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November 8, 2006

Via Facsimile and Mail

Lorelei Stevens
Wall Street Brokers, Inc.
500 Wall Street #405
Seattle, WA 98121-1577

Re: Note Brokers

Dear Ms. Stevens:

In response to your letter dated October 16, 2006, I offer the following information about whether a license is required to be a note broker in Utah. You are free to publish any of this information in the *Noteworthy Newsletter*.

You asked: "Is a license required in your State to be a 'note broker'?" The answer is yes.

Types of Note Brokers

Although you have not defined the term "note broker," we have heard of several variations of the note broker business. These include:

1. Note Brokers (Consignment) Some people purchase training courses teaching them how to broker notes. They contact owners of real estate notes (seller-financed notes), negotiating to purchase the stream of future mortgage payments from the note holder for a lump sum. The note broker then offers the note for sale on a note network or web site. When a buyer is found, the broker takes the money from the purchaser, pays the agreed-upon price to the note seller and keeps the difference.
2. Note Broker (Reseller) Some brokers actually purchase notes from sellers and then resell those notes on a web site or note network. In these situations, the broker is the buyer of notes from the real estate note holder. The broker then offers this note – his note – for sale to others. The broker becomes the note seller.
3. Note Broker (Finder) Some brokers act in only a matchmaking role. They find notes for sale and find buyers wanting notes. The brokers then match the buyers and sellers together. The buyers and sellers negotiate directly with each other. The broker is paid a commission or other fee for putting the buyer and seller together.

4. Partial Note Sale Some note holders sell only a portion of their notes, not the entire note. For example, a note holder who has a ten year note may sell the right to receive five years of payments on the note, retaining the right to receive the last five years of payments.

There may be note brokering that is done in ways other than these four listed. But, whether the note brokering uses one of these variations or some other structure, the securities laws still will apply. Brokers will need to be licensed and the other regulatory requirements of the securities laws still apply.

What Note Brokers Need to Know

There are three things note brokers need to know about the securities laws relating to note brokering.

1. If securities are being sold, registration of the securities is required or the securities must qualify for an exemption. Because many of these notes are offered publicly on web sites or other networks, it is deemed a public offering of the securities and few exemptions are available.
2. If notes are securities, anyone selling notes must be licensed as a broker-dealer or an agent. In fact, the law requires a license before securities can even be offered, whether or not securities are sold.
3. Whenever securities are offered or sold, the law requires the seller to give complete disclosure about the securities, the broker, and the seller. (For notes, this would include information about the note itself, the seller of the note, the person who is promising to make payments on the note, the experience and qualifications of the note broker, etc.).

Three Definitions

There are three definitions in the securities laws that someone engaging in note brokering must know:

1. Security The definition of a “security” includes more than just stocks, bonds, and mutual funds. Securities include all types of investments. The law lists more than fifteen types of investments that are considered securities. The first item listed in the statute defining “security” is a “note.” Utah Code Ann. §61-1-13(1)(x)(i)(A). **Notes are securities.** They are used as investments. Investors buy notes because they hope to profit from interest payments that the debtor will pay on the note.¹

¹ There actually are two different types of notes used in business: investment notes and notes used to secure a loan from a bank. The second type of note (the promissory note you give to the bank) can be converted to an investment note if it is sold by the bank and separated from the collateral.

In 1990, the U.S. Supreme Court explained four ways that a note given to a bank or other financial institution can change to an investment note. These are (a) when the buyer of the note is primarily interested in profit to be made from the note, rather than viewing the note as collateral for some product that was sold to the person who signed the note, (b) if the note is offered to the public or commonly traded for speculation or investment, (c) if members of the

2. Agent An agent is anyone who sells or attempts to sell securities. It includes brokers selling their own notes and those acting as intermediaries offering and selling notes from other sellers. Utah Code Ann. §61-1-13(1)(b)(i). A person might be licensed as an agent for a broker-dealer or as an agent for an issuer. (The issuer is the person or entity that creates the notes.)
3. Broker-Dealer A broker-dealer is someone engaged in the business of effecting securities transactions. This means that anyone buying and selling securities (such as notes) must be licensed as a broker-dealer. Utah Code Ann. §61-1-3(1). This definition also may apply to web sites and note networks that list notes available for sale. By offering notes for sale, a person – or a network – is in the business of offering and selling securities.²

The bottom line is that in most cases, notes that are brokered are securities. Anyone selling notes or listing notes for sale is most likely violating the law if the person is not licensed to sell securities and has not registered the securities for sale. Thus, the examples listed on pages one and two, above, as well as similar types of note brokering, would require that the sellers be licensed and the notes be registered.

Penalties for Violations of the Law by Note Brokers

The consequences of buying or selling notes without complying with the securities laws are serious. Consequences include:

- Criminal penalties: Any violation of the securities laws can be prosecuted as a felony. The note broker can be sent to jail for at least a year and ordered to pay fines of thousands of dollars.
- Civil or administrative enforcement penalties: Each state has a securities enforcement agency that investigates violations of the law and can bring enforcement action. This may be a civil lawsuit seeking an injunction, fines, and restitution, or it might be an administrative proceeding in which the violator is fined, ordered to cease violating the law, and barred from engaging in the securities business in the future. Violators often are ordered to pay restitution to all customers.
- Private litigation: Any person who buys a security from someone who is required to be licensed, but is not licensed, can sue the seller and get a full refund of the purchase plus interest. This means that a note broker and perhaps issuers – without realizing it – are guaranteeing the success of the note. If the note goes bad and the note broker is not licensed, the buyer can require the note broker to repurchase the bad note at the original

public think of the note as an investment, rather than just being tied to some product sold to the debtor, and (d) when the note is no longer held by a bank, but is offered to the public where the public offering is not overseen by banking or insurance regulators. *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

² A person can be licensed as an agent of an issuer with only one issuer in a given year. If an agent will be selling securities from more than one issuer during any year, the person will need to become a broker-dealer. Utah Rule 164-4-1(E)(4)(a).

purchase price plus interest. In Utah, the law requires that the unlicensed broker repurchase any note sold and pay the buyer 12% interest. Treble damages are available.

We believe that these penalties are very similar to the penalties that could be imposed by every state and by the SEC. The violations are sufficiently serious to be categorized as felonies. It is up to each jurisdiction to decide whether that jurisdiction wants to prosecute violations to seek criminal, civil, or administrative penalties. Each buyer of a note always has the right to file a separate lawsuit to get a refund, whether or not the government has taken enforcement action.

Examples of Enforcement Actions

Securities agencies in most states bring many enforcement cases against sellers of promissory notes. During the first ten months of 2006, the Utah Division of Securities has brought enforcement actions against many sellers of promissory notes. Out of 49 enforcement cases brought or settled by the Division during 2006, at least 20 involved some type of promissory notes being sold. Some of these have been criminal cases. While no cases have yet been brought against note brokers, we are investigating companies which sell courses teaching investors how to become note brokers and which sponsor web sites that list notes to be bought and sold.

Readers are encouraged to read about the Division's enforcement cases involving notes on our web site at www.securities.utah.gov. The web site contains press releases announcing each action and a link to the enforcement proceedings (if it is an administrative enforcement case). The web site also has some of the pleadings relating to criminal cases referred to the Utah Attorney General or district attorneys.

Cases involving the sale of notes that may be of interest to note brokers include:

- Dean Udy, Dec. 21, 2005 (criminal charges against a stock broker for selling promissory notes to his customers).
- Millionaire Investment Group, Mar. 28, 2006 (accusing a promoter of raising money from investors to buy and sell real estate. Criminal charges were filed May 11, 2006).
- Video Projects, May 3, 2006.
- Golden Age Marketing, May 4, 2006.
- Royal American Management, June 26, 2006.
- Blacksmith Management, Aug. 4, 2006.
- DeWitt Investments, Sept. 6, 2006.

Conclusion

The information here reflects the views of the Utah Division of Securities. I expect that the same or similar answers would be given by other states or the SEC. I strongly encourage anyone

buying and selling notes to consult with an attorney experienced in securities law before conducting any note brokering. The consequences of violating the law are too severe to engage in this business without being licensed and without complying with the other legal requirements.

If you have bought a note-brokering course from a company that promised to teach you how to get rich buying and selling notes, you should ask for a refund. If you cannot get a refund, talk to your state's consumer protection office or the Federal Trade Commission and ask for their help because you probably have been sold a product under false pretenses.

Sincerely,

A handwritten signature in black ink that reads "Wayne Klein". The signature is written in a cursive style with a large, stylized 'W' and 'K'.

WAYNE KLEIN
Director, Division of Securities