New Rules Under The Colorado Securities Act Now Effective

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I. Introduction

The Colorado Securities Act, found at C.R.S. § 11-51-101 *et seq.* (the "CSA"), is administered by the Securities Commissioner (C.R.S. § 11-51-701) subject to the oversight of the Colorado Securities Board (C.R.S. § 11-51-702.5(4). The CSA, like securities acts in many other states has a broad applicability to "securities" and requires the availability of a registration or an exemption from registration before securities are offered or sold to investors in or from Colorado; it requires the licensing of broker-dealers, investment advisers, and their representatives involved in securities transactions in Colorado; and the CSA provides significant enforcement powers to the Commissioner including bringing cease and desist actions (C.R.S. § 11-51-606(1.5)), or civil or administrative enforcement actions (C.R.S. § 11-51-601, -602, and -606). Under C.R.S. § 11-51-603, the Commissioner may refer evidence of a violation of the CSA that constitutes a felony or misdemeanor to the attorney general's office or the appropriate district attorney for consideration of prosecution.

The Commissioner has adopted rules interpreting the CSA which are found at 3 CCR 704-1, available through the Colorado Secretary of State's website. C.R.S. § 24-4-103(11) requires that the Secretary of State maintain the official publication of the state's administrative rules. The Securities Division has also maintained its "Notice of Proposed Rulemaking," "Draft Statement of Basis and Purpose" for the rulemaking (dated March 6, 2017), and the redlined rule changes as originally proposed on the Division of Securities website (Rulemaking Combined Notice_3-31-17.pdf, available at https://www.colorado.gov/pacific/dora/rulemaking-notices-opinions (last reviewed August 7, 2017).

On July 15, 2017, the new rules under the CSA became effective. While the republication included many unchanged rules, there were substantive updates which will be discussed in this memorandum.

II. Rules Governing Exemptions from Registration of Securities

- C.R.S. § 11–51–308(1)(B)(l) provides an exemption for nonissuer transactions in securities which are listed in recognized securities manuals. Rule § 51–3.9 (Transactional Securities Exemption for Non-Issuer Distribution of Outstanding Security) identified a list of manuals for which the nonissuer transaction was available. In the amended rules:

  - Standard & Poor's Standard Corporation Descriptions was removed

- OTC Markets Group Inc. (with respect to securities included in the OTCQX and OTCQB markets) was included.

- C.R.S. § 11–51–308(1)(p) provides exemptions from registration for securities being issued under certain SEC regulations. Rule § 51–3.13 now includes a state exemption from registration for offerings made under Tier 2 of federal Regulation A and Section 18(b)(3) of the Securities Act of 1933. The new rule also updates initial filing requirements and submissions for any Reg A Tier 2 offerings, it adds provisions allowing for additional twelve-month period renewals of Reg A Tier 2 offerings, and adds provisions allowing for amendments to increase the amount of securities offered under Reg A Tier 2.

III. Crowdfunding in Colorado

- When the Colorado Crowdfunding Act was adopted in 2015 ((H.B. 15-1246; amended H.B. 16-1049), it limited offerings to $1,000,000 (or $2,000,000 if audited financial statements were available for the issuer). C.R.S. § 11-51-308.5(3)(a)(XI) prohibits the crowdfunding exemption from being used in conjunction with other exemptions from registration under the CSA which offerings are part of a "single plan of financing." Rule § 51–3.24(K) defines the term "single plan of financing" lists factors to be considered when determining whether offers and sales should be regarded as part of a single plan of financing in a manner very similar to Rule 502(a) of Regulation D – providing clarity to the Colorado Crowdfunding Act.

- As originally adopted, the Colorado Crowdfunding Act required that offerings be made in accordance with SEC Rule 147 for intrastate offerings. In October 2016 the SEC adopted an additional rule for intrastate offerings, Rule 147A. Rule § 51-3.24(L) expanded the Colorado Crowdfunding Act to include offerings under federal Rule 147A.

- Federal Regulation CF (crowdfunding) is now available. While securities issued under the federal Rule (enacted pursuant to the JOBS Act of 2012) are "covered securities" and thus exempt from state review, states can require informational filings and payment of a fee. Rule § 51–3.31 imposes a filing requirement, the ability to renew a filing after twelve months, and a filing fee for federal crowdfunding offerings.

IV. Electronic Delivery of Offering Documents and Signatures.

- The Colorado rules, through the addition of § 51–3.32, now allows for delivery of offering documents over the Internet and allows for use of electronic signatures.

V. Broker-Dealer Regulation -- Business Brokers and M&A Brokers and Cybersecurity Practices.

- Colorado has Rule § 51-2.1.1(B) exemption business brokers dealing in a closely-held corporation with no more than a single buyer from the broker-dealer registration

requirements of the CSA found in C.R.S. § 11-51-401. In the new rules, the Commissioner added Rule § 51–3.33 defining and exempting merger and acquisition brokers ("M&A Brokers") from the CSA's licensing requirements provided the M&A Broker limits its activities as described in the new rule.

- Colorado has now adopted Rule § 51–4.8 which imposes general guidelines for reasonable cybersecurity practices, and mandates a number of specific practices on broker-dealers doing business in Colorado. Brokers must now protect "confidential personal information," "establish and maintain written procedures reasonably designed to ensure cybersecurity," incorporate cybersecurity in annual risk assessments, use of secure (encrypted) email and dual factor authentication, and disclose to clients the risk of using electronic communications. These rules are less prescriptive than the rules recently adopted by the New York Department of Financial Services which impose obligations on most national broker-dealers. Compliance with the NYFDS rules likely equal compliance with the Colorado rules.

VI. Investment Adviser Rules

- C.R.S. § 11-51-401(1.5) prohibits a person from acting as an investment adviser or an investment adviser representative in Colorado unless licensed or exempt from licensing. To provide greater definition to the licensing requirement, the new rules include Rule § 51–4.3(J)(IA) which discusses four acts or practices which require licensing as an investment adviser and compliance with statutes and rules pertaining thereto. The rule now makes it clear that

  - Lawyers, accountants, engineers or teachers are subject to licensing if the investment advice they render is not "solely incidental to the professional's regular professional practice with respect to clients."

  - Broker-dealers and broker-dealer agents must be licensed if, for a fee, the broker-dealer or broker-dealer agent "provides investment advice to clients if the investment advice is not solely incidental to the conduct of business as a broker-dealer or broker-dealer agent."

  - Insurance agents who, for a fee, provides investment advice to a client, must be licensed as an investment advisor or investment advisor representative. There is no "solely incidental" exception.

  - Others (not described above) must be licensed as investment advisers or investment adviser representatives if they advertise or hold themselves out as a provider of investment advice, of they publish an article which (for a fee) gives investment advice based upon the specific investment situations of clients, or receives a fee from an investment adviser for customer referrals.

- The new rules add § 51–4.4(J)(IA) which increases the obligations on a person applying for licensing as an investment adviser representative if the person has unpaid FINRA arbitration awards.

- The new rules update the books and records requirements for licensed investment advisers in Rule § 51–4.6(A)(19)(IA) and now requires an annual review and certain supervisory procedures.

- New Rule § 51–4.11(IA) discusses requirements and conditions for a private fund advisers to exempt themselves from investment adviser licensing requirements, including imposing further requirements for exemption for private fund advisers who advise at least one (3)(c)(1) fund that is not a venture capital fund.

- New Rule § 51–4.12(IA) requires investment advisers to engage in business continuity and succession planning in the case of a loss of, or relocation of an office, or the death of the adviser.

- New Rule § 51–4.13(IA) requires that investment advisers must maintain a positive net worth of from $10,000 to $35,000, depending on various factors discussed in the rule. Investment advisers with discretionary authority or custody who do not meet the minimum net worth requirements must also maintain a surety bond.

- New Rule § 51–4.14(IA) imposes cybersecurity requirements on investment advisers similar to the requirements imposed on broker-dealers discussed in Rule § 51-4.8, above.

- New Rule § 51–4.15(IA) which requires that any licensed investment adviser who wishes to charge a fee based on a share of the capital gains or the capital appreciation of the funds or any portion of the funds of a client must comply with 17 CFR § 275.205–3. The federal rule only permits the use of such fee if the client is a "qualified client" as defined therein.

- The rule amendments for investment advisers is also discussed in *Law Week Colorado* (July 31, 2017) in an article by Kaley Laquea on page 8 entitled "*Colorado Division of Securities Changes Licensing Rules*."

VII. Conduct of Hearings by the Colorado Securities Board and the Office of Administrative Courts

- The new rules update and add to Chapter 6 which governs procedures for hearings conducted by the Colorado Securities Board and the Office of Administrative Courts. The rules include provisions discussing:

  - Hearings to review either summary stop orders or summary orders suspending an exemption under C.R.S. § 11-51-606(3)(a) or (b) [Rule § 51–6.1, not substantively amended];

  - Hearings on orders to show cause why a securities license should not be summarily suspended under C.R.S. § 11-51-606(4) [Rule § 51-6.2, not substantively amended];

- Hearings on orders to show cause why a cease and desist order should not enter under C.R.S. § 11-51-606(1.5) [Rule § 51–6.3, amended and reorganized];

- Hearings on the denial, suspension or revocation of a registration statement and the denial or revocation of exemption from registration under C.R.S. § 11-51-310 [Rule § 51-6.4, a new rule addressing the described issues]; and

- Hearings on the denial of an applicant or suspension, revocation, censure, limit or other conditions on the securities activities of a broker-dealer, sales representative, investment adviser or investment adviser representative under C.R.S. § 11-51-410 [Rule § 51–6.5, a new rule addressing the described issues].

VIII. Local Government Investment Pool Trust Funds

- Additions to Rule § 51–9.3 dealing with registration, reports and bookkeeping of the Local Government Investment Pool ("LGIP") Trust Funds