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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

GARY PIERCE, Chairman
BOB STUMP
SANDRA D. KENNEDY
PAUL NEWMAN
BRENDA BURNS

2011 APR 25 P 4: 31

AZ CORP COMMISSION
DOCKET CONTROL

In the matter of:
RADICAL BUNNY, L.L.C., an Arizona
limited liability company,
HORIZON PARTNERS, L.L.C., an Arizona
limited liability company,
TOM HIRSCH (aka THOMAS N. HIRSCH)
and DIANE ROSE HIRSCH, husband and
wife,
BERTA FRIEDMAN. WALDER (aka
BUNNY WALDER), a married person,
HOWARD EVAN WALDER, a married
person,
HARISH PANNALAL SHAH and
MADHAVI H. SHAH, husband and wife,
Respondents.

DOCKET NO. S-20660A-09-0107

SECURITIES DIVISION'S REPLY TO
RESPONDENTS' POST-HEARING
MEMORANDUM

Arizona Corporation Commission

DOCKETED

APR 25 2011

DOCKETED BY [Signature]

The Securities Division ("Securities Division") of the Arizona Corporation Commission
("Commission") hereby submits its Reply to Respondents' Post-hearing Memorandum with respect
to the administrative hearing for Respondents Horizon Partners, L.L.C., Tom Hirsch, Diane Rose
Hirsch, Berta Friedman Walder, Howard Evan Walder, Harish Pannalal Shah, and Madhavi H.
Shah ("Respondents' Memorandum") ("Division Reply Memorandum"). This reply to
Respondents' Post-Hearing Memorandum is supported by the following Memorandum of Points and
Authorities.



1 violated A.R.S. §§ 44-1841, 44-1842, and 44-1991(A) because they were not involved in the sale  
2 of securities. *See* Respondents' Memorandum at 14:12-20:10. Respondents also argue that that  
3 Radical Bunny and the RB Managers did not violate the antifraud provisions of the Arizona  
4 Securities Act because the RB-MLtd Loans were "secured." *See* Respondents' Memorandum at  
5 20:1121:17. Respondents reach this conclusion by (1) patently disregarding well-established law  
6 applicable to the determination of when an investment is a security under the Arizona Securities  
7 Act; and (2) relying on affirmative defenses to fraud which are not supported by the evidence or  
8 not available under the Arizona Securities Act.

9  
10 **A. Respondents patently disregard well-established law applicable to the determination of  
when an investment is a security under the Arizona Securities Act.**

11 It is the position of the Division that Radical Bunny, Horizon Partners, Hirsch, B. Walder, H.  
12 Walder, and Shah were involved in three different types of transactions involving the offer and sale  
13 of securities in the form of investment contracts to the investors of Radical Bunny and Horizon  
14 Partners.<sup>2</sup> The three investment contracts offered and sold by Horizon Partners and Radical Bunny  
15 are: (1) limited liability company membership interests in Horizon Partners from approximately  
16 1998 until September 2005; (2) limited liability company membership interests in Radical Bunny  
17 from approximately 1999 until September 2005; and (3) the RB-MLtd Loan Program from  
18 approximately September 2005 until June 2008. *See* Division Memorandum at 39:9-44:19.

19 Respondents argue that they could not have violated A.R.S. §§ 44-1841, 44-1842, and 44-  
20 1991(A) because the fractionalized interests in the MLtd Loan secured notes that were sold by MLtd  
21 to the MLtd Pass-Through Investors, including Horizon Partners and Radical Bunny, and the  
22

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23 <sup>2</sup> The question of whether a security exists is a question of law. *See Daggert v. Jackie Fine Arts, Inc.*, 152  
24 Ariz. 559, 564, 733 P.2d 1142, 1147 (Ct. App. 1986). Respondents argue that the Commission should not  
25 entertain the legal opinions of experts in this matter. *See* Respondents' Memorandum at 23:20-24:19.  
26 However, the Division did not present any expert testimony on the legal issue of whether or not the Horizon  
Partners or Radical Bunny investments constituted securities under the Arizona Securities Act. Instead, the  
Division elicited testimony from certain professionals regarding the disputed factual allegations. *See*  
Division Memorandum at ¶¶ 88-89, 138-150, 152-155, 171-175, and 182-191.

1 fractionalized interests in the RB-MLtd Notes that were sold by Radical Bunny and the RB Managers  
2 to the Participants are not securities. *See* Respondents' Memorandum at 14:12-20:10. The  
3 Respondents focus on the "notes" subject to the MLtd Pass-Through Participation Program (i.e.,  
4 the MLtd Loan secured note) and RB-MLtd Loan Program (i.e., the RB-MLtd Note) and ignore  
5 the *entire package* of services that were included as part of these investment programs (i.e.,  
6 investment contract) in support of their argument. *Id.* Respondents argue that, as a matter of law,  
7 the notes, the proceeds of which were used by MLtd, in part, to finance construction, with a fixed  
8 rate of return,<sup>3</sup> and a maturity of one year are not securities under the Arizona Securities Act. *Id.*  
9 Respondents fail to cite relevant Arizona law and rely solely on federal judicial decisions in  
10 support of their argument. *Id.* Respondents' reliance on federal law is misplaced because the  
11 Arizona courts have defined when notes are securities for purposes of the registration provisions of  
12 the Arizona Securities Act and when notes are *not* securities for purposes of the antifraud  
13 provisions of the Arizona Securities Act.

14 The federal Securities Act of 1933 ("Securities Act of 1933"), the federal Securities Exchange  
15 Act of 1934 ("Exchange Act of 1934"), and the Arizona Securities Act each list first under the  
16 definition of the term "security" the phrase "any note." *See* 15 U.S.C. § 77b(a)(1) (Section 2(a)(1));  
17 15 U.S.C. § 78c(a)(10)(Section 3(a)(10)); A.R.S. § 44-1801(26). The definitional section of all three  
18 acts also include the qualifying phrase "unless the context otherwise requires."

19 Most courts concur that securities laws do not apply to all notes. *See, e.g., Marine Bank v.*  
20 *Weaver*, 455 U.S. 551 (1982) (securities laws are not intended to provide enhanced protection against  
21 all fraud.). Because the term "any note" encompasses instruments issued in both a consumer context  
22 and in investment context, the courts have sought to balance economic realities with investor  
23 protection. In order to impose securities laws only on notes issued as investments, under federal law

24 \_\_\_\_\_  
25 <sup>3</sup> The concept of fixed rate of return versus variable rate of return has been addressed by numerous federal  
26 courts the determination of whether or not an investment scheme is an investment contract under the *Howey*  
test. In those cases, the Supreme Court has held that it is the expectation of profits from the efforts of others  
that is the relevant inquiry. *See SEC v. Edwards*, 540 U.S. 389, 397 (2004).

1 the courts developed a number of tests by which to determine if a specific note is a security, or if “the  
2 context otherwise requires.” See *State v. Tober*, 173 Ariz. 211, 212-213, 841 P.2d 206, 207-208  
3 (1992).<sup>4</sup>

4 Arizona courts look to federal courts for guidance in interpreting state securities statutes. See  
5 *Nutek Info. Sys., Inc. v. Arizona Corp. Comm'n*, 194 Ariz. 104, 108, 977 P.2d 826, 830 (1998).

6 However, “state and federal securities laws were adopted to serve different purposes.” *King v. Pope*,  
7 91 S.W.3d 314, 319 (Tenn. 2009). The central aim of the federal securities law is to ensure full  
8 disclosure and honest markets. See *Reves v. Ernst & Young*, 494 U.S. 56, 60 (1990) (explaining that  
9 federal securities laws are designed “to eliminate serious abuses in a largely unregulated securities  
10 market.”), quoting *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975). State securities  
11 law, while promoting disclosure, has investor protection as its overreaching purpose. See *King*, 91  
12 S.W. 3d at 319. (“[S]tates enacted securities regulation to protect investors.”).

13 Like other state courts, Arizona courts have repeatedly held that the purpose of the Arizona  
14 Securities Act is broad public protection. See *State v. Baumann*, 125 Ariz. 404, 411, 610 P.2d 38, 45  
15 (1980) (explaining that state securities laws are “designed to protect the public from fraud and deceit  
16 arising in [securities] transactions.”); *Eastern Vanguard Forex Ltd. v. Arizona Corp. Comm'n*, 206  
17 Ariz. 399, 411-412, 79 P.3d 86, 98-99 (Ct. App. 2003) (declining to follow Ninth Circuit  
18 interpretations of control liability that do not adequately protect the investing public). Accordingly,  
19 Arizona courts do not defer to federal case law when to do so would be inconsistent with the policies  
20 embraced by the Arizona Securities Act. *Siporin v. Carrington*, 200 Ariz. 97, 103, 23 P.2d 92, 98 (Ct.  
21 App. 2001) (refusing to follow restrictive federal precedent on the meaning of investment contracts);  
22 see also, 1951 Ariz. Sess. Laws ch. 18, § 20 (stating intent and purpose of the Arizona Securities Act).  
23 Consequently, Arizona courts have developed *two* separate approaches in distinguishing between

24 <sup>4</sup> Prior to 1990, there were four judicial tests used to determine when a note is a not security under federal  
25 securities law causing a split among the various federal courts regarding the use of the judicial tests, namely:  
26 (a) the “family resemblance test” (Second Circuit); (b) the “commercial - investment test” (First, Fifth,  
Seventh, and Tenth Circuits); (c) the *Howey* test (Eighth and District of Columbia Circuits); and (d) the  
“risk capital test” (Ninth Circuit). See *Reves v. Ernst & Young*, 494 U.S. 56, 63-67 (1990). In *Reves*, the  
U.S. Supreme Court rejected the three other judicial tests and adopted the “family resemblance” test. *Id.*

1 security and non-security notes under the Arizona Securities Act.<sup>5</sup> The analysis used depends upon  
2 whether the issue is the violation of the registration provisions or the violation of antifraud provisions  
3 of the Arizona Securities Act.

4 1. The MLtd Loan secured notes and the RB-MLtd Notes are securities for  
5 purposes of the registration provisions of the Arizona Securities Act.

6 For purposes of the registration provisions, the Arizona Supreme Court held that A.R.S. §§ 44-  
7 1841 and 44-1842 provided a clear meaning for the words “any note,” and, therefore, the court had no  
8 reason to use any of the tests fashioned by the federal courts for determining whether a particular note  
9 was a security. *Tober*, 173 Ariz. at 213, 213 841 P.2d at 208. Specifically, the Arizona Supreme  
10 Court looked to the Arizona statutory definition of security and held that *all* notes are securities that  
11 must be registered [with the Arizona Corporation Commission] unless an exemption applies. *Id.*  
12 Specifically, the *Tober* court stated:

13 We disagree. In our view, *neither* the “risk capital” test of *Amfac*, the “family  
14 resemblance” test of *Reves v. Ernst & Young*, \*\*\* nor any variant applies to the  
15 charges under A.R.S. § 44-1841 and § 44-1842. These two sections are part of a  
16 comprehensive statutory scheme that defines the universe of securities, exempt  
17 securities, and exempt transactions. The statutory scheme leaves no room for judicial  
18 gloss, and thus there is no uncertainty in its application.

19 *Id.* (citation omitted) (emphasis added). Despite Respondents’ argument to the contrary, *Tober*  
20 applies to all cases, administrative, civil, and criminal, involving violations of the registration  
21 provisions of the Arizona Securities Act. *See* Respondents’ Memorandum at 19:3-7; *Tober*, 173 Ariz.  
22 at 213, 841 P.2d at 208; *MacCollum v. Perkinson*, 185 Ariz. 179, 185, 913 P.2d 1097, 1103 (Ct. App.  
23 1996). Accordingly, the MLtd Loan secured notes and the RB-MLtd Nots are securities for purposes  
24 of the registration provisions of the Arizona Securities Act. *See* Division Memorandum at ¶¶39-47,  
25 54-57, 60-61, and 73.

26 There is no evidence in the record to dispute the fact that the MLtd Loan secured notes were  
sold to the MLtd Pass-Through Investors, including Horizon Partners and Radical Bunny, through a

<sup>5</sup> Federal court have applied the *Reves* test in both registration and antifraud contexts. *See e.g., S.E.C. v. R.G. Reynolds Enterprises, Inc.*, 853 F.2d 1125 (9<sup>th</sup> Cir. 1991).

1 registered securities dealer, Mortgages Limited Securities.<sup>6</sup> See Division Memorandum at 50-53.  
 2 There is no evidence in the record to dispute the fact that Horizon Partners and Radical Bunny are not,  
 3 and have never been, registered with the Commission as securities dealers. See Division  
 4 Memorandum at ¶¶8 and 21. There is no evidence in the record to dispute the fact that the RB  
 5 Managers are not, and have never been, registered with the Commission as securities salesmen. See  
 6 Division Memorandum at ¶¶25, 29, 34, and 37. Accordingly, Horizon Partners, Radical Bunny, and  
 7 the RB Managers sold securities in violation of A.R.S. § 44-1842. See A.R.S. § 44-1842; Division  
 8 Memorandum at 44:22-45:12.

9  
 10 2. Respondents failed to meet their burden in establishing that the MLtd Loan  
 11 secured notes and the RB-MLtd Notes are exempt from the registration  
 12 provisions of the Arizona Securities Act.

13 There is no evidence in the record to dispute the fact that Horizon Partners and Radical Bunny  
 14 did not register their investment opportunities with the Commission. See Exhibits S-1(a) and (b);  
 15 Division Memorandum at ¶248. Accordingly, Horizon Partners, Radical Bunny, and the RB  
 16 Managers sold unregistered securities in violation of A.R.S. § 44-1841. See A.R.S. 44-1841.  
 17 Respondents nevertheless seem to argue that the MLtd Loan secured notes and the RB-MLtd Notes  
 18 are not subject to the registration provisions of the Arizona Securities Act because they constitute  
 19 “commercial notes” or “commercial paper.” See Respondents’ Memorandum at 3:13-18; 19:3-20:10.  
 20 The Division disagrees.

21 Consistent with the broad remedial purposes of securities regulations, persons claiming an  
 22 exemption bear the burden of proving that the transactions or securities qualify for the exemption.  
 23 See A.R.S. § 44-2033; *SEC v. Ralston Purina Co.*, 346 U.S. 119, 127 (1953). According to  
 24 Arizona law, “in any action, civil or criminal, when a defense is based upon any exemption...the  
 25 burden of proving the existence of the exemption shall be upon the party raising the defense...”.

26 <sup>6</sup> The issue of whether or not the securities or transactions in securities represented by MLtd and/or MLS of the fractionalized interests in the MLtd Loan secured notes to the MLtd Pass-Through Investors were exempt from the registration requirements of A.R.S. § 44-1841 is not before this tribunal.

1 A.R.S. § 44-2033. The burden of proof rests with the party claiming the exemption to prove the  
2 transaction qualified for the exemption. *See State v. Barber*, 133 Ariz. 572, 578, 653 P.2d 29, 35  
3 (App. 1982); *Baumann*, 125 Ariz. 404, 610 P.2d 38 (1980). The court in *Barber* declared

4  
5 [T]o begin our analysis of this issue, we first note that the state is not required to  
6 prove that the securities and transactions were not exempted by law. A.R.S. § 44-  
7 2033 provides: *In any action, civil or criminal, when a defense is based upon any*  
8 *exemption provided for in this chapter, the burden of proving the existence of the*  
*exemption shall be upon the party raising the defense, and it shall not be necessary*  
*to negative the exemption in any petition, complaint, information or indictment, laid*  
*or brought in any proceeding under this chapter.*

9  
10 *Barber*, 133 Ariz. at 578, 653 P.2d at 35 (emphasis added). During the administrative hearing, the  
11 Respondents did not meet their burden in establishing that the MLtd Loan secured notes and/or the  
12 RB-MLtd Notes qualified for an exemption from registration under the Arizona Securities Act.

13 Section 18(b)(4)(C) of the Securities Act of 1933 preempts state securities registration  
14 provisions with respect to securities included in section 3(a) of the Securities Act of 1933, which  
15 includes any note that “arises out of a current transaction or the proceeds of which have been or are to  
16 be used for current transactions, and which has a maturity at the time of issuance of not exceeding *nine*  
17 *months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.*”<sup>7</sup>  
18 15 U.S.C. § 77r(b)(4)(C) (emphasis added). For purposes of section 3(a)(3) of the Securities Act of  
19 1933 and section 3(a)(10) of the Exchange Act of 1934, courts have followed the Securities and  
20 Exchange Commission’s (“SEC”) interpretation of the scope of the provisions. *See Securities and*  
21 *Exchange Commission Release No. 33-4412 (September 20, 1961) (“section 3(a)(3) [of the Securities*  
22 *Act of 1933] applies only to prime quality negotiable commercial paper of a type not ordinarily*  
23 *purchased by the general public, that is, paper issued to facilitate well recognized types of current*  
24 *operational business requirements and of a type eligible for discounting by Federal Reserve banks”);*

25 <sup>7</sup> Even if Section 18(b)(4)(C) of the Securities Act of 1933 preempts the registration requirement for the  
26 MLtd Loan secured notes and/or the MLtd-RB Notes imposed by A.R.S. § 44-1841, A.R.S. §44-1842  
requiring dealer and salesman registration still applies to the federal covered securities transaction unless an  
exemption is available under another provision of A.R.S. title 44, chapter 12. *See A.R.S. § 44-1843.02(D).*

1 *see also e.g. S.E.C. v. J.T. Wallenbrock and Assoc.*, 313 F.3d 532, 541 (9<sup>th</sup> Cir. 2002) (“[T]he  
2 exception applies only to commercial paper, defined by the Supreme Court as ‘short-term, high quality  
3 instruments issued to fund current operations and sold only to highly sophisticated investors.’ ”),  
4 *quoting Reves*, 494 U.S. at 65; and *S.E.C. v. R.G. Reynolds Enterprises, Inc.*, 952 F.2d 1125, 1132 (9<sup>th</sup>  
5 Cir. 1991) (Exceptions under the Securities Act of 1933 and the Securities Exchange Act of 1934 are  
6 interpreted to apply only to commercial paper, which is “short term paper of the type available for  
7 discount at a Federal Reserve bank and of a type which rarely is bought by private investors.”),  
8 *quoting* the Congressional record at H.R. Rep. No. 85, 73d Cong., 1<sup>st</sup> Sess. 15 (1933).

9 Consistent with this federal preemption, A.R.S. § 44-1843(A)(8) exempts securities and  
10 dealers and salesmen from registration requirements of A.R.S. §§ 44-1841 and 44-1842 when the  
11 securities are

12 commercial paper that arises out of a current transaction or the proceeds of which have  
13 been or are to be use for current transactions, that evidence an obligation to pay cash  
14 within *nine* months of the date of issuance or sale, exclusive of grace, or any renewal  
15 of such paper that is likewise limited, or any guarantee of such paper or of any such  
16 renewal.

17 A.R.S. § 44-1843(A)(8) (emphasis added). Pursuant to the undisputed facts of this case, this  
18 exemption is not applicable to the securities offerings made by Respondents for two reasons. First, it  
19 is undisputed that the RB-MLtd Notes had a maturity date in excess of nine months (i.e., one year).  
20 *See* A.R.S. § 44-1843(A)(8); Division Memorandum at ¶¶108, 117-119, and 122. It is also  
21 undisputed that the MLtd Loan secured notes had maturity date ranging between 6 and 18 months. *See*  
22 Division Memorandum at ¶42. Respondents failed to present evidence regarding which, if any, of the  
23 MLtd Loan secured notes in which Horizon Partners and Radical Bunny purchased participation  
24 interests had a maturity date of less than nine months. *See* A.R.S. § 44-1843(A)(8).

25 Second, the Respondents failed to present evidence regarding which, if any, of the HP  
26 Participants, RB Participants, or Participants were “highly sophisticated” investors. *Wallenbrock*, 313  
F.3d at 541; *see also* 1966 Ariz. Sees. Laws. ch. 197, § 11(C) (stating that the Arizona courts may use

1 as a guide the interpretations given by the SEC and federal courts in construing substantially similar  
 2 provisions in the federal securities laws). Accordingly, Horizon Partners, Radical Bunny, and the RB  
 3 Managers sold unregistered securities in violation of A.R.S. § 44-1841. *See* A.R.S. 44-1841.

4 3. *The RB-MLtd Notes are securities for purposes of the antifraud provisions of*  
 5 *the Arizona Securities Act.*

6 While in *Tober* the Arizona Supreme Court left open the issue of whether the definition of a  
 7 security was the same for antifraud as for registration purposes, the appellate court in *MacCollum*, 185  
 8 Ariz. 179, 185, 913 P.2d 1097, 1103 (App. 1996) concluded that the definition of security was not the  
 9 same for purposes of the antifraud provisions of the Arizona Securities Act, and adopted the analysis  
 10 articulated in *Reves*.<sup>8</sup> *MacCollum*, 185 Ariz. at 185, 913 P.2d 1097. Although the *Reves* test was  
 11 designed to interpret federal law, Arizona courts apply it to determine whether a note is a non-security  
 12 for purposes of fraud under the Arizona Securities Act.<sup>9</sup> *Id.*; *see also* A.R.S. § 44-1991(A).

13 The *Reves* court started with the *presumption* that notes are securities and established a two-  
 14 part test with which the presumption may be rebutted. *Reves*, 494 U.S. at 63. The first part of the  
 15 *Reves* test is that the presumption may be rebutted by a showing that the note “bears a strong  
 16 resemblance” to an instrument listed in an enumerated category of exceptions. *Id.*

17 Elaborating on the family resemblance test, the Supreme Court identified a four-factor test  
 18 to assist in ascertaining whether a note resembles one of the families of notes that are not securities.  
 19 The factors are balanced to reach a determination. The first factor established by the Court is to  
 20 assess the motivations of the buyer and seller to enter into the transaction at issue. If the seller’s

21 <sup>8</sup> The “family resemblance” test was developed by the federal courts in the Second Circuit. *See e.g.*,  
 22 *Exchange Nat’l Bank of Chicago v. Touche Ross & Co.*, 544 F.2d 1126 (2<sup>nd</sup> Cir. 1976). Under this test, the  
 burden of proof is on the party asserting that “the context otherwise required” that a note not be within the  
 federal definition of securities.

23 <sup>9</sup> The cases cited in Respondents’ Memorandum apply the *Howey* test to transactions that are distinguishable  
 24 from the transactions at issue. *See* Respondents’ Memorandum at 15:15-16:17. In *United Hous. Found.,*  
 25 *Inc. v. Forman*, 421 U.S. 837 (1975), the Supreme Court applied the *Howey* test to find that a purchaser’s  
 26 share of “stock” entitling him to lease an apartment in a nonprofit apartment cooperative was not a security  
 because the transaction related to obtaining a place to live, not an expectation of profit. In *United California*  
*Bank v. THC Fin. Corp.*, 557 F.2d 1351 (9<sup>th</sup> Cir. 1977), the court held that a “put letter” requiring a party to  
 buy on demand promissory notes underlying a line of credit to a financially troubled business was not “risk  
 capital” and not subject to the securities laws.

1 purpose is to raise money for the general use of a business enterprise or to finance substantial  
2 investments and the buyer is interested in primarily in the profit the note is expected to generate,  
3 the instrument is likely to be a security. *Id.* The second factor is the plan of distribution. The  
4 court stated that the plan of distribution must be examined to determine if the “note” is an  
5 instrument in which there is “common trading for speculation or investment.” *Id.* at 68-69; *see also*  
6 *MacCollum*, 185 Ariz. at 187, 913 P.2d at 1105 (“Offering and selling to a broad segment of the  
7 public is all that is required to establish the requisite ‘common trading’ in an instrument.”), *quoting*  
8 *Reves*, 494 U.S. at 68 and *citing Landreth Timber Co. v. Landreth*, 471 U.S. 681, 694 (1985) (stock  
9 of closely held corporation not traded on any exchange held to be a security). The third factor is to  
10 examine the reasonable expectations of the investment public. The Court stated that it will  
11 consider instruments to be securities on the basis of such public expectations, even where an  
12 economic analysis of the circumstances of the particular transaction might suggest that the  
13 instruments are not securities as used in that transaction. *Id.* The fourth and final factor is whether  
14 some factor such as the existence of another regulatory scheme significantly reduces the risk of the  
15 instrument, thereby rendering application of the securities laws unnecessary. *Id.*

16 The second part of the *Reves* test is that if the note does not resemble one of the families of  
17 notes that are not securities, then, using the same four factors, the presumption may be rebutted by  
18 a showing that the note represents a category that should be added as a non-security. *Id.*

19 Respondents’ rely on *AMFAC Mortgage Co. v. Arizona Mall of Tempe*, 583 F.2d 426 (9<sup>th</sup>  
20 Cir. 1978) for their argument that simply because MLtd used the proceeds the RB-MLtd Loans, in  
21 part, to fund its construction loans, the RB-MLtd Notes are not securities.<sup>10</sup> The Division disagrees  
22 because: (1) Respondents’ reliance on *AMFAC* is misplaced; and (2) a meaningful analysis of the  
23 *Reves* test with the facts of this case demonstrates otherwise.

24  
25  
26 <sup>10</sup> The Division does not contend that Radical Bunny and the RB Managers violated the antifraud provisions of the Arizona Securities Act prior to the institution of the RB-MLtd Loan Program in September 2005. *See* Division Memorandum at 45:13-48:26.

1 First, Arizona courts use the *Reves* test to determine when a note is a non-security for  
2 purposes of the anti-fraud provisions of the Arizona Securities Act. See *MacCollum*, 185 Ariz. at  
3 185, 913 P.2d at 1097. Furthermore, *AMFAC* was decided before *Reves*, and the “risk capital test”  
4 set forth in *AMFAC* is no longer controlling precedent whether note transactions are securities  
5 under federal securities law. See e.g. *Wallenbrock*, 313 F.3d at 536-542, quoting *Reves*, 494 U.S.  
6 at 65. In fact, the *AMFAC* court used the *Howey* test to hold that a promissory note given to a  
7 company making a construction financial loan was not subject to the securities laws because the  
8 loan was not risk capital subject to the entrepreneurial or managerial efforts of the developer. See  
9 *AMFAC*, 313 F.3d at 431-433. The commercial loan transaction in *AMFAC* is no way analogous to  
10 the note transactions between Radical Bunny and the Participants, who very much relied on the RB  
11 Managers to manage their investments. See Division Memorandum at ¶¶91-92 and 39:23-44:16.  
12 The federal circuit courts have also held that when using the *Reves* analysis, it is important to bear  
13 in mind that a “participation in an instrument might in some circumstances be considered a security  
14 even where the instrument itself is not.” See *Pollack v. Laidlaw Holdings, Inc.*, 27 F.3d at 808,  
15 811-812 (2<sup>nd</sup> Cir. 1994) (applying the *Reves* test to hold that mortgage participations were  
16 securities under federal law), citing *Banco Espanol de Credito v. Security Pac. Nat’l Bank*, 973  
17 F.2d 51, 55 (2<sup>nd</sup> Cir. 1992).

18 Second, Respondents have not provided any evidence to rebut the *Reves* presumption that  
19 the RB-MLtd Notes are securities. Respondents also fail to specify which judicially-created  
20 category of non-security note, if any, that these notes most resemble. The evidence in the  
21 administrative record supports the determination that the RB-MLtd Notes are securities under the  
22 *Reves* test because:

- 23 (1) The participants entered into the investment to make money. It is clear that  
24 the motivation of the Participants was investment. Radical Bunny was  
25 raising funds to finance a substantial investment in the RB-MLtd Notes in  
26 which Radical Bunny was to be repaid a 2% greater interest rate than what

1 these entities were repaying to their investors. The Radical Bunny and the  
2 RB Managers represented to investors in the “welcome letter” that the  
3 experience would be “financially rewarding.” *See* Division Memorandum  
4 at ¶¶108 and 113; Division Reply Memorandum at ¶251.

- 5 (2) Participations in the RB-MLtd Loans were widely distributed to a broad  
6 segment of the public. Radical Bunny and the RB Managers sold  
7 participations in the RB-MLtd Notes were sold to at least 900 account  
8 holders from Arizona and at least 24 states and five foreign countries  
9 primarily through word of mouth and referrals to individuals who had no  
10 pre-existing relationship with Radical Bunny or the RB Managers.<sup>11</sup> *See*  
11 Division Memorandum at ¶¶58-59, 93, and 103;
- 12 (3) The investors reasonably expected to make money from their participations  
13 in the RB-MLtd Notes. In describing the RB-MLtd Loan Program to  
14 offerees and investors, Radical Bunny and the RB Managers used the term  
15 “investment” in their communications; contrasted the investment to  
16 investing in stock; represented that their investments it was “safe,” “secured”  
17 by real estate, interest was paid to investors “like clockwork,” “MLtd has to  
18 be very strict because it is subject to inspections and audits all the time,” and  
19 their investment was safe except in a doomsday scenario. *See* Division  
20 Memorandum at ¶¶113-114 and 156-165; and
- 21 (4) There was no regulatory scheme that would significantly reduce the risk of  
22 the investment and thereby render the application of the securities laws

23 <sup>11</sup> Respondents argue that since they did not solicit investments through advertising, then no offer or sale of  
24 securities occurred. However, whether or not general solicitation is used in the offer and sale of a security is  
25 relevant only to the affirmative defense that the security or security transaction was exempt from the  
26 registration provisions of the Securities Act. It is Respondents’ burden of proof to show that an exemption  
applies. *See* A.R.S. § 44-2033. Furthermore, even if the security or security transaction was exempt from  
registration, the security or security transaction is still subject to the antifraud provisions of the Arizona  
Securities Act. *See* A.R.S. § 44-1991(A).

1 unnecessary. The Participants were not given deeds of trust securing their  
2 individual investments because the RB Managers believed that MLtd would  
3 repay its obligations. Hirsch and Shah were employed as CPAs, B. Walder  
4 was employed as an educator, and H. Walder was employed as a pharmacist.  
5 None of these professions are subject to a regulatory scheme that could have  
6 significantly reduced the risk of the investment and hereby rendered  
7 application of the securities laws unnecessary. See Division Memorandum  
8 at ¶¶24, 28, 32, and 36.

9 Consequently, the RB-MLtd Notes are securities for purposes of the antifraud provisions of the  
10 Arizona Securities Act.

11 **B. Respondents rely on affirmative defenses to fraud which are not supported by the**  
12 **evidence or not available under the Arizona Securities Act.**

13 1. Radical Bunny did not have an enforceable collateral lien in the assets of MLtd  
14 at the time of the offer and sale of the participation interests in the RB-MLtd  
15 Loan Program.

16 Respondents argue they did not misrepresent the safety of the investment because Radical  
17 Bunny had an “equitable lien” in the assets of MLtd. See Respondents’ Memorandum at 20:11-  
18 21:17. The evidence in these proceedings does not support this contention for two reasons. First,  
19 Respondents do not cite to any evidence that the RB Managers told any Participant at any time that  
20 Radical Bunny had an “equitable lien” in the assets of MLtd. In fact, it is undisputed that the RB  
21 Managers repeatedly misrepresented to the Participants that the *Participants’* investment funds  
22 were “secured” and “collateralized” by real estate.<sup>12</sup> See Division Memorandum at ¶¶87-232.

23 <sup>12</sup> While the Respondents’ Memorandum does not raise the defense of “advice of counsel” to the Division’s  
24 fraud allegations, its Statement of Facts seem to suggest that this defense is available to actions for  
25 violations of the Securities Act. See Respondents’ Memorandum at 10:3-11:7. However, the registration  
26 and antifraud provisions of the Arizona Securities Act are strict liability statutes. This means that Radical  
Bunny and/or the RB Managers need not know that the conduct in which they are engaging in is proscribed,  
or even know that the investment involved is a security. Therefore, “advice of counsel” is not an available  
defense to a violation under the Arizona Securities Act. See e.g., *Tober*, 173 Ariz. at 213, 841 P.2d at 208,  
*citing State v. Barrows*, 13 Ariz. App. 130, 464 P.2d 849 (1970); *Garvin v. Greenback*, 856 F.2d 1392, 1398  
(9<sup>th</sup> Cir. 1988), as modified by A.R.S. § 44-1995.

1 Second, the subsequent events in the MLtd Bankruptcy establish that Radical Bunny's  
2 alleged collateral interest in the assets of MLtd was disputed, litigated, and ultimately settled. *See*  
3 Division Memorandum at ¶¶233-245. The undisputed testimony of counsel for the Chapter 11  
4 Trustee in the RB Bankruptcy establishes that the Bankruptcy Court approved the MLtd POR, after  
5 a negotiated settlement in which Radical Bunny was "deemed" to have an allowed secured claim in  
6 certain, but not all of, the assets of MLtd. *Id.* Respondents' argument that the Bankruptcy Court  
7 *found* that Radical Bunny was a secured creditor for the *full* amount of the pooled loans  
8 misrepresents the MLtd Bankruptcy proceeding to this tribunal. Also, Respondents' reliance on  
9 the Bankruptcy Court's December 10, 2010, order on an administrative claim ("MLtd December  
10 2010 Order") is misplaced because Radical Bunny was a "legally presumed" secured creditor for  
11 purposes of that order. *See* Respondents' Motion to Supplement the Record, Exhibit A at ¶73;  
12 Division's Supplemental Response to Respondents' Motion to Supplement the Record.  
13 Regardless of the outcome of the appeal from the MLtd December 2010 Order, there is no factual  
14 dispute that the RB Manager's representations and omissions about the security and collateral of  
15 the investment were false at the time they were made. Consequently, Radical Bunny and the RB  
16 Managers violated the antifraud provisions of the Arizona Securities Act. *See* A.R.S. § 1991(A).

17 2. *Reliance is not an element of fraud under the Arizona Securities Act.*

18 Respondents argue that Radical Bunny and the RB Managers did not commit fraud by  
19 misstating material facts and misleading investors because: (1) the investors were given offering  
20 materials that contained "truthful disclosures;" and (2) the RB Managers told the Participants that  
21 there were "no guarantees" with respect to their investments and, therefore, could not have  
22 reasonably relied on contrary information. *See* Respondents' Memorandum at 21:18-23:19. The  
23 Division disagrees because the affirmative defenses available in federal securities cases relied upon  
24 by Respondents<sup>13</sup> are not applicable to fraud under the Arizona Securities Act. *See* A.R.S. § 44-

25 <sup>13</sup> *See e.g., Zobrist v. Coal-X, Inc.*, 708 F.2d 1511 (10<sup>th</sup> Cir. 1983) (An element of Section 10(b) of the  
26 Exchange Act of 1934 is justifiable or reasonable reliance on a misrepresentation. Under 17 C.F.R.  
240.10b-5, a purchaser may be deemed to have constructive knowledge of the contents of a prospectus  
because failure to read a prospectus may make the purchaser's reliance on oral representations

1 1991(A).

2 Reliance is a common law concept that is a necessary element of an action for common law  
 3 fraud. The federal courts have followed the common law and read a reliance requirement into a  
 4 claim under SEC Rule 10b-5. See 17 C.F.R. 240.10b-5; *Dura Pharmaceuticals, Inc. v. Broudo*, 544  
 5 U.S. 336, 341-342 (2005) (The elements of a SEC Rule 10b-5 claim are (1) material misrepresentation or  
 6 omission of fact; (2) scienter; (3) connection with the purchase and sale of a security; (4) reliance; (5)  
 7 economic loss; and (6) loss causation.). The Arizona courts, however, have held that reliance is not an  
 8 element of proof in both regulatory enforcement and private actions under A.R.S. § 44 1991(A).  
 9 See *Trimble v. Am. Sav. Life Ins. Co.*, 152 Ariz. 548, 553, 733 P.2d 1131, 1135-36 (Ct. App. 1986);  
 10 *Rose v. Dobras*, 128 Ariz. 209, 214, 624 P.2d 887, 892 (Ct. App. 1981). As explained in *Aaron v.*  
 11 *Fromkin*, “[t]he elements of securities fraud are articulated within the statute itself.” 196 Ariz. 224,  
 12 227, 994 P.3d 1039, 1042 (Ct. App. 2000). Nothing in the language of the language of A.R.S. § 44-  
 13 1991(A) speaks of reliance. See A.R.S. § 44-1991(A).

### 14 III. CONCLUSION

15 For the reasons set forth above and in the Division Memorandum, the Securities Division  
 16 requests that the relief requested in the Division Memorandum be granted. See Division  
 17 Memorandum at 54:16-55:8.

18 RESPECTFULLY SUBMITTED this 25<sup>th</sup> day of April, 2011.

19 

20 Julie Coleman  
 21 Chief Counsel of Enforcement for the Securities  
 22 Division of the Arizona Corporation Commission

23  
 24 unreasonable.); *In Re Donald Trump Casino Securities Litigation-Taj Mahal Litigation*, 7 F.3d 357, 371-373  
 25 (applying the “bespeaks cautionary doctrine”). The bespeaks cautionary doctrine holds that when an  
 26 offering document’s opinions or omissions are accompanied by “meaningful cautionary statements” which  
 do not affect the “total mix” of information the document provided to investor will not form the basis of a  
 claim for fraud under federal securities law. *Id.*; cf. *Huddleston v. Herman & MacLean*, 640 F.2d 534, 543-  
 544 (5th Cir. 1981) (holding that a general warning was insufficient to render a known misrepresentation  
 immaterial as a matter of law).

1 ORIGINAL and 13 copies of the foregoing  
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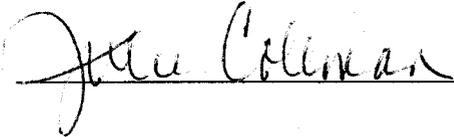
2 Docket Control  
3 Arizona Corporation Commission  
1200 W. Washington St.  
4 Phoenix, AZ 85007

5 COPY of the foregoing hand-delivered  
this 25<sup>th</sup> day of April, 2011, to:

6  
7 Lyn Farmer  
Administrative Law Judge  
8 Arizona Corporation Commission  
1200 W. Washington St.  
9 Phoenix, AZ 85007

10 COPY of the foregoing mailed this  
25<sup>th</sup> day of April, 2011, to:

11  
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15 By:   
16 \_\_\_\_\_