or (7) notes evidencing loans by commercial banks for current operations. *Id*. (emphasis added).

The *Reves* Court set forth four factors used in determining if a note bears a strong resemblance to one of the above-listed enumerated notes:[3]

> First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit[4] the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security.
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> Second, we examine the "plan of distribution" of the instrument to determine whether it is an instrument in which there is "common trading for speculation or investment."
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> Third, we examine the reasonable expectations of the investing public....
>
> Finally, we examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.

While both state and federal courts have tried to enumerate the factors and characteristics used in determining if a note is a security, these courts have also held generally that "application of the term 'security' turns not on the form or characterization of

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[2] *Id*. at 64.

[3] *Id*. at 66 (emphasis added; citations omitted).

[4] In a related context, in which the Supreme Court confirmed that an investment scheme promising a fixed rate of return can be an "investment contract" and thus a "security" subject to the Federal Securities Act, the Court indicated that the term "profits" as used in the context of interpreting what constitutes a "security" means profits in the sense of the income or return that investors seek on their investment, not the profits of the enterprise in which they invest, and may include, for example, dividends, other periodic payments, or the increased value of the investment. The Court also stated that the is no reason to distinguish between promises of fixed returns and promises of variable returns for purposes of the test, so understood. In both cases, the investing public is attracted by representations of investment income. "Moreover, 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." SEC v. Edwards, 540 U.S. 389, 394 (2004).

the transaction but on the economic realities underlying the transaction.[5] For example in *Reves*, the Supreme Court emphasized that in applying the definition of a security under the Federal Securities Act, courts should not be bound by legal formalisms, but instead take account of the economics of the transaction under investigation. "Congress' purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called." *Id*. at 62. An example of this "contextual" approach can be seen in *SEC v. Wallenbrock*,[6] in which the court found that notes, which were part of a ponzi scheme, were securities and that even though the notes nominally had a maturity of less than nine months, the commercial paper exception did not apply because the notes were not short-term, high quality instruments issued to fund current operations and sold only to highly sophisticated investors).

Except for any promissory note secured solely by home mortgage, none of the promissory notes issued in the Farah/Dodge transactions summarized above in Categories A, B, C and D clearly bear a "strong resemblance," in terms of four Reves factors, to any of the enumerated categories of debt instruments in Reves.

Accordingly, based upon the foregoing, the loans in the Farah/Dodge transactions secured by property other than a home mortgage would be presumed to be a security. The Securities Bureau could reasonably have alleged that one or more of the FRM transactions in Categories A, B, C and D potentially violated the NH Securities Act because they may have involved the offer and sale of unregistered promissory notes that constitute securities, and because either or both of Farah and Dodge acted as unlicensed "broker-dealers in connection with such transactions."[7]

II. The ownership interests in the trusts formed by Dodge were "securities" under the NH Securities Act

An ownership interest in a trust formed by Dodge creates an additional layer of investment risk for an investor beyond the risk inherent in indirectly loaning funds to a borrower. Among other things, the terms of the trust (including the ability to remove the trustee), the qualifications, experience and financial resources of the trustee, the existence of and policies regarding related party transactions between Dodge and Farah would be important to an investor in a trust.

With respect to the Farah/Dodge transactions summarized above in Categories C and D – namely, the investors acquire an interest in a trust formed by Dodge – the Securities Bureau could reasonably have alleged that one or more of the FRM transactions in Categories C and D potentially violated the NH Securities Act because they may have

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5 *See, e.g., Idaho v. Gertsch*, 49 P.3d 392 (2002)

6 313 F.3d 532 (9th Cir. 2002).

7 The New Hampshire Act defines a broker-dealer as "any person engaged in the business of effecting transactions in securities for the account of others or for his own account," subject to certain exceptions. RSA 421-B:III. Under the NH Securities Act, it is "unlawful for any person to transact business in this state as a broker-dealer . . . unless such person is licensed under [the NH Securities Act]. RSA 421-B:6,I.

involved the offer and sale of unregistered interests in the trusts that constitute securities under the NH Securities Act and because either or both of Farah and Dodge acted as unlicensed broker-dealers in connection with such transactions.

III. The series of interconnected transactions orchestrated by Dodge and Farah constitutes "investment contracts" and therefore are securities for purposes of the NH Securities Act

With respect to the Farah/Dodge transactions summarized above in Categories B, C and D – namely, the series of interconnected transactions orchestrated by Dodge and Farah – the Securities Bureau could reasonably have alleged that one or more of the FRM transactions in Categories B, C and D potentially violated the NH Securities Act because they may have involved the offer and sale of unregistered "investment contract" and therefore a security for purposes of the NH Securities Act and because either or both of Farah and Dodge acted as unlicensed "broker-dealers in connection with such transactions.

The leading case interpreting the term "investment contract" under the Federal Securities Act is *SEC v. W.M. Howey Co.*, 328 U.S. 293 (1946), and the commentary to the Uniform Securities Acts on which the NH Securities Act is based clearly indicates that the drafters of the Uniform Securities expected the term "investment contract" would be interpreted consistent with the evolution of the Howey test.

The *Howey* Court held that the test for whether a particular scheme is an investment contract depends upon whether the scheme involves an investment of money in a common enterprise with profits to come from the efforts of others. The *Edwards* Court held that an investment scheme promising a fixed rate of return would satisfy the "profits" element of Howey test and therefore constituted an "investment contract" and thus a "security" subject to the Securities Act.

Moreover, in circumstances similar to the types of transactions summarized above under Category B, C and D, the SEC has maintained that a promise of a fixed return does not preclude a scheme from being an investment contract.[8]

[8] *See, e.g., In re Abbett, Sommer & Co*., 44 S.E.C. 104, 1969 WL 95359 (1969) (holding that mortgage notes, sold with a package of management services and a promise to repurchase the notes in the event of default, were investment contracts); see also In re Union Home Loans (Dec. 16, 1982), 26 S.E.C. Docket 1517, 1519 (report and order regarding settlement, stating that sale of promissory notes secured by deeds of trust, coupled with management services and providing investors "a specified percentage return on their investment," were investment contracts.