

Securities-Related Prosecution in Kansas: A Primer

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Introduction

In an effort to aid district and county attorney offices across the state in identifying and charging securities-related felonies, this article explains the nature and scope of securities fraud and other related criminal prosecution in Kansas. Moreover, the article seeks to explain the unique advantages of prosecuting various types of financial crime under the Kansas Uniform Securities Act versus prosecuting under more general fraud and theft theories. Lastly, this article explains the role of the Office of the Kansas Securities Commissioner ("KSC") as the principle regulator of Kansas' securities law in the state and the partnership role the agency can serve in assisting district and county attorneys in their roles as the primary prosecutorial authorities in their jurisdictions.

The Kansas Uniform Securities Act

Since becoming the first state in the nation to adopt wide-ranging securities-related or "blue sky" laws in 1911, Kansas has led the way as an effective and efficient state regulator of securities offerings and capital formation.¹ The Office of the Kansas Securities Commissioner is the executive-branch agency charged with enforcing these laws. Among other duties, the Commissioner enforces three main acts: the Kansas Uniform Securities Act (K.S.A. 17-12a101 et seq.); the Kansas Loan Brokers Act (K.S.A. 50-1001 et seq.); and the Kansas Land Sales Practices Act (K.S.A. 58-3301 et seq.). This article is limited to a discussion of the regulatory structure and criminal provisions of the Kansas Uniform Securities Act.

The Kansas Uniform Securities Act ("Act"), codified in K.S.A. 17-12a101 et seq., provides a comprehensive regulatory scheme of professional registration (i.e. broker-dealers, agents, investment advisers, and investor adviser representatives),

securities offerings registration, compliance exams and audits, and coordination with federal and self-regulatory organization regulators.²

Beyond the Act's administrative scope, however, lies a very potent criminal code that can be used by Kansas prosecutors, in certain factual circumstances, to enhance the penalties otherwise available under general fraud or theft statutes. The Act's criminal code is comprised of three main types of violations, all of which are classified as varying severity levels of felonies: 1) securities fraud (K.S.A. 17-12a501 et seq.); 2) securities or professional registration related violations (K.S.A. 17-12a301 et seq.; 17-12a401 et seq.); and 3) administrative rule or order violations (17-12a508(a)(1)). The specific relevance of this discussion for Kansas district and county attorneys is found in the expanded prosecutorial toolset available through the Act. As a result, some of the enhanced statutory penalties for securities-related offenses under the Act will be discussed briefly before considering the specific elements of these crimes.

Enhanced Criminal Penalties for Securities-Related Crimes

K.S.A. 17-12a508 contains the criminal penalties for various offenses under the Act, all of which range between severity level 2 and severity level 7 felonies. There is no crime under the Act that is classified lower (less severe) than a severity level 7 felony. Securities fraud violations (K.S.A. 17-12a501 or -502) are classified according to the resulting financial loss: the top level, a loss of \$1,000,000 or more is a severity level 2, nonperson felony; the middle levels, losses of at least \$250,000, \$100,000, and \$25,000 are severity level 3, 4, and 5 nonperson felonies respectively; and the bottom level, a loss of less than \$25,000, is a severity level 6, nonperson felony. Similarly, registration-related offenses and administrative rule or order violations range between

Footnotes

1. For a thorough history of Kansas securities law, including a narrative of how Kansas became the first state in the nation to adopt comprehensive securities regulation, see Rick Fleming, *100 Years of Securities Law: Examining a Foundation*

Laid in the Kansas Blue Sky, 50 Wash. L.J. 583 (2011).

2. The most established and well known self-regulatory organization in the securities industry is the Financial Industry Regulatory Authority (FINRA).

severity level 5, 6, and 7, nonperson felonies, depending on the amount of financial loss.

Moreover, K.S.A. 17-12a508(a)(5) provides that “[a]ny violation of [the professional registration, securities-offerings registration, or securities fraud statutes] resulting in a loss of \$25,000 or more *shall be presumed imprisonment*” (emphasis added). In other words, *all* securities-related crimes resulting in a loss more than \$25,000 constitute presumptive imprisonment crimes regardless of the defendant’s criminal history score, and even fraud resulting in the loss of just one dollar (\$1), *when connected with the offer, sale, or purchase of a security*, is classified as a severity level 6, nonperson felony, constituting a presumptive imprisonment crime for criminal history scores of A-G.

What Is a Security?

The three securities-related criminal offenses discussed below have one common element: the presence of a legally recognized security. The statutory definition of “security” in the Act is located in K.S.A. 17-12a102(28), and contains a long list of financial instruments and interests considered legally recognized “securities.” This statutory definition largely mirrors the definition for a “security” under the federal Securities Exchange Act of 1934, which the Kansas Supreme Court referenced when holding that “the Kansas [Uniform Securities] Act should be developed by court decisions which are firmly grounded on prior state decisions and upon decisions of the federal courts, and the courts of our sister states.”³

In addition to the more formal types of “securities” such as stocks, bonds, and stock options, the most common types of securities found in criminal investment fraud schemes are “notes” and “investment contracts.” The commonly recognized test for determining whether a “note” is considered a legal security was established by the U.S. Supreme Court in *Reves v. Ernst & Young*, 494 U.S. 56, 62 (1990). In essence, the *Reves* test requires that courts conduct a “family resemblance” test beginning with the presumption that all “notes” are securities.⁴ This presumption may be rebutted if an instrument bears a strong “resemblance,” after an examination based on four stated factors, to “one of a judicially

crafted list of categories of instruments that are not securities” or if an issuer “convinces the court to add a new instrument to the list.”⁵

The foremost definition of an “investment contract” was established by the U.S. Supreme Court in *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293 (1946). In *Howey*, the Supreme Court found that an investment contract exists when a person: 1) invests money, 2) in a common enterprise, 3) with the expectation of profit, 4) from the efforts of others.⁶ This test was adopted by the Kansas Legislature in K.S.A. 17-12a102(28)(D), which states that an “investment contract” is an “an investment in a common enterprise with the expectation of profits to be derived primarily from the efforts of a person other than the investor.”

Three Types of Securities-Related Offenses

1. Securities Fraud

The first, and most common, category of securities-related criminal offenses in Kansas is securities fraud. K.S.A. 17-12a501 provides:

It is unlawful for a person, in connection with the offer, sale, or purchase of a security, directly or indirectly: (1) To employ a device, scheme, or artifice to defraud; (2) to make an untrue statement of a material fact, or omit to state a material fact necessary in order to make a statement made, in the light of the circumstances under which it is made, not misleading; or (3) to engage in an act, practice, or course of business that operates as a fraud or deceit upon another person.

In other words, the Kansas Securities Act calls for specific, enhanced penalties for *general fraud* (whether conducted by device, scheme, or artifice; via omission or misrepresentation of material fact; or by a defrauding act, practice, or course of business) when that fraud is *connected with the offer, sale, or*

3. *State ex rel. Owens v. Colby*, 231 Kan. 498, 501 (1982).

4. *See Reves v. Ernst & Young*, 494 U.S. 56, 63-64 (1990).

5. *See id.*

6. *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).

purchase of a security.

Securities fraud is perhaps the most broad-ranging type of securities-related criminal offense in Kansas and may be among the types of financial crimes most commonly seen by district and county attorneys' offices in the state. When reviewing or investigating financial crimes or general fraud, Kansas prosecutors and law enforcement should stay alert to corresponding securities or investment-related activity within such schemes, due to the enhanced penalties available if one additional element ("in connection with the offer, sale, or purchase of a security") is present in the fact pattern.

2. Registration Offenses

The second category of securities-related criminal offenses in Kansas is professional or securities-offering registration offenses. K.S.A. 17-12a301 et seq. establishes the general registration requirements and procedures for all securities offerings in the state. The system is designed to provide a notice-based and merit-based system for reviewing securities offerings in Kansas. Similarly, 17-12a401 et seq. establishes the general registration requirements and procedures for securities professionals and firms (i.e. broker-dealers, agents, investment advisers, and investment adviser representatives) doing business in Kansas. Registration under the Act is a primary function of the KSC, so enforcement of these provisions is not directly connected to the day-to-day functions of district and county attorneys. Nevertheless, Kansas prosecutors should note these registration offenses as potential parallel charges in securities-related criminal activity.

3. Violation of Administrative Rules or Orders

The third and final category of securities-related criminal offense in Kansas is intentional violation of administrative rules or orders issued by the KSC. K.S.A. 17-12a508(a)(1) provides that "a conviction for an intentional violation of the Kansas uniform securities act, or a rule adopted or order issued under this act [exceptions omitted] . . . is a severity level 7, nonperson felony" (emphasis added). Additionally, under K.S.A. 17-12a508(a)(4),

violation of certain cease and desist orders issued under the Act is a severity level 5, nonperson felony. Although the KSC office is in the best position to police this type of violation on a day-to-day basis, Kansas prosecutors and law enforcement, when reviewing or investigating investment-related financial crime in the state, should coordinate with the KSC to determine whether the defendant is a repeat offender subject to prior adverse administrative action or has intentionally violated KSC rules or regulations. This determination could reveal additional felony charges applicable in the case.

Conclusion: The Role of the KSC in Criminal Prosecutions

K.S.A. 17-12a508(c) establishes that the primary prosecutorial authorities for securities-related criminal offenses in Kansas are local district and county attorneys. The KSC does not have independent prosecutorial authority to bring criminal actions in state district court, so the decision to charge and prosecute securities-related offenses is solely at the discretion of the local district and county attorneys. However, the KSC has specialized prosecutors, legal staff, and other resources available to independently litigate or co-chair securities-related prosecutions under special assistant attorney designation if authorized by the local authority, and the agency has had a long and successful history of coordinating and working with local prosecutors to litigate securities-related offenses. In addition to utilizing this brief survey of securities-related prosecution in Kansas, Kansas prosecutors are encouraged to use the KSC as a resource when investigating and prosecuting financial crimes in the state. 🌐

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